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Challenges and Opportunities in International Franchising

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WHAT IS THE IMPACT OF THE NEW CONTRACT LAW AND THE MACRON ACT ON FRANCHISE AGREEMENTS?

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1. The impact of the Macron Act on franchise agreements

The "Macron Act", recently passed in to law on August 6, 2015, provides a patchwork of many new sectoral regulations favoring the liberalization of the French economy. Among 308 articles and in addition to amendments regarding supplier/distributor relations (maximum payment term to be set at 60 days from the date of invoicing; specific form of single annual agreement between suppliers and wholesalers), the Act adds two new articles to the French Commercial Code (L.341-1 and L.341-2), applicable to contracts between the operator of a retail business and a commercial-distribution network to which he belongs.

The two main points are the following:

1.1 A mandatory uniform term applicable to all contracts between the affiliate/franchisee operating as a retailer and a commercial-distribution network to which he belongs

Franchise agreements, related agreements and any distribution agreement that includes an exclusive or quasi-exclusive clause, are subject to Article L.341-1 of the French Commercial Code, which provides that "*all contracts (i) concluded between a person making available to an operator of a retail business a trade name, a trademark or a store brand in consideration of an exclusive/quasi-exclusive commitment* <u>and</u> (ii) "*the shared purpose of which is the operation of one or several retail outlets which include clauses which are liable to limit the freedom of the outlet's operator to carry on his business*", shall all have the same expiry date.

This mandatory uniform term has been adopted in order to enable the retail-business operator to join another distribution network if he so wishes. Thus, as a direct consequence of this "legal indivisibility", is that if one of the agreements is terminated, all of the other agreements binding this operator, are automatically terminated on the same date. However, this "termination contagion effect" does not apply to (i) commercial leases, and to (ii) participative franchise agreements (agreements in which the franchisor owns a stake in the franchisee's or master franchisee's holding company).

1.2 Post-term non-competition clauses contained in franchise agreements will be on principle deemed null and void: to be valid, they require fulfillment of 4 cumulative conditions

According to Article L.341-2 of the French Commercial Code, post-term non-competition clauses (including non-affiliation clauses) included in franchise agreements, will be deemed null and void (with few strict exceptions as explained below).

However, this kind of covenant applying after expiry or termination of a franchise agreement remains valid, provided that the following cumulative conditions are fulfilled:

- it relates to goods or services competing with those to which the agreement relates;
- it is limited to the premises where the franchisee conducted its business during the franchise agreement;
- it is essential for the protection of substantial, secret and specific know-how belonging to the franchisor; and
- its duration does not exceed one year from the expiry or termination of the agreement.

These conditions are identical to those set out in Article 5.3 of the EU Exemption Regulation on Vertical Agreements (330/2010/EC) and to the EU case-law (ECJ January 28, 1986, *Pronuptia*).

It should have a significantly restrictive effect on the French case-law, which used to be more open-minded regarding post-term non-competition clauses, which were generally allowed (i) for a duration of more than one year in franchise agreements if proportionate to the interests to be protected and deemed necessary for the protection of the franchisor's know-how, and (ii) for the franchisee's exclusive territory or a radius of several kilometers around the franchisee's premises.

However, caution would seem to dictate waiting for the development of the case-law on interpretation of this provision and it cannot be ruled out that the Courts will interpret it in the light of European Union case law.

The most controversial provision passed at the first reading by the Parliament, namely, the general limitation of the term applicable to agreements within a distribution network, capped at 9 years, and the prohibition of implied renewal rights, was removed from the final version following intense lobbying by the French Franchise Federation and some major food retailers.

These new provisions shall enter in force after on August 6, 2016, but in the meantime any franchise agreement governed by French law should be made to comply with the "Macron Act" developments.

2. The Order dated February 10, 2016 reforming contract law: the expected consequences for franchise agreements

2.1 Introduction

Order N° 2016-131 dated February 10, 2016 reforming contract law, which will enter into force starting on October 1, 2016, modifies the French Civil Code in depth. It will govern automatically all agreements made after that date. Without waiting for that time, the various players in franchise agreements should adapt to these new rules and in particular when drafting franchise agreements, the negotiation of which has already begun and which are due to be entered into and/or become effective after October 1, 2016.

