



Emergence of fair franchising laws

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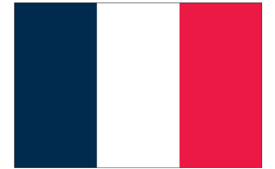
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Agenda

- What is “*Fair Franchising*”
- Pre-Contractual Phase (Disclosure)
- Contractual Phase (Relationship)
- Post-Contractual Phase (Termination, Non-Renewal, Transfers, etc.)
- Reflections



Countries: Australia, Germany, France, the Netherlands, Kingdom of Saudi Arabia, USA

What is “*Fair Franchising*”?

- Aimed to create a balanced (fair) relationship between entrepreneurs (franchisees) and brands (franchisors).
- Promote detailed pre-contractual disclosure, fair and balanced treatment during the relationship, and post-relationship mobility.
- Initiatives to adopt fair and mutually beneficial business practices. (e.g., franchisee associations and collective bargaining, trade associations (e.g., AAFD, AAHOA), US and International Relationship Laws, Other Proposals, etc.)
- “Fair franchising laws” and “relationship laws” often used interchangeably.

Main Elements of FFLs and Franchisee Protection

- **Pre-Contractual Disclosure** to ensure the franchisee understands their investment.
- **Registration/Filing** for approval of franchise offering and accountability
- **Fair contract terms** to avoid one-sided agreements (i.e., adhesion contracts)
- **Protections from unlawful termination and non-renewal** to, among other things, require “good cause” for taking notable actions, such as termination, nonrenewal, or assignment refusal.

What is “*Fair Franchising*”?

- Australia: address “power imbalance between franchisors and franchisees”
- France: preventing a “significant imbalance”
- Germany: “avoiding unfair disadvantage”
- Netherlands: transparency and approval rights
- United States: unequal bargaining power between franchisors and franchisees

Pre-Contractual Disclosure: Germany

- Franchise Code of Ethics requires full disclosure
- Civil Code requires disclosure of all material facts
- Case law deals with
 - Misrepresentation, false information
 - Incomplete information
 - Silence, when the franchisor should have spoken

Pre-Contractual Disclosure Example: Germany

Aufina was a German real estate brokerage franchise

The Franchisor had stated that “only 3 % of Aufina franchisees fail” when in reality 28 franchisees (of 130) were dissatisfied with the financial results of their Aufina business. The costs and expenses for franchisees were high (franchise fee, marketing fee, minimum office size) reducing their profitability significantly.

This was a breach of the duty of full and fair disclosure because the Franchisor did not explain that 28 franchisees were in financial difficulty, albeit they had not failed. As such the franchisee came to believe that success was guaranteed.

The court found that the franchisor had to make the franchisee aware that success in business is never guaranteed and no investment is free from risk. The Franchisor argued that the Franchisee should have understood that every business brings with it certain risks and such basic information is not within the scope of disclosure. This was not made sufficiently clear. A factor was the lack of business experience on the part of the franchisee. The court merely applied a 10 % discount for lack of due diligence on the part of the franchisee and awarded 90% of the claim.

Pre-Contractual Disclosure: Australia

- **FDD (including, a copy of the franchise agreement)** at least 14 fourteen days before: (a) the franchisor and the franchisee enter into a franchise agreement, or (b) the payment of a non-refundable fee in connection with the proposed agreement.
- **Key Facts Sheet** summarizing provisions in the FDD.
- Copy of the **Australia Franchising Code of Conduct**, one of the laws that franchisees and franchisors must follow.
- **Information Statement**, which is an official document explaining franchising, no later than 7 days after expression of interest and before FDD is provided.

Pre-Contractual Registration: Australia

- Franchisors wishing to enter into a FA must join the **Franchise Disclosure Register** at least 14 days before entering into a FA. (No regulatory approval; filing only.)
- Maintained by the Australian Government's Treasury Department.
- Public information about franchisor (e.g., contact details, description of business, historical operations, Australia existing and proposed expansion, establishment costs, fees, information about renewal, compensation for goodwill, restraint of trade clauses, FDD URL (if applicable), FA URL (if available), etc.)
- Existing franchisors must be on the Register.
- After joining, must update or confirm the information included in the Register each year. Must be completed before the 14th day of the 5th month of the last FY.

