

TOWARDS FRANCHISING IN INTERNATIONAL TRADE

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Abstract

First part of the article deals with the general description and definition of franchising system. After description of possible types of franchise contracts, a part of the paper is also dedicated to the topic, what is franchise agreement and what is not (like exclusive distribution and purchasing agreements). Different clauses from agreements which may be considered as restrictive are discussed in next part. Last part deals with the Pronuptia case, which is considered as major case in this field.

Key words

Franchising, franchise, franchise agreement, competition, franchisor, franchisee, Pronuptia case.

Introduction

The term franchising has French origins and was used for advantaged trading without taxes.¹ But today is the meaning very different and what stays is probably the fact that franchising as selling system enjoys some advantage in competition law, which are normally not allowed and considered as banned.

In this paper I intend to prove whether that is true, if so, how far can franchisor go in infringements of competition rules and where are limits of franchise regulation, when it comes to competition effects in European area. The Europe (in comparison to Canada and USA) is typical for none national regulation of franchise contracts. As we call in-nominated contract those, who are (often) used in public but has no codeficated name in any code or bill.

¹ Řezníčková, M., Franchising: podnikání pod cizím jménem, 2. vyd., Praha : C.H. Beck, 2004. ISBN 8071798940, p.113

The reason for regulating franchising contract may be the wish to protect smaller businessmen and sole-proprietorship against experienced franchisors².

Franchising does concern many legal branches. One of them is competition law for general reason of trading conditions between franchisor and franchisee, which are legally independent trading entities, but in fact they are so close like depended entrepreneurs.

Czech Competition Code was in the past followed by directives of Office for protection of competition no. 198/2001 Coll. about general exemption for certain kind of vertical restraints, where franchising contracts belong to. This directive and some other block exemptions were annulled by the Office with legal force from 1.10.2005 for simple reason: The exemption was similar to European exemption rules issued by Commission and for creation of duplicated regime with similar effects.

Definition

There are more definitions of franchising, but usually means an arrangement whereby the proprietor of trade mark, trade name or other distinctive marketing presentation (the franchisor) grants one or more parties (the franchisees) a license to use that trade mark, trade name or presentation in the supply of goods or services and to arrange their premises in accordance with the distinctive layout or format associated with the franchisor.³ The franchisee keeps independency, all risks in trade, including financial risks and shall pay fees to a franchisor (calculated per amount, time, consumption, franchisor's expenses on marketing etc.).

Types of franchising

The typical example of franchising company is McDonald's. As everyone knows, there are independent entrepreneurs running their canteens, but they are fall under scope of uniformity, regionally same or similar products, same level of services and quality. For "outsider" all the canteens look similar or same.

² Jakubíková, D., Franchising, Plzeň : Západočeská univerzita, 1997. ISBN 8070823399, p.13

³ Roth, P.M., Bellamy, Ch., Child, G., European Community Law of Competition, London : Sweet and Maxwell, 2001. ISBN 0421564407, p. 503

We may distinguish more types of franchising than the mentioned one⁴:

- Distribution Franchise – The franchisee sells specified goods in an outlet bearing the franchisor's name. Two other sub-categories may be identified: manufacturer's franchises and chain franchise. The first includes namely cosmetics and luxury goods, where all are produced by the one franchisor, the latter includes broader spectrum of products such as food, hardware, automotive parts etc.
- Service Franchise – the services are offered in this case under same name or mark, typically restaurants and hotels cleaners or travel agents are often concerned.
- Manufacturing Franchises – the recipient of the franchisee is the producer of some product in this case. Principal examples are agreement in the beverage industry, such as Coca-cola. Competition problems may arise partly from production restrictions or partly from distribution restrictions. A condition for exemption is the preservation of freedom with respect to prices and parallel supplies within the franchise system.⁵

Franchising as selling system can be applied to almost every type of product; a normal franchise agreement for the distribution of goods is lengthy document of up to 100 pages, presenting in great details the way in which the parties are to carry out their mutual obligations.⁶

It is essential to most of franchising contracts that they do or may restrict competition, because they incline to be exclusive distribution system. In case they fall under Article 81(1), we still may consider if the contract falls under one of the exemptions.

There is number of clauses, which are considered as a partial or total distortion of competition. Following clauses may be considered as restrictive:

Territorial issues:

- Not to sell contract goods to somebody, who would resell it in the located area (obligation for both franchisor and franchisee)
- Not to sell contract goods dealers outside the franchising framework / not to include new franchisee in located area

⁴ Ritter, L., Braun, W. D., Rawlinson, F., EC Competition Law, Kluwer Law International : Cambridge, 2000. ISBN 9041112677, chapter IV

⁵ Ritter, L., Braun, W. D., Rawlinson, F., EC Competition Law, Kluwer Law International : Cambridge, 2000. ISBN 9041112677, chapter IV

⁶ Goyder, D. G., EC Competition Law, Oxford University Press : New York, 2003. ISBN 0199257884, p. 209

- Not to change the location of shops

Price issues:

- Sell at (minimum) prices laid down by franchisor

Direct competition:

- Not to sell competing goods (or in certain extend)
- Not to work in competing business after end of franchising agreement

Is it a franchise agreement or not?

