Franchising: A Comparison of the EEC and US Legislative Approaches,

With Particular Reference to Territorial Exclusivity.

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ACRONYMS AND ABBREVIATIONS

A.G.	Advocate General
COJ	Court of Justice
EEC	European Economic Community
EFF	European Franchise Federation
FTC	Federal Trade Commission
NAAG	National Association of Attorneys General
NASAA	North American Securities Administrators Association
NCCUSL	National Conference of Commissioners on Uniform State Law
UFOC	Uniform Franchise Offering Circular
UK	United Kingdom
US	United States

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ABSTRACT

Franchise law is an interdisciplinary subject within the wide field of legal research. Franchising is a unique business method that has special effects in virtually every aspect of the law.

This thesis focuses on the legislation which was specially enacted to deal with franchising. General legislation which has, among other consequences, secondary effects on franchising, is outside the scope of this thesis.

Most of the thesis will concentrate on the two jurisdictions in which the franchise method is already well established, the European Economic Community (hereinafter - the EEC) and the United States (hereinafter - the US). In both jurisdictions, the economic influence of the franchise method is expected to grow further in the future. The legal status of franchising in Canada is not discussed in length in this thesis because franchise legislation is a rare exception in Canada.

The study compares two different legal approaches that have been taken towards franchising in the last two decades. The first approach which emphasizes aspects of competition law is found in the EEC; the second, which emphasizes the need to protect the franchisee's investment, is found in the US.

Each of these approaches is dominant in the related jurisdiction, however, it is not suggested that legislation under the dominant approach is the only legal treatment given to the franchise method in the concerned jurisdiction.

To effectively compare the two approaches it is necessary to isolate and analyze one aspect of the franchise method. This aspect is used to examine the impact of the two legal approaches.

Territorial exclusivity in franchise agreements has two contradictory results and these results match the legal approach towards franchising in each of the US and the EEC. Territorial exclusivity not only protects the franchisee's rights in the franchise; but it at the same time has clear effects on free competition in the market. It is therefore appropriate that this aspect of the franchise method be chosen to be the leading comparative theme of this thesis.

Another important reason for this choice is the fact that territorial exclusivity is the main subject in the EEC discussion of franchising and is dealt with there under competition law.

The different approaches in the two jurisdictions towards the franchise method are demonstrated and examined from the territorial exclusivity perspective so that this aspect of the franchise method serves as an instrument for comparison. The role and importance of the territorial exclusivity granted to the franchisee in franchise agreements is also examined for itself.

Territorial exclusivity in franchise agreements was analyzed under competition/antitrust law in the two jurisdictions. Therefore a secondary consequence of this thesis is an understanding of the legal methods which were meant to obtain free competition in the economic market, as found in the US and in the EEC.

Another secondary but fundamental consequence of the thesis is a presentation of different types of franchise legislation found in the US and franchise legislation found in the EEC.

An in-depth comparative examination and analysis of the different approaches taken towards the franchise method has practical applications for both the franchise agreement parties and legislatures. It will serve to provide a better understanding of the scope of the franchise method itself and the factors that should be taken into account when the use of the method is being considered. It will also reveal considerations that should be weighed one against the other by legislatures, especially in jurisdictions in which the franchise method is sufficiently developed that its regulation is contemplated.

The first chapter of this thesis is a general introduction to the franchise method and its main characteristics and features. Also included, is an introduction to the different types of franchise specific legislation. In the second chapter, the development of the approach taken towards the franchise method in the EEC is examined. The chapter includes an analysis of the Court of Justice's (hereinafter - the COJ) well-known Pronuptia judgment, the EEC individual exemptions for franchise agreements issued by the EEC Commission and the Commission's franchise regulation.

The first part of the third chapter, deals with the antitrust law in the US to the extent it concerns franchise agreements. In this part, US federal and state antitrust legislation is reviewed. This part also includes an analysis of the GTE landmark judgement. The second part of the third chapter examines franchise legislation to protect franchisees in the US, both at the federal and at the state level. The study in both parts of the third chapter is done through concentrating in the status of territorial exclusivity.

The fourth and last chapter presents broad comparisons and general conclusions.

Chapter I

THE FRANCHISE METHOD - AN INTRODUCTION.

1. Business aspects of the franchise method.

1.1 An introduction.

The franchise method is a fast and efficient way to achieve business expansion. It is used mostly in the retail trade field in connection with various types of goods and services.

There is no one generally accepted definition that describes the franchise method[1]. Different legislatures, government agencies, and franchise associations throughout the world have each adopted their own definitions of the franchise method. This is the reason that what is regarded as a franchise in one jurisdiction might not be regarded as a franchise in another jurisdiction.

The franchise method is used by an owner of a successful business method, of a well-known trademark used by this business and of a product or products sold under this trademark[2].

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[1]. J.E., Pattison, Establishing a Transnational Franchise (New York: Matthew Bender, 1988), at 1-4: "The term is a fluid one ... and the term has been applied to a variety of commercial relationships".

[2]. F., Zaid, Canadian Franchise Guide (Toronto: De Boo, 1983-), at 1-403.

The franchise method is a more sophisticated distribution method[3] in comparison to other distribution possibilities, such as branches owned by the supplier, agencies employed by him or joint ventures in which he is one of the parties.

The owner of trademark and a developed business method is **the franchisor.** The franchisor sells the right to use the trademark and the business method in connection with certain goods or services, that is, the **franchise right**, to an independent undertaking[4]. The buyer of these rights is the **franchisee.** The consideration given to the franchisor for the franchise rights usually consists of initial fees in a fixed amount of money, followed by continuous royalties usually calculated as a percentage of the gross sales of the franchisee's outlet, to be paid periodically to the franchisor[5].

Should the franchisee be interested in keeping the franchise rights after the original agreed period has expired, he will be usually required to pay renewal fees to the franchisor[6].

The franchise rights are usually limited to a certain period and to a defined location and/or territorial zone[7]. The franchisee is usually required to buy all of the

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[3]. D., Zendel, "Franchising - A Global Phenomenon" (1988), 76 Trademark Reporter 137, at 148.

[4]. E.M., Andrews, "European Franchising Go Global" (June 1988) Europe 381, at 381 : "Franchising depends on large markets, where entrepreneurs can perfect a retailing concept and stamp out copies over and over again".

[5]. D.L., Foster, The Complete Franchise Book (New York: Prima Publishing, 1987), at 41-48; This way of payment is used in franchise systems more frequently than it is used in other types of distribution systems.

[6]. See Zaid, supra, note 2, at 1-403.

[7]. The selection of the business location by the franchisee is therefore very important. See M.A., Goldberg, "The Nuts and Bolts of Site Selection" in Franchising - Current Issues in Financing Leasing and Remedies in Default (conference held in Toronto, March 22, 1985), in section VI of the conference materials.

products or at least most of the products from the franchisor directly, or from suppliers previously approved by the franchisor.

Out of legal literature it is possible to identify three main types of businesses included in the franchise method - business format franchise, product franchise and manufacturing franchise. While this division is very rough and is sometimes artificial since it is common to find systems which combine features of two or more of these groups[8], for the purpose of analysis in this thesis this division is adherent to.

The first type, the business format franchise, is recognized as a separate business method in most jurisdictions. The recognition of the other two types as part of a separate business method, varies from one jurisdiction to another.

1.1.1 The business format franchise. Its main feature is the strictness towards the uniform business format used by the system's outlets and the uniform identity of all the outlets bearing the franchise system's trademark. The uniformity applies to all details, from the business decoration and the employees' uniforms, to the product's shape, size and packaging. The franchisor continuously guides and trains the franchisee on the day-to-day operation of the outlet. The franchisor requires the franchisee to follow a highly detailed operating manual in order to maintain and control the uniformity and the quality of the specific franchised outlet. The franchisor

[8]. Several commentators divide the franchise method into more than three groups. See for example - G.H., Hadfield, "Problematic Relations: Franchising and the Law of Incomplete Contracts" (1990) 42 Stanford Law Review 927, at 933; In other cases the method is divided into fewer than three groups as it was divided in the federal *Franchise Rule* of the US into to business opportunity franchises and package franchises - See Federal Trade Commission Interpretive Guidelines to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49966, Aug. 24 1979.

usually operates joint advertising programs and other joint programs to the benefit of its franchisees and the franchise system[9]. One of the best known examples of a business format franchise is a fast food franchise system.

1.1.2 The product franchise. In contrast to business format franchises, the emphasis in this group is not on the uniformity of the business method used in the distribution of products but on the products themselves[10]. Usually, only a few selected products are sold in a product franchise outlet[11].

The typical product franchisee identifies himself only by the franchisor's trademark. While the restrictions against selling a competitor's product are generally very strict, the franchisor imposes uniformity and exercises quality control measures over the franchisee to a much lesser extent than the business format franchisor[12]. Recognizable examples of this type of franchise system are gasoline stations and automobile dealerships[13].

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[9]. A.S., Konigsberg, International Franchising (New York: Transnational Juris, 1991), at 1.3.

[10]. For example, the quality of the product itself, which is in the franchisor's hands rather than in the franchisee's hands, is in most cases much more important than the business method by which it is sold.

[11]. See Zendel, supra, note 3, at 141.

[12]. A distinction should be made between a product franchise and mere distributorship. This distinction is not very easy to make. A distributorship usually does not include: strict control over sales methods, a business plan and royalties payments; See also Pattison, supra, note 1, at 1-14: " .. [F]ranchising involves more complex relationships than the simple role of the product distributor"

[13]. L.G., Rudnick, "An Introduction to Franchising" in M., Mendelsohn, International Franchising - An Overview (New York: North Holland, 1984), at 28.

<u>1.1.3 The manufacturing franchise</u>[14]. In this group the franchisor is the owner of a manufacturing method and usually owns a patent as well. The franchisee is granted the right to produce a product according to the franchisor's patent and/or manufacturing method and to sell the product under the franchisor's trademark[15]. Examples of manufacturing franchises are found in the soft drink industry.

In some cases a franchise system is a combination of a business format or a product franchise and a manufacturing franchise. An example of a combination of manufacturing and business format franchise in which the latter is dominant is found in some fast food franchise systems in which the product is both manufactured and distributed by the franchisee.

Since a wide consensus is found in legal literature in relation to the business format franchise as a separate business method, which contains all the special features of the franchise method, this type of business is treated in this thesis as the basic form of franchising within the franchise method. It is submitted that the special components of the business format franchise make it different enough[16] from other business methods to justify special legal considerations when various legal issues are considered.

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[14]. Also described as 'industrial franchise' or 'production franchise'.

[15]. J.E., De Cockborne, "The New Block Exemption Regulation on Franchising" (1989), 12 <u>Fordham International Law Journal</u> 242, at 260.

[16]. A.S., Konigsberg, "An Examination of the Nature of the Relationship Between Franchisor and Franchisee" in <u>Franchises</u> (Toronto: The Law Society of Upper Canada, Department of Education, 1988), A-5: "... [I]t is important to understand that the franchisor/franchisee relationship is a 'special' one that requires original analysis by our courts with regard to this relationship which is peculiar to the business of franchising".

1.2 The common features of the franchise method.

The franchise method can be distinguished from other types of business methods by its special features. The features presented below point out the uniqueness of the franchise business method and are based on the materials reviewed and on what is commonly included in franchise agreements. In the course of the analysis in this thesis the selection of these features will be further clarified.

Five unique features have to be kept in mind:

(1) **Intellectual property.** Some type of an intellectual property is always involved in a franchise relationship. In all three types of franchises, a trademark usually exists, and the license to use it is granted by the franchisor to the franchisee[17]. In the business format franchise, commercial know-how, a part of the "business format" itself, plays an important role side by side with the trademark[18]. In product franchises, the trademark is of paramount importance. In manufacturing franchises, technical know-how and patents are at the centre of the relationship. In most franchises, goodwill rights and trade secrets are also an integral part of the relationship.

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[17]. D., Gurnick, "Nuts and Bolts of Trademark Registration" (Summer 1991), 11 Franchise Law Journal 27, at 27.

[18]. M., Van Empel "Franchising in the EEC: Pronuptia et Post" (1986), 20 Journal of Trade Law 401, at 402: The commentator suggests that the franchise system offers a shortcut to efficient and sophisticated business formulas.

(2) Continuous relationship. The relationship between the franchisor and the franchisee is continuous[19]. On the one hand, the franchisor trains the franchisee and supplies him with guidance and advice. This continuous and up-to-date assistance provided by the franchisor to the franchisee is referred to below as "franchise services"; on the other hand, the franchisor supervises and controls the business conduct of the franchisee to ensure the uniformity of the franchise system and the quality of the products sold in the franchised outlet. The supervision and control of the franchisor over the franchisee is referred to below as "quality control measures"[20].

The continuous connection between the franchisor and the franchisee is an outcome of the continuous supply of franchise services and application of quality control measures by the franchisor in the course of the relationship[21].

The extent of the quality control measures exercised and the franchise services supplied varies from one specific franchise system to another.

(3) Legal relationship. The legal relationship between the parties to a

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[19]. S., Maker, "In Defence of Franchisors: The Law and Economies of Franchise Quality Assurance Mechanisms" (1988), 33 Villanova Law Review 721, at 723.

[20]. V., Korah, Franchising and the EEC Competition Rules, Regulation 4087/88 (Oxford: ESC Publishing, 1989), at 1: "The franchisor has to maintain sufficient control over his franchisees to ensure that the premises look alike and that the goods and services are sufficiently similar for each outlet to contribute to the reputation of the network. Initially, the franchisor gives each franchisee advice as to how to set up and operate the business, and continues to assist it through the duration of the relationship."

[21]. B.J., Walker, "A Comparison of International -vs- Domestic Expansion by U.S. Franchise Systems" in Konigsberg, supra, note 9, at A.2(37) in respect to quality control measures and at A.2(44) in respect to franchise services.

franchise agreement is special, when compared with other business contracts. Even though the franchisor and the franchisee are independent undertakings and the franchisor is not the employer of the franchisee, the franchisee is not an independent party in the usual sense, as, for example is a party to a joint venture agreement.

Two criteria can be used to assess the uniqueness of the franchise legal relationship, the first is the concept of 'ownership' and the second one is the concept of 'control'[22].

In an independent-contracting relationship, each of the parties owns a share of the assets and controls his share of the assets[23] while in an employment relationship the employer both owns the assets and exercises control over them. A franchise relationship is a combination of the functions of ownership. In an independent-contracting relationship, on the one hand, and controi in an employment relationship on the other. The franchisor controls the franchisee's business conduct in a way that resembles the employer's control over an employee in an employment relationship. However, the franchisee owns the outlet and manages it in a way that resembles the ownership of assets by an independent party of a joint venture relationship. Thus, the franchisee is independent to a degree, but when the franchisor exercises quality control measures, the franchisee's independence is necessarily

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[22]. See Hadfield, supra, note 8, at 971: The definition of control is - ".. [T]he authority to determine how an asset (including labour efforts) will be used and/or disposed of. While we often think of ownership as implying control, this need not to be the case.."

[23]. The assets can be labour or knowledge and do not have to be property in the regularly known sense.

reduced[24].

(4) **Types of people that become franchisees.** There are some common characteristics of those who become franchisees. Usually, they are not experienced business people but are individuals[25] who see franchising as the best and least risky way to become owners of their own businesses. In many cases, the individual is transformed overnight from being an employee to being a small business owner. As a result, the relationship between the experienced franchisor and the usually much less experienced franchisee is not as equal as it is usually between two experienced business people. Even if the franchisee is experienced at business, the franchisor generally possesses superior bargaining powers[26]. The business superiority of the franchisor affects the content of the franchise agreement and the way it is exercised between the parties.

(5) **Financial risk.** In contrast to other types of business agreements the financial risk in franchising is to a large extent one party's risk, the franchisee. The franchisee acquires the outlet in which the business is conducted, adapts its appearance according to the requirements of the franchisor, invests his own labour

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[24]. See Van Empel, supra, note 18, at 402: The writer describes the franchise relationship as a compromise between independence and uniformity.

[25]. A.J., Trebilcock, "Structuring the Franchise" in How to Structure and Operate a Franchise System (Conference held in Toronto, May 17, 1984), at III.3 of the conference materials.

[26]. M.H., Ogilvie, "Contracts - Franchise agreement - Exclusion Clause - Economic Duress - Inequatability of Bargaining Powers - Long live Freedom of Contract" (1982), 60 Canadian Bar Review 733, at 737-738.

in it and, in addition, pays the franchisor initial fees and continuous royalties.

The difference between the risk of the franchisee and the risk of an independent small-business owner is that the non-franchised business owner does not pay the various franchise fees in addition to the regular investment in the business. In contrast with the franchisee, the small business owner is also not dependent on the supplying of franchise services from a franchisor for the existence of his business.

When the franchisee's outlet does not commercially succeed, the franchisee suffers hugh financial losses while the franchisor suffers only minor financial losses although his reputation might be damaged[27].

To summarize, the common features of the franchise method are the existence of intellectual property in several forms, the continuous relationship between the franchisor and the franchisee as expressed by the franchise services and in the quality control measures, the uniqueness of the legal relationship between the franchisor and the franchisee as explained through the legal concepts of ownership and control, the common patterns of franchisees which derive the franchisor's superior business experience and bargaining powers, and the high financial risk experienced by the franchisee when establishing a franchise outlet.

[27]. The franchisor might lose some of the franchise system's goodwill and this will make it difficult for him to sell more franchises in the future. Up to that time the franchisor has benefited financially because he had already collected the franchise fees and the royalties.

1.3. The advantages of the franchise method.

There are many advantages to the franchise method and only the main advantages are mentioned here[28]. Franchising is a very convenient tool for a business expansion since the franchisor has to make only a minimal financial investment[29]. While the franchisor has to grant rights in his intellectual property, to provide franchise services and to apply quality control measures, the exercise of these practices requires a small financial investment in comparison, for example, to business expansion through branches. Monies initially invested by the franchisor are recovered reasonably quickly, since the franchisor obtains immediate revenues from the franchise initial fees and periodic royalties[30].

From the franchisee's point of view[31], the transfer of a business formula enables an individual with no previous business experience to start a small business of his own[32], expecting greater chances of success[33] in comparison to a new, totally

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[28]. For a broader discussion, R., Justis, & R., Judd, Franchising (Ohio: South-Western Publishing, 1989), at 34.

[29]. See Korah, supra, note 20, at 1-2.

[30]. See Zendel, supra, note 3, at 140. The franchisor also enjoys the participation of motivated managers, the franchisees, who are committed to the success of their business because they own it.

[31]. A review of the benefits the franchise method provides to the franchisees can be found in Ungar v. Dunkin Donuts 531 F. 2d 1211 (1976), at 1222.

[32]. See Van Empel, supra, note 18, at 402.

[33]. For example, in the United Kingdom, the failure rate of franchisees is only 4% - See R., Cannon, "Franchising in the United Kingdom", a paper submitted at a franchise conference organized by a law firm, Soloway Wright (Ottawa, Ontario: October 18, 1991).

independent, small-businesses owner[34].

The franchise method is beneficial not only to the parties of the agreement but also to consumers because it allows more competitors to enter the retail market. In a franchise outlet the consumer often obtains a better product and pre- and post-sale services. This is due to the quality control measures applied by the franchisor over the franchisee, the interest of the franchisor in maintaining the system's goodwill and the interest of the franchisee in his own business success.

The advantages gained by the parties of a franchise agreement are emphasized in US and Canadian legal literature. In the European context the emphasis is on the benefits of the method to consumers as an outcome of enhancement of competition[35]. This difference in emphasis is a first indication of how franchise agreements are legally dealt with in different ways in the US and the EEC. This difference between the jurisdictions is a main theme in this thesis.

1.4. International and large scale franchising.

When a franchisor makes a decision to 'go international' or to spread his franchise system extensively[36] he may choose to sell franchises directly to potential

[34]. The franchisee cannot be described as independent due to the quality control measures applied by the franchisor and the enforcement of a business formula.

[35]. EEC Press Release, Brussels, 24 June 1987. at 1; See also, EEC Press Release, Brussels, 28 Jan. 1986 at 2.

[36]. See Cannon, supra, note 33, at 1: ".. [A]s economies throughout the world embrace franchising as a method of business expansion and franchise systems mature, there is a tendency for franchisees to seek development outside their domestic markets"; See also E., Kaynak, Transnational Retailing (New York: Walter

franchisees. In that event he provides franchise services and exercises quality controls over the new franchisees by himself, as it is done in small scale franchise systems. This arrangement results in practical problems in the day-to-day connection between the franchisor and the franchisees The franchisor is frequently located in a great geographical distance from its franchisees so that they cannot enjoy the benefits of close relationship which are very important to the success of the method.

The granting of a "master franchisee" over a defined territory[37] is usually a better choice than the above possibility from the franchisor's point of view. A master franchisee receives the right to grant franchises to franchisees in a territory allocated to him by the franchisor[38]. The size of the territory granted to the master franchisee may vary in size from one or several cities to one or more countries[39].

A typical part of a master franchisee agreement is a 'development scheme' in which the master franchisee is required to develop a franchise system in the territory allocated to him up to a certain size within a defined period of time. The development scheme is normally strictly imposed by the franchisor on the master

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de Gruyter, 1988), at 45.

