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NEW APPROACHES AND CHALLENGES IN INTERNATIONAL FRANCHISING

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**WHAT FUTURE FOR A EUROPEAN CONTRACT LAW?
The Common Frame of Reference and the Green Paper of the
European Commission**

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1. The European legal framework

The European Union is a common market without internal barriers, but legislations of the member States are very different. This means that companies dealing with counterparts of another member state will have to face the problem of conflicting laws.

This is not an insuperable problem, as shown by the experience of the US. However, while almost all US state laws are based on common principles, the law of the members states of the EU show very substantial differences, especially between common law and civil law countries. A further reason for diversification is the fact that most national rules on contracts are the outcome of centuries of legal thinking.

This explains why the idea of developing a European Contract Law is an important issue for discussion.

An important aspect to be considered is that, apart from some exceptions (product liability, commercial agency, antitrust) there are almost no European rules dealing with B2B contracts. The EU has, on the contrary, enacted a great number of directives for the protection of consumers. This risks to negatively affect any project dealing with B2B contracts, as will be seen later.

2. The actions taken by the European Commission

With its 2001 *Communication on European Contract Law* the Commission launched a public consultation on the problems arising from differences between contract law of the members states and proposed with its *Action plan* of 2003 to establish a Common Frame of Reference (CFR) containing common principles, terminology and model rules.

The Commission financed an international academic network which worked out a Draft Common Frame of Reference (DCFR) published in 2008.¹

The DCFR actually looks like a draft code of obligations. It is a long text (more than 200 articles) of high academic level, but complicated and rather far from the expectations of the business world,

On 26 April 2010, the Commission set up an expert group on a Common Frame of Reference which should prepare a user-friendly text in simple language, which could in the future become an optional instrument for cross-border contracts within the European Union.

In the meantime a *Green Paper on policy options for progress towards a European Contract Law* for consumers and businesses has been published in July 2010.² This paper launched a public consultation on the possible policy options in this field, requesting answers within the end of January 2011.

¹ Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference. Interim Outline Edition, prepared by the Study Group on a European Civil Code and the Research Group on EC Private Law (Acquis Group), edited by Christian von Bar, Eric Clive and Hans Schulte-Nölke, Sellier European Law Publishers, München 2008.

² Green Paper from the Commission on policy options for progress towards a European Contract Law for consumers and businesses, dated 1.7.2010 COM(2010)348 final.

3. The DCFR

3.1 A European Civil Code?

The DCFR actually looks like a European civil code or code of obligations, although called with the ambiguous term of “Common Frame of Reference”.

The DCFR deals with B2B and B2C contracts at the same time. It contains specific rules applicable only to B2C contracts, but the fact of dealing in the same text with these two situations inevitably affects also the rules applicable generally to both B2B and B2C contracts. This implies the inclusion of rules which resent the influence of consumer protection principles, which are not always appropriate for B2B contracts.

See, for example, Article II – 7:207 on Unfair exploitation, which says:

II. – 7:207: Unfair exploitation

- (1) A party may avoid a contract if, at the time of the conclusion of the contract:
 - (a) the party was dependent on or had a relationship of trust with the other party, was in economic distress or had urgent needs, was improvident, ignorant, inexperienced or lacking in bargaining skill; and [. . .]

Another surprising provision is contained in Article II-4:104, where it is said that a merger clause which is not individually negotiated only establishes a presumption that the parties intended that their prior statements were not to form part of the contract.

3.2 The provisions of the DCFR concerning agency, franchising and distributorship contracts

The DCFR contains a specific section (part IV-E) on distribution contracts, with a chapter stating general rules all contracts of this type and specific chapters on each type of agreement (agency, distributorship, franchise).

These provisions are a purely academic exercise on distribution law which risks to introduce principles which do not correspond to the needs of the interested parties and do not take into account the current business practice. It appears clearly that these rules have been drafted without any knowledge of the reality of distribution contracts.

A few examples are sufficient to show the gap between the DCFR rules on distribution and reality.

With respect to contracts for an indefinite period Article IV.E.-2:302 introduces - for all distribution contracts - the presumption that a notice period of one month for each year of duration of the contract with a maximum of 36 months is to be considered reasonable. This period is not the mandatory minimum period which is limited to six months, but it is said later (Article IV.E.-2:303) that the aggrieved party will be entitled to damages calculated on the "reasonable" period, which means that the terminated party will be able to claim exorbitant amounts in case of termination.

