

Franchising Under EC Competition Rules

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A valuable analysis of new EEC draft; document judged balanced overall, adoption projected

I shall discuss franchising and the possibility of enforcing rights flowing from franchise contracts, which clearly presupposes that these are legal, valid and enforceable. The subject is timely, because GD IV has just circulated, in preparation of the July meeting of the Consultative Committee, its revised draft for a Block Exemption Regulation for Franchising Agreements.

It is impossible to find a comprehensive and yet not impracticably wide definition for the nearly endless variety of franchise agreements. To illustrate, there are agreements in which: the franchisee produces the franchise products under the franchise; the manufacturer franchises wholesalers in respect of the distribution of his products; a joint purchasing association or management company of a chain of independent traders franchises its members in respect of their product range, their management, their accounts, their advertising and their distribution policy; franchise systems of manufacturers in respect of retailers or of wholesalers in respect of retailers; the creator of a new marketing or service concept will franchise trading or service establishments.

Within these or other groups of franchise agreements the depth of control exercised by the franchisor varies just as widely. The franchisor may be interested solely in income from franchise royalties, or in furthering the sales of his products, or in the commission from those whose interests he furthers or in the well-being of affiliates or member companies.

Certain contractual systems of

cooperation between companies are recognized as franchise systems under some jurisdictions, as simple distribution systems under others and as simple cartels by some.

It thus appears eminently reasonable for the Court of Justice to have concluded in its *Pronuptia* decision that the standing of franchise agreements under the EC competition rules can be determined only case by case with regard to the surrounding circumstances and in respect of each individual contractual provision.

At the same time the Court wisely found franchise agreements to be generally — or, should we say, tententially — procompetitive. Tententially, they do indeed further competition by making possible the market entry of many franchisors, their products, marketing or service concepts and of many small entrepreneurs as franchisees, none of whom could have gone it alone, and by enabling others to withstand the power of the industrial or trading giants.

◀ Ruling ▶

On top, in ruling on *Pronuptia* the Court expanded by leaps its fledgling rule of reason when it held as outside the scope of the strictures of Article 85 all restraints imposed upon the franchisee or the franchisor that are “inherently necessary” for the proper functioning of a legitimate franchise system. A concept that would have been utterly rejected not so very long ago, when the competition rules were administered by Commission Services and by a Court staffed by purists, who felt that any restriction whatever in the competitive freedom of enterprises could be justified only in the scope of the limited possibilities of Article 85,

paragraph 3.

The Commission carried the Court's ball in its three franchise decisions in *Pronuptia*, *Yves Rocher* and *Computerland*.

Given the infinite variety of franchise systems and the obvious difficulties in categorizing them, it does indeed appear gutsy of the Commission — and commendable — to plan the enactment of a block exemption regulation and to have presented a draft so soon after the Court's *Pronuptia* judgment. To me, it appears even more commendable that what the Commission has come up with is a document that appears quite balanced and reasonable, even though quite a few individual provisions could stand improvement. To be sure, the published draft has received its share of criticism, but it would seem to speak for GD IV that the criticism has been quite restrained and by and large seem to have cancelled each other out. In its revised draft, recently circulated among the Consultative Committee, the Commission has improved its published draft in a number of significant details.

I will outline only the major provisions, as now revised.

For the purposes of the proposed Regulation, franchise agreements are defined as limited, in terms of the categorization by the Court of Justice, to the “distribution franchise” and the “service franchise.” They do not encompass the “industrial franchise,” under which the franchisee manufactures the franchise products according to the know-how and under the control of the franchisor (Whereas-Clause 3). Thus, franchise agree-

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ments are defined as agreements under which the franchisor grants the franchisee, in exchange for financial consideration, the right to exploit the franchise for the purpose of marketing goods or services (Article 1, paragraph 2a). In its revised draft the Commission suggests the words "direct or indirect financial consideration" to provide for the cases in which the franchisor sells his products to the franchisees instead of exacting a royalty.

Franchises pertain to a package of rights to commercial or intellectual property such as trademarks, trade names, trade emblems, utility and design models, copyrights, know-how and patents to be exploited in the distribution of products or services to the ultimate consumer (Article 1, paragraph 2b) — thus, systems in which manufacturers or wholesalers are the franchisees are not to be block-exempted, or are systems, the gist of which is the exploitation of technological property rights. To be block-exempted the system must embrace at least:

—The use of a common trade name or trademark and a common design of the premises or transportation vehicles (the limitation to this common design can be and has been criticized — at least it has now been extended to vehicles to embrace catering and similar mobile businesses).

—The communication by the franchisor of substantial know-how.

—And a continuous flow of commercial or technical assistance by the franchisor during the life of the agreement (the wisdom of the limitation to the continuity of this assistance can equally be and has been questioned). To be sure, even the technical know-how to be provided by the franchisor must pertain to the marketing of products or the provision of services (the proper manner to cook a hamburger) and may not pertain to the technology for manufacturing products.

In the revised draft the definition of "products of the franchisor" has been expanded to include products manufactured for the franchisor and/or bearing his trademark or trade name (Article 1, paragraph 2c). Some restraints are to be block-exempted only in respect of the

franchise products. It is now clear that they need not be manufactured by the franchisor. It suffices that they bear his trademark.