[37]. See Pattison, supra, note 1, at 2-6. Master franchisee is sometimes called an Area franchisee or a sub-franchisor in the legal literature.

[38]. A master franchisee may be the one who actually sells the franchise or he may be only the one who has the right to exercise quality control over the franchisees and the duty to provide franchise services to them, while the franchisor reserves the right to sell the franchises himself.

[39]. See the definition of master franchisee in the EEC Regulation 4087/88 on franchising, OJ L359, 23.12.1988, p. 46, at article 3(c): "... [T]he right to exploit a franchise for the purposes of concluding franchise agreements with third parties, the franchisees". The regulation is broadly discussed below.

franchisee[40].

Both legal and practical differences exist between a master franchisee agreement and a regular franchise agreement:

> ".. [A] master franchise agreement is not truly a franchise agreement but is more in the nature of an 'umbrella' type agreement, which gives the sub franchisor the right to enter into unit-sub-franchise agreements"[41].

The considerations governing the legal relationship between the franchisor and the franchisee are not always similar to those influencing the legal relationship between the franchisor and the master franchisee.

1.5 The interested parties.

To standardize the terminology used in this thesis[42] the different participants in a franchise system are briefly reviewed. **The franchisor** owns intellectual property rights and a developed business formula. He grants a license (i.e a franchise) to the franchisee to use these rights in exchange for franchise fees and royalties. **The franchisee** accepts the franchise to run an outlet under the franchisor's trademark, goodwill, business know-how and control. **The master franchisee** functions in

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[40]. M., Abell, The International Franchise Option (London: Waterlow Publishers, 1990) at 100: Chapter 8 of the book discusses the development schedule.

[41]. See Konigsberg, supra, note 9, at XV.IV.7.

[42]. Some vagueness was caused by terminology differences in legal literature and legislation in regard to franchising; See also, The International Bar Association, Section of Business Law, International Franchise Committee, International Franchising: Commonly Used Terms (London: The Association, 1989).

international franchise systems and in widespread national franchise systems and is usually granted the right to sell franchises to franchisees in a defined territory; in other cases, the master franchisee is only allowed to provide franchise services or exercise quality control measures without himself selling the franchises. **The supplier** is the person whom the franchisor signs agreements with to achieve good prices and good quality for his franchise system so that he can maintain the system's financial viability and goodwill. Usually the franchisee is required in the franchise agreement to buy the franchise products only from the franchisor himself or from suppliers authorized by him[43]. **The customer** is the end-user who buys the franchised product from the franchisee (i.e. the goods or the service). The role of the customer in a franchise system is important to keep in mind since it will figure in the evaluation of the method in general and the treatment given to it under competition/antitrust laws.

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[43]. It is noteworthy to mention that this provision in the franchise agreement might create 'third parties' rights to suppliers even though they are not formal parties to a franchise agreement. This may have different legal implications in different jurisdictions.

2. Legislative aspects of the franchise method.

2.1 General introduction to franchise specific legislation.

2.1.1 The origins of franchise legislation.

The franchise method was first developed in the US and its roots are in governmental franchises for production and distribution of public utilities[44]. The first private company to use a franchise system to distribute its product in the United States was the Singer Sewing Machine company, as early as 1860[45].

In the early days of the 20th century, automobile dealers and soft drink franchised bottlers appeared in the US and by 1930 the oil companies gave up their traditional company-operated outlets and established franchisee outlets[46].

The era of modern franchising, dominated by business format franchises, began after World War II in the United States:

> "..[I]t provided an alternative means of supplying goods and services to the country which was experiencing enormous growth in population,

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[44]. A., Young, Franchising in the UK (London: Adlers, 1988), at 3: In the U.K. it was argued that the roots of franchising are with practices exercised in the distant past - "The Baronial system, dating back as far as the England of Norman times, possessed many of the elements which are common in franchising today. The Barons, having been granted territories by the king, represented him in their areas and collected and paid royalties .."; It is interesting to note that in ancient times a franchise included, by definition, an allocation of an exclusive territory.

[45]. See Kaynak, supra, note 36, at 43.

[46]. C.R., Rosenfield, The Law of Franchising (New York: The Lawyers Co-operative, 1970 & Supp. 1972), at 4-7.

incomes, and marketing opportunities".[47]

In the era of modern franchising two main directions of legislative development are identified. The first direction is the "protective" legislation which was largely enacted in the US and is very dominant in it. The second direction is the competition legislation which is unique to the EEC. These two types of legislation are referred to below as "franchise specific legislation". The absence of franchise specific legislation in a particular jurisdiction does not mean that franchising escapes legal scrutiny but only that franchising is treated under the general legal rules of that jurisdiction[48].

By enacting franchise specific legislation, the legislature reveals two concepts; first, it reveals that the legislature consider franchising, as defined by it, a separate type of business method, different enough from other types of businesses to qualify for a distinct legal treatment; secondly, it reveals what problem does the legislature finds dominant in respect to the franchise relationship, and what it considers to be the best regulatory approach toward that relationship [49].

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[47]. See Zendel, supra, note 3, at 138. This citation can be used to describe Europe's 1992 economic situation.

[48]. See Pattison, supra, note 1, at 1-6; Example for general laws are those regulating antitrust, securities, technology transfer and general liability.

[49]. See also Konigsberg, supra, note 9, at III.I.1.: "... [I]t is the basis upon which to evaluate the viability of franchising in a particular country..".

2.1.2 The problematic relationship between franchisor and franchisee.

The widespread use of the franchise method in the modern era led to a wave of fraud and deception in the US[50]. This phenomenon was caused, in part, by the unequal bargaining powers of the parties to a franchise agreement, the inexperience of franchisees, the financial attractiveness of the franchise method to prospective franchisees and franchisors[51] and the fact that in this type of business, one side, the franchisee, bears the financial risk to a very large extent. All these factors left franchisees vulnerable to unscrupulous franchisors.

Finance frauds had two main patterns. First, there were frauds by so-called, 'fly by night' franchisors[52], who sold franchises to innocent franchisees; the franchisees paid franchise fees and in addition invested in the acquisition of the outlet and then found themselves without a business, franchise services or supplies, because the franchisors who sold them the franchises had soon disappeared[53]. The main cause of this problem was identified by US authorities as the lack of up-to-date and sufficient information supplied by the franchisees prior to the franchise

50. Senate Committee on Commerce, The Fairness in Franchising Act, S. Rep. No. 74, 94th Cong., 2d sess. (1976).

51. Case 161/84 Pronuptia de Paris GmbH v. Pronuptia de Paris Irmgard Schillgalis [1986] E. Comm. Ct. J. 353, at 368, [1986] 1 C.M.L.R. 414: The Advocate General says that the franchise agreements are ".. extraordinarily attractive to franchisors as a new distribution method" (this is the leading franchise case in the EEC).

52. H., Brown, Franchising - Realities and Remedies (New York: Law Journal Seminars Press, 1991), at 1-7.

53. In many cases the franchisor did not own, or was not able to provide, developed business method, intellectual and industrial property rights or franchise services and quality control measures.

transaction.

Secondly, franchisors who exercised their superior bargaining powers and business experience, made the franchisees sign one-sided agreements. These agreements gave franchisors virtually unlimited powers, caused unfairness in the franchise relationship and deprived franchisees of their rights. Quality control measures were many times used by the franchisors for collateral purposes, in a way which was not meant to achieve the real objectives of the measures - to ensure the quality of the business and the product. The most common clauses used in this connection were the termination and non-renewal clauses[54]. Instead of using these provisions only when a franchisee did not comply with the quality standards of the franchise system, some franchisors used these provisions to cancel the right of franchisees in successful franchised outlets and to sell the franchise to another franchisee, often for higher royalties.

Another problem of the franchise method was not only the inexperience of the franchisees but also the inexperience of the franchisors. Sometimes franchisors did not understand the needs and uniqueness of a franchise system, as for example, the continuous relationship feature of the franchise method, and aimed only for quick and easy expansion capital.

[54]. See Abell, supra, note 40, at 236-237.

2.1.3 The types of franchisee's protective legislation.

In response to the problems described above, legislative initiatives were designed to protect the franchisee from dishonest and inexperienced franchisors[55]. Thus, federal and state legislation is found in the United States[56], provincial legislation is found in Canada[57] and various types of legislation to protect the franchisee are found in other parts of the world[58].

The EEC member states and the EEC itself did not find that the risk of abuses by franchisors in franchise relationships should be dealt with through legislation specifically regulating the franchise method. Thus, there is no franchise protective legislation at the EEC level and among the EEC member states only France has legislation for the protection of franchisees. The French legislation is very

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[55]. See Young, supra, note 44, at 4; See also Konigsberg, supra, note 9, at III.II.3; See the legislative intent as expressed in California's *Franchise Investment Law*, Cal. Corp. Code, s. 31001: ".. [I]t is the intent of this law to prohibit the sale of franchises where such sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled"; See also in Nebraska's *Franchise Practices Act*, Neb. Rev. Stat., s. 87-401: "The legislator finds and declares that distribution and sales through franchise arrangements in the state vitally affect the general economy of the state, the public interest and welfare. It therefore necessary in the public interest to define the relationship and responsibilities of the franchisors and the franchisees in connection with franchise arrangements".

[56]. The world's first franchise legislation was the Californian *Franchise Registration and Disclosure Act*, Cal. Corp. Code s. 31000, enacted in 1970; See, infra, at paragraph 2.2.2.

[57]. Alberta's *Franchises Act* R.S.A. 1980, c. F-17; See, infra, at paragraph 2.2.1.

[58]. For example, the Australian (federal) franchise legislation contains a complex procedure for disclosure of information and other regulation. See W., Pengilley, "International Franchising Arrangements and Problems in Their Negotiation" [1988], New Zealand Law Journal 79, at 83; See also T., D'Aloisio, "International Franchising - Australia" (1988), International Business Law Journal 99, at 99; See also, as examples, the situation in Japan and in Brazil: R.A., Lipstein, "International Franchising and Distribution: US and Foreign Law Countries" (1988), 16 International Business Lawyer 414, at 415.

moderate in comparison to the legislation in the US[59].

Franchise protective legislation can be divided into four main groups[60]. The first group imposes **disclosure requirements** of various financial, contractual, personal and other details connected to a specific franchise business[61] (hereinafter - disclosure legislation). The requirements vary from jurisdiction to jurisdiction - from wide and detailed disclosure requirements to general and unspecified disclosure requirements.

Under this type of legislation the franchisor is required to supply the disclosed information directly to the franchisee prior to the conclusion of a franchise agreement, using a format prescribed by the legislator. There is no public official involved in the process and the disclosure is done directly by the franchisor to the franchisee[62].

The second group imposes **registration requirements**, added to the disclosure requirements (hereinafter - registration legislation). The franchisor must have his standard offer of a franchise approved and registered by a public official. After the

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[59]. The French legislation is moderate because it is of the disclosure type. It does not include registration requirements. For a description of this legislation see Konigsberg, supra, note 9, at III.1.2.

[60]. J.B., Kobak, "Significant Factors in the Franchisor-Franchisee Relationship" (1987), 32 New York Law School Law Review 795, at 795-796: The writer divide the legislation into two groups only - "procedure" regulations and "substantive" regulations. The former group includes registration and disclosure legislation and the latter group includes relationship legislation.

[61]. The information required may include, for example, details related to the history and the background of the franchisor and the individuals associated with it, the nature of the franchise and the proposed terms of the franchise agreement.

[62]. In some cases a "Notice" legislation system is applied. Under this system the franchisor registers only his name and address in a registration office and files a declaration of his intention to sell franchises in the particular jurisdiction. In addition to the notice, the franchisor have to supply full disclosure directly to the franchisees as in regular disclosure legislation.

information submitted to the public official has been approved and registered[63], the franchisor is required to disclose the approved information to the franchisee prior to the franchise sale[64]. The information is usually submitted to the public official in a similar format used by franchisors under disclosure legislation.

Thirdly, and more rarely found in countries that regulate franchising, is legislation that **regulates the relationship** between the parties of the franchise agreement[65] (hereinafter - relationship legislation). The main thrust of this type of legislation is to regulate the terms under which the franchisor may terminate a franchise agreement or the terms under which the franchisor may refuse a renewal of the franchise agreement with the same franchisee for an additional period[66]. Under these laws the franchisor is normally required to have a "good cause", defined differently in different laws[67], for termination or non-renewal of a franchise

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[63]. An example to the wide discretion of the public official is found in South Dakota law - *Franchises for Brand Name Goods and Services* - S.D. Codified Laws Ann., s. 37-5A-38: "Conditions Imposed on Registration By Director: The director shall have power to place such conditions, limitations and restrictions on any registration as may be necessary to carry out the purposes of this chapter"

[64]. The registration requirements have been criticized. See, for example: Alberta, Department of Consumer and Corporate Affairs The Alberta Securities Commission Discussion Paper (Edmonton, The Department, 1988), at 75: ".. [I]t is not clear that this paperwork in fact achieves the goal of facilitating fairer bargaining between unequal parties".

[65]. See Konigsberg, supra, note 9, at III.II.3

[66]. Under relationship legislation the way the franchisor exercises his contractual rights is regulated; See T.M., Pitegoff, "Franchise Relationship Laws: A Minefield for Franchisors" (1989), 45 Business Lawyer 289, at 291-292.

[67]. The definition of the term "good cause" is varied from one jurisdiction to another especially under the U.S. states' franchise legislation; See M., Fern, & P.I., Klein, "Restrictions on Termination and Non-renewal of Franchises: A Policy Analysis" (1981), 36 Business Lawyer 1041, at 1044-1045; Usually 30 - 90 days of prior notice of alleged breach of contract will be required to be provided to the franchisee. In most of the laws of this type an opportunity to cure the breach is given to the franchisee before the franchisor is eligible to argue that he has a 'good cause' for legal action.

agreement[68]. The legislative requirements are imposed regardless of the clauses stipulated in the franchise agreement itself. This type of legislation has been criticized because it is said to have a severely negative impact on the principle of freedom of contract. It is interesting to note that several relationship laws explicitly ensures that the franchisee will not suffer competition from the franchisor in the franchisee's exclusive territory[69];

Fourth, is **specific relationship legislation** for specific areas of trade. This legislation exists in the most attractive and widespread fields of product franchises such as automobile dealerships and gasoline stations[70]. This legislation regulates the contractual relationship between the parties of a product franchise agreement, but it differs from the general relationship legislation discussed above because its provisions are normally more comprehensive and regulate more details of the legal relationship between the parties[71]. This type of legislation is outside the scope of this thesis since it does not concern business format franchises in general.

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[68]. This legislation is a clear attempt of the legislature to offset the franchisor's superiority over the franchisee. The courts are not interested in the overall long term interests of the franchisor or in the possibility that he will be more profitable if he uses another method. The legislation has been interpreted by courts in a franchisee protective manner. It seems that this kind of legislation tends to limit free competition in the area of franchising; See Kobak, supra, note 60, at 799.

[69]. These special clauses are dealt with below when analysing the legal policy towards territorial exclusivity found in the US protective legislation.

[70]. Forty nine of the US states enacted legislation to regulate the relationship between the parties of automobile dealership agreements; See for example, in New York - N.Y. Gen. Bus. Law, s. 11-A-197. See also the gasoline station legislation in N.Y. Gen. Bus. Law, ss. 11-B-199(a) - 199(k).

[71]. Examples for details regulated in specific relationship legislation are: 1. disposition of the franchise upon death of the franchised dealer; 2. the sale of goods and parts by the franchisor to the franchisee; 3. additional franchisees in the franchised territory; See Kobak, supra, note 60, at 796: the basic concepts of the general and the specific legislation are similar.

2.2 Franchise specific legislation in the world.

2.2.1 Canada:

In Canada only one province, Alberta, has enacted franchise specific legislation[72]. The *Franchises Act*[73] is protective legislation of the registration type[74]. It is administered by the Securities Commission of Alberta. The structure of the *Franchises Act* is reviewed here as a general example for franchise registration legislation.

In addition to the standard franchise agreement itself, a statement containing a long list of "material facts" related to the franchise business is required to be filed in a "full, true and plain" manner and in a specific format in order to be registered. The registrar holds discretionary powers to approve or to reject a registration, or alternatively, to exempt franchisors from registration[75].

The registrar requires the franchisor to demonstrate sufficient financial resources and business experience to be able to provide the product and the

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[72]. However - "There are continuing indications that franchise legislation is being studied in the province of Ontario, confirming the ongoing interest of legislators and policy makers in franchising as a separate industry" - See F., Zaid, "Federal Legislation and Recent Case Law Affecting Franchising" in Franchising (Toronto: The Law Society of Upper Canada, 1988), at G-1; See also T., Gilbert, D., Thomson, & P., Dabbikin, Franchising in Canada (Toronto: CCH, 1986) at 24.

[73]. See Alberta's *Franchises Act*, R.S.A. 1980, c. F-17; see also L.H., Polsky, Franchising in Canada, Paper submitted at International Bar Association symposium (Washington D.C.: May 7-8, 1990).

[74]. See the Discussion Paper, supra, note 64, at 73-76.

[75]. Alberta Securities Commission, Policy 3.1 pursuant to *Franchises Act*, effective May 25, 1990.

franchise services outlined in the franchise agreement[76]. The content of the franchise agreement is examined very carefully by the registrar who may impose changes in the termination, renewal, transfer or other provisions of the agreement[77]. Franchise trade is forbidden prior to proper registration unless an exemption from registration has been granted. The franchisee must receive the disclosure file in the same format it was approved for registration by the registrar[78].

In all other Canadian provinces there is no special legislative treatment for franchise agreements[79], although other general laws, not specifically meant to regulate franchising, govern unfair conducts in franchise agreements as they generally govern many other types of agreements[80].

In an attempt to achieve uniformity in potential franchise legislation in the different Canadian provinces, the Uniform Law Conference of Canada suggested in 1980 a *Uniform Franchise Act*[81]. The suggested *Uniform Franchise Act* is divided into

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[76]. Alberta Securities Commission An Introduction to Franchising in Alberta - for Franchisors (1986), at 6.

[77]. In contrast to relationship legislation, these clauses are examined here at the pre-sale, phrasing stage; See L.H., Polsky, "Franchise Regulation in Alberta" in Franchising (Toronto: The Law Society of Upper Canada, 1988), at H-17.

[78]. As indicated in the Discussion Paper, supra, note 64, at 74, the registration requirements are not cost-free: "On the negative side, there is a significant cost to franchisors for the legal services required to comply with the Act. These costs and inconveniences associated with franchises legislation may be significant enough to cause potential franchisors to stay out of Alberta. Also, the franchise legislation imposes administrative costs on the public purse of the province".

[79]. Product franchise legislation that existed in New Brunswick was repealed in 1988 almost immediately after it was enacted.

[80]. For example Ontario's *Business Practices Act* R.S.O. 1990, c. B-55.

[81]. The *Uniform Franchise Act*, in Uniform Acts of The Uniform Law Conference of Canada (Toronto: Uniform Law Conference of Canada, 1991), at 18c-1.

a part on disclosure requirements and a part regulating the relationship between the franchisor and the franchisee, including termination and renewal of franchise rights.

It is noteworthy that even though the only existing franchise legislation in Canada, the *Franchises Act* of Alberta, requires registration, the Uniform Law Conference recommended for disclosure requirements only, which are easier to comply with from the franchisor's viewpoint but are less protective of the franchisee.

2.2.2 United States:

The US is highly regulated[82] by over a hundred **state laws** dealing specifically with franchising, one **federal rule** which regulates franchise systems in general directly[83] and two federal laws which govern franchise agreements for specific products only[84].

> "While disclosure guidelines have been established by governmental entities or voluntary associations in some countries, such guidelines are quite brief and flexible compared to the analogous U.S. standards established by the Federal Trade Commission and various state authorities"[85]

[82]. See Andrews, supra, note 4, at 19.

[83]. See the *Franchise rule*, infra, note 86; see also Ibid., at 13: "...[A]merican disclosure requirements are far more extensive than in any European country". Indeed, the US is the most highly franchise regulated country in the world.

[84]. *Automobile Dealer's Day in Court Act*, 15 U.S.C. ss. 1221 - 1225 and *Petroleum Marketing Practices Act*, 15 U.S.C. ss. 2801 - 2806.

[85]. See Pattison, supra, note 1, at 1-5.

The federal *Franchise Rule*[86] was enacted by the Federal Trade Commission[87] (hereinafter - the *Franchise Rule*). It is a disclosure rule and does not require registration. It applies only when state legislation for franchising does not exist or when the state franchise legislation is less strict than the federal rule[88]. The existence of the federal *Franchise Rule* means that the franchise method is specifically regulated, at least by disclosure requirements, in each US state.

The US franchise specific legislation as enacted in the different states and at the federal level is unique in the world. In no other jurisdiction does franchise specific legislation consist of all four possible types of protective legislation.

Only two states, Oregon and Michigan, have disclosure legislation[89]. Most of the franchise regulating states have registration legislation which is basically similar to the *Franchises Act* of Alberta, described above[90]. These laws require an approval and registration of a comprehensive offering circular. The circular must be approved by a public official and has to be submitted to the franchisee between 2 and 10 days

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[86]. *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures* 16 C.F.R., s. 436.1 et post.