A further surprising principle is contained in Article IV.E.-2:305 which recognizes in general terms, for all types of distribution contracts, a goodwill indemnity. The indemnity is due only if a party

has significantly increased the other party's volume of business, which would mean - according to the commentary under such Article - that it would have little application in the context of franchising, where the customers are mainly attracted by the image of the franchisor. However, this interpretation is not supported by the wording of Article IV.E.-2:305 which seems to cover any situation where the franchisee has increased the sales of the products. This would imply the introduction of a substantial additional burden upon franchisors, with a substantial increase of the cost of dealing with European counterparts.

As regards specifically franchising contracts, Chapter 4 of Book IV-E contains a number of provisions which are worded very generally and may widen excessively the responsibilities of the franchisor, such as the obligation to grant the franchisee "a right to use the intellectual property rights to the extent necessary to operate the franchise business" (Article IV.E.-4:201), the obligation to "provide the franchisee with assistance in the form of training courses, guidance and advice in so far as necessary for the operation of the franchise business, without additional charge for the franchisee" (Article IV.E.-4:203), the obligation to "make reasonable efforts to promote and maintain the reputation of the franchising network", and in particular to design and coordinate advertising campaigns without additional charge to the franchisee (Article IV.E.-4:207).

4. The project of a user-friendly CFR

An expert group set up in April 2010 is preparing a more user-friendly version of the CFR, in order to verify if could become an optional instrument for cross-border contracts within the European Union.

The experts are having a meeting each month and are progressing quite quickly.

The Commission has created a "Sounding Board", i.e., a group of stakeholders (representing business, consumers, bar associations, etc.) which meets monthly the experts and discusses the upcoming issues. I am participating for the International Chamber of Commerce to this Sounding Board.

The scope of this project is not yet very clear (and will also depend on the outcome of the consultation launched with the Green Paper).

It seems that this new CFR draft will cover only general rules on contracts, and will not deal with specific contracts, except for the contract of sale.

It also seems that it will apply both to B2B and B2C contracts with special rules for B2C contracts, when required.

5. The Green Paper

With the Green Paper on policy options for progress towards a European Contract Law for consumers and businesses (July 2010) the EU Commission launched a public consultation on the possible policy options in this field.

The Commission submits that differences between national contract laws may entail additional transaction costs and legal uncertainty for businesses and lead to a lack of consumer confidence in the internal market. Consumers and businesses, in particular small and medium enterprises (SMEs) having limited resources, may be reluctant to engage in cross-border transactions. The purpose of the Green Paper is to set out the options on how to strengthen the internal market by making progress in the area of European Contract Law, and launch a public consultation on them. Depending on the evaluation of the results of the consultation, the Commission could propose further action by 2012.

The Green Paper proposes a number of options for a future instrument of European Contract Law:

- publication of the results of the expert group to be used as source of inspiration for national legislators;
- an official “toolbox” for the legislator;
- a recommendation addressed to the member states;
- an optional instrument of European Contract Law to be used by the parties instead of a domestic law; and
- a directive for the harmonization of national laws.

Since, the deadline for responses was 31 January 2011, the results are not yet known.

6. Conclusions

It does not seem that these initiatives can give an actual result within a short term.

The most likely outcome is the optional instrument, i.e. a set of rules which may govern a contract instead of the domestic rules of the member states.

However, it is difficult to set up a workable instrument that satisfies at the same time consumers and business. Consumers will need to get the highest level of protection, if the optional instrument is to prevail over national laws. Business will need (at least as regards B2B contracts) a simple set of rules, fully respecting freedom of contract, which could facilitate cross-border transactions within the EU.

At present a part of business organizations would not be against the optional instrument, provided it is made of simple and acceptable rules. Others take the view that such instrument is not necessary and that business can live without it, also because they fear a too academic and consumeristic approach. And, actually, the greatest fear is that a bad optional instrument might become in the future the basis for directly applicable rules.