Know-how is defined as limited to commercial and marketing know-how (Article 1, paragraph 2d).

The franchise agreement may contain the following restraints of competition:

—The obligation of the franchisor, in the contract territory not to appoint other franchisees, not himself to exploit the franchise or a similar marketing concept, and/or not to sell his products to others (Article 2, paragraph a).

—The obligation of the franchisee to desist from "active marketing" of the franchise products outside his territory (Article 2, paragraph d — this provision was added in the recently revised draft).

—The obligation of the franchisee to sell the franchise products only to end users or other franchisees (Article 2, paragraph e — a provision in the published draft guaranteeing the freedom of the franchisee to sell to others, whenever the products in question are available from other sources, has fortunately been deleted).

—A general no-competition obligation imposed upon the franchisee, limited to products competitive to those constituting the major subject matter of the franchise (Article 2, paragraph f — this clause was added in the revised draft).

In contrast to the published draft, the "white list" restrictions imposed upon the franchisee in Article 3 is applicable only whenever the clauses there listed are necessary to protect the franchisor's rights or to maintain the identity or reputation of the network — according to the structure and the preamble of the draft this limitation would appear to have any effect only in those (exceptional) cases in which the clauses listed constitute restraints of competition. Nonetheless, this newly introduced limitation of the scope of the "white list" is unfortunate as it may in many cases result in doubts as to the applicability of the group exemption. It was obviously prompted by the holding of the Court in *Pronuptia* that res-

traints "inherently necessary" to preserve the integrity of the system do not contravene Article 85. The "white-listed" clauses include the following restraints imposed upon the franchisee:

—Minimum quality requirements for the products to be sold or used by the franchisee (Article 3, paragraph a — the extension of this provision to products to be used by the franchisee was added in the revised draft). This provision is not limited to franchise products or services but extends to products or services that the franchisee is free to trade in or perform independent of the franchise.

—Exclusive purchasing obligations whenever it is, for practical reasons, impossible to establish objective quality criteria (Article 3, paragraph b). The requirement that the establishment of quality criteria be for practical reasons impossible appears unnecessarily harsh.

—In territories, in which the franchise would compete with the franchisor or other franchisees, neither directly nor indirectly to exploit the franchise in a similar business — for up to a year following the expiration of the franchise agreement (Article 3, paragraph c).

—The limitation of the use of the know-how for purposes of exercising the franchise, following its expiration or termination for as long as the know-how has not become public (Article 3, paragraph d).

—Nonexclusive grant-back obligations (Article 3, paragraph f — this clause has been added in the revised draft).

—Best-efforts and minimum-sales clauses (Article 3, paragraph i).

—The obligation to apply the business methods prescribed by the franchisor and to work the licensed rights (Article 3, paragraph k).

—The prohibition to change the location of the franchise premises (Article 3, paragraph n).

The franchisee must be free to source the franchise products from other franchisees (Article 4, paragraph a). Whenever the franchisee is obligated to honor the franchisor's (or toll manufacturer's) guarantee for products bearing the franchisor's trademark, he must be obligated to honor it also in respect

of products sold by other franchisees (Article 4, paragraph b).

The franchisee must be obligated to hold himself out as an independent entrepreneur, without, however, interfering with the identical appearance of the franchise network (Article 4, paragraph c). The know-how transmitted to the franchisee and the other rights, the subject of the franchise, must be described in writing in as much detail as practically possible (Article 4, paragraph d). This clause gives me considerable headaches, and I have — to no avail — strenuously looked for help in the interpretation thereof in the drafts for both the know-how and the franchise block exemption.

The "black list" includes *inter alia* the following:

—Cross franchises among competing manufacturers (Article 5, paragraph a).

—The obligation imposed upon the franchisee not to source other than franchise products of like

quality, unless this is required to maintain the integrity or the identity and reputation of the franchise network, or unless such products are competitive to those constituting a major subject matter of the franchise (Article 5, paragraph b).

—Whenever the franchisor has franchise products toll-manufactured, he must be prepared to admit other toll manufacturers suggested by franchisees, except for objective reasons in the interest of maintaining the integrity of the system (Article 5, paragraph c).

—Direct or indirect resale price maintenance practices (Article 5, paragraph e).

—Restrictions upon either party to sell franchise products to end users in view of the place of residence of such end users (Article 5, paragraph g).

—The franchisee is prevented from obtaining minority shares of competing companies listed on the stock exchange (Article 5, paragraph k — in the published draft

this clause pertained to the purchase of the shares of any competitor).

As in other more recent block exemption regulations, the draft provides for an opposition procedure for franchise agreements that require individual notification.

These, in brief, are the contents of the recently revised draft. It is indeed a pity that it did not turn out better. I have indicated my criticism in respect of some of its provisions and, for the sake of perfection, I could criticize a great many more.

On the other hand, it could be much worse. Gauged by past experience I feel that we can, by and large, be quite satisfied. I do believe that overall it is quite a balanced document and that our franchising friends will be able to live with it.

I believe that we can expect the draft to breeze by the July session of the Consultative Committee without any major amendments and to become the law of the land before the year is out.