Pre-Contractual Registration: US

- No Federal Registration
- 13 US Registration States
 - These states require a franchisor to secure registration by filing an FDD with the state administrator before engaging in the offer and sale of franchises.
 - There may be State-Specific requirements (e.g., state-specific disclosure, state-specific timing requirements, etc.)
 - CA, HI, IL, IN, MD, MI, MN, NY, ND, RI, VA, WA, WI
 - CT, NC, SC, LA, ME require registration where trademarks are not registered with USPTO
 - Some registration states barely look at/rubber stamp the FDD; others take a hard look and issue comment letters
- 9 states merely require filing as a business opportunity/exemption and do not review FDD at all
 - CT, FL, KY, NE, NC, SC, SD, TX, UT
 - LA, GA require filing where trademarks are not registered with USPTO

Pre-Contractual Phase: KSA

- Franchisee must receive a disclosure document in Arabic 14 days before FA is signed/money is paid
- Franchisor must register both the FA and the FDD
- Disclosure items include detailed financial disclosures
- Franchisor cannot franchise unless they have 2 stores open
- Franchisor must have a registered trade mark

Pre-Contractual Disclosure KSA

- Disclosure items include
- Total estimated invested required from the franchisee
 - The Form to be completed is very detailed. US style approach to detail on fees and investment by category
 - Optional financial performance disclosures
- Site Selection information
- A summary of key contractual rights and obligations

Post-Contractual Registration: KSA

Example Saudi Arabia: The Franchisor must register the franchise agreement and the disclosure document with the Ministry of Commerce and Industry within 90 days of execution of the franchise agreement. The documents must be translated, certified and supported by a POA.

The costs of translation are high and franchisors cannot self-register as the website of the ministry requires a local address and mobile number. For foreign franchisors the process is onerous.

Interestingly the duty to include a translated copy of the full annual accounts of the company was recently abolished. Spain completely abolished franchise registration due to the considerable administration involved with no obvious benefit to local franchisees.

Contractual Phase: France

- “*Significant imbalance*”
- Article L.442-1, I, 2° French Commercial Code
- Mandatory, regardless of governing law and assessed in the context of entire agreement.

Contractual Phase: France

Subway Decision:

- **Significant Imbalance** = (i) total absence of reciprocity; and (ii) significant disproportion between the parties' respective obligations.
 - Clause in favor of the franchisor;
 - Does not provide the franchisee with any counterpart, either arising from another clause, or from the fact that it is necessary for the coherence and homogeneity of the network, which guarantees the success of the franchisee's own investment; and
 - Is not compensated in an overall rebalancing of the contract.
- **Dispute Resolution**
 - Subway franchise agreements in France: Dutch law; NY arbitration; French translation; English version takes precedence.

Contractual Phase: France

Assignment/Transfer (Pizza Sprint/Domino's)

- No assignment without franchisor's express prior consent.
- Franchisee to inform franchisor of anything affecting franchisee's capital, identity, etc. at least 2 months before any change.
- No equivalent requirements for franchisor.

HELD: Null and void.

Termination (Pizza Sprint/Domino's)

- Franchisor had sole right to terminate FA eg non-payment of invoice to suppliers or if breach of "spirit" of the FA.

Supply requirements (Pizza Sprint/Domino's)

Minimum stock clause. Franchisees to purchase through that supplier (connected to franchisor's group).

- No commercial advantage for franchisees
- Constraint on franchisees' freedom to manage their business
- Compromised status of franchisees as independent entrepreneurs
- Not justified to preserve consistency of franchise network or know how.

HELD: Franchisor to discontinue this practice.

Contractual Phase: Netherlands

- “Good franchisor” and “good franchisee”
- Franchisee approval rights to System changes
- Annual reports showing how fees were spent
- Goodwill
- Dutch Franchise Act subject to parliamentary review in 2025.

If Franchisor wants to change its system and that change would require Franchisee to incur costs:

- costs to be below a contractually agreed **threshold**; or
- Franchisor must obtain the **consent of a majority** of its existing franchisees in the Netherlands.