My personal opinion is that an optional instrument could be a useful tool for simplifying cross-border trade within the EU, but only if the following conditions (which at present seem difficult to achieve) can be met:

- the optional instrument should deal only with B2B transactions;
- it should state clear and simple rules which can be understood by lawyers and businessmen and avoid rules limiting party autonomy, except in extreme cases;
- it should cover all contracts used in trade between member states
- its rules should prevail over any mandatory provisions of national laws

Extract from the DCFR, part. IV-E

Part E.

Commercial agency, franchise and distributorship

Chapter 1:

General provisions

Section 1:

Scope

IV. E. – 1:101: Contracts covered

(1) This Part of Book IV applies to contracts for the establishment and regulation of a commercial agency, franchise or distributorship and with appropriate adaptations to other contracts under which a party engaged in business independently is to use skills and efforts to bring another party's products on to the market.

(2) In this Part, "products" includes goods and services.

Section 2:

Other general provisions

IV. E. – 1:201: Priority rules

In the case of any conflict:

(a) the rules in this Part prevail over the rules in Part D (Mandate); and

(b) the rules in Chapters 3 to 5 of this Part prevail over the rules in Chapter 2 of this Part.

IV. E. – 1:202: Derogation

The parties may exclude the application of any of the rules in this Part or derogate from or vary their effects, except as otherwise provided in this Part.

Chapter 2:

Rules applying to all contracts within the scope of this part

Section 1:

Pre-contractual information duty

IV. E. – 2:101: Pre-contractual information duty

A party who is engaged in negotiations for a contract within the scope of this Part has a duty to provide the other party, a reasonable time before the contract is concluded and so far as required by good commercial practice, with such information as is sufficient to enable the other party to decide on a reasonably informed basis whether or not to enter into a contract of the type and on the terms under consideration.

Section 2:

Obligations of the parties

IV. E. – 2:201: Co-operation

The parties to a contract within the scope of this Part of Book IV must collaborate actively and loyally and coordinate their respective efforts in order to achieve the objectives of the contract.

IV. E. – 2:202: Information during the performance

During the period of the contractual relationship each party must provide the other in due time with all the information which the first party has and the second party needs in order to achieve the objectives of the contract.

IV. E. – 2:203: Confidentiality

(1) A party who receives confidential information from the other must keep such information confidential and must not disclose the information to third parties either during or after the period of the contractual relationship.

(2) A party who receives confidential information from the other must not use such information for purposes other than the objectives of the contract.

(3) Any information which a party already possessed or which has been disclosed to the general public, and any information which must necessarily be disclosed to customers as a result of the operation of the business, is not regarded as confidential information for this purpose.

Section 3:

Termination of contractual relationship

IV. E. – 2:301: Contract for a definite period

- (1) A party is free not to renew a contract for a definite period. If a party has given notice in due time that it wishes to renew the contract, the contract will be renewed for an indefinite period unless the other party gives that party notice, not later than a reasonable time before the expiry of the contract period, that it is not to be renewed.
- (2) Where the obligations under a contract for a definite period continue to be performed by both parties after the contract period has expired, the contract becomes a contract for an indefinite period.

IV. E. – 2:302: Contract for an indefinite period

- (1) Either party to a contract for an indefinite period may terminate the contractual relationship by giving notice to the other.
- (2) If the notice provides for termination after a period of reasonable length no damages are payable under IV. E. – 2:303 (Damages for termination with inadequate notice). If the notice provides for immediate termination or termination after a period which is not of reasonable length damages are payable under that Article.
- (3) Whether a period of notice is of reasonable length depends, among other factors, on:
 - (a) the time the contractual relationship has lasted;
 - (b) reasonable investments made;
 - (c) the time it will take to find a reasonable alternative; and
 - (d) usages.
- (4) A period of notice of one month for each year during which the contractual relationship has lasted, with a maximum of 36 months, is presumed to be reasonable.
- (5) The period of notice for the principal, the franchisor or the supplier is to be no shorter than one month for the first year, two months for the second, three months for the third, four months for the fourth, five months for the fifth and six months for the sixth and subsequent years during which the contractual relationship has lasted. Parties may not exclude the application of this provision or derogate from or vary its effects.
- (6) Agreements on longer periods than those laid down in paragraphs (4) and (5) are valid provided that the agreed period to be observed by the principal, franchisor or supplier is no shorter than that to be observed by the commercial agent, the franchisee or the distributor.
- (7) In relation to contracts within the scope of this Part, the rules in this Article replace those in paragraph (2) of III. – 1:109 (Variation or termination by notice). Paragraph (3) of that Article governs the effects of termination.