There might be and often are doubts whether a certain contract is a franchise contract or not. As we need to distinguish the franchising contract from others, which are not covered from competition exceptions, the franchise contract differs to exclusive distribution and purchasing agreements because franchisees use the franchisor's trade name and the franchise agreement normally provides for the communication of commercial know-how and the payment royalties.⁷

The franchise contract distinguishes from commercial agency agreements because the franchisees are independent traders who bear the full financial risks of their business. The franchise contract distinguishes from selective distribution agreements, because a franchisee does not distribute competing goods and employs the franchisor's trade name and commercial know-how, for which he pays the royalties. It differs also to know-how licensing agreements because a distribution or service franchising agreement normally does not confer technical, but commercial know-how.⁸

The Pronuptia Case⁹

This case showed that European Court of Justice took a relatively positive attitude to franchising. In this case, Mrs. Schillgalis concluded a franchising agreement under the

⁷ Ritter, L., Braun, W. D., Rawlinson, F., EC Competition Law, Kluwer Law International : Cambridge, 2000. ISBN 9041112677, chapter IV

⁸ Ritter, L., Braun, W. D., Rawlinson, F., EC Competition Law, Kluwer Law International : Cambridge, 2000. ISBN 9041112677, chapter IV

⁹ Case 161/84, *Pronuptia de Paris GmbH v. Irmgard Schillgalis* [1986] ECR 353.

trade mark Pronuptia de Paris to sell wedding dresses. This agreement included several competition restrictions on both her and Pronuptia:

- a) Franchisee had exclusive right to use the trade mark for marketing purposes (in Hamburg, Oldenburg and Hannover)
- b) Pronuptia won't open other shop or provide goods in that territory to the third parties
- c) Franchisee gets assistance regarding marketing/ education etc.

In return Mrs. Schillgalis accepted a large number of restrictions, which included following:¹⁰

- a) To sell wedding gowns under the trade mark Pronuptia de Paris (in especially designed shops)
- b) To purchase 80 per cent of goods (wedding dress) from Pronuptia or approved partners, use only approved marketing tools
- c) To pay entry-fee and royalty fees (15 000 DM and 10% turnover)
- d) Not to compete (refrain from competition) in any way with Pronuptia.

The Franchisee was sued later for refusing to pay royalties, but she claimed, that the agreement is void under Article 81. Court of Justice ruled in line with its earlier decisions on distribution agreements, that the compatibility of franchise agreement with Article 81 was not to be evaluated in the abstract, but rather only in the light of provisions of each agreement and the economic context.¹¹

One of key messages from the Pronuptia case is that there are inherent restrictions in the franchising system as such. The court stated two conditions to be fulfilled: First, the franchisor must be able to communicate his know-how to the franchisees and provide them with the necessary assistance in to enable them to apply his methods, without running the risk that that know-how and assistance might benefit competitors, even indirectly. It follows that provisions which are essential in order to avoid that risk do not constitute restriction on competition for the purposes of Article 85 (1) – today Article 81. That is also true of a clause prohibiting the franchisee, during the period of validity of the contract and for a reasonable period after its expiry, from opening a shop of the same or similar nature in an area where he may compete with a member of the network.

¹⁰ Goyder, D. G., EC Competition Law, Oxford University Press : New York, 2003. ISBN 0199257884, p. 211

¹¹ Ritter, L., Braun, W. D., Rawlinson, F., EC Competition Law, Kluwer Law International : Cambridge, 2000. ISBN 9041112677, chapter IV

The same may be said about the franchisee's obligations not to transfer his shop to another party without the prior approval of the franchisor. That provision is intended to prevent competitors from indirectly benefiting from the know-how and assistance provided.

Secondly, the franchisor must be able to take the measures necessary for maintaining the identity and reputation of the network bearing his business name or symbol. It follows that provisions which establish the means of control necessary for that purpose do not constitute restrictions on competition for the purposes of Article 85 (1)¹² – today Article 81.

Conclusion

There are always reciprocal benefits between franchisor and franchisee as well as both sides stipulations, which protect each other interest. The franchisor may extend his/her own business without running many outlets, which is very demanding on capital. The franchisee may start up business easily with no former experience, but with proved methods and know-how granted from franchisor. They both are likely to conclude an agreement with strong provisions restricting the competition. The Pronuptia case stated also for future, that provisions which establish the means of control necessary for the purpose of franchise network DO NOT constitute restrictions on competition for the purpose of Article 81.

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¹² Case 161/84, *Pronuptia de Paris GmbH v. Irmgard Schillgalis* [1986] ECR 353.

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