[87]. Because the FTC is involved, a failure to comply with the *Franchise Rule* is treated as an "unfair act" or a "deceptive act" under the *Federal Trade Commission Act* 15 U.S.C. s. 45 et post. This may result in civil penalties imposed by the FTC.

[88]. See FTC guidelines, Supra, note 8, at 10.

[89]. Oregon: *Franchise Law*, Or. Rev. Stat., ss. 50-650.005 - 650.085; Michigan: *Franchise Investment Law*, Mich. Comp. Laws, ss. 445.1501 - 445.1545.

[90]. See for example: Minnesota's *Franchise Law*, Minn. Stat. ss. 80C.01 - 80C.22; New Jersey's *Franchise Practices Act*, N.J. Rev. Stat. ss. 56:10-1 - 56:10-15.

prior to sale of a franchise[91].

Some states have franchise relationship legislation, either separate or combined with registration requirements in the same law[92]. This type of legislation usually deals with termination and non-renewal but in some cases covers other subjects in the franchise agreement as well, such as the scope of the territorial exclusivity granted to the franchisee.

Almost all states have franchise legislation on specific products[93], and, at the federal level, two laws exist, one which regulates automobile dealership agreements and the other, gasoline station operating agreements[94].

Those states which have franchise laws that require registration jointly developed the Uniform Franchise Offering Circular (hereinafter - the UFOC)[95]. This is a **uniform format** to satisfy registration requirements and is accepted by all the concerned states. An alternative to this format, also accepted by most of these states, is the format of the disclosure document under the *Franchise Rule*[96]. These

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[91]. See, for example, the New York state *Franchise Sales Act* Gen. Bus. Law, s. 680 et post. The New York department of law will rarely approve an 'offering prospectus' for registration without changing one or more of the franchise agreement provisions; See 60 NY Jur 2d franchises chapter, s. 29.

[92]. See for example: The *Retail Franchising Act* of Virginia, Va. Code Ann., Ch. 8, ss. 13.1-557 - 13.1-574; The *Franchise Investment Law* of Wisconsin, Wis. Stat. Ann. s. 553.01 - 553.78; The *Franchise Disclosure Law* of Indiana, Ind. Code, Ch. 23-2-2 ss. 5-1 - 5-50.

[93]. In the fields of automobile, petroleum and liquor retailing.

[94]. See supra, note 83.

[95]. Uniform Franchise Offering Circular, NASAA Reports (Chicago: CCH), at s. 4001, p. 2201; The UFOC was adopted by the Midwest Securities Commissioners Association in 1975.

[96] In the adoption of the UFOC and the acceptance of the *Franchise Rule* format, a tendency towards unification of the regulation of the franchise method in the US can be identified.

two frameworks for disclosure are not identical, however, the nature of the information required to be disclosed is basically the same.

The disclosure format of the UFOC is also accepted in Alberta, under its legislation, with only minor adjustments being required[97].

The diversity of the US franchise specific legislation has led to attempts to develop a uniform law. Two model franchise acts now exist in the US. The first is the *Uniform Franchise and Business Opportunities Act*[98], suggested by the National Conference of Commissioners on Uniform State Law (NCCUSL) in 1987. This is a disclosure type legislation that was recommended by the Conference for enactment in all the states. The current legislation existing in most states is of the registration type.

The second suggestion of a model for state franchise legislation was made by the North American Securities Administrators Association (NASAA). The NASAA introduced in August 30, 1990[99] the *Model Franchise Investment Act*, a registration type legislation[100].

Neither of those model acts has been adopted to date by any of the states, but the possibility still exists that one of the model acts will be adopted in the future

[97]. See Konigsberg, supra, note 9, at III.II.5.

[98]. NCCUSL, 96th Annual Meeting, California, July 31, 1987. As cited at G., Glickman, Franchising (New York: Matthew Bender), at vol. 3, appendix E.

[99]. NASAA Reports (Chicago: CCH, 1990) p. 3145, S. 4301 et post.; See also as cited at Glickman, Ibid., at Vol. 3, appendix F.

[100]. This is not surprising given the fact that the suggestion was made by the officials who administer the existing franchise registration laws; See D.M., Bollinger, "Model Franchise Investment Act. Dances With Wolves" (Winter 1991), 10 Franchise Law Journal 3, at 5.

either by states changing their existing franchise specific legislation, or by states which do not yet possess franchise specific legislation[101].

2.2.3 Europe:

In Europe the development of the franchise trade method[102] did not result in the adoption of the US approach to franchise legislation. The undesirable results of the franchise method's rapid development in the US were severe, as mentioned above, and influenced federal and state legislators to enact various types of protective legislation for franchisees. The US protective legislation and bad experiences with respect to franchises trade influenced the legislators of other jurisdictions in the world to consider the protection of franchisees by regulating the franchise method[103].

In spite of the US experience, neither the majority of the legislators of the EEC member states nor the EEC authorities saw fit to enact franchise protective

[101]. For the various considerations regarding the possible adoption of the NASAA's Model Act, see D.E., Wieczorek, "The Model Franchise Investment Act. A Field of Dreams" (Winter 1991), 10 Franchise Law Journal 1, at 31.

[102]. See Press Release 24.6.1987, supra, note 28, at 1: "Franchising agreements have developed considerably in the community during recent years as a new form of marketing. The 85,000 franchised outlets, belonging to 1500 franchise networks... They are particularly important in sectors such as clothing, fast food, car rentals and hotels"; See also D.W., Fox, "Distribution Franchising Under EEC Law" (1987), Solicitors' Journal 378, at 378: ".. [H]as become highly popular in the EEC countries during the past decade or so".

[103]. Example of jurisdictions which have introduced legislation but have not followed through with it are Australia, Sweden and the Province of Quebec in Canada. See Konigsberg, supra, note 9, at III.I.1, Footnotes 1-3.

legislation[104]. As mentioned above, the only EEC member state that adopted franchise legislation was France, which did so only in 1989. The French *Pre-Sale Disclosure Act*[105] is not limited to franchise agreements but regulates all agreements in which exclusive rights have been granted. This French legislation is of the disclosure type and requires the franchisor to provide to the franchisee a disclosure document that includes "honest information" about details mentioned in a wide and general manner in the law[106]. The law does not require the franchisee to obtain administrative registration of any kind, nor does it require the information to be disclosed in a special format.

When compared to the protective measures in the US and in the province of Alberta, the French legislation is exceptionally moderate. There is no administrative interference in the franchise sale process under the French legislation and the disclosure requirements are much less detailed than those commonly found in the US.

The United Kingdom (the UK) is an example of that majority of EEC member states which have no franchise specific legislation even though the franchise

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[104]. A.S., Joslyn, "Legislative Definition of the Franchise Relationship" (1987), 32 New York Law School Law Review 779, at 779.

[105]. G., Sautereau, Franchising in France, Paper submitted at a franchise conference organized by law firm, Soloway Wright (Ottawa, Ontario: October 18, 1990), at 10: "... [T]he committees work had stressed out the importance and necessity of pre-sale disclosure by franchisors to franchisees before the execution of any agreement and the necessity to have a specific legislation on that point."

[106]. Examples of the information to be disclosed are details about: experience, growth possibilities, termination & renewal & transfer and exclusivity. The disclosure document is to be provided to the franchisee 20 days before the execution of the franchise agreement.

method is well known and widely used in their jurisdictions[107].

In the UK, as well as in most of the other EEC member states, a strong franchise trade association exists[108]. The association attempts to compel its member franchisors to comply with a voluntary code of ethics[109]. The code of ethics encourages the standardization of the franchise agreements and attempts to prevent the inclusion of unfair provisions in them[110]. It is not difficult to identify in the codes of ethics of franchise associations in the EEC member states, the influence of the US franchise protective legislation. The European franchise associations are members of the European Franchise Federation (hereinafter - the EFF)[111]. The EFF published in 1981 the "European Code of Ethics - Franchising"[112]:

> "The European Code of Ethics for Franchising provides that franchise contracts should be fair and designed to ensure good management practices, and should be drawn up in clear terms in the national language of the franchisee"[113]

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[107]. See Young, supra, note 44, at 12.

[108]. See Andrews, supra, note 4, at 18: "... [M]ost EC member states now have franchise trade associations, which coordinate their efforts through the European Franchising Federation ..."

[109]. See Cannon, supra, note 33, at 4; See Young, supra, note 44, at 10-11.

[110]. European Community Commission, The Cooperation Between Firms in the Community - Franchising (Brussels: The Commission, 1978), at 11.

[111]. For more details about the EFF and its code of ethics see Konigsberg, supra, note 9, at A.5(2) - (3).

[112]. In Europe Nov. 26, 1981 - "Commerce: European Commission has Published 'European Code of Ethics for Franchising"; The obligations of the parties should be defined in clear terms in a contract written in the national language of the franchisee; See Pattison, supra, note 1, Item 6: "European Code of Ethics For Franchising".

[113]. See Pattison, supra, note 1, at 11-4: It is specified in the Code of Ethics that "The franchise contract will specify in particular the points set out below, it being understood that the provisions adopted will be consistent with the national or community law.... - the definition of 'open territorial rights' granted to the franchisee, including options (if granted) on adjoining territories".

Despite the present paucity of franchise protective legislation in Europe, one can argue that these associations and their codes of ethics do offer a satisfactory, although voluntary, substitute for formal legislation and have helped to prevent the problems that had appeared in the US. One can also argue that due to the strong status of franchise association in Europe, no specific EEC legislation to protect franchisees is required either at the EEC level or at the level of the EEC member states. It should not be forgotten, however, that although the franchise associations contribute to the protection of franchisees, their primary concern is to preserve the interests of franchisors.

The EEC has neglected the possibility of specific legislation to protect franchisees. The attention of the EEC has, instead, been focused on the application of EEC competition law to franchise agreements, beginning with the well known Pronuptia judgement[114], which started a new legal discussion in Europe about the legal aspects of franchising. It eventually led the EEC Commission to adopt a 'block exemption' regulation for franchise agreements, which excluded them from the prohibition against anti-competitive practices of the *EEC Treaty*. This regulation is the first and only piece of franchise specific legislation at the EEC level and will be further discussed below.

[114]. See Pronuptia judgement, supra, note 51.

3. Conclusions.

In focusing on franchising in the US and the EEC, two different approaches taken by legislators in two highly industrialized parts of the world can be compared. The US has concentrated on measures intended to protect the franchisee from the risks he might experience when entering into a franchise agreement. The *Federal Rule* and the different US state laws fulfil this protection purpose to a varied extent because some laws are more strict than others, from the franchisor's viewpoint.

In the Europe, protective legislation is a rare exception and the franchisee is protected mainly indirectly by franchisors' associations imposing strict rules, in the form of codes of ethics, upon their members[115].

The recent developments in the EEC competition law which have resulted in competition legislation being enacted to regulate franchising should be considered carefully, since in the absence of EEC franchise legislation to protect franchisees, it is the only set of rules at the EEC level which govern, and which therefore affect, franchise systems directly.

[115]. It is assumed that the EEC franchisors organized themselves in this way anticipating that otherwise their governments might adopt US style legislation. It is clear that self imposed restrictions are less threatening and less expensive to comply with than formal legislation, and therefore preferable to franchisors.

Chapter II

FRANCHISING AND COMPETITION LAW IN THE EEC.

As discussed above, two main kinds of legal treatment were given to franchising. The first is franchisee's protective legislation dominant in the US, and the second is franchise competition legislation dominant the EEC. In this chapter, the development of the franchise competition legislation in the EEC is traced.

The central issue in the course of the development of the franchise legislation in the EEC was that of territorial exclusivity in franchise agreements. Territorial exclusivity is primarily meant to defend the exclusive rights of the franchisee in the territory allocated to him by the franchisor. Territorial exclusivity also permits the franchisor to exercise quality control measures effectively over the franchisee[116].

There are three main types of territorial restrictions that establish territorial exclusivity in franchise agreements:

1. a restriction preventing the franchisee from exploiting the franchise outside an outlet approved by the franchisor; this restriction is also known as a "location clause". When all the franchise agreements in a franchise system include a location clause the effect is a division of territorial zones among the franchisees.

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[116]. For a survey of more benefits and purposes of territorial exclusivity in franchise agreements, see infra, Ch. III, at paragraph 2.7.2.3.

2. a restriction over the franchisor, to prevent the franchisor himself from opening another outlet in the franchised territory.

3. a restriction over the franchisor, to prevent him from authorizing third parties to open franchised outlets in the allocated territory.

It should be kept in mind that territorial exclusivity is usually subject to intensive negotiation between the parties of a franchise agreement. The extent of the territorial exclusivity is an outcome of a compromise between the interests of the franchisor and the franchisee. The franchisee tends to seek the broadest possible territorial protection for his outlet, while the franchisor tends to narrow the territorial protection in order to keep for himself the option of expanding the franchise system. The franchisor may reserve to himself the right to place his own outlet in the franchised territory, or otherwise not insist on including this right in the franchise agreement but charge higher franchise fees or royalties.

The emphasis on territorial exclusivity in the legal materials discussing the franchise method in the EEC, was a main reason why this thesis concentrates on the legal approach towards territorial exclusivity in the franchise method[117].

Territorial exclusivity serves as an instrument in the comparison of approaches between the EEC and the US and permits the crystallization of the conclusions that are drawn from this comparison.

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[117]. See Pattison, supra, note 1, at 3-6: "Territorial restrictions are of critical concern to many international franchises, ... The legal and business consequences of such restrictions can be profound".

1. Competition law in the European community.

1.1 General introduction.

1.1.1 The role of competition law in the EEC.

"Jean Monnet, one of the European Communities' founding fathers, said that the whole *EEC Treaty* is about competition"[118]. Free competition is today, still, one of the EEC's main concerns, if not its central concern:

> "It is now widely accepted that the benefits which are expected to flow from an internal market presuppose the existence of a system of healthy competition, where firms are free to vie with each other for consumers by offering the highest quality product at the best price"[119].

Competition law is a means to achieve economic goals[120]. The economic theory is that freer competition between enterprises in the market has the potential of achieving best economic results through an improvement of price levels and quality of goods and services. Competition law is actually a legal application of economic theories. Therefore, due to the dynamism of economic theories:

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[118]. S.A., Crossick, "Franchising in Europe - EEC" in Mendelshon, supra, note 9, at 335: .

[119]. Sir L., Brittan, Competition Policy, a paper submitted to the Centre for European Policy Studies (Brussels: 15 July, 1991), at 4.

[120]. Some commentators do not accept the premise that the main aim of competition law is economic, for example, in N., Green, T.C., Hartley & J.A., Usher, The Legal Foundations of the Single European Market (Oxford: Oxford University Press, 1991), at 198: " .. [C]ompetition law is a fluid, dynamic instrument which has the capability of changing to meet developing economic and political situations. Thus, it is not accurate to describe any specific purposes as the main objective. Rather, one must view the rules of competition as serving different purposes at different points of time in history".

"..[C]ompetition policy [is a] somewhat slippery concept whose scope is the subject of considerable debate"[121].

Competition law is regarded as having a very important role in the development of the common market. It has been said that a common market could have never been achieved without efficient rules of competition[122]. Therefore, in the EEC, competition law has more than a merely economic role; it is considered to have, in addition, a direct political role. Its political role is to eliminate barriers to trade between the EEC member states[123] to permit the economic union[124] in the Common Market.

1.1.2 The competition law articles in the *EEC Treaty.*

The broad objectives of EEC competition law were set down in Articles 2 and 3 of the Treaty of Rome[125] (hereinafter - the *EEC Treaty*)[126]. In Art. 2 the goals of the *EEC Treaty* in general are found:

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[121]. See Brittan, supra, note 119, at 1.

[122]. See De Cockborne, supra, note 13, at 243.

[123]. See Pattison, supra, note 1, at 6-3: ".. [S]trong hostility among community officials to any form of national market protection .. the EEC strong prejudice against territorial restrictions results in close scrutiny of such contracts".

[124]. The precise definition of the term 'economic union' it outside the scope of this thesis. The usage of the term is done here as a referral to a state of economic integration between several jurisdictions

[125]. The European Economic Community was formed by the six original member states (now twelve member states) in 1958 under the Treaty of Rome.

[126]. See Appendix I, for the full text of these Articles.

"...[T]o promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an acceleration of the standard of living and closer relations between the states belonging to it".

Art. 3 provides the general means to be used in order to achieve the goals specified in Art. 2. In the Art. 3 list, one of the means specified is, at paragraph (f):

"The institution of a system ensuring that competition in the common market is not distorted".

The specific means to achieve a system of undistorted competition are found in Articles 85 to 94 of the *EEC Treaty*. The basic objective of these articles is the protection of:

" ... [A] system of competition which encourages efficient production, technical progress and fairness towards the consumer"[127].

The EEC relies on the legal instruments provided by the *EEC Treaty*, to protect the common market from the imposition of **governmental and private restraints** on free competition in the market.

The main concern of this thesis is the protection of the common market from private restraints on competition. This is the emphasis since franchise agreements are a format of business relationship in the private business sector. The protection of the EEC market from private restraints on competition is achieved by Art. 85 and 86 to the *EEC Treaty*[128].

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[127]. See Brittan, supra, note 119, at 3.

[128]. For the full text of these articles, see Appendix I.

1.1.3 The process of analysing issues of competition law.

Generally speaking, the process of analysing of a particular business practice under competition law (in the EEC and in other jurisdictions) is divided into two stages.

At **the first stage**, it is decided if the business practice at issue has enough economic influence in the market, to justify consideration by the competition enforcement authorities[129]. The business practice in question must be examined in its overall legal and economic context, taking into account the existence of other business practices of the same type and the economic structure of the market[130]. Theoretically, every agreement between two parties restricts free competition in the market to a certain degree because it creates contractual obligations for the two parties. In practice, only above a certain level, different in each jurisdiction, is a restraint on free competition of interest to the authorities responsible of the preservation of free competition in the market.

If the decision at the first stage was that the business practice concerned has enough economic influence in the market to be prohibited, a **second stage** requires the balancing of negative and positive effects of the business practice against one another to evaluate if the business practice should be allowed even though it is

[129]. Commission Notice of 19 Dec. 1977 Concerning Agreements of Minor Importance Which Do Not Fall Under Article 85(1) of the Treaty Establishing the European Community OJ C313, 29.12.1977, p. 3.: under this notice franchise agreements effect of which on trade between member states is negligible do not fall within the prohibition on restrictive agreements in Art. 85(1).

[130]. See Crossick, Supra, note 13, at 352.

restrictive.

It must be noted, though, that it is possible that the first stage of analysis might automatically result in illegality of a business practice and the second stage of analysis would not be required (this possibility depends on the competition/antitrust law of the specific jurisdiction).

The existence of a certain business practice in a market does not always affect competition in an absolutely clear way (either positively or negatively). A business practice might, in many cases, have negative and positive effects on competition at the same time. A common example of two possible conflicting influences on free competition resulting from the same business practice, is when a practice has negative effects on intrabrand competition but at the same time has positive effects on interbrand competition. **Intrabrand competition** is the competition between franchisees, distributors or retailers within one distribution system. **Interbrand competition** is the competition of one distribution system with other distribution systems. The concepts of interbrand and intrabrand competition, as explained here, will be of further use. A certain business practice may reduce the competition among retailers within one distribution system, but of the same time it may enhance the competitiveness of the same distribution system with other distribution systems in the market. The possibility that restrictive business practices have positive effects as well should be taken into consideration; otherwise competition law, which intends to improve economic efficiency and welfare, may cause undesirable economic results and reduce the economic efficiency in the market.

The decision as to how to achieve the appropriate balance between the positive and negative effects of a business practice is a policy making decision[131]. Normally, only economic criteria are applied when making this decision but it is also possible to consider other benefits or detriments to the market resulting from a specific practice. Such effects may be political or social and may prevail over the economic effects of a restrictive business practice[132].

The process of balancing between negative and positive effects of a business practice is referred to in the US as an application of a 'rule of reason'. The US 'rule of reason' is discussed in the next chapter[133]. In the EEC, the process of balancing, while similar to the US, was not officially regarded as an application of a 'rule of reason'. The use of the term 'rule of reason' in the context of the EEC competition law is therefore taken from the US antitrust law terminology.

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[131]. An example of an economic balancing between negative and positive effects on competition, in the first stage of competition law analysis, can be found in the EEC Commission's Notice Concerning Agreements, Decisions and Concerted Practices in the Field of Cooperation Between Undertakings OJ C75, 29.7.1968, p. 3., in which the Commission said as early as 1968 that it: "Welcomes cooperation among small and medium sized enterprises where such cooperation enables them to work more efficiently and increase their productivity and competitiveness in a larger market".

[132]. An example of a possible social policy benefit of a restrictive provision is the protection of the franchisees from unfair behaviour of the franchisor.

[133]. See infra, Chapter III, paragraph 2.1.3.

1.2 Articles 85 and 86 to the *EEC Treaty*.

1.2.1 The prohibition.

Articles 85 and 86 of the *EEC Treaty* were meant to prevent distortion of free competition in the EEC by **private** business practices.[134]

Art. 85(1), the prohibition against restrictions of free competition, applies to undertakings who agreed among themselves to exercise a business practice that might interfere with free competition in the Common Market. The emphasis in the article is on practices applied between two or more parties, by means of agreement or concerted practice. The article states clearly that only measures that "..may affect trade between member states" are prohibited. Thus, while EEC competition law applies when inter-state trade is affected, national competition law of the EEC member states applies to domestic transactions.