Contractual Phase: (Australia)

- *A franchisee can change their mind, end the agreement and get some or all their money back* (i) during a 14-day cooling off period, or (ii) within 14 days after receiving leasing information, if they are leasing premises from franchisor or affiliate.
 - *Jim's Dog Wash*. Misrepresenting to a franchisee that cooling off rights ended 14 days after entering into FA or making a payment to the franchisor, whichever was earlier.
- Common law obligation to **act in good faith** applies to any matter arising in the franchising relationship, including, negotiations, performance, dispute resolution, and the end, including termination, of FA.
 - Bad faith is acting for ulterior motive or to undermine or deny the other party the benefits of a contract.
- Cannot restrict or impair franchisees from lawfully associating (e.g., franchise association).
- FA cannot have a general release from liability or contain or require a franchisee to sign a waiver of any verbal or written representation made by franchisor.
- Cannot unreasonably withhold consent to a transfer of the franchise (42 days).

Contractual Phase: (Australia)

- Under the Australian Consumer Law (ACL), contract terms in **standard form small business or consumer contracts** are unfair if they:
 - cause a significant imbalance in the rights and obligations of the parties under the contract;
 - are not reasonably necessary to protect the legitimate interests of the party advantaged by the term; and
 - would cause detriment to other party if applied or relied upon.
- From November 9, 2023, franchisors are prohibited from entering standard form contracts with small businesses or consumers which include unfair contract terms (UCTs).
- Examples of UCTs are unilateral variation clauses, withholding and set-off payment clauses, audit power clauses, restraint of trade clauses and termination clauses.

Contractual Phase: US

- Free Association
 - ten states make prohibitions on free association illegal
 - AR, CA, HI, IL, IA, MI, MN, NE, NJ, WA
- Such laws are fairly straight forward and generally prohibit the franchisor from hindering the franchisees right to join a lawful trade association or to associate among one another.

Post-Contractual Phase **MEGAN**

- Protect the Franchisee from early termination for minor breach
- Gives the Franchisee a right to terminate
- Requires the Franchisor to buy back certain items
- Prohibits or regulates restrictive covenants
- Prohibits or regulates Franchisor buy-out options

Post-Contractual Phase: Australia

- Termination
 - If franchisor wants to terminate, they must follow the processes set out in the Franchising Code.
 - If a franchisee wants to terminate agreement early, the Franchising Code sets out a procedure they can follow to propose this to the franchisor.
 - Reasonable notice of termination.
- Dispute Resolution: Parties must try to resolve dispute by writing to each other about the nature of the dispute, followed by mandatory mediation, conciliation and voluntary arbitration.
 - Can't make franchisees resolve disputes outside the state or territory where their business is based, or outside Australia.
- No court has suggested that goodwill generated by franchisee belongs to franchisee.

Post-Contractual Phase: Germany

Good Cause: According to German Law, a long-term agreement can only be terminated for important reasons. The parties cannot deviate from this important principle so the franchisor cannot stipulate that minor breaches are deemed to be good cause.

Compensation: The Franchisee is entitled to compensation if a non-compete is enforced against them. The Franchisee may also be entitled to a goodwill payments (similar to the Netherlands)

Post-Contractual Phase: Germany

Example : The Burger King case

The Franchisee had not paid the royalties because there was an underlying dispute over the closure of a loss making location . After giving final notice to pay Burger King terminated the agreement. The contract provided the right to terminate if any sum due was not paid in 10 days. This termination clause was struck out, as it allowed the theoretical possibility to terminate if a minor sum (e.g. \$ 5) was overdue. Further the cure period of 10 days was unreasonably short. The franchisee also refused to permit announced audits. Again the court felt, this was not a sufficiently material breach to justify termination.

The Court stated that a 20 year contract cannot be terminated easily. The termination clause was unfair and invalid. The minimum cure period in a 20 year contract should be 6-12 weeks. The question to ask is whether Burger King can be expected to continue the relationship or whether termination is a fair remedy in view of the breach.

Post-Contractual Phase: Netherlands

Goodwill

- FAs to include methodology for calculation of goodwill.
- Franchisor to pay franchisee this goodwill amount if franchisor takes over the franchisee's business or if franchisor transfers the franchisee's business to a third party.
- Can be zero for "hard franchises".