The following considerations seek to describe, on a non-exhaustive basis, the developments provided by the reform and which are likely to have a considerable impact on the structure of the franchisor/franchisee relationship.

Certain new provisions, to apply henceforth to all business contracts, are well known to franchisors already, such as the duty to negotiate and enter into agreement in good faith (Article 1104), or the general duty of pre-contractual disclosure, created by the new Article 1112-1 of the Civil Code, which has not extended in any way the duty for a franchisor subject to the Doubin Act dated December 31, 1989 (Articles L. 330-3 and R. 330-1 and 2 of the Commercial Code governing exclusive or quasi-exclusive relations between a licensor or franchisor, and the franchisee or licensee partner) to provide, within the 20 days preceding execution of the franchise agreement, any information of the essence for the purposes of the franchisee's consent (review/survey of the local and nationwide markets, franchisor's brand(s), names of the franchisor's officers, the two latest profit and loss statements, an updated list of franchisees, and if applicable a forecast profit and loss statement).

Other novel provisions are likely to have an impact on franchise agreements and their parties, namely:

(i) in order to reinforce the contractual balance between the parties, the Courts have been granted new powers, which may impact significantly on the parties' autonomy, treated previously as a sacrosanct principle of contract law. Thus the Courts are granted discretion to amend the very terms of the agreement through the principle of "hardship" (*imprévision*), or to remove from an adhesion contract a clause creating a "*significant imbalance*". Thus, the Courts will not only have a right to void or terminate an agreement, as previously, but also henceforth to amend it, including its economic features: amendment or deletion of the clause.

In any event, this reform is a blow against legal security, as no contracting party will be able to rely on an assurance/certainty that the agreement will be performed on the terms agreed at the time when it was made.

(ii) the reform codifies the plea of breach, subject to implied review by the Court.

2.2 An extended opportunity for the Courts to interfere in order to rebalance a franchise agreement?

(i) Acceptance of Court-ordered amendment on the grounds of hardship

The new Article 1195 of the Civil Code provides that:

"If a change in circumstances, unforeseeable at the time of execution of the agreement, makes performance unduly onerous for a party which had not agreed to bear the related risk, the latter may apply to the other party for renegotiation of the agreement. It shall continue to perform its obligations during the renegotiation.

In the event of refusal or failure of the renegotiation, the parties may agree to terminate the agreement, at such date and on such terms as they shall determine, or apply jointly to the Court for its adaptation. Absent agreement within a reasonable time, the Court may, upon one party's motion, amend the agreement or terminate it, at such date and on such terms as it shall determine".

This article provides an option to challenge an agreement in the event of circumstances unforeseen by the parties. Yet until now, the French civil law had always denied the revision of agreements on the basis of hardship, and thereby displayed a steadfast allegiance to the binding nature of contracts: the Supreme Court has always denied the Courts a right, upon one party's motion, to remedy the imbalance caused by circumstance.

However, in practice, the economic players have multiplied contractual adaptations in order to anticipate the risks of upheaval, in particular through hardship clauses.

This is why the need to include in the Civil Code provisions relating to hardship was not necessarily felt, at least among large companies, which have legal departments and receive advice from lawyers experienced of such matters. On the other hand, this new system is of definite benefit to small and medium-sized enterprises which may now back their transactions with a statutory "safety net", in the absence of contractual provision for changed circumstances.

The wording of Article 1195 of the Civil Code provides for two stages. First, it imposes on the parties a duty to renegotiate the agreement, performance of which has become "*unduly onerous*" for one of them, owing to an "*unforeseeable change in circumstances*", the "*risk*" of which had not been accepted by the victim. Second, if the renegotiation is denied or fails, the parties may choose, jointly, either contractual termination or a joint application to the Court for "*adaptation*" of the agreement. Absent agreement "*within a reasonable time*", they may unilaterally apply to the Court, which may "*amend the agreement or terminate it*".

The purpose of this provision is to encourage negotiation and incite the parties to make the negotiation succeed. It is of real practical value as it offers negotiation while providing alternatives in the event of failure.

Nevertheless, there are some limitations in the wording of Article 1195 of the Civil Code. The option to "*terminate*" the agreement "*at such date and on such terms*" as the Court shall set involves some uncertainty for the parties: as regards the date, which will the Court select as the end of the contractual relationship? Will the ruling be retroactive? As for the terms set by the Court, will they include indemnification for the party on which termination of the agreement is imposed?