The Art. 85(1) prohibition is very short and does not provide much guidance. The accurate scope of the prohibition is left to the discretion of the EEC enforcement authorities and the European Court of Justice (hereinafter - the COJ)[135].

When reading Art. 85(1), the *prima facie* interpretation seems to be that,

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[134]. See Appendix I for the full text of Articles 85 and 86.

[135]. The function of the COJ is defined in Art. 164 to the EEC Treaty: "The Court of Justice shall ensure that in the interpretation and application of this Treaty the law is observed".; See also in R., Mathijsen, A Guide to European Community Law 4th. Ed. (London: Sweet & Maxwell, 1985), at 55, the author wrote that the task of the COJ is: ".. [N]ot only to interpret, but also to state what the law is when the existing legislation does not explicitly provide for it".

whenever a business practice in agreements or concerted arrangements has negative effects on free competition in the EEC, it is prohibited, regardless of its possible beneficial effects[136]. The text of the article can be literally construed as an absolute prohibition[137]. In practice, the Article has not been construed as an absolute prohibition. Not every theoretical effect on competition is considered prohibited under Art 85(1):

> " ... [O]nly **perceptible** effects on competition and trade between member states are relevant under Art. 85(1)"[138] (emphasis added).

In a recent lecture, Mr. L. Brittan, the EEC Commissioner responsible for competition said that when the EEC Commission (hereinafter - the Commission)[139] exercises its authority to enforce articles 85 and 86 of the *EEC Treaty*, the Commission continues to direct its efforts against:

> "... 'classic' infringements of Art. 85 and 86: **market sharing** and price fixing cartels and serious abuse of monopoly power in major industrial sectors"[140].

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[136]. See Korah, supra, note 20, at 5: The prohibition in Art. 85(1) has been broadly interpreted by the Commission and the COJ.

[137]. In other words the article should be interpreted the same way the *Sherman Act* was interpreted before the introduction of the 'rule of reason' to it. See infra, Chapter III, paragraph 2.1.2.

[138]. Case 5/69 Volk v. Vervaecke [1969] E.C.R. 295; [1970] C.M.L.R. 273; See also J., Peeters, "The Rule of Reason Revisited: Prohibition on Restraints of Competition in the *Sherman Act* and the *EEC Treaty*" (1989), 37 American Journal of Comparative Law 521, at 539: "... [N]o thorough economic analysis was required so long as the restraint of competition exceeded minimum threshold of approachability".

[139]. The EEC Commission is responsible for the functioning and development of the common market. See Mathijsen, supra, note 135, at 42: "...[the Commission] ... is the guardian of the community legislation ... In short, it should be seen as the executive branch of the Community".

[140]. Sir L. Brittan, Competition policy and procedures, a paper addressed to the Centre for European Policy studies (Brussels, The Centre, Sep. 16, 1991), at 3; Certain types of agreements have been consistently refused exemption. These are, in particular, market sharing agreements and agreements relating to prices - See Crossick, supra, note 118, at 342.

It is important to bear in mind, in the context of the thesis, that 'market sharing' is presented by the Commissioner as one of the main concerns of the Commission.

Art. 85 and 86 seek to achieve the same objective - the maintenance of effective competition within the common market[141]. The prohibition found in Art. 86 is against unilateral business practices only, when an undertaking abuses a dominant position it holds in the common market. Franchises are agreements between two parties and not a unilateral practice. This is the reason why Art. 86 to the *EEC Treaty* is outside the scope of the thesis.

Under Art. 85(2) to the *EEC Treaty*: "Any agreements or decisions prohibited pursuant to this Article shall be **automatically void**" (emphasis added). From this wording one might understand that a single anti-competitive clause in an agreement may cause the agreement as a whole to be void. However, the COJ has interpreted this section in a more flexible way. The Court has held that only the provisions which themselves distort free competition in the market are void and not the whole agreement of which they are part[142].

Since article 85 is directly applicable to the EEC member states[143] and can be invoked in their courts, the term "void" might also be interpreted by national

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[141]. Case 7/72 Europemballage Coorporation and Continental Can Company v. commission [1973] E.C.R. 215.

[142]. Case 56 & 58/64 Etablissements Consten SA and Grunding - Verkaufs GmbH v. Commission [1966] E.C.R. 341.

[143]. Not only the COJ but also the national courts are obligated to apply the EEC competition law.

courts. One commentator wrote that in the event Art. 85(1) is invoked in a national court:

> "The effect of this provision, and in particular the degree of severability, are **matters for national law**"[144] (emphasis added).

Under the English law for example the 'blue pencil' principle of the common law applies. It means that only when the provisions rendered void are fundamental to the agreement as a whole, will the agreement be void. In other jurisdictions within the EEC, the interpretation given to the term "void" may be different according to legal principles of each jurisdiction.

1.2.2 The application of a balancing process.

Art 85(3) acknowledges that some factors exist that might override the restrictive effects of business practices on free competition. Art. 85(3) can be described as an EEC type 'rule of reason' - similar to some extent to the 'rule of reason' under the US Antitrust law[145]. The US 'rule of reason' was developed by the US Courts. The EEC "rule of reason" is a legislative mechanism, applicable only under defined conditions stipulated in Article 85(3) itself[146].

By virtue of the balancing process in Art. 85(3), the prohibition found in Art.

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[144]. S.A., Crossick & M., Mendelsohn, "Franchising in Europe: Consequences of Pronuptia" (1986), 14 International Business Lawyer 220, at 220.

[145]. See infra, chapter III, at paragraph 2.1.3.

[146].The EEC 'rule of reason' is given by the legislator while the US 'rule of reason' was developed by the courts.

85(1) is limited. By way of comparison, the same limitation cannot be found in Art. 86; in contrast with Art. 85, the prohibition against restrictive practices that fall in the scope of Art. 86 is absolute and not flexible in the sense that if a business practice was analyzed and evaluated illegal under this article there is no way to apply a balancing process (a 'rule of reason') to it.

Art. 85(3) includes four conditions applicable in the balancing process. The application of Art. 85(3) may result in an exemption of a business practice found restrictive under Art. 85(1), from voidness under Art. 85(2), or from fines that can be imposed by the Commission.

The following are the four conditions of Art. 85(3): 1. The business practice in question should improve production or distribution of goods, or promote technical or economic progress; 2. Consumers should be allowed a fair share of the resulting benefit of the business practice; 3. Only restrictions which are indispensable to the attainment of the benefit should be allowed; 4. The restrictive practice should not eliminate free competition in a substantial part of the market.

The first condition is the central one. It states the kinds of beneficial effects of a business practice, that might allow its exemption from the Art. 85(1) prohibition.

The full citation of the condition is:

> "[the business practice] .. contributes to improving the production or distribution of goods or to promoting technical or economic progress"

The wording of this condition seems to imply that economic criteria only should be applied in the balancing process under Art. 85(3) because "technical progress" and "improving the promotion of distribution", two aspects found in the condition, entail

economic benefits.

An alternative view of the Article is that economic criteria may be only one consideration among others. One of the aspects found in the article is "promoting .. economic progress". The fact that the signatories to the *EEC Treaty* found it necessary to mention economic progress separately from the other possible benefits found in Art. 85(3) may suggest that the latter are not purely within economic criteria but, may be interpreted to include non-economic content as well[147].

1.2.3 The enforcement of Art. 85.

Regulation 17 - the first regulation implementing Art. 85 and 86 of the *EEC Treaty*[148], was enacted by the EEC Council about 30 years ago. The Regulation provides the Commission with the authority and means to enforce the EEC competition law:

> "... [T]he Commission has extensive powers to terminate infringements and to impose fines, backed by wide powers of investigation"[149]

Under Regulation 17 both the COJ and the Commission can interpret Art.

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[147]. See Brittan, supra, note 119, at 12: ".. [T]he competition rules themselves acknowledge that factors other than pure competition can sometimes be of overriding importance".

[148]. Regulation 17/62 OJ 13, 21.2.1964, p. 204.

[149]. C., Bellamy & G.H., Child, Common Market Law of Competition (London: Sweet & Maxwell, 1987), at 492.

85(1)[150], but only the Commission has authority to grant **an exemption** from the application of Art. 85(1) by virtue of Art. 85(3). The COJ itself has no authority to grant an exemption[151]. This division of powers was decided upon by the Council, even though there is no indication of it in the wording of Art. 85(3) itself[152].

In the US, by way of comparison, the courts both decide the scope of the prohibition against business practices which distort free competition (equivalent to Art. 85(1).) and the possible application of the "rule of reason" (equivalent to Art. 85(3)). In the US, the process of balancing between the negative and positive effects of a business practice on free competition is done by the courts. In the EEC the process of balancing is done by an administrative body - the Commission.

The Commission has also a authority to declare that under Art. 85(1) there are no grounds for administrative action. In this event the Commission will not bring an action or impose fines in respect of a particular business practice. This declaration by the Commission is called **negative clearance**. While a negative clearance protects the business practice involved against actions taken by the Commission, it does not bind either the national courts of the member states or the COJ[153]. Private parties are not prevented from alleging that an agreement is contrary to Art. 85(1) and therefore void.

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[150]. See Brittan, Supra, note 119, at 14; national enforcement would be a welcome ally to the community enforcement.

[151]. See Regulation 17, supra, note 148, at Article 9(1).

[152]. It is doubted if this interpretation made by the Council is what the *EEC Treaty* signatories really meant.

[153]. V., Korah, EEC Competition Law and Practice 3ed. Ed. (Oxford: ESC, 1987), at 34.

When the Commission grants **a clearance**, the business practice in question is declared as not prohibited under Art. 85(1). When the Commission grants **an exemption**, the Commission declares that even though it considers the business practice is prohibited under Art. 85(1), it finds that it should be exempted from the prohibition by virtue of Art. 85(3)[154]. This provides absolute protection against any action based on Art. 85(1), even by private parties.

An exemption under Art. 85(3) or a clearance under Art. 85(1) may be granted by the Commission only if it is provided with the agreement concerned in advance; otherwise the Commission is prevented from exercising these powers. Reporting the agreement to the Commission is the procedure of "notification" under Articles 4 and 5 of Regulation 17.

Another important regulation in the Art. 85(1) context is Regulation 19/65[155]. The regulation authorizes the Commission to issue 'block exemptions' under Art. 85(3) from the prohibition of Art. 85(1). The regulation broadens the authority of the Commission from the granting of individual exemptions only for notified agreements and according to their specific facts, to the granting of exemptions for groups of agreements that have similar characteristics without checking the facts. Agreements exempted under a 'block exemption', by way of regulation adopted by the Commission in advance, do not have to be notified to the Commission, as required under Regulation 17 for individual exemptions.

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[154]. See Regulation 17, supra, note 148, at Art. 2 and Art. 6.

[155]. Regulation 19/65 OJ 36, 6.3.1965, p. 533.

The types of agreements included in Regulation 19/65 and which, therefore, can be subjected to 'block exemptions' are: restrictive **exclusive territory** and exclusive purchase agreements, and agreements that contain restrictions imposed "in relation to the assignment or use of **industrial property rights**"[156] (emphasis added).

When recalling the main features of the franchise method as discussed in chapter I, it is clear that in general franchise agreements fit quite readily within the scope of Regulation 19/65. Nevertheless, almost 25 years passed between the enactment of regulation and its actual application by the Commission to the franchise method[157].

1.2.4 Judicial review by the COJ.

The COJ has the authority to review the Commission's means of enforcement of Art. 85 of the *EEC Treaty*.

The Court has jurisdiction under Art. 173 to the *EEC Treaty* to review the legality of decisions that were taken by the Commission, following appeals made by natural or legal persons to whom the decisions were addressed[158]. In the context of competition law, the COJ may review a decision of the Commission to grant or to refuse an individual exemption or clearance. The Court may also review any other

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[156]. Ibid., at Article 1(1).

[157]. See Block exemption" regulation 4087/88, infra, note 185.

[158]. For the full text of Art. 173 see Appendix I.

decision made by the Commission pursuant the enforcement of the EEC competition law.

The COJ also rules on questions of Community law referred to it by national courts of the EEC member states under Art. 177 to the *EEC Treaty*[159]. Art. 177 is the mechanism by which the COJ interprets provisions of Community law that are directly applicable through the national courts (for example questions about the scope and interpretation of Art. 85 and 86 of the *EEC Treaty*)[160].

2. The franchise method under competition law.

2.1 The legal situation prior to Pronuptia.

Franchising has been known and used extensively in the EEC since the 70s. In many EEC member states, such as France, the United Kingdom and Germany, franchising is a regular method of trade.

Franchise agreements commonly contain territorial exclusivity clauses that, at least theoretically, have restrictive effects on competition[161]. It is, therefore, surprising to see that the first time an organ of the EEC seriously dealt with the

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[159]. For the full text of Art. 177 to the *EEC Treaty* see Appendix I.

[160]. K., Lasok, The European Court of Justice - Practice and Procedure (London: Butterworths, 1984), at 46: "References for preliminary ruling are in the nature of an interlocutory step in the proceedings before a national court or tribunal, designed to obtain a ruling from the court on a point of Community law which has arisen in the course of the litigation between the parties [i.e. at the national court o.g.]".

[161]. See, supra, Chapter I, at paragraph 1.2: the common features of franchise agreements.

topic, was the COJ, in 1986[162]. This delay is somewhat odd given the efficiency with which the Commission is known to treat anti-competitive practices and the importance attributed to competition law as being essential to the success of the common market in the EEC. Two possible explanations can be given the this delay. It is possible that the Commission did not consider franchise agreements important enough in the EEC economy to warrant a comprehensive discussion; or, the Commission may have thought that the general contribution of franchise agreements in the EEC economy was larger than their potential anti-competitive consequences, and, therefore, that treatment of the subject was not urgently required[163].

In a report on "Cooperation Between Firms - Franchising", published by the Commission in 1978[164], there is a greater emphasis on the potential problems in the relationship between the parties to a franchise agreement than on the potential effects of franchise agreements on free competition in the EEC[165]. The emphasis in the report was clearly on possible EEC rules to protect franchisees and not on possible competition law rules[166]. In the context of EEC competition law it was

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[162]. European Communities Commission, Sixteenth Report on Competition Policy (Brussels: the Commission, 1987) at 106.

[163]. Franchising could be described as a form of cooperation between small businesses. As mentioned above, the EEC encourages this kind of cooperation. See supra, note 131.

[164]. See the Report, supra, note 110, at section IV. The Report was submitted to the Commission by a Sub-group on Cooperation Between Firms in the EEC. The sub-group was set up by the EEC working party of experts on Commerce and Distribution.

[165]. In the conclusion of the Report, Ibid., at 18, it was stated: "... [T]hought should be given to whether specific community rules should be formulated, especially as franchising is often transnational".

[166]. For the purpose of protective regulation, Art. 100 to the *EEC Treaty* could have been used as a legal source for legislation -see H., Smit & P.E., Herzog, The Law of the European Economic Community - A Commentary on the EEC Treaty (New York: Matthew Bender, 1976-), at 3-556.6; After the *EEC Treaty* was

stated in the conclusion of the report that:

> "..in certain cases, individual franchising contracts may run counter to the principles embodied in Article 85 of the EC treaty .. [but the committee thinks that] .. **in view of the size of this field, this aspect should not be pursued in greater detail in this report**"[167] (emphasis added).

In light of the full content of the report, it is submitted that the words 'size of this field' are describing the number of potential infringements of Art. 85(1) by franchise agreements and not the degree of use of the franchise method in the EEC. It appears that the Commission, at the time this report was published in 1978, was not concerned with the possible effects of the franchise method on free competition in the EEC.

The Commission was "forced" to consider the effects of the franchise method only after the COJ had to consider the subject in the Pronuptia judgement[168]. The action in Pronuptia was not initiated by the Commission but by private individuals; it was referred to the COJ from the German Supreme Court. Had the German Court not sought a preliminary ruling from the COJ under Art. 177 of the *EEC Treaty*, it is possible that franchise agreements would still not have been discussed by the Commission up to the present time[169].

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amended, Art. 100a to the Treaty could have been used as a source for legislation.

[167]. The Report, supra, note 110, at 16.

[168]. See Pronuptia judgement, supra, note 51.

[169]. Even though the Commission paid some attention to franchise agreements it seems that it did not enforce the EEC competition law to it. Research failed to disclose any application to the COJ for an annulment of a Commission decision under the second paragraph of Art. 173 to the *EEC Treaty*. Had the Commission attempted to enforce Art. 85(1) to franchise agreements, the chances are that such an application for annulment would have been made prior to the Pronuptia.

Given the conclusion of the report discussed above, it appears that if the Commission had eventually considered regulation on franchising, the chances are that this regulation would have been connected to the relationship of franchisors and franchisees within franchise systems, similar to the US protective legislation[170].

The Pronuptia judgement changed the course of development in the field of franchise legislation. The tendency to enact protective legislation for franchisees was replaced by a scrutiny of competition law issues.

2.2 Introduction to competition law treatment of franchising.

As mentioned above, the first time the COJ was confronted with the matter of franchising was in the Pronuptia case[171].

Pronuptia was a French company which distributed wedding dresses and accessories using the method of business format franchising. Germany was one of the

[170]. See supra, note 166, for possible legal sources for legislation. The procedures that could have been used by the Commission for legislative purposes were either a regulation or a directive under Art. 189 of the *EEC Treaty*. A **regulation** is directly applicable to the EEC member states and there is no need for further national implementation. A **directive** like a regulation binds member states but, each member state is free to implement it in the methods it chooses; See also J.V., Louis, The Community Legal Order 2ed Ed. (Brussels: The European Perspectives series, 1990), at 83.

[171]. See Pronuptia judgement, supra note 51; See Crossick & Mendelsohn, supra, note 144, at 220, The author wrote that Pronuptia: "... [H]as been the most significant legal development affecting franchising in Europe"; See R.J., Goebel, "Case 161/84 Pronuptia de Paris GmbH v. Pronuptia de Paris Irmgard Schillgalis" (1986), Common Market Law Review 683, at 691: the importance of the case - 1. implications for legal theory in the antitrust field, 2. practical repercussions for franchising as an important instrument for vertical distribution.; See also Young, supra, note 44, at 59.

EEC member countries to which Pronuptia had extended its distribution system[172]. Pronuptia has authorized a master franchisee to conclude agreements with franchisees[173]. In the facts of the case the master franchisee concluded (in Germany) three franchise agreements with one German franchisee. An exclusive territory within Germany was granted in each agreement[174].

The master franchisee and the franchisee had a conflict about royalties payment; the matter was taken to the German courts. The franchisee submitted that the franchise agreement infringed Art. 85(1) of the EEC Treaty and should therefore be declared void according to Art 85(2) of the Treaty. If the agreement had been declared void the result would probably have freed the franchisee from any obligation to pay the royalties that were otherwise due.

The case arrived eventually to the German Supreme Court (the Bundesgerichtshof) which identified issues of EEC law and referred to the COJ three specific questions asking for preliminary ruling[175]:

The first question concerned the applicability of Art. 85(1) to the franchise

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[172]. The company did not only use the franchise method but also company-owned branches and subsidiaries. These facts affect the economic implications on the common market but they were not discussed or considered to be important by the COJ.

[173]. The COJ virtually ignored the fact that a master franchisee is involved and that the agreement in question is between him and a franchisee (the original franchisor was not involved).

[174]. The fact that the franchisee was given large territories is not compatible with the basic principle of the franchise method. One of the principles of the method is that the franchisee manage his own outlet and therefore has a day-by-day connection with the market and can also supervise the quality of goods and services in his outlet. In three separate territories granted to one franchisee, this principle cannot be maintained. The COJ did not mention or consider the size of the territory in its judgement.

[175]. See supra, paragraph 1.2.4, an explanation of a referral to the COJ by a national court under Art. 177 to the EEC Treaty.

agreement.

The second question concerned the applicability of 'block exemption' Regulation 67/67[176] on exclusive dealing agreements to the franchise agreement.

The third question concerned the application of Reg. 67/67[177] to particular clauses of the Pronuptia franchise agreement, should the COJ decide the second question in the affirmative.

The fact that the franchise method was to be examined by the COJ for the first time made the large and established community of franchisors anxious about the possible consequences and they waited impatiently for the judgement; as one commentator wrote:

> "...[I]nterested circles had become quite concerned. All of a sudden an enormous aggregate amount invested within the framework of franchise agreement appeared at risk"[178].

Generally speaking the COJ took a positive approach towards franchise agreements as a business method. It determined that only a few provisions of the Pronuptia franchise agreement fell within the scope of the prohibition of Art. 85(1) and that most of the provisions commonly found in business format franchise agreements were legal.

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176. Regulation 67/67 OJ 57, 25.3.1967, p. 849; The regulation was enacted under Reg. 19/65 and was not originally meant to cover franchise agreements.

177. Regulation 67/67 no longer exists. It was replaced by two regulations - Regulation 1983/83 on the application of Art. 85(3) to the Treaty to categories of exclusive distribution agreements OJ L173, 30.6.1983, p. 1, and Regulation 1984/83 on the application of Art. 85(3) of the Treaty to categories of exclusive purchasing agreements OJ L173, 30.6.1983, p. 5.