Post-Contractual Phase: Saudi Arabia

Post termination Protections: Franchisor must compensate the franchisees if termination or non-renewal does not meet the standards of the law. The law sets out a list of permitted grounds for termination such as

- persistent non-compliance with the franchise agreement despite notice from the franchisor;
- Franchisee's operation of the franchised business amounts to a threat to public health and safety;

Buy-Back The Franchisor must buy back all material assets used solely in the franchised business that the franchisee has purchased from the franchisor or from a third party nominated by the franchisor. The repurchase price used when fulfilling the buy-back obligation shall not be less than the price originally paid by the franchisee after depreciation

Post-Contractual Phase: US (Termination/Non-Renewal)

Termination/non renewal

- Prior written notice required
- Good cause required
 - *Baskin Robbins*: New York state; failure to pay franchise fees, advertising fees, supply charges, service charges, attorney fees, and late charges = good cause for termination
 - *Valentine*: Ninth Circuit; franchisee's failure to agree to franchise agreement allowing franchisor to convert from a full service to a gas only station constituted good cause for nonrenewal under the PMPA.
 - *Wright-Moore*: Seventh Circuit; Franchisor's "internal economic reasons . . . are not, by themselves under Wisconsin's franchise relationship laws, good cause for termination or nonrenewal of a franchisee, [because] . . . a franchisor could virtually always claim a plausible business reason for termination." Instead "good cause" under Wisconsin law must relate to the particular franchisee or its performance.

U.S: Transfer and Assignment

- Prior written notice required; must also specify material reasons for denial in some states
- Generally must have “good cause”/cannot unreasonably withhold consent to transfer
- Some states specify what constitutes “good cause” or “reasonable cause” for withholding consent to assign/transfer and are aggressive with their approach
- Conditional consent often allowed
 - E.g, compliance with franchisor’s standards, training, transfer fee, etc.

Post-Contractual Phase: US (Anti-Discrimination)

- “Discrimination” typically refers to differential treatment of similarly situated franchisees. Importantly, however, discrimination by way of differential treatment does not necessarily mean that franchisees must be treated uniformly.”
- Ten states have explicit prohibitions against discrimination
 - AR, CT, HI, IL, IN, IA, MI, MN, WA, WI
- Some laws also apply on an industry-wide basis. *E.g.*, the Petroleum marketing, supply chain, and laws applying to motor vehicle franchises.
- When a state does not have an explicit anti-discrimination statute, franchisees may bring such claims by relying on the “good cause” requirements of a state's relationship laws governing termination, renewal, and transfer; state “unfair business practice” type laws; or common law duties such as the implied covenant of good faith and fair dealing.

Post-Contractual Phase: US (Anti-Discrimination)

- Discrimination claims by franchisees are rarely granted.
- *Canada Dry*: Seventh Circuit; the Court held that Canada Dry did not discriminate against Franchisee even though Canada Dry had never terminated a franchisee for similar reasons (poor quality and failure to meet sales goals) and stated that “proof of ‘discrimination’ requires a showing of arbitrary disparate treatment among similarly situated individuals or entities.”

Post-Contractual Phase: US (anti-discrimination (cont.))

Original Great American Chocolate Chip Cookie Co: Seventh Circuit assessed a termination claim based on multiple breaches of the franchise agreement where the Franchisee tried to argue that the Franchisor's lenient treatment of other franchisees was a defense to termination. In denying this defense and holding in favor of the Franchisor, the court stated that "[t]he fact that the [franchisor] may . . . have treated other franchisees more leniently is no more a defense to a breach of contract than laxity in enforcing the speed limit is a defense to a speeding ticket."

Post-Contractual Phase: US (Discrimination; Good Faith and Fair Dealing Claims)

- Some claims of discrimination have been brought as claims for breach of the implied covenant of good faith and fair dealing
- For example, in *D&K Foods, Inc*: District of Maryland court denied franchisor's motion to dismiss a claim by a franchisee that franchisor breached the implied covenant of good faith and fair dealing by failing to extend the franchisee financial assistance that it granted to other franchisees. The court stated that whether the implied covenant was breached "depends largely on the outcome of the other factual inquiry," and therefore could not be resolved at that stage.
- Such claims may be even more viable in states like Washington, which explicitly requires that parties to a franchise agreement deal with each other in good faith.

Reflections

1. What are some of the key challenges with the laws we covered?
2. Is a one-size-fits-all approach to fairness in franchising appropriate?
3. Is education the issue?
4. Is fair franchising the new norm internationally?

Q&A

Any questions?