IV. E. – 2:303: Damages for termination with inadequate notice

- (1) Where a party terminates a contractual relationship under IV. E. – 2:302 (Contract for indefinite period) but does not give a reasonable period of notice the other party is entitled to damages.
- (2) The general measure of damages is such sum as corresponds to the benefit which the other party would have obtained during the extra period for which the relationship would have lasted if a reasonable period of notice had been given.
- (3) The yearly benefit is presumed to be equal to the average benefit which the aggrieved party has obtained from the contract during the previous 3 years or, if the contractual relationship has lasted for a shorter period, during that period.
- (4) The general rules on damages for non-performance in Book III, Chapter 3, Section 7 apply with any appropriate adaptations.

IV. E. – 2:304: Termination for non-performance

- (1) Any term of a contract within the scope of this Part whereby a party may terminate the contractual relationship for non-performance which is not fundamental is without effect.
- (2) The parties may not exclude the application of this Article or derogate from or vary its effects.

IV. E. – 2:305: Indemnity for goodwill

- (1) When the contractual relationship comes to an end for any reason (including termination by either party for fundamental non-performance), a party is entitled to an indemnity from the other party for good-will if and to the extent that:
 - (a) the first party has significantly increased the other party's volume of business and the other party continues to derive substantial benefits from that business; and
 - (b) the payment of the indemnity is reasonable.
- (2) The grant of an indemnity does not prevent a party from seeking damages under IV.E.–2:303 (Damages for termination with inadequate notice).

IV. E. – 2:306: Stock, spare parts and materials

If the contract is avoided, or the contractual relationship terminated, by either party, the party whose products are being brought on to the market must repurchase the other party's remaining stock, spare parts and materials at a reasonable price, unless the other party can reasonably resell them.

Section 4:

Other general provisions

IV. E. – 2:401: Right of retention

In order to secure its rights to remuneration, compensation, damages and indemnity the party who is bringing the products on to the market has a right of retention over the movables of the other party which are in its possession as a result of the contract, until the other party has performed its obligations.

IV. E. – 2:402: Signed document available on request

- (1) Each party is entitled to receive from the other, on request, a signed statement in textual form on a durable medium setting out the terms of the contract.
- (2) The parties may not exclude the application of this Article or derogate from or vary its effects.

[...]

Chapter 4: Franchise Section 1: General

IV. E. – 4:101: Scope

This Chapter applies to contracts under which one party, the franchisor, grants the other party, the franchisee, in exchange for remuneration, the right to conduct a business (franchise business) within the franchisor's network for the purposes of supplying certain products on the franchisee's behalf and in the franchisee's name, and under which the franchisee has the right and the obligation to use the franchisor's tradename or trade mark or other intellectual property rights, know-how and business method.

IV. E. – 4:102: Pre-contractual information

- (1) The duty under IV. E. – 2:101 (Pre-contractual information duty) requires the franchisor in particular to provide the franchisee with adequate and timely information concerning:
 - (a) the franchisor's company and experience;
 - (b) the relevant intellectual property rights;
 - (c) the characteristics of the relevant know-how;
 - (d) the commercial sector and the market conditions;
 - (e) the particular franchise method and its operation;
 - (f) the structure and extent of the franchise network;
 - (g) the fees, royalties or any other periodical payments; and
 - (h) the terms of the contract.
- (2) Even if the franchisor's non-compliance with paragraph (1) does not give rise to a mistake for which the contract could be avoided under II. – 7:201 (Mistake), the franchisee may recover damages in accordance with paragraphs (2) and (3) of II. – 7:214 (Damages for loss), unless the franchisor had reason to believe that the information was adequate or had been given in reasonable time.
- (3) The parties may not exclude the application of this Article or derogate from or vary its effects.

IV. E. – 4:103: Co-operation

The parties to a contract within the scope of this Chapter may not exclude the application of IV. E. – 2:201 (Co-operation) or derogate from or vary its effects.