178. See Van Empel, supra, note 18, at 401; Perhaps the COJ could not have taken a negative approach towards the franchise method. Had the COJ decided differently in this advanced stage of market development, the effect on thousands of existing franchise agreements could have severely shaken the EEC economy.

The COJ focused its discussion on the territorial exclusivity granted to the franchisee in the franchise agreements. The Court found that territorial exclusivity provisions infringed Art. 85(1)[179] because it divided the market between the franchisees or between the members of the franchise system. This effect was also referred to in the EEC as 'market sharing'.

The COJ was not prepared to apply regulation 67/67 to the franchise agreement[180]. The Court stated that, as far as regulation 67/67 was concerned, the franchise method was different from other distribution methods to which the Regulation was applicable.

Since the Court concluded that no existing 'block exemption' regulation covered franchise agreements, the Commission, as the only EEC organ holding the authority to exercise Art. 85(3), was left with the task of considering possible individual exemptions. It had to consider an individual exemption for the territorial exclusivity provisions in Pronuptia's agreement[181], and for the territorial exclusivity clauses in other specific franchise agreements that had been notified to the Commission in the meantime[182].

The Commission also had the option of issuing a 'block exemption' regulation

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[179]. M., Duggan, "Drafting Franchise Precedent: Some Guidelines" (1986), 130 Solicitor's Journal 673, at 674: "The Pronuptia decision will have a significant effect on the practice of granting exclusive areas to franchisees, since such an approach will now be brought with danger".

[180]. The arguments of the COJ and the opinion of the Advocate General are discussed below.

[181]. The franchise agreement of Pronuptia was notified to the Commission as required under Regulation 17. See infra, note 184.

[182]. D.A., Schmitz & A., Van Hamme, "Franchising in Europe - The First Practical EEC Guidelines" (1988), 22 International Lawyer 717, at 729.

to govern the problematic provisions in franchise agreements generally, exercising its authorities under Art. 83(3), Regulation 17 and Regulation 19/65.

The Commission declared almost immediately after the Pronuptia judgement that, in general, it was desirable to issue a 'block exemption' regulation in respect of the franchise method. However, to acquire some experience in the field and to consider outstanding cases, the Commission preferred to begin with individual exemptions granted to specific franchise systems, in the format of Commission decisions[183].

Five individual exemptions were granted by the Commission to franchise systems: Pronuptia itself, Yves Rocher, Computerland, Charles Jourdan and ServiceMaster[184].

Thereafter, the Commission issued in Regulation 4087/88[185] a block exemption for franchise agreements . The 'block exemption' regulation was enacted in 1988, only two years after the 1986 Pronuptia judgement.

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[183]. As the Advocate General said: "It is the task of the Commission first to acquire the necessary experience by adopting a number of individual decisions in representative cases". See Pronuptia judgement, supra, note 51, at 371.

[184]. Pronuptia decision OJ L13, 15.1.1987 P. 39; Computerland decision OJ L222, 10.8.1987, p. 12; Yves Rocher decision OJ L8, 10.1.1987, p. 49; ServiceMaster decision OJ L332, 3.12.1988, p. 38; Charles Jourdan decision OJ L35, 7.2.1989, P. 31.

The individual exemption granted to the Pronuptia standard agreements followed an application for clearance or exemption filed by Pronuptia on 22 April 1983 (this is the equivalent for notification under Regulation 17). The exemption, and not a clearance, was given to the standard form of retail franchise agreement of the franchisor intended by the franchisor to be concluded with all its franchisees.

[185]. See Regulation 4087/88 on the application of Art. 85(3) of the Treaty to categories of franchise agreements OJ L359, 28.12.1988, P. 46; For the full text of the regulation see Appendix II.

2.3 The franchise method in the Pronuptia judgement.

The franchise system examined by the COJ in the Pronuptia judgement is a business format franchise[186]. The Court did not explicitly mention the term business format franchise in its judgement but the main features of the franchise system as described by the Court, match the features of this type of business[187]. The Court also examined the questions raised by the German Supreme Court from the perspective of business format franchising. While the COJ described the features of the franchise system involved, it did not attempt to present a precise definition of the franchise method in general[188], nor was the Court required to do so under EEC competition law.

The Court in Pronuptia divided the franchise method into three sub-groups: distribution franchises, service franchises and production franchises. The COJ limited itself to an analysis of distribution franchises and wrote that service franchises or production franchises were outside the scope of the judgement.

2.4 The limited application of Art 85(1) to franchise agreements.

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[186]. The Advocate General in the Pronuptia case, Mr. P. VerLoren van Themaat, reviewed the common features of the franchise method which he found in academic writings, in the case law of the national courts of the member states and in the European Code of Ethics. He identified the following characteristics: the independence of the franchisor and the franchisee, a license to use symbols and to use know-how, a uniform manner of presentation in the franchised outlet, and royalty payments by the franchisee to the franchisor.

[187]. See Pronuptia judgement, supra, note 51, at p. 381; See also De Cockborne, supra, note 15, at 254.

[188]. See Gobel, supra, note 171, at 687: "Somewhat unfortunately, there is no attempt to define franchising as such"

An examination of the legal reasoning applied by the COJ under Art. 85(1), when analysing the franchise method, follows. First, the Advocate General's (hereinafter - the A.G.)[189] opinion in Pronuptia is reviewed and then it is compared with the COJ judgement.

The opinion of the A.G. is mentioned here alongside the COJ judgement because several commentators preferred the A.G.'s opinion to the COJ decision, and called on the Commission to follow the A.G.'s opinion as closely as possible when drafting the 'block exemption' regulation[190] for franchising.

2.4.1 The Advocate General's opinion.

The A.G.'s opinion does not form an official part of an EEC judgement. Normally the COJ is assisted by the opinion of the A.G. but reaches its own conclusions[191].

In Prunoptia, the A.G. underlined the importance the COJ attributed to

[189]. In official publications of COJ judgements, the opinion of the A.G. is cited before the decision of the Court; The duties of the A.G. in a case before the COJ are defined in Art. 166 to the EEC Treaty: "It shall be the duty of the Advocate General, acting with complete impartiality and independence, to make, in open court, reasoned submissions on cases brought before the Court of Justice, in order to assist the Court in the performance of the task assigned to it in Art. 164 .."; See also D., Lasok & J.W., Bridge, Law and Institutions of the European Communities 4th Ed. (London: Butterworths, 1987), at 249: "He [i.e. the A.G. o.g.] is required to consider the issues in a case impartially and individually and to reach his own personal conclusion as to what in the law and justice should be done".

[190]. See Van Empel, supra, note 18, at 412 - ".. [I]t is preferred to the COJ approach and will help better to the development of the EEC economy.."

[191]. The A.G.'s opinion serves a useful purpose since the COJ is usually the first Court ruling on questions of Community law.

interbrand competition over intrabrand competition[192] in previous cases[193] and said that, generally speaking:

> "Art. 85(1) can only apply when it can be shown in a particular case that they [i.e. restrictive provisions o.g.] cause injury to third parties ... which will seldom be the case where there are adequate alternative chains of distribution for similar products"[194].

The A.G. emphasized that comprehensive economic analysis is required whenever a business practice is analyzed under Art. 85(1)[195].

The A.G. suggested the following test for the application of Art. 85(1) to franchise systems:

1. The franchisor should be from one member state and the franchisee from another member state; and

2. The franchisor should have a substantial share of the market for the relevant product; and

3. the franchise agreement should either (a). restrict parallel imports or exports, or (b). set prices that could not have been charged if effective competition existed[196].

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[192]. The system encourages competition between distribution systems, while at the same time it lessen competition among members of one of the distribution systems.

[193]. See Pronuptia judgement, supra, note 51, at 364: the reference the A.G. was making to the Grunding Consten case.

[194]. Ibid., at 369.

[195]. Ibid, at 362; See Van Empel, supra, note 18, at 405: Every agreement should be examined on its own merits, taking into account its specific provisions. The specific circumstances of the relevant market should be taken into account; The A.G. relied on analysis of real commercial elements on the one hand and case law in neighbouring fields on the other.

[196]. See Pronuptia judgement, supra, note 51, at 370.

In the A.G.'s view, then, the violation of Art. 85(1) by a franchise agreement might occur only when free competition in the market was severely distorted. The conditions described by the A.G. would likely be fulfilled in a limited number of cases[197].

The opinion of the A.G. can be interpreted as calling on the COJ to apply an economic process of balancing, that is, a 'rule of reason', when applying Art. 85(1) and not to leave the process of balancing exclusively for the Commission when it administers Art. 85(3).

2.4.2 The COJ - two conditions for legality.

The COJ itself applied a process that can be described as balancing between negative and positive effects of a business practice under Art. 85(1)[198], but the content of this balancing process was different from that suggested in the A.G.'s opinion. As one commentator has written, the practice applied by the COJ can be described as an equivalent of the US 'rule of reason':

> "The court's doctrinal approach ... is to read Art. 85(1) in a decidedly flexible manner which is analogous to the 'rule of reason' approach taken by the

[197]. See Gobel, supra, note 171 at 686.

[198] See Van Empel, supra, note 18, at 411: "Some - this author among them - would be inclined to argue that here (again) the court has accepted to apply the 'rule of reason' similar to the one in regular use in American antitrust law. Others prefer to see this as a normal application of the 'per se' provisions of Art. 85(1) under somewhat exceptional circumstances".

American courts applying United States antitrust laws"[199].

General positive approach.

The COJ said that ".. [F]ranchise agreements for distribution ... cannot be assessed *in abstracto* but depend on the provisions contained in such agreements"[200] and that as such, **franchise systems do not interfere with competition.** The COJ did not explicitly weigh pro-competitive against anti-competitive effects when arriving at this conclusion. Nevertheless, it seems correct to say that the Court reached to its conclusion as a result of assessing the influence of franchise systems in general on free competition in the EEC and evaluated that the positive effects of franchise systems in general prevailed over their negative effects[201].

The two necessary conditions.

After the general statement the Court made, favouring the franchise method[202], the Court went on to say that:

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[199]. See Goebel, supra, note 171, at 692; compare to a US judgement which held that vertical territorial restrictions and consumer restrictions are not per se violations of the US antitrust laws - Continental TV Inc. V. GTE Sylvania Inc. 433 US 36 (1977); See also Korah, supra, note 20, at 21: "It is not an application of the rule of reason as originally applied in the USA in as much as no balancing is required between the pro- and anti-competitive effects of the agreement, but there is a little balancing done in the U.S. these days".

[200]. See Pronuptia judgement, supra note 51, at 381; The COJ referred to 'distribution franchise' agreements only.

[201]. The COJ implied in its argumentation to the contribution of the franchise method to the enhancement of competition in the EEC. The COJ said that the method improved distribution of products; See Pronuptia judgement, supra, note 51, at 371: ".. rapid penetration of new products or products with particular qualities"

[202]. See Gobel, supra, note 171 at 691: "extremely favourable attitude towards franchising".

> "in order for the system to work **two conditions must be met**"[203] (emphasis added).

The COJ's first condition is that the franchisor must be able to communicate his know-how[204] and provide assistance to the franchisees ".. without running the risk that know-how and assistance might benefit competitors even indirectly"[205]. The COJ's second condition is that the franchisor must be able to take measures necessary for maintaining the identity and the reputation of its system[206]. The Court treated these two conditions as absolutely necessary for the existence of the franchise method, therefore, these conditions are referred below as the "necessary conditions". The necessary conditions stipulated by the COJ are the equivalent of franchise services (the first condition) and quality control measures (the second condition) described at the first chapter of this thesis as two main features of the franchise method. Thus, the Court was relying on the special features of the franchise method in its reasoning concerning the scope of Art. 85(1) prohibition.

In the next section of the judgement the COJ said that all the clauses in the franchise agreement which were meant to achieve the two necessary conditions were not caught by the prohibition of Art. 85(1)[207]. The COJ did not offer an explanation

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[203]. See Pronuptia judgement, supra, note 51, at 381-382.

[204]. See Goebel, supra, note 171, at 694: ".. [T]he court neither provides a definition of know-how nor suggests any limits of what might be claimed to be truly valuable and therefore protestable know-how"

[205]. See Pronuptia judgement, supra, note 51, at 382.

[206]. Ibid., at 382.

[207]. See Goebel, supra, note 171, at 695-697. Commentators are criticizing the justification of broad exemptions for groups of clauses.

for its conclusion.

A proposed interpretation of the approach of necessary conditions.

The COJ's ruling could be interpreted to say that since **franchising in general** is beneficial to the economy, then any clause necessary for the existence of a franchise system should be allowed because otherwise franchising as a business method would disappear from the EEC market[208].

This possible interpretation can be understood in two ways. The first, that the necessary clauses - those forming franchise services and quality control measures - would automatically be considered legal and an evaluation of the clauses in their economic framework is not required (this is an equivalent for the concept of 'per se' legality in US antitrust law[209]; hereinafter - the 'per se' legality approach).

The second way of understanding the COJ practice is that necessary clauses are legal only when their economic analysis in the overall economic framework of the market allows their existence. If this possibility is chosen, it means that the COJ in Pronuptia applied a court-made 'rule of reason' under Art. 85(1), equivalent to the 'rule of reason' of the US.

Several comments can be made about the COJ analysis in light of the two

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208. In its practice, the COJ accepted the submission of the franchisor. See Pronuptia judgement, supra, note 51, at 379: The franchisor said that Art. 85(1) does not apply when the provisions "..[D]o not include restrictions on the liberty of the contracting parties which go beyond these which are **the necessary concomitants of a franchise system..**" (emphasis added).

209. The 'per se' legality approach means that the clauses considered are **always legal** and an economic balancing process is not necessary. See infra, chapter III, at paragraph 5.1.

possibilities suggested to construe it:

Firstly, the COJ did not examine the economic framework in which the Pronuptia franchise system operated. The COJ was supposed to determine if within the given economic framework the agreement in question distorted competition and affected trade between the EEC member states[210]. The Court did not establish that the business practices in Pronuptia restricted competition to a perceptible degree, but went directly to the stage of balancing between the competing effects of the business practice on free competition[211]. For example[212], the COJ did not examine the size of the franchise system, or whether or not the franchisor holds a substantial part of the product market. The COJ did not even establish what the product[213] or what the markets in question were.

Secondly, if it is correct that the COJ applied a court-made 'rule of reason' and not a 'per se' legality approach, it created a dual balancing process - both under Art. 85(1) and under Art. 85(3). A court-made 'rule of reason' might be justified in the absence of a legislator-made 'rule of reason'[214] because of the need for

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[210]. The COJ approach in respect of the "effect on trade between member states", a condition stipulated in Art. 85(1), is discussed below, infra, at paragraph 2.6.

[211]. J.S., Venit, "Pronuptia: Ancillary Restraints - Or Unholy Alliances" (1986) 11 European Law Review 213, at 221: The commentator wrote that the COJ judgement - ".. [R]eaffirms that balancing of pro- and anti-competitive effects may occur under Art. 85(1)".

[212]. See Goebel, supra, note 171, at 693; and see Crossick, supra, note 13, at 352: ".. [T]he agreement must be considered in its all legal and economic context, taking into account the existence of other agreements of the same type".

[213]. The facts as were understood from other sources is that Pronuptia used to trade in more than 1000 different products.

[214]. This was the situation in the US; See infra, chapter III, paragraph 2.1.2.

flexibility in competition law analysis. When the flexibility is already provided by a legislature-made 'rule of reason', as in Art. 85(3) to the *EEC Treaty*, the creation of another 'rule of reason' by the Court is difficult to justify on the same grounds. A dual 'rule of reason' also creates uncertainty about the scope and application of each of the legislature-made rule and the court-made rule.

Thirdly, even if one accepts that the COJ has jurisdiction under Art. 85(1) not only to decide if a business practice is prohibited, that is, whether or not it has perceptible restrictive effect on the market, but also to apply a balancing process, an economic evaluation should have been applied by the Court. The mere fact that the franchise method *in abstracto* is beneficial to the EEC economy, does not necessarily justify the conclusion that all clauses required for the existence of franchise systems (the two necessary conditions) should automatically be declared legal. There is wide room for assessment of these clauses against the background of the market framework and other economic considerations.

The practice of not evaluating the economic framework of the franchise system, could be explained if one attributes to the COJ a 'per se' legality approach instead of a 'rule of reason' approach. It is possible to argue that a 'per se' legality approach was applied by the COJ towards clauses "necessary" for the existence of the franchise system. When this approach is applied the examination of the economic framework of the business practice in question is not required.

2.4.3 Territorial exclusivity provisions were prohibited by the COJ.

A rigid approach towards territorial exclusivity.

In the next part of the judgement the COJ said that clauses not included in one of the two necessary groups, described above, cannot be declared legal. The Court held that clauses which result in "market sharing"[215] (i.e. as a result of territorial exclusivity clauses) and/or "prevent franchisees from engaging in price competition between each other"[216] are, in principle, within the scope of Art 85(1) and therefore prohibited.

Since the COJ, previously in the case, took a 'rule of reason' approach or even a 'per se' legality approach under Art. 85(1)[217], the sudden turn the Court took into a **'per se' illegality**[218] approach, that is, an automatic prohibition of certain clauses without an economic analysis, makes the judgement seem internally inconsistent. This suggestion is especially valid, as explained below, in respect of territorial exclusivity clauses.

Territorial restrictions which create territorial exclusivity for the franchisees were considered by the Court to distort free competition. They were thought to divide the market between the franchisees themselves, or between the franchisor and

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215. The EEC authorities have always considered market sharing as a classic competition distorter; See Brittan, supra, note 119, at 4:"The community puts particular emphasis on the elimination of vertical restraints and territorial restrictions which tend to divide markets"; See also Brittan, supra, note 140, at 3.

216. See Pronuptia, judgement, supra, note 51, at 383.

217. See Venit, supra, note 212, at 217: "An American lawyer would say that the court was, in effect, applying the doctrine of ancillary restraints i.e. identifying the legitimate purpose of the contractual arrangements and then excluding from the prohibition on restrictive agreements all contractual provisions that are reasonably related to the successful realisation of this legitimate purpose".

218. The terminology is taken from US antitrust law. 'Per se' illegality means that a business practice is declared illegal regardless of its economic framework. See, infra, chapter III, at paragraph 2.1.3.

the franchisees. Therefore the Court treated these clauses as automatically prohibited under Art. 85(1) to the *EEC Treaty*[219].

The difference between new and established franchises.

It should be noted, that the precise wording of the Court is that the territorial exclusivity amounts to a limitation on competition ".. if it concerns a business name or symbol **which is already well known**"[220] (emphasis added).

This may be interpreted to mean that if an already widespread trademark had not been involved, the Court would have taken a more flexible approach. As one commentator wrote:·

> "Thus, the court seems to leave open the possibility of balancing under Art. 85(1) where the franchisor is also a new entrant in the market"[221].

This point of the COJ judgement was overlooked by the Commission when it issued, following Pronuptia, the individual exemptions and the 'block exemption' regulation. Therefore, under the current EEC competition law, no difference is made between young and mature franchise systems[222].

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[219]. It is noteworthy that by not defending the franchisee exclusive right of franchisees in their territories, the COJ offsets one of the franchisee's very few protection in a franchise agreements.

[220]. See Pronuptia judgement, supra, note 51, at 384.

[221]. See Venit, supra, note 212, at 218; See Korah, supra, note 20, at 9:".. [T]he court referred to territorial protection being restrictive of competition only after the network had become widespread".

[222]. The idea of distinguishing between young and mature franchise systems under antitrust law can also be found in P.F., Zeidman, "Antitrust Law: Legal Problems in the Life Cycle of a Franchisee" (1981), 50 Antitrust Law Journal 855, at 857.

The investment consideration is rejected by the Court.

The COJ was aware of the possibility that by not allowing territorial exclusivity in franchise agreements, it might cause franchisees to avoid investments in franchise systems because they cannot be expected to take the risk of investing if they are not granted a protected territory (the argument is referred to below as the "investment consideration").

Addressing the investment consideration, the COJ has implied that its jurisdiction is limited to Art. 85(1) and wrote that the investment consideration is a matter for Art. 85(3):

> "That consideration, however, is relevant only to an examination of the agreement in the light of the conditions laid down in Art. 85(3)"[223].

The approach the Court took towards the investment consideration is open to question. The franchisee experiences a high degree of financial risk and he is usually an unexperienced business person. Without territorial exclusivity the franchise method might be considered too risky by franchisees to invest in. Exclusive territory serves as a reasonable compensation for the financial risk of franchisees because it allows them to recover their investments and start to profit more quickly than without an exclusivity. The franchise business method can exist as a distribution method only if potential franchisees will continue and buy franchises from franchisors; they would do so only if they are compensated for the great financial risk involved in the acquisition of a franchise.

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[223]. See Pronuptia judgement, supra, note 51, at 384.

Due to the high degree of financial risk involved, the investment consideration is more significant in the franchise method context than in the context of other business methods. It is also more significant in the franchise method context because a portion of franchise fees and royalties is commonly paid by franchisees for the territorial exclusivity.

In light of the flexible approach of the COJ, in the earlier part of the judgement towards necessary clauses, the Court's approach towards the investment consideration may be criticized. The Court examined and applied the special features of the franchise method in the early part of the judgement but was reluctant to do the same when it evaluated the investment consideration.