An essential feature of the reform: as the provisions of Article 1195 are not mandatory in nature, it seems possible for the franchise agreement (i) to restrict or exclude the duty to renegotiate borne by the parties, and (ii) to bar the option for the Court to amend the agreement.

The drafting of such a clause can be expected to be intricate, having regard in particular to the risk of its being held null and void as creating a significant imbalance between the parties' rights and duties.

(ii) ***Extension of the censure of unfair terms: deletion of clauses creating a significant imbalance***

The new Article 1171 of the Civil Code, created by the Order, provides that:

"In an adhesion contract, any clause creating a significant imbalance between the rights and duties of the parties to the agreement shall be null and void.

The evaluation of significant imbalance shall relate neither to the principal purpose of the agreement nor to the adequacy of the price to the service".

This article is inspired by special areas of the law, to wit, consumer law and the law of restrictive trade practices. The concern in that legislation was to protect the parties in a weak bargaining position. By way of illustration, the following has been held to create significant imbalances: (i) a clause providing that delivery times were stated for information only and providing for damages in the event of the buyer's termination of the sale for late delivery;[1] and (ii) a clause for termination without cause of an open-ended agreement[2]. The criteria usually selected by the case-law are a partner's dependency, the lack of reciprocity or consideration, and the disproportion between the parties' obligations.

This notion of significant imbalance is also used in consumer law. The current Article L. 132-1 of the Consumer Code treats as unfair, in agreements between professionals and non-professionals, "*clauses, the purpose or effect of which is to create, to the detriment of the non-professional or consumer, a significant imbalance between the rights and duties of the parties to the agreement*". In that area, the legislator used the technique of lists of terms presumed to be unfair, and therefore void. There is

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1 Paris Court of Appeals, N° 08/21750, April 27, 2011, *Mr. Bassam v. SNC Société Presse Pars Services*.

2 Rouen Court of Appeals, N° 12/01200, December 12, 2012, *Société Azuki v. Société Sofresid*.

accordingly a black list of twelve unfair terms (Article R. 132-1 of the Consumer Code), and a gray list of terms presumed to be unfair (Article R. 132-2 of the said Code). The criteria used by the precedents in consumer law are the same as those used for anti-trust law, to wit, unilateral discretionary power, uneven allocation of risk, benefits without consideration, or lack of reciprocity.

- ***The scope of review of significant imbalance: restriction to adhesion contracts***

The scope of unfair terms is restricted under Article 1171 to "*adhesion contracts*", where such clauses are most common. This notion has now been delineated by the definition under Article 1110 of the Civil Code, whereby: "*an adhesion contract is one in which the terms and conditions, not subject to negotiation, are pre-determined by one of the parties*".

Is there a rebuttable presumption that a franchise agreement is to be characterized as an adhesion contract, since the various franchise agreements entered into by a franchisor reproduce the same terms, with a concern for consistency and contractual unity within the network? In the final analysis, it will all depend on how the case-law will interpret the concept of adhesion contracts under this new legislation.

In order to avoid franchise agreements being treated as adhesion contracts, or at least in order to secure evidence in the event of future litigation, the franchisor must be able to prove that the agreement was negotiated with the franchisee, or at the very least that certain terms are the outcome of negotiation.

With that concern for legal security, the display of "conspicuous evidence" of negotiation in the agreement itself is desirable. Thus, the recitals to the agreement can specify that the franchisee had an opportunity to negotiate it, with assistance from advisers, or an appendix to the agreement could include a written report on the whole process of contract negotiation.

In addition, Article 1171 of the Civil Code does not deal with the relationship between generally-applicable law and special areas of law. For instance, the legislation based on the Order does not specify how it is to fit with the Commercial Code, even though both instruments may relate to franchise agreements, and likewise all agreements made between professionals.