Section 2:

Obligations of the franchisor

IV. E. – 4:201: Intellectual property rights

- (1) The franchisor must grant the franchisee a right to use the intellectual property rights to the extent necessary to operate the franchise business.
- (2) The franchisor must make reasonable efforts to ensure the undisturbed and continuous use of the intellectual property rights.
- (3) The parties may not exclude the application of this Article or derogate from or vary its effects.

IV. E. – 4:202: Know-how

- (1) Throughout the duration of the contractual relationship the franchisor must provide the franchisee with the know-how which is necessary to operate the franchise business.
- (2) The parties may not exclude the application of this Article or derogate from or vary its effects.

IV. E. – 4:203: Assistance

- (1) The franchisor must provide the franchisee with assistance in the form of training courses, guidance and advice, in so far as necessary for the operation of the franchise business, without additional charge for the franchisee.

(2) The franchisor must provide further assistance, in so far as reasonably requested by the franchisee, at a reasonable cost.

IV. E. – 4:204: Supply

(1) When the franchisee is obliged to obtain the products from the franchisor, or from a supplier designated by the franchisor, the franchisor must ensure that the products ordered by the franchisee are supplied within a reasonable time, in so far as practicable and provided that the order is reasonable.

(2) Paragraph (1) also applies to cases where the franchisee, although not legally obliged to obtain the products from the franchisor or from a supplier designated by the franchisor, is in fact required to do so.

(3) The parties may not exclude the application of this Article or derogate from or vary its effects.

IV. E. – 4:205: Information by franchisor during the performance

The obligation to inform requires the franchisor in particular to provide the franchisee with information concerning:

(a) market conditions;

(b) commercial results of the franchise network;

(c) characteristics of the products;

(d) prices and terms for the supply of products;

(e) any recommended prices and terms for the re-supply of products to customers;

(f) relevant communication between the franchisor and customers in the territory; and

(g) advertising campaigns.

IV. E. – 4:206: Warning of decreased supply capacity

(1) When the franchisee is obliged to obtain the products from the franchisor, or from a supplier designated by the franchisor, the franchisor must warn the franchisee within a reasonable time when the franchisor foresees that the franchisor's supply capacity or the supply capacity of the designated suppliers will be significantly less than the franchisee had reason to expect.

(2) For the purpose of paragraph (1) the franchisor is presumed to foresee what the franchisor could reasonably be expected to foresee.

(3) Paragraph (1) also applies to cases where the franchisee, although not legally obliged to obtain the products from the franchisor or from a supplier designated by the franchisor, is in fact required to do so.

(4) The parties may not, to the detriment of the franchisee, exclude the application of this Article or derogate from or vary its effects.

IV. E. – 4:207: Reputation of network and advertising

(1) The franchisor must make reasonable efforts to promote and maintain the reputation of the franchise network.

(2) In particular, the franchisor must design and co-ordinate the appropriate advertising campaigns aiming at the promotion of the franchise network.

(3) The activities of promotion and maintenance of the reputation of the franchise network are to be carried out without additional charge to the franchisee.

Section 3:

Obligations of the franchisee

IV. E. – 4:301: Fees, royalties and other periodical payments

(1) The franchisee must pay to the franchisor fees, royalties or other periodical payments agreed upon in the contract.

(2) If fees, royalties or any other periodical payments are to be determined unilaterally by the franchisor, II. – 9:105 (Unilateral determination by a party) applies.

IV. E. – 4:302: Information by franchisee during the performance

The obligation under IV.E.–2:202 (Information during the performance) requires the franchisee in particular to provide the franchisor with information concerning:

(a) claims brought or threatened by third parties in relation to the franchisor's intellectual property rights; and

(b) infringements by third parties of the franchisor's intellectual property rights.

IV. E. – 4:303: Business method and instructions

(1) The franchisee must make reasonable efforts to operate the franchise business according to the business method of the franchisor.

(2) The franchisee must follow the franchisor's reasonable instructions in relation to the business method and the maintenance of the reputation of the network.

(3) The franchisee must take reasonable care not to harm the franchise network.

(4) The parties may not exclude the application of this Article or derogate from or vary its effects.

IV. E. – 4:304: Inspection

(1) The franchisee must grant the franchisor reasonable access to the franchisee's premises to enable the franchisor to check that the franchisee is complying with the franchisor's business method and instructions.

(2) The franchisee must grant the franchisor reasonable access to the accounting books of the franchisee.