The approach the COJ took towards the investment consideration appears even more open to question when it is compared with the approach of the COJ in an earlier judgement[224].

In the Nungesser judgement, a French institute (INRA) developed a new kind of maize seeds that could survive cold climates. INRA licensed Nungesser to grow and sell the seeds exclusively in Germany. The EEC Commission published a decision declaring that the exclusive license agreement infringed Art. 85(1) to the *EEC Treaty*, Nungesser filed an application with the COJ[225], seeking a declaration that the Commission's decision was void.

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[224]. Case no. 258/78 L.C. Nungesser v. EC Commission [1983] 1 C.M.L.R. 278.

[225]. Nungesser used the procedure articulated in Art. 173 to the *EEC Treaty*. See supra, at paragraph 1.2.4.

The COJ described the exclusivity in the license agreement in question:

> ".. the owner merely undertakes not to grant other licenses in respect of the same territory and not to compete himself with the licensee on the territory"[226]

The scope of the territorial exclusivity granted to the licensee in Nungesser's agreement resembles the scope of the territorial exclusivity granted to the franchisee in Pronuptia's agreement.

In the Nungesser judgement the Court held that the territorial exclusivity provisions were compatible with Art. 85(1) and not prohibited. The justification for the approval of the territorial restrictions, was that if they would not be allowed, the licensee:

> ".. might be deterred from accepting the risk of cultivating and marketing this product, such a result would be damaging to the dissemination of a new technology and would prejudice competition in the Community .." [227]

This argument, accepted by the COJ in Nungesser, is the equivalent of the investment consideration, rejected by the COJ in Pronuptia[228].

2.5 The application of regulation 67/67.

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226. See Nungesser judgement, supra, note 224, at 352.

227. Ibid., at 353; See also Bellamy & Child, supra, note 149, at 354: The authors have written that in Nungesser the Court - ".. [U]pheld arguments based on the need to encourage the licensing of new technology. Specifically the Court held that an exclusivity provision in an "open" license - i.e. a license that did not grant absolute territorial protection did not, in itself, fall within Art. 85(1)".

228. See Korah, supra, note 20, at 8: "In numerous cases, the court has recognized the need for territorial protection when substantial investments are required". The author brings as one of the examples the Nungesser case; See also Korah, supra, note 153, at 97-98.

The COJ was not prepared to exempt the territorial restrictions it prohibited under Art. 85(1) by using the existed Regulation 67/67[229]. This regulation was meant to cover exclusive supply and purchase agreements and was enacted when franchise agreements were not yet widespread in the EEC[230].

By rejecting the possible application of Regulation 67/67 the Court expressed the view that, as far as this regulation concerns, the franchise method is different from other distribution methods. The Court's decision in this point may be interpreted to mean that every distribution method which has special characteristics should be considered separately under the competition law of the EEC.

The COJ's approach gave further impetus to the Commission's tendency to issue 'block exemptions' separately, to each type of agreement that has very specific characteristics, instead of regulating several types of agreements in a few and more general regulations.

The US Supreme Court took an approach which is the opposite of that taken by the COJ and by the Commission. The US Supreme Court treated virtually all types of distribution agreements, including franchise agreements, in the same manner for antitrust law purposes[231]. In the US, the Courts were ready to apply broader common denominators than those applied in the EEC to distinguish between different business methods.

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[229]. See Regulation 67/67, supra, note 176.

[230]. See Pronuptia judgement, supra, note 51, at 372.

[231]. See GTE judgement, supra, note 195.

2.6 Effect on trade between member states.

The effect on trade between member states is an important component of Art. 85(1) that was hardly mentioned in the Pronuptia judgement. The possible effect on trade between member states is a question of evidence, but, the COJ did not discuss any data related to the economic circumstances affecting Pronuptia[232].

Given the absence of economic data in the judgement it is hard to understand when reading it how the COJ reached the conclusion that trade between member states was negatively affected[233]. The COJ dealt with the subject of "effect on trade" briefly in its judgement and wrote that the territorial exclusivity clauses in the franchise agreement were

> "... liable to affect trade between member states, even if they are entered into by undertakings established in the **same** member state, in so far as they prevent franchisees from establishing themselves in another member state"[234] (emphasis added).

Since the COJ did not examine any economic data, it can be understood that the COJ was satisfied with the fact that a **theoretical** barrier for the establishment of a franchise in another member state was created. This theoretical effect probably fulfilled, in the Court's view, the requirement stipulated in Art. 85(1) that trade

[232]. The COJ ignored the fact that the franchise agreement in question was between a **master franchisee** and a franchisee, and the fact that the distribution system was not strictly consist of franchisees but also of subsidiaries. The Court did not define the relevant product or what is the relevant geographic area in which trade between member states was effected.

[233]. It is assumed that this conclusion was reached to because otherwise Art. 85(1) could not have been applied.

[234]. See Pronuptia judgement, supra note 51, at 384.

between member states would be affected[235].

The COJ's decision on this point is different from the view expressed by the A.G. in his opinion . The A.G. suggested that Art. 85(1) should be interpreted to prohibit business practices only when the franchisor and the franchisee involved are from **different** EEC member countries[236].

In the regulation 4087/88 the Commission declared that franchise agreements:

> "..[M]ay in particular affect intra-community trade where they are concluded between undertakings **from different member states** or where they form the basis of a network which extends beyond the boundaries of a single member state"[237] (emphasis added).

This approach is closer to the A.G.'s suggestion than to the COJ's view[238]. It appears that in the regulation the Commission went back to the A.G.'s opinion and preferred it to the judgement in Pronuptia.

The finding of the judgement could have been different had the COJ adhered to the wording of Art. 85(1). Had the COJ applied an economic analysis to decide if trade between member states was affected, territorial exclusivity in franchise agreements could have been declared legal as early as 1986.

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[235]. See Venit, supra, note 212, at 221: "Many commentators believe that a violation of Art. 85(1) should not be based on a mere theoretical possibility and would therefore require some evidence that it was likely that the franchisee would, in the absence of the restriction, have attempted to establish herself in another member state"; See also at 222: ".. [T]he analysis of the effect on trade suggests that this requirement of Art. 85(1) may in future be found to be satisfied in unexpected and disturbing ways".

[236]. See supra, at paragraph 2.4.1.

[237]. See Regulation 4087/88, supra, note 185, at Paragraph (6) to the preamble. The regulation is broadly analyzed in paragraph 2.8.

[238]. Again no distinction was made between a case in which a master franchisee is involved and a case in which a franchisor and a franchisee are the only two parties to an agreement.

2.7 The application of Art. 85(3): individual exemptions for franchise agreements.

After the delivering of Pronuptia judgement one commentator wrote:

> "...[A]lthough the Court of Justice ruling in **Pronuptia** has provided a highly benevolent view of franchising, which means that many franchising agreements do not violate Art. 85(1) at all, there still remains a grey area of uncertainly as to some fairly common franchise clauses..."[239].

As mentioned above, the Commission did not immediately issue a block exemption to clear the uncertainties. The Commission preferred to gain experience in the franchise field through individual exemptions. The five individual exemptions issued by the Commission after the 1986 Pronuptia judgement and before the issuance of the 'block exemption' regulation in 1988 were **Pronuptia** in the bridal dresses and accessories market; **Yves Rocher**, a cosmetic franchise granted by a manufacturer of cosmetics; **Computerland** for the distribution of numerous different brands of computers not manufactured by the franchisor; **ServiceMaster**, a franchise for housekeeping, cleaning and maintenance services at the consumer's house; and **Charles Jourdan** for the distribution of top quality shoes and handbags[240].

2.7.1 The scope of the franchise method in the individual exemptions.

All five individual exemptions involved business format franchises; therefore, the focus on the features of the business format method in these decisions is not

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[239]. See Goebel, supra, note 171, at 702. The Commentator was referring to territorial exclusivity clauses.

[240]. For a reference to the five decisions see, supra, note 164.

surprising. In the Pronuptia decision, for example, the following description is found:

> "The use of the same name and a uniform business system and the payment of royalties ... were typical features which set franchise agreements apart..."[241].

The individual exemptions resemble one another because all of them attributed importance to the business formula as an integral part of a franchise in the EEC[242]. From the Commission's individual exemptions, it becomes apparent that like the COJ before, the Commission perceives that only when a business bears the characteristics of business format franchising, is it considered to be a real franchise and as such entitled for special treatment.

2.7.2 The conditions of Art. 85(3).

The structure of all five individual exemptions is fairly similar. First the Commission establishes the applicability of Art. 85(1) to the clauses of the franchise agreement in issue. Following the COJ Pronuptia judgement, the Commission declared Art. 85(1) inapplicable to clauses necessary for the existence of franchise agreements. The clauses forming the franchise services and quality control measures were therefore declared outside the prohibition of Art. 85(1).

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[241]. See Pronuptia decision, supra, note 184, at 42.

[242]. The Commission referred in all five decisions to the use of identifying marks and proven trading methods and to the application of an original and changing distribution formula; See Yves Rocher decision, Ibid., at 57; Reference to the uniform business methods and to an original method of selling was made in the Computerland decision, Ibid., at 16; In the Charles Jourdan decision, Ibid., at 38, the Commission emphasized the role of the original and evolving distribution formula.

In all 5 individual exemptions the Commission found that clauses relating to territorial exclusivity cannot be declared outside the scope of Art. 85(1) because they do not comply with one of the two necessary conditions, therefore these clauses were prohibited.

Since the territorial exclusivity was prohibited under Art. 85(1), the Commission had to establish grounds for the exemption of these clauses which creating territorial exclusivity under Art. 85(3) of the *EEC Treaty*[243]. As mentioned above there are four conditions for possible exemption under Art. 85(3)[244]. The Commission found that all four conditions were satisfied in the five individual exemptions.

2.7.2.1 Improvement of distribution.

In the five decisions the Commission found that the combined effect of all the provisions in the franchise agreement involved, including territorial restrictions, improve the distribution of the products concerned. To show how this condition of Art. 85(3) was fulfilled, the Commission emphasized the benefits of the franchise method to the franchisor, franchisee and consumer[245]:

[243]. See Korah, supra, note 20, at 27: ".. [W]as exempted and not cleared, even when the market was competitive and territorial protection limited". The author also wrote at 30: "In my view, it could well be argued that in the circumstances of all these decisions there was no appreciable restriction on competition".

[244]. See supra, at paragraph 1.2.2.

[245]. For a reference for all decisions see supra note 184; See Pronuptia decision, at 46, Computerland decision, at 20-21, ServiceMaster decision, at 41, Charles Jourdan decision, at 38.

The franchisor - The possibility of the franchisor to extend his network and penetrate new markets without having to undertake major financial investment, when otherwise it would not be possible for him to carry out such an investment, or at least not so rapidly.

The franchisee - enjoys the benefits of the franchisor's established name, reputation, expertise and tried and tested commercial know-how[246].

The consumer - the method opens the market to new competitors and therefore intensifies interbrand competition[247]. The consumer benefits from the outcomes of more competition in the market. The Commission also mentioned the specific benefits of territorial exclusivity in franchise agreements to the consumer. The Commission said that the restrictions compel franchisees to concentrate their efforts in a given area. Also, thanks to the territorial exclusivity, the franchisor can better plan the production of the franchised products and thus guarantee the quantity of supplies[248].

2.7.2.2 Fair share to consumers.

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246. See Computerland decision, Ibid., at 21. Only in this decision it is stated that the franchise method permit the franchisor to negotiate favourable terms for the franchisees. This possibility might be considered anti-competitive and it is therefore peculiar that the Commission mentioned it in its decision.

247. For example, in the Pronuptia decision, supra note 184, at 44, the Commission said: "The franchise .. opens up a market to new competitors, intensifying interbrand competition and increasing the competition faced by firms distributing their products through a branch net-work using a standard business format and product range".

248. The fact that the franchisees remain the owners of their own businesses result in commercial dynamism and diligence. See Charles Jourdan decision, Ibid., at 38.

In this part of the individual exemptions there is an overlap between the arguments the Commission used to satisfy the "fair share" requirement and to satisfy the "distribution improvement" requirement[249].

The benefits to consumers are therefore mentioned again under the "fair share" consideration and are further detailed[250].

One rationale found in all 5 individual exemptions is that the homogeneity in franchise systems along with the standardization of the product and the direct link between the franchisor and the franchisee all ensure that the consumer will enjoy the benefits achieved as a result of the franchise method[251].

Another rationale is that the competitiveness of the market of the particular product together with the possibility that consumers will buy the product[252] elsewhere in the franchise system, forces the franchisees to pass the benefits gained by the franchise method to consumers[253]. The competition in the market in general and among franchisees in particular tends to force all the franchisees within a franchise system to offer better quality, services and prices.

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[249]. The distribution improvement requirement was discussed in the preceding paragraph.

[250] In several decisions the benefits of the specific franchise system in question are brought, for example, in Computerland decision, Ibid., at 21, the possibility to compare wide range of different brands in one location in the Computerland system. In Yves Rocher decision, Ibid., at 57, the possibility to enjoy wide range of cosmetics - more rapidly available.

[251]. See Yves Rocher decision, Ibid, at 57.

[252]. See ServiceMaster decision, Ibid, at 41.

[253]. See Pronuptia decision, Ibid., at 46. Naturally the possibility of a consumer to buy a franchised product in other franchised outlets is limited because of practical reasons.

2.7.2.3 The restrictions on competition are indispensable.

Under Art. 85(3), if restrictions on competition are not indispensable to those benefits attained by them, then such restrictions are not allowed. Here the Commission directly evaluated territorial exclusivity, and explained why territorial restrictions were indispensable to achieve the benefits of the franchise method.

As discussed above, the COJ was not prepared to use the investment consideration to clear the territorial exclusivity from Art. 85(1) prohibition. It left the task to the Commission to deal with the investment consideration under Art. 85(3).

The Commission stated in its individual exemptions that territorial exclusivity was indispensable because prospective franchisees would otherwise be unwilling[254] to undertake the necessary investment and risks involved in a franchise[255].

Another line of argumentation is found in ServiceMaster decision:

> "The limited territorial protection is also necessary to ensure that the franchisees will concentrate their service activity on their own territory"[256].

This is an example of the way territorial exclusivity may be used as a quality control measure.

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[254]. The well-known argument of the 'free rider' is not mentioned in the decisions. The 'free rider' argument is that undertakings will not invest in better services and quality products if there is a possibility that a competitor may take advantage of their goodwill established following their investment without paying for it. In other words, people will not invest in the market if they are not protected from "free riders"; See Zendel, supra, note 3, at 729-731.

[255]. See Pronuptia decision, supra, note 184, at 47; See also Korah, supra, note 20, at 19: ".. [A]pproach transactions *ex ante* - to consider what protection is necessary to enable franchising to take place - and not merely *ex post*, after investments have been made".

[256]. See ServiceMaster decision, Ibid., at 42.

In each of the 5 individual exemptions the Commission was careful to emphasize that territorial exclusivity should be considered indispensable only when it is limited and not when it is absolute[257]. The fact that the territorial protection granted to the franchisees was considered limited, played an important role in the individual exemptions. The precise difference between limited and absolute territorial restrictions is dealt below[258]. In principle, limited territorial exclusivity means that the franchisor cannot ensure that he has total control of the market.

2.7.2.4 The restriction does not eliminate competition for substantial part of the products in question.

Under Art. 85(1), business practices are examined in the market context, to see if they restrict competition to such an extent that affects free competition in the common market. Under the condition of Art 85(3) discussed here, the Commission has to decide if the restriction on competition is so severe that it might eliminate competition for a substantial part of the market.

Under Art. 85(1) the requirement is that free competition was distorted and the distortion went **above a minimal level**, while under Art. 85(3) the requirement is that free competition would not be distorted **to a level above** the maximum level

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[257]. See Yves Rocher decision, Ibid., at 57:".. [C]ertain of receiving a **degree of protection against competitors**" emphasis added); and see also ServiceMaster decision, Ibid., at 41: "..[T]**he limited** territorial protection ... is necessary" (emphasis added).

[258]. A reflection of this requirement for limited protection is found in Regulation 4087/88. See infra, at paragraph 2.8.3.

stipulated in the article.

The Commission took into account the economic framework of the market of the specific product in each individual exemption and demonstrated that a sufficient degree of intrabrand competition was preserved. The Commission maintained that the reduction of intrabrand competition must be as little as possible. Therefore, it has laid down the following criteria:

1. Absolute territorial exclusivity cannot be allowed. Franchisees must remain free to sell to other franchisees[259] and to any consumer entering their outlets[260];

2. The size of the exclusive territory must be reasonable and not too large[261];

3. The franchisees must be free to determine the prices of franchised products without interference of the franchisor[262].

2.7.3 The scope of the exempted territorial restrictions in the individual exemptions:

The Commission attributed importance to the fact that territorial exclusivity

259. See ServiceMaster decision, Ibid, at 41.

260. See Charles Jourdan decision, Ibid, at 38.

261. See Yves Rocher decision, Ibid., at 58; See also Computerland decision, Ibid., at 21.

262. See Pronuptia decision, Ibid, at 47; See also Charles Jourdan decision, Ibid., at 38.

in the franchise agreements was not absolute. The difference between absolute (or "closed") territorial exclusivity and limited (or "open") territorial exclusivity is emphasized in all five individual exemptions[263].

In the Pronuptia decision, the territorial exclusivity of the franchisee was considered 'open' because the franchisees were not restricted from selling to other franchisees within the system[264]. The franchisees were also allowed to sell to any consumer entering their outlet even if the consumer came from a territory franchised to another franchisee[265]. In some of the individual exemptions, prior to the issuance of the decision, the franchisor was forced by the Commission to delete from the franchise agreement the provisions which forbade the franchisee to sell products to other franchisees.

The Computerland decision is the only decision in which territorial exclusivity of a master franchisee is mentioned[266]. The territorial exclusivity is described as:

".. [A]n exclusive right to open a fixed number of Computerland stores in a

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[263]. See Korah, supra, note 20, at 33: "Both territorial protection and cross supplies are matters on which the commission has traditionally been strict, owing to the goal of integrating the market".

[264]. See Pronuptia judgement, supra, note 184 at 41. This was an amendment done in the original franchise agreement following a request of the commission.

[265]. In the Yves Rocher decision, supra, note 184, at 58, the territorial restrictions were not considered absolute because the franchisee was allowed to sell the franchise products to any consumer entering the shop, and because the franchisee was allowed to sell to, or obtain supplies from, other franchisees; In the Charles Jourdan decision, supra, note 184, at 38, the territorial exclusivity of the franchisee was not considered absolute, because the franchisees were allowed to sell to any consumer regardless of his place of residence. The franchisees were also allowed to deal with other franchisees in the franchise system.

[266]. In the Computerland decision, the territorial protection of the regular franchisee was not considered absolute, because no franchisee had a marketing or clientele exclusivity (every franchisee is free to actively seek for consumers and sell to them), and because the franchisees are free to determine their sources of supply (the franchisees are free to buy from other franchisees).

designated area over a limited period of time"[267].

The Commission did not provide that the territorial exclusivity of the master-franchisee should be limited in any manner[268].

ServiceMaster decision is the only individual exemption in which the Commission examined a service franchise system. The territorial exclusivity granted in this system was adapted to the requirements of a service business and to the fact that the services were provided in the consumer location and not in a permanent franchised outlet. The territorial exclusivity in Servicemaster was not considered absolute because every franchisee was allowed to supply services to **non-solicited** consumers (a term provided by the Commission) even outside his allocated territory[269].

To summarize, in franchise agreements in general, the limited exclusivity was obtained, in the Commission's view, as a result of the freedom of franchisees to deal with one another and to sell freely to any consumer entering their outlets[270]. In the case of a service franchise the Commission allowed the franchisor to prohibit franchisees from actively seeking consumers outside their territories. It did not allow the franchisor to stop franchisees from supplying services to non-solicited consumers.

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[267]. See Computerland decision, supra, note 184, at 15.

[268]. See Computerland decision, supra, note 184, at 21: The Commission simply held that "[T]he same arguments referred to .. [regarding the regular franchise agreement o.g.] .. apply *mutatis mutandis* to the 'development area agreement'".

[269]. The franchisee was not allowed to **actively** seek for consumers outside his territory. See ServiceMaster decision, supra note 184, at 41.

[270]. The freedom to deal with other franchisees in the same system is also known as "cross supplies".

No limitations were required by the Commission in respect to territorial exclusivity granted to a master franchisee.

2.7.4 Summary of the individual exemptions section.

Under Art. 85(1) the Commission's approach was governed by the Pronuptia judgement. Similarly to the COJ judgement, franchise services and quality control measures were considered necessary and clauses contained in these groups were permitted. In contrast with the necessary clauses, the territorial exclusivity clauses were considered automatically prohibited under Art. 85(1).

Under Art. 85(3) the Commission discussed many benefits of the franchise method and found that, in general, the method satisfied the four conditions stipulated in Art. 85(3). The Commission has balanced two interests against one another: the economic efficiencies of the franchise method and the potential barriers to trade between the EEC member states. The compromise between the two competing effects was found by permitting territorial exclusivity in franchise agreements only when its scope was not absolute.