Article 1105 of the Civil Code, however, fills that gap by enacting the precedent-based rule whereby general rules apply subject to special rules. More specifically, it provides that:

"*Special rules relating to certain contracts are established in the provisions specific of each of them. General rules are applicable subject to these special rules.*"

- ***The manner of the Courts' evaluation of significant imbalance***

Under consumer law, the legislator favors a comprehensive approach of the contract having regard to the circumstances in which it is made. The list of terms presumed to be unfair contained in Articles R. 132-1 and R. 132-2, however, requires the Court in fact to evaluate the significant imbalance clause by clause. Unlike consumer law, anti-trust law does not list any terms presumed to be unfair or contain specific indications under Article L. 442-6,I, 2° of the Commercial Code setting the manner of the Courts' evaluation of significant imbalance.

In most cases, the Courts perform a concrete evaluation and accordingly a comprehensive analysis of the agreement in order to determine by reference to the background whether or not the parties negotiated.

Recently, in two judgments dated March 3, 2013 and one dated September 29, 2015,[3] the Supreme Court seems to have put an end to the uncertainty as to whether, in particular, significant imbalance was to be evaluated on the basis of an analysis clause by clause, or of an analysis of the contract as a whole. The Court upheld the convictions of two leading retailers on the basis of significant imbalance, and chose the concrete evaluation of the imbalance selected by the lower Courts, by performing "*a comprehensive and concrete evaluation of the agreement*",[4] and by assessing "*the background against which it [had been] made and its structure*".[5]

Accordingly, two kinds of recommendations may be made:

- the first is that the Courts applying generally-applicable law ought to prefer a comprehensive approach of the agreement to a clause-by-clause approach, especially since unlike consumer law, the generally-applicable law contains no list of terms presumed to be unfair;

- the second is for evaluation to be performed *in concreto* with regard to the background against which the agreement containing the significantly-unbalanced term was made: analysis *in concreto* provides a limitation of the review of significant imbalance. This allows evaluation of the substantial character of the significant imbalance.

Such a comprehensive and practical approach is essential for the Courts' evaluation of the validity of terms contained in a franchise agreement, as the protection of know-how justifies the inclusion of contract terms restricting both the franchisee's freedom to trade and his freedom of establishment/enterprise.

The Courts should take into account the specific features of a franchise agreement when evaluating the validity of its terms mirroring the Competition Authority's acceptance of the effect of these contractual boundaries for the purposes of anti-trust law: where they are needed for, and proportionate to, the protection of identifiable, secret and substantial know-how, in addition to the resulting gains of economic efficiency for consumers.

- ***The rules of review of significant imbalance: the beneficiaries of the right of action***

The new Article 1171 of the Civil Code does not expressly identify the beneficiary of the right of action for significant imbalance. This is a conspicuous divergence from the special areas of law, which provide for mechanisms of referral to the courts by certain parties not privy to agreements affected by significant imbalance.

Thus, in the law of restrictive trade practices, Article L. 442-6-III provides not only that the action may be brought before the appropriate civil or commercial court by "*any party proving an interest*", but also "*by the Public Prosecutor, by the Minister in charge of the economy or by the Chairman of the Competition Authority when the latter observes, in a matter within his jurisdiction, a practice referred to under this Article*".

In the specific case of a franchise agreement, the right of action is restricted to the franchisee himself, unless the clause(s) of which the franchisee complains is (are) applied to all the franchisees of the network and directly or indirectly affect the consumers and/or competitors.

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3 Cass. Com., September 29, 2015, N° 13-25.043.

4 Cass. Com. March 3, 2015, N° 14-10.907.

5 Cass. Com. March 3, 2015, N° 13-27.525.

- ***The sanction of significant imbalance***

Article 1171 of the Civil Code provides that the unfair term shall be "*null and void*". This provision is mandatory.

This sanction, provided under generally applicable law, is the same as provided for under consumer law by Article L. 132-1[6]. It deviates from the solution under the law governing restrictive trade practices according to which the existence of significant imbalance may cause its originator to incur liability through an action in damages.

- ***The recommendations for the franchisor to avoid a characterization of significant imbalance***

Certain recommendations may be made for a franchisor to avoid being exposed to a charge of making the franchisee subject to an unbalanced obligation[7], naturally in a situation governed by neither the Commercial Code nor the Consumer Code.

In this regard the franchisor must adapt the way it negotiates and drafts franchise agreements. Without excising the necessary protection of its know-how, it should prevent, insofar as possible, the franchise agreement being treated as an adhesion contract. For that purpose, the agreement should contain "conspicuous evidence" of negotiation, and in any event, not contain terms imposing on the franchisee any obligation that is unilateral and non-reciprocal, or excessive and out of proportion with the interests to be protected.