The automatic prohibition of absolute territorial exclusivity was criticised by several commentators. One of them wrote:

> "It is regretted that the Commission has decided to treat exclusive territories as restricting competition when, although the franchised name may be famous, there is substantial competition. There should be no need to apply these definitions when the market is competitive. Franchisors cannot protect their

franchisees from other brands"[271].

2.8 'Block exemption' regulation 4087/88.

Regulation 4087/88[272] represents the present legal situation within the EEC in respect of the franchise method and territorial exclusivity provisions found in franchise agreements[273]. The Regulation implements the findings of the Pronuptia judgement and the five individual exemptions by means of a 'block exemption'.

The Commission's view was that a regulation is needed because it would make an investment in a franchise system more secure and predictable[274] and as a result it will permit the EEC market to benefit from the advantages of the franchise method. The benefits of the franchise method to interbrand competition in the EEC were emphasized in the regulation:

> ".. [G]ive franchisors the possibility of establishing a uniform network with limited investment, which may assist the entry of new competitors to the market, particularly in the case of small and medium-sized undertakings, thus increasing interbrand competition ..[and increasing the].. possibility to compete more efficiently with large distribution undertakings"[275]

The need for a regulation was questioned by several commentators. One of

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[271]. See Korah, supra, note 20, at 51.

[272]. See Regulation 4087/88, supra, note 185. For the full text of the regulation, see Appendix II.

[273]. See De Cockborne, supra, note 15, at 270-273.

[274]. See Press release, 28.1.86, supra, note 28, at 1: "..[I]n order to provide parties to such agreements with the necessary legal certainty .."

[275]. See Regulation 4087/88, supra, note 185, at paragraph 7 of the preamble.

them has written:

> "In view of the small number of franchisors that enjoy market power and the generally beneficial effects that franchised networks are likely to have, I would have preferred the Commission not to adopt block exemption but to have granted formal negative clearances to all the cases it has decided..."[276].

Regulation 4087/88 is applicable to a wide scope of business format franchise agreements and does not distinguish between service and distribution franchises[277].

2.8.1 The definition of a franchise agreement in the Regulation

Regulation 4087/88 includes comprehensive definitions[278] of a 'franchise' and of a 'franchise agreement' [279]. Franchise is defined as:

> "[A] package of industrial and intellectual property rights ... to be exploited for the resale of goods or the provision of services to **end users**" (emphasis added).

Franchise agreement is defined as an agreement that contains:

1. financial consideration;

2. A right to exploit the franchise for the purpose of marketing of goods or services;

3. At least three obligations should appear in the agreement:

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[276]. See Korah, supra, note 20, at 133.

[277]. The definition of a franchise in the regulation was already discussed above.

[278]. See Smit & Herzog, supra, note 166, vol. 2, at 2-236.79; The precise definition is meant to prevent enterprises from calling an ordinary agreement related to the distribution of goods or services a franchise agreement in order to enjoy the benefits of the 'block exemption'.

[279]. See Reg. 4087/88, supra, note 185, at Art. 1.

(a). use of **common name and presentation**,

(b). **communication of commercial know-how** by the franchisor to the franchisee,

(c). **continuing provision of commercial or technical assistance** during the life of the franchise.

In the next paragraph, commercial know-how is defined as:

> "a package of non patentable practical information, resulting of experience and testing by the franchisor, which is secret, **substantial** and identified" (emphasis added).

The definition found in the regulation includes most of the common features of the business format franchise method. An attempt is made to describe the 'business format' itself in a clear manner by incorporating it into commercial know-how terminology. Also found in the definition is a recognition of the continuous nature of franchise relationship[280] and the tendency to make franchise systems uniform.

Even though the definition of a franchise in the regulation is very detailed, or maybe because it is so detailed, the regulation provides a considerable scope for interpretation and comments, for example[281]:

1. It is not clear what is the extent of 'substantial' in the definition of 'know-how', a term which forms an important part of the definition of the franchise

[280]. The franchise services are explicitly mentioned while the quality control measures are only implied by the importance attributed to the common manner of presentation in this definition.

[281]. See Joslyn, supra, note 114, at 779: "A great deal can depend on whether the statutory definition of franchise is satisfied"; in the US the question whether or not an agreement qualified within the franchise agreements definition provided a fertile source for litigation.

agreement in the regulation. For example, is the know-how provided by a licensor to a licensee in certain product franchise agreements substantial enough to make the system eligible to be included in the block exemption?[282].

2. The inclusion of common presentation as part of the franchise definition may have the effect of limiting the number of franchise systems that may enjoy the block exemption. This limitation is not justified because there are cases in which, even though the franchisor's business formula is used by the franchisee, no common presentation is applied.

3. The number of parties to the franchise agreement is restricted in the regulation to two. This limits the flexibility of the franchise agreement and the possibility of including a master franchisee as a third party to the principal agreement[283].

4. According to the definition of franchise, the franchisee is prevented from selling to wholesalers and may only sell the franchised products to **end users.**

2.8.2 The framework of the Regulation.

The regulation includes a 'white list' of clauses that commonly appear in

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[282]. The same criticism was made about the definition of know-how in regulation 556/89, see infra, note 294; See also Smit & Herzog, supra, note 166, at 3-238.86: "... [P]ractically it will be very difficult to distinguish a substantial body of technical information from a non-substantial one".

[283]. This practice is especially common when a foreign franchisor is involved; See Korah, supra, note 20, at 34: Sometimes - "... [T]riparitate agreements are necessary to enable the franchisor to retain its rights in the mark"

franchise agreements which are automatically exempted from the application of Art. 85(1); and an intermediate list of provisions which are only exempted if:

"in so far as they are necessary to protect the franchisor industrial or intellectual property rights or to maintain the common identity.."[284].

The other part of the regulation is a 'black list' of clauses commonly appear in franchise agreements[285]. The 'black list' is divided into two sections. The first section specifies the clauses that **must be included** in a franchise agreement to make the agreement qualify for an exemption; the second section specifies provisions that **must not be included** in an agreement to make it qualify for an exemption[286].

2.8.3 Territorial exclusivity provisions in the regulation:

In franchise agreements.

In Art. 2 of the regulation, the Commission specifies the territorial clauses that are automatically exempted from Art. 85(1) prohibition.

Paragraph 2(a) includes obligations that can be imposed on the franchisor in a franchise agreement:

"(a) an obligation on the franchisor, in a defined area or the common market, the contract territory, not to:
- grant a right to exploit all or part of the franchise to third parties.
- itself exploit the franchise, or itself market the goods or services which are the subject matter of the franchise under a similar formula.

[284]. See Regulation 4087/88, supra, note 185, at Art. 2 and Art. 3.

[285]. For a comprehensive analysis of the 'black list' see Korah, supra, note 185, at 81-89.

[286]. See Regulation 4087/88, supra, note 185, at Art. 4 and Art. 5.

- itself supply the franchisor's goods to third parties".

Paragraphs (c) to (e) of Art. 2 includes the obligations that can be imposed on the franchisee in a franchise agreement:

"(c) ... to exploit the franchise only from the contract premises[287];
(d) .... to refrain, outside the contract territory, from seeking consumers for the goods or the services which are the subject matter of the franchise;
(e) .... not to manufacture, sell or use in the course of the provision of services, goods competing with the franchisor's goods which are the subject-matter of the franchise.."

The regulation allows a comprehensive system of territorial restrictions and therefore a wide territorial exclusivity. All the exempted provisions in paragraphs 2(a) and 2(c) through 2(e) may appear in the same franchise agreement. In the franchise agreements examined in the individual exemptions, such a comprehensive system of territorial restrictions was never applied.

It seems also that the scope of the exempted restrictions themselves is relatively wide. In paragraph 2(d), for example, the franchisor, is allowed to restrict the franchisee from actively seeking consumers outside the franchised territory. A similar restriction was found only in the individual exemption on ServiceMaster. The restriction was justified in that decision due to the special needs of a service business. In the regulation, the Commission made it possible to apply the restriction to any type of franchise agreement and not only to service businesses.

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[287]. This is a "location clause". In Art. 3(2)(i) to the regulation, the following provision in franchise agreements is cleared from the application of Art. 85(1): ".. [the franchisee cannot o.g.] without the franchisor's consent to change the location of the contract premises". It is not easy to draw the line between this permitted provision and the prohibited 'location clause'.

In master franchisees agreement.

Art. 2(b) exempts territorial exclusivity granted in master franchisee agreements[288]. The exemption is given with respect to:

> "an obligation on the master franchisee not to conclude franchise agreements with third parties outside its contract premises".

The fact that a master franchisee agreements are governed by the regulation was criticised. The grounds for criticism were that many of the articles of the regulation, primarily designed for regular franchise agreements, cannot be practically and legally applied to master franchisee agreements. The application is not possible because the nature of master franchisee agreements is, in many aspects, different from the nature of regular franchise agreements[289].

The territorial exclusivity must not be absolute.

Art. 4 provides the provisions that must be included in a franchise agreement so that the agreement qualifies for an exemption.

Paragraph 4(a) includes the compulsory limitation intended to prevent territorial exclusivity in franchise agreements from becoming absolute. An exemption under the regulation is granted only when the following provision is included in the agreement:

"(a) the franchisee is free to obtain the goods .. from other franchisees; where

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[288]. See Zaid, supra, note 2, at 2-1131: "The definition of a master franchisee agreement is still too basic and does not account of the many techniques which are employed in the establishment of the master franchisee agreement".

[289]. See Konigsberg, supra, note 9, at XV.IV.7; See also in chapter I, at paragraph 1.4.

> such goods are also distributed through another network of authorized distributors, the franchisee must be free to obtain the goods from the latter"

Following the individual exemptions, territorial exclusivity is considered 'open' and is legal only when franchisees are free to trade with one another or with other distributors of the franchised product[290].

2.8.4 Social policy provisions in the regulation.

Under Art. 4 of the regulation there are two more provisions that must be included in a franchise agreement to permit its exemption. The subject matter of these provisions was not discussed in the Pronuptia judgement or in the five individual exemptions.

One compulsory provision that must be included in a franchise agreement forces franchisees to honour guarantees for franchised products, regardless of the outlet these products were sold in. The second provision forces franchisees to indicate their status as independent undertakings to prospective consumers.

These two compulsory provisions are only indirectly connected with protection of free competition in the market. It appears that the provisions were primarily meant to benefit consumers on social policy grounds rather than on economic grounds.

Given that provisions based on social policy grounds were allc ·ed to appear

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[290]. The freedom to trade with other distributors of the franchised product was not stipulated in the individual exemptions.

in this competition regulation, there was nothing to stop the Commission from enacting in this part of the franchise regulation (the compulsory provisions section), provisions to protect franchisees from the superior bargaining powers and business experience of franchisors, but the Commission has chosen not to do so.

2.8.5 Paragraph to protect franchisees.

It is important to note that the Commission did not totally neglect the protection of franchisees from the business superiority of franchisors.

In Art 8 of the regulation the Commission was given authority to withdraw an exemption[291] **after** it was granted, when it finds that as a result of the exemption the common market was effected significantly, and the affects are "incompatible with the conditions laid down in Art. 85(3)".

One of the reasons the Commission may use to justify an exemption being revoked is found in paragraph 8(e). In contrast with the other paragraphs of article 8, the grounds for revocation stipulated in paragraph 8(e) are not economic. The Commission was given the power to withdraw an exemption if:

> "(e) the franchisor uses its right to check the contract premises and means of transport, or refuses its agreement to requests by the franchisee to **move the contract premises or assign its rights and obligations under the franchise agreement**, for reasons other than protecting the franchisor's industrial or intellectual property rights, maintaining the common identity and reputation of the franchise network or verifying that the franchise abides by its obligations under the agreement" (emphasis added).

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[291]. This power is pursuant to Art. 7 of Regulation 19/65 - see supra, note 155.

This paragraph is the only piece of legislation in the EEC jurisprudence which has protective consequences for franchisees[292] (hereinafter - the "protective paragraph"). The fact that a protective paragraph is found in the 'block exemption' demonstrates that the Commission was not reluctant to include a measure to protect franchisees in a competition regulation.

The protective paragraph can be compared to the relationship legislation found in the US. Similarly to the relationship legislation, the paragraph regulates aspects of the relationship between the parties to a franchise agreement, **after** the agreement is signed. In contrast with the protective paragraph, the relationship legislation of the US regulates, primarily, termination and renewal of franchise agreements. Unfair termination of an agreement is perceived in the US as the main problem in franchisor-franchisee relationship. In the EEC regulation, unfair termination is not even mentioned[293]. The paragraph concentrates on transfer of franchise rights and on changes of the franchised outlet's location.

When comparing this protective paragraph to the franchise protective

[292]. "Additional Opinion of the Economic and Social Committee on the Draft Commission Regulation (EEC) on the Application of Article 85(3) to the Treaty to Categories of Franchising Agreements" in Competition Policy - Economic and Social Committee (Brussels: 1990), 15, at 18. The Commission probably took into account the comments of the Economic and Social Committee to the draft of the Regulation: "We would urge the commission to take account above all of the social aspects, especially the problem which may be arise from the hierarchical ... relationship between franchisor and franchisee".

[293]. See Pronuptia decision, supra note 184, at 41. The absence of consideration given to termination provisions in franchise agreements can also be seen in the Commission individual exemption of Pronuptia. Among the clauses of the franchise agreement, cited by the Commission when describing the agreement, was a clause stating that the contract between the parties may be terminated if "either party breaches his obligation". In a jurisdictions in which a tendency to protect franchisees exist this type of a provision would have probably attracted much attention, because it gives broad legal powers to the franchisor against the franchisee. The Commission did not mention in its decision that the existence of this clause is problematic in any way.

legislation of the US two comments can be made:

It is somewhat peculiar that the only protective legislation in the EEC level is relationship legislation. Disclosure legislation is more moderate and interferes less in freedom of contract. It seems that the Commission could have considered moderate measures to protect franchisees instead of adopting relationship legislation. Since relationship legislation and no other type of protective legislation was chosen by the Commission to be enacted, it could have been useful to solve in this legislation the problem of unfair termination as well.

The protective paragraph found in the regulation is not a comprehensive treatment to the problematic relationship between franchiors and franchisees. If the Commission considered that franchisees should not be protected in the EEC, then a sole protective paragraph is not needed either; but if the Commission considered that franchisees in the EEC should be protected, then the sole paragraph in the franchise regulation is not enough.

2.8.6 Territorial restrictions in other block exemptions:

For purposes of comparison, other block exemption regulations should be examined. Two other block exemption regulations have been chosen: Regulation 556/89[294] which governs technical know-how licensing, and Regulation 1983/83[295]

[294]. Regulation 556/89 on the application of Art. 85(3) of the Treaty to certain categories of know-how licensing agreements, OJ L61, 4.3.1989, p. 1.

which governs exclusive distribution agreements. These two regulations were selected out of the seven existing 'block exemption' regulations (the franchise regulation is the eighth one)[296]. The know-how regulation was selected because of the resemblance between technical know-how and commercial know-how found in franchise agreements. The distribution regulation was selected because of the resemblance between exclusive distribution rights and the exclusivity found in franchise agreements.

In Reg. 556/89, on technical know-how, Art. 1(1) specifies the clauses of territorial exclusivity exempted from the application of Art. 85(1)[297]. Paragraph 1(2) of the regulation stipulates that territorial exclusivity granted to the licensee of technical know-how must not exceed the period of 10 years. No other limitations for the application of territorial exclusivity clauses were found in the regulation; therefore, under the know-how regulation, territorial exclusivity is limited in time but

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[295]. See Regulation 1983/83, supra, note 177; This regulation replaced regulation 67/67 which was considered in Pronuptia judgement and was held inapplicable to franchising; See also Korah, supra, note 20, at 45: "The commissions development of different codes for each kind of agreement as opposed to the broad brush approach towards vertical agreements under U.S. antitrust is regrettable"

[296]. The specific categories of agreements for which 'block exemption' regulation is available today in the EEC are: exclusive distribution, exclusive purchasing, exclusive patent licensing, specialization, research and development, motor vehicle distribution, franchising and know-how licensing.

[297]. **Paragraphs 1(1) and 1(2) to regulation 556/89 exempt obligations on the part of the licensor:** "(1) ... not to license other undertakings to exploit the licensed technology in the licensed territory; (2) .... not to exploit ... in the licensed territory himself". **Paragraphs 1(3) to 1(6) exempt territorial restrictions accepted by the licensee:** "(3) ... not to exploit ... in territories within the common market ... reserved for the franchisor; (4) .... not to manufacture or use the licensed product .. in territories .. licensed to other franchisees; (5) .... not to pursue an active policy of putting a licensed product in the market in the territories .. licensed to other franchisees; (6) .... not to put the licensed product on the market in the territories licensed to other licensees within the common market"

not in scope.

Regulation 1983/83, on exclusive distribution, begins with a general exemption in Art. 1:

> "... Art. 85(1) of the Treaty shall not apply to agreements to which only two undertakings are party and where by one party agrees with the other to supply certain goods for resale within the whole or defined area of the common market only to that other"

The scope of territorial exclusivity allowed in the distribution regulation is narrower than what is allowed in the franchise regulation[298]. The distribution regulation states that only those restrictions explicitly allowed in it are permitted in distribution agreements. Absolute territorial exclusivity is not allowed.

The provisions found in the technical know-how regulation, the distribution regulation and the franchise regulation, demonstrate the central importance attributed to territorial exclusivity in the EEC. All three regulations discuss broadly territorial exclusivity clauses. Absolute territorial exclusivity is prohibited in all three regulations.

The potential impact of exclusivity was limited by using different means. In the technical know-how regulation, the limited effect was achieved by an imposition of a **time limit** on the territorial exclusivity. In the franchise regulation the limited effect was achieved by an explicit limitation on the **scope** of the exclusivity. In the distribution regulation it was achieved by a general prohibition of restrictions not

[298]. **The only restriction allowed, on the supplier, is found in paragraph 2(1) to Regulation 1983/83:** "... not to supply the contract goods to users in the contract territory". **The only territorial restriction allowed, on the exclusive distributor is found in paragraph 2(2) to the Regulation:** "(c) ... to refrain, outside the contract territory and in relation to the contract goods, from seeking consumers, from establishing any branch , and from maintaining any distribution depot".

specified in the regulation and the restrictions specified there do not allow absolute territorial exclusivity.

Three main conclusions can be drawn out from the comparison among the regulations:

1. Territorial exclusivity is generally considered problematic under the EEC competition law.

2. To satisfy the requirement that territorial exclusivity would not be absolute, the Commission used also limitations of time and not only limitations of scope.

3. Franchise agreements were treated more favourably than other distribution agreements. The territorial exclusivity allowed in franchise agreements is wider than that allowed in other categories of agreements.

3. Summary and conclusions.

The discussion in this chapter will be summarized under three headings - the franchise method, territorial exclusivity within the franchise method and competition law in the EEC in general.

3.1 The Franchise method.

Concentration on competition law. No serious attempt to protect the franchisees. The EEC authorities concentrated on the status of the franchise method under competition law in the EEC. Franchises were analyzed without any reference to the problems involved in the relationship between the franchisors and the franchisees.

The EEC authorities focused on preventing 'market sharing' in the Common Market. The emphasis was on territorial exclusivity, frequently found in franchise agreements. Other important aspects of the franchise agreement which should have been more seriously discussed were neglected, such as: the risk of exploitation of the franchisee by the franchisor, the problem of unbalanced franchise agreements and the risk of the franchisees being abused when quality control measures are applied by the franchisor.

Franchising was recognized as a separate business method. The COJ examined the features of the franchise method in the Pronuptia judgement and concluded that these features justified special treatment for the franchise agreement which was discussed in the case under the EEC competition law.

The Court was not only willing to recognize the franchise method as a separate business method, but, it also referred to the special features of the method in its reasoning. The features that the Court considered as forming the franchise method are typical to the business format franchising.

The Commission, in its individual exemptions and 'block exemption' regulation, has followed the COJ approach. It found the franchise method, that is, 'business format' franchising, different enough from other distribution methods to justify special consideration. The recognition of the uniqueness of the franchise method under competition law made the Commission enact the 'block exemption' regulation for franchising.

The existence of a regulation for franchising tends to standardize the form and content of franchise agreements in the EEC market. Franchisors want to see their agreements exempted from the prohibition of Art 85(1) and included within the scope of the regulation. To avoid any risk franchisors tend to follow strictly the format of the exempted provisions as set out in the regulation. This tends to create standardization of franchise agreements in the EEC.

The franchise method was already established in the EEC when it was first examined. When the franchise method was considered by the COJ for the first time, it was already well established in Europe as a business method. The COJ's Pronuptia judgement and the development of franchise competition law in the EEC were influenced by this fact. The COJ and the Commission were not able to examine the questions of competition law without considering the potential impact of their decisions on many existing franchise systems in the EEC. This can be one of the explanations for the positive approach, taken by the COJ and the Commission, towards the franchise method in general. It may also explain why were the necessary clauses automatically considered legal in Pronuptia.

Master franchisees. Master franchisee agreements were treated as being similar to regular franchise agreements. This approach is found mainly in the individual exemptions and in the 'block exemption' regulation.

The difference between a franchise agreement and a master franchisee agreement was discussed in the introduction of this thesis. The difference is clear enough to justify separate considerations of each of these types of agreements [299].