Characterizing a franchise agreement as an adhesion contract will not, however, result in the eradication of terms regarded as excessively unbalanced, provided that the franchisor supports them with objective grounds, the foremost being the preservation of its know-how.

2.3 Codification of the plea of breach under the Courts' supervision

A plea of breach, by provisionally freezing a contract's effects, may be used as an alternative form of amicable resolution of contract disputes. The plea of breach is a newcomer to the Civil Code, whereas it was previously based solely on precedent, grounded -indirectly- in the (former) Article 1184 of the Civil Code, which was initially intended for other purposes. A plea of breach creates a holding position, by freezing provisionally the liability for an obligation to be provided by the party raising it, until a new event or new behavior by the other contracting party breaks the deadlock.

It is a response -coercive but provisional- intended to put pressure on the partner to perform its obligations. The response needs to be measured and proportionate: withholding performance is to be handled with care, when the non-performing obligor is in such economic dependency that the plea of breach raised against it might jeopardize its business.

The Order provides for it in two forms, in two separate Articles as follows:

(i) First, a plea of ordinary breach permits one party to withhold performance, even though it is due, if the other party fails to perform. It is now based on Article 1219 of the Civil Code, which provides that "*a party may refuse performance of its obligation, even though it is due, if the other fails to*

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6 That Article will become L. 212-1 starting on July 1, 2016.

7 Vogel & Vogel blog, "*Négociation commerciale : quelles précautions prendre pour éviter d'être accusé de déséquilibre significatif ?*", June 30, 2015.

perform its own and that failure is sufficiently serious". As applied to a franchise agreement, this concerns for instance the option for the franchisor not to deliver to the franchisee, when the latter has failed to make payment when due, as specified under the franchise agreement.

(ii) Second, a plea of anticipatory breach permits one party to withhold performance when it is clear that the other will not perform when due. The requirement is that the prospect of failure must be clear, i.e., definite. A risk is not sufficient, therefore. This is another statutory enactment of a precedent-based solution. It is laid down by Article 1220 of the Civil Code, whereby "*a party may withhold performance if it is clear that the other party will not perform when due, and that the consequences of such failure shall be sufficiently serious for it. Such withholding shall be notified as soon as possible*". As applied to a franchise agreement, this is the notice by the franchisor to the franchisee that the goods ordered will be delivered only if paid for prior to shipment. This situation is frequent for a franchisee in a difficult financial position, whose outstanding liabilities are significant.

The shared feature of the two aforesaid articles is that their application is contingent on a sufficiently serious breach. A Court hearing a claim by a franchisee unhappy with the franchisor's plea of breach may not censure that franchisor if the latter has provided in writing to the franchisee the objective reasons for its denial of performance.

Conclusion

The reform of contract law and the provisions of the Macron Act relating to retail trade result in reinforcing the protection enjoyed by franchisees, regarded as the weaker parties, and improving mobility between chains. Although these factors appear as a revolution causing legal uncertainty for all the players in franchise agreements, who will need to adapt, the actual impact of these reforms on franchise agreements should not be overstated. A franchise agreement is, and must remain, a particular kind of convention requiring specific contract terms to protect the franchisor's know-how.

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Biography of the author

Olivier Binder is a partner at Granrut Avocats where he focuses on Distribution, Franchising, Competition law and Commercial Real Estate. Prior to joining Granrut Avocats in September 2011, Olivier Binder was a founding partner with Cejef-Alexen. Olivier Binder has assisted a wide variety of French and foreign clients over the past 25 years across a range of litigation, counseling, advisory and crisis-management issues. Olivier Binder has been a member of the Paris Bar since 1979, holds a DESS post-graduate degree in private law from University of Paris II (1972) and an Executive MBA from HEC (1989). Olivier Binder is a member of the "French Franchise Federation" panel of experts, the French representative in the European Practitioners Network of Eurofranchise Lawyers (EFL), a registered arbitrator with the International Arbitration Chamber of Paris, and a founding member of the AADPC (Association of Commercial Property Lawyers). From 2000 to 2003, Olivier Binder was a member of the UNIDROIT Study Committee (UN-Rome), participating in the drafting of an international model law on "disclosure of pre-contractual information".