3.2 Territorial exclusivity.

The COJ, in Pronuptia, treated territorial exclusivity clauses differently from other clauses of the franchise agreement. The Court was not ready to recognize territorial exclusivity as necessary to the franchise method, not even in light of the

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[299]. This suggestion can be supported by the general tendency of the EEC authorities to divide distribution agreements into specific types, and to deal with each type separately.

'investment consideration'.

When it comes to territorial exclusivity, the COJ, suddenly changed its approach from a flexible to a rigid one. The flexible approach that the COJ took towards franchise services and quality control clauses in the franchise agreement was interpreted above in the chapter as an application of a court-made 'rule of reason' under Art. 85(1), or alternatively, as an application of a 'per se' legality rule under Art. 85(1). The COJ could have logically applied this flexible approach to territorial exclusivity clauses as well, if only it had focused on economic considerations. In practice, however, the economic context of the territorial exclusivity clauses in the franchise agreement was not even considered by the Court.

The prohibition of territorial exclusivity in Pronuptia cannot be explained solely on economic grounds. The COJ and the EEC authorities concentrated on preventing barriers to trade between the EEC member states, even when the barriers involved were only theoretical. The preventation of barriers to trade, regardless of their economic effects is a political consideration. This political approach can be explained by the development of the economic union between the EEC member states which is in its relatively early stage. Every barrier to trade, even when only minimal, has the potential of injuring the fragile union. Territorial exclusivity in franchise agreements has, from the viewpoints of Court and the Commission, a potential to create territorial barriers for business along the borders of the EEC member states and therefore it was prevented.

3.3 Competition law in general.

When applying Art. 85 of the EEC Treaty to the Pronuptia franchise agreement, the COJ was not consistent in its reasoning. The COJ first took a flexible approach and then a rigid approach. It appears that the allocation of powers between the COJ and the Commission is one of the reasons for this inconsistency.

When the Pronuptia case was heard by the COJ, the franchise method was already well established in the EEC. On the one hand the Court had to act within its limited authorities under Art. 85(1). On the other hand the Court did not want to damage existing franchise agreements, that were perceived as benefiting the EEC economy.

The Court "stretched" its authority under Art. 85(1) and declared legal clauses that were necessary to the existence of the franchise method. In this way the COJ ensured that most existing franchise agreements would not be affected by the judgement.

The Court could not have "stretched" its authority under Art. 85(1) to clear clauses for territorial exclusivity in the franchise agreement. It was well established in the EEC at that time, that territorial exclusivity distorts free competition, and thus could be exempted from illegality only under Art. 85(3). The assumption that territorial exclusivity is usually regarded as a distortion free competition is supported by the fact that all 'block exemption' regulations reviewed include a reference to territorial exclusivity and exemptions are granted to clauses of this type.

If the COJ had the authority to exempt an agreement under Art. 85(3) and not only to enforce the prohibition of Art. 85(1), the Pronuptia judgement might have been much more consistent internally in its reasoning. If the COJ had this authority, it would not have had to interpret Art. 85(1) in such a wide manner as it did, and the necessary clauses would probably not have been held to lie outside the scope of Art. 85(1) without an analysis of the economic framework of the market.

In such a scenario the COJ could likely have used Art. 85(3) instead of Art. 85(1) to grant an exemption to some of the necessary clauses, and it could have also exempted the territorial exclusivity clauses.

The question remains, whether in view of the Pronuptia judgement, the COJ should be granted the authority to act under Art. 85(3) and not only under Art. 85(1) to the *EEC Treaty*. Generally speaking, the results of the Pronuptia judgement were favourable for the franchise method, but it could have been better if territorial exclusivity in franchise agreements was declared legal already in Pronuptia and not two years and five decisions later.

Chapter III

THE FRANCHISE METHOD UNDER THE US ANTITRUST LAW AND THE US FRANCHISE PROTECTIVE LEGISLATION.

1. Introduction.

The aim of this chapter is to be able to compare the situation in the US to the situation in the EEC, to understand the different approaches taken towards the franchise method in these jurisdictions.

Since the franchise method in the EEC was examined mainly from the point of view of competition law, the US chapter begins with a review and an explanation of several concepts of antitrust law in the US relevant to the objectives of this thesis. The chapter goes on to explore US antitrust law treatment of territorial exclusivity in distribution agreements in general and in franchise agreements in particular. An examination of franchise protective legislation in the US follows; the provisions that regulate territorial exclusivity directly and indirectly are identified. The chapter concludes with a comparison between the protective legislation findings and the findings of the antitrust law survey.

It should be noted that only the aspect of territorial exclusivity is discussed in this chapter, even though there are other issues which arise when franchise agreements are considered under the US antitrust law and/or franchise protective legislation. The emphasis on territorial exclusivity is to facilitate the comparison between the US and the EEC.

It should also be noted that in the US, the view of the franchise method is much broader than the view of this method in the EEC. Not only business format franchises, but many types of distribution agreements are also treated as franchises both by US legislatures and by the courts.

2. Main legislation within US antitrust law.

Free competition in the market is a very important objective in US law. US antitrust law, like the EEC competition law, is based on the assumption that free competition in the market is desirable both socially[300] and economically[301]. Free competition is valued because it tends to keep prices down to the lowest level, to keep quality higher, and to cause the best allocation of resources.

The economic theory behind the concept of free competition has often been questioned[302] but, up to the present time, the approach in the US has not been changed; the protection of free competition in the market is still considered highly

300. It is alleged that there is a close connection between economic freedom and personal freedom - in United States v. Topco Associates 405 US 596 (1972): "They are as important to the preservation of economic freedom and our free enterprise system as the bill of rights is to the protection of our fundamental personal freedom"; It is also believed that monopoly power leads to political power.

301. J.T., McCarthy, Trademarks and Unfair Competition (New York: LCP), at 1.

302. See for example R.A., Posner, Antiturst Law - An Economic Perspective (Chicago: University press, 1976).

beneficial.

At present, the US economy is a compromise between two economic streams. The *Laissez Faire* doctrine, at one end of the spectrum, calls for as little as possible government interference in the economic affairs of the market. At the other end of the spectrum various measures of government control of free enterprise are found in the US[303].

The concept of free competition in the market place is closer to the *Laissez Faire* doctrine than to government interference in the market[304]. Therefore, it is somewhat ironic, though not unusual[305], that free competition in the US economic market is protected by a governmental interference in the market through antitrust law[306].

There does not exist an agreed-upon definition of what constitutes a distortion of free competition in the US market. The term "unfair competition" is dynamic and changing[307]. Its content cannot be assessed in the abstract but it is connected with the economic framework of the business practice involved.

A full review of antitrust law in the US is outside the scope of this thesis. The

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[303]. For example the protective franchise legislation.

[304]. The assumption of free competition is that the market regulate itself. Any interference in the market, private or governmental, is a distortion of this basic assumption.

[305]. It is not unusual because rights are often protected by certain restrictions on other rights.

[306]. The US antitrust law is the equivalent of the EEC competition law.

[307]. A.D., Neale & D.G., Goyder, The Antitrust Laws of The U.S.A. (Cambridge: University Press, 1980), at 20.

survey of antitrust law in this thesis focuses on Art. 1 of the *Sherman Act*[308], since it is the central federal prohibition against restrictive business practices in the US market. Art. 5 of the *Federal Trade Commission Act* is discussed briefly, as it is the legislation under which the federal *Franchise Rule*[309] was enacted. State antitrust laws, enacted in most of the US states, are examined in this chapter because they are the equivalent of the *Sherman Act*, in the state jurisdictions.

2.1 Art. 1 of the *Sherman Act*[310].

2.1.1 An introduction.

The *Sherman Act* was enacted in 1890. It was the first federal law in the US meant to defend free competition in the market and is still the most significant federal law in this area.

Art. 1 of the *Sherman Act* states:

> "Every contract .. in restraint of trade or commerce among the several states, or with foreign nations, is declared to be illegal ..".

This provision is similar to Art. 85(1) of the *EEC Treaty*. As in the EEC, the effect on trade between the member states of the economic union is mentioned in the prohibition of anti-competitive practices. The effect on trade between the states

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308. See the *Sherman Act*, infra, note 310.

309. See the *Franchise Rule*, supra, note 86; See also chapter I, at paragraph 2.2.2.

310. 15 USC s. 1.

is not of the same importance in the US antitrust law, as the "effect on trade between member states" in the EEC competition law[311].

The parties to a transaction prohibited by Art. 1, must be separate entities and cannot be part of the same business enterprise as in a parent-subsidiary relationship[312].

Art. 1 of the *Sherman Act* is enforced by the Federal Department of Justice, by state Attorneys General and by the Federal Trade Commission[313]. The Article can also be invoked by one of the parties in a private civil action[314].

2.1.2 The development of the 'rule of reason'.

After the *Sherman Act* was enacted in 1890, the US courts applied it as an **absolute prohibition** of business practices which restrict free competition in the market. Any restriction of trade whatsoever was considered illegal and forbidden under the law; the reasons and/or explanations for the business practice were not

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[311]. In fact the term "commerce among several states" was interpreted almost literally, therefore it is said in Glickman, supra, note 98, at 13-95: "The question of interstate or foreign commerce has rarely been raised in franchise cases because few franchise operations are **limited to a single state**" (emphasis added); Compare this to the COJ view in Pronuptia judgement, that a business practice may "affect trade between member states" even if the transaction was made within one member state.

[312]. It may be alleged that when the franchisee is very strictly controlled by the franchisor they do not constitute two different entities, in the sense that they could be said to be part of the same legal enterprise; Compare to "agreement between undertakings" in Art. 85(1) to the *EEC Treaty* and the discussion about it in Computerland decision, supra, note 184, at 16; and in Yves Rocher decision, supra, note 184, at 51. In both cases the Commission found it necessary to demonstrate that the franchisor and the franchisee are independent undertakings and cannot be considered part of the same legal enterprise.

[313]. See infra, at paragraph 2.2, an explanation about the Federal Trade Commission.

[314]. P.C., Jones, Litigating Private Antitrust Actions (New York: McGraw Hill, 1984), at 326.

relevant once it was restrictive[315]. The actual economic impact of the restriction in the market was not relevant either[316].

This approach was not logical from an economic viewpoint since it had a potential of excluding beneficial business practices from the market in addition to damaging business practices. The US courts therefore, began to look for interpretative ways to permit more flexibility under the *Sherman Act*. The need for flexibility caused the US Supreme Court to invent the 'rule of reason'. Under the 'rule of reason' the Courts evaluate the business practice in question in its economic framework; a balancing process takes place and business practices are not automatically declared illegal.

Justice Peckham, of the US Supreme Court, was the first to suggest, in 1898, that a business practice should be assessed in its economic framework. The Judge wrote that if an anti-competitive effect of a business practice was only incidental to a legitimate business purpose, the business practice should be considered valid[317].

> "... [C]ertain kinds of agreements entered into between persons engaged in the same business for the direct and bona fide purpose of properly and reasonably regulating the conduct of their business among themselves and with the public. If an agreement of this nature while apt and proper for the purpose thus indicated, should possibly, though only indirectly and unintentionally, affect interstate trade or commerce **in that event we think the agreement would be good**"[318] (emphasis added).

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[315]. L.A., Sallivan, Handbook of Law of Antitrust (Minnesota: West Publishing, 1977), at 167-171.

[316]. In the *Sherman Act* there was no equivalent to the EEC Art. 85(3).

[317]. This is the basis to the US 'ancillary restraints' doctrine that was alleged by several commentators to be employed by the COJ in the Pronuptia judgement.

[318]. Anderson v. US 171 US 604 (1989), at 616; see also United States v. Addyston Pipe & Steel Company 85 F. 271 (1899), at 280-282.

Only an agreement which was intended solely to restrain competition should, according to Justice Peckham view, be declared void.

Chief Justice White, of the US Supreme Court, was the first, in 1911, to use the phrase 'rule of reason' in a judgement. He also clarified the meaning of the rule:

> ".. [T]reating as illegal all contracts or acts which were unreasonably restrictive of competitive conditions, **either from the nature** or character of the contract or act, **or where the surrounding circumstances** were such as to justify the conclusion that they had not been entered into or performed with the legitimate purpose of reasonably forwarding personal interest and developing trade, but on contrary, were of such character as to give rise to the interence or presumption that they had been entered into or done with the intend to do wrong to the general public and to limit the right of individuals, thus restraining the free flow of commerce ..."[319] (emphasis added).

The 'rule of reason' test was subsequently further clarified by Justice Brandeis of the US Supreme Court:

> "The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition"[320].

When applying this test, the Court indicated that the complete economic and factual situation connected to the business practice in question should by analyzed.

The application of the 'rule of reason' was not extended to every business practice that come under scrutiny. In the US case law many business practices remained automatically prohibited, or, using the antitrust law terminology, those business practices are viewed as being 'per se' illegal. One of the main issues in the US antitrust law is whether a business practice falls into the 'rule of reason' group

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[319]. Standard Oil Company v. United States 221 US 1 (1911), at 58.

[320]. Chicago Board of Trade v. United States 221 US 106 (1918), at 179.

or the 'per se' illegal group.

2.1.3 The difference between the 'per se' rule and the 'rule of reason'.

A distinction should therefore be made between two groups of illegal practices[321]: firstly, the **'per se'** illegal business practices; these restrictions on free competition cannot be economically justified and are considered anti-competitive, regardless of their surrounding economic data. The assumption the courts are making when the 'per se' rule is applied is that the business practice falling within it cannot have any beneficial effect in the market that may override their restrictive effect on free competition, and that therefore there is no need to examine their economic framework[322]. Secondly, the business practices qualified for a **'rule of reason'** treatment are considered illegal only if they reduce competition in the market substantially[323]. Such practices may be considered illegal only in context of the surrounding economic circumstances[324]:

"... economic data must be adduced to prove that a contractual restraint or

[321]. J.G., Van Cise, W.T. Liftland & L.T., Sorkin, Understanding the Antitrust Laws (New York: Practising Law institute), at 33-36.

[322]. US Department of Justice, Antitrust law Division, Antitrust Enforcement Guidelines for International Operations (Washington D.C.: The Department, Nov. 10, 1988), at 25: ".. [S]o inherently anticompetitive and so rarely beneficial that extensive analysis of their precise effects is unnecessary". The most common example for practices considered 'per se' illegal is price fixing.

[323]. The common explanation to their legality is that these practices generate pro - competitive efficiencies.

[324]. R., Collmann, Collmann's Unfair Competition, Trademarks and Monopolies (New York: Chllaghan), at 4-107: "Restrictions which increase competition may not be violative of antitrust law. The same holds true with respect to certain commercial agreements such as exclusive dealing ..."

practice harms competition"[325].

2.2 Art. 5 of the *Federal Trade Commission Act*[326].

The Federal Trade Commission (hereinafter - the FTC) is an administrative body established by the US Congress. It was granted an authority to determine whether business practices, exercised in the modern economic world, should be considered unfair and whether they affect interstate commerce. The US Congress took the position that the economy develops more quickly than antitrust legislation can be adapted to it by the courts and so the *FTC Act* was designed to meet "the increasing complexity of human activities"[327].

The FTC was established for the purpose of bridging the gap between economic reality and legal solutions, and to enhance the legal and business certainty in the market. It was empowered to determine which business practices are illegal under the definitions of the *FTC Act*.

Art. 5(a)(1) is the central provision of the *FTC Act*:

> "**Unfair methods of competition** in or effecting commerce, and **unfair or deceptive acts** or practices in or effecting commerce, are declared unlawful" (boldfacing added).

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325. See Glickman, supra, note 98, at 13-80.

326. 15 USC s. 45.

327. See Collmann, supra, note 324, at. 24-2; To some extent the FTC fulfils the same role as of EEC commission. It enforces antitrust law and also exempt activities from the scope of the prohibition when "modern" needs dictate it.

The FTC is also authorized to enforce the *Sherman Act* alongside the US Department of Justice[328].

The FTC issues trade regulation rules to prevent the unlawful practices, as defined in the Act[329] and it also exercises its enforcement powers in individual cases. The trade regulation rules issued by the FTC have been accorded the force and effect of federal law[330]. One of the trade regulation rules issued by the FTC is the *Franchise Rule*[331] which was discussed in the first chapter of this thesis. The *Franchise Rule* has therefore the same legal status as a regular federal law.

2.3 State antitrust laws.

Antitrust legislation is found in most of the US states. Few of the states enacted legislation before the enactment of the federal *Sherman Act* and most of them enacted their antitrust laws after the *Sherman Act* was enacted and adopted its principles to a varied extent. The state antitrust laws are enforced by the state Attorneys General. Several commentators think that the state antitrust laws are of no importance in the US antitrust system:

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[328]. See the Guidelines, supra, note 322, at p.20, footnote 4: "The FTC may proceed in a civil action under section 5 to the FTC Act against conduct that violates the Sherman Act. The FTC has exclusive authority to enforce the FTC Act's prohibition ... only the Department [of justice in the US o.g.], however, is authorized to prosecute criminal violations of the Antitrust laws".

[329]. 15 USC s. 46(g).

[330]. See Collmann, supra, note 324, at 24-151.

[331]. See chapter I, at paragraph 2.2.2; See also the *Franchise Rule*, supra, note 86.

".. [S]uch state statutes are often not to be of any practical use"[332]

Other commentators think that these laws are significant enough and therefore should always be considered:

> ".. [S]tate antitrust acts frequently are relied on for variety of reasons. Some state antitrust laws are broader in certain areas than the federal counterparts"[333]

State antitrust laws are examined here, as the latter view is preferable to the writer, primarily because the *Sherman Act* does not overlap with state antitrust legislation. The federal law governs business practices that affect trade **among states** and the state legislation governs business practices **within the states**[334].

As a general principle the state courts are required to follow the federal case law when they are interpreting and applying the *Sherman Act*[335]. When state courts are interpreting and applying state antitrust legislation, this principle is not valid because the state antitrust statutes are independent and do not conflict with the *Sherman Act*. Several state antitrust statutes have an interpretation provision which requires the state courts to adhere to the principles of the federal interpretation of the *Sherman Act* when interpreting the state antitrust statute; in this case the state

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332. See Brown, supra, note 52, at 7-39.

333. J., von Kalinowski, Antitrust Laws and Trade Regulation (New York: Matthew Bender), at 132-5, and at 132-6 "Where a state statute is broader than federal law, antitrust plaintiffs, whether private or governmental, may have recourse under the state act when none is available under federal law".

334. 54 Am. Jur. 2d, Monopolies, at s. 452: "Soon after the *Sherman Act* which applies only to restraints of interstate and international trade and commerce, the states passed similar legislation to reach agreements and companies beyond the scope of federal power".

335. Ibid., at 13-215: "Where the same facts give rise to both a federal and a state cause of action, a state court may find a federal decision res-judicata" (emphasis added).

courts must follow the federal precedents not because the federal law is superior in legal importance to the state law but because the state law explicitly requires it[336]. In practice the state courts tend to follow and apply the principles developed in federal antitrust cases, even though they are not obligated to apply them, because it is usually convenient and practical to do so.

The National Association of Attorneys General of the states (the NAAG), did not accept that the Federal Department of Justice's guidelines for the application of antitrust law to vertical agreements[337] should bind the antitrust enforcement authorities of the states. The NAAG issued guidelines of its own to govern the enforcement of antitrust law in state jurisdictions[338].

3. Basic concepts in US antitrust law.

The antitrust concepts introduced in this section are used generally in the US, both under the federal and the state antitrust law.

The difference between the 'rule of reason' and the 'per se' rule has been explained above. The US judiciary developed several methods to distinguish between business practices qualified for a 'rule of reason' evaluation and those to which a 'per

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[336]. 54 Am. Jur. 2d, Monopolies, s. 453.

[337]. US Department of Justice, Antitrust law Division, Guidelines for vertical restraints (Washington D.C.: The Department, January 23, 1985). The legal term "vertical agreements" will be explained below.

[338]. National Association of Attorneys General, Vertical Restraints Guidelines adopted in winter meeting, Baioxi, Mississippi, Dec. 4 1985. See especially in section 4.16 to the guidelines; See Glickman, supra, note 98, at.13-218 - "[NAAG guidelines] .. would subject both franchisors and franchisees to a much more searching analysis than the Justice Department guidelines".

se' should be applied. The classification of a business practice into either one of these groups is crucial to the final decision in an antitrust law case.

As a given, territorial exclusivity clauses in franchise agreements, are normally treated in the US as **non price restrictions** in **vertical agreements** and therefore qualify for a 'rule of reason' analysis. This is the reason why only the concepts of vertical and horizontal restrictions and price and non-price restrictions, and no other concepts of the US antitrust law, are discussed in this sub-chapter.

3.1 Horizontal and vertical restraints.

The difference between horizontal and vertical agreements has been described as follows:

> "A vertical agreement is one made between firms operating in different levels of the same trade whereas horizontal agreement is one made between competitors or potential competitors"[339].

Franchise agreements are considered vertical in nature, because the franchisor and the franchisee are operating in different levels of the market and are not competitors.

A rough division is made in the US between vertical restraints (i.e. in vertical agreements), usually considered qualified for a 'rule of reason' analysis, and horizontal restraints (i.e. in horizontal agreements), usually considered to fall under

[339]. See Korah, supra, note 20, at 10; See also Pattison, supra, note 1, at 6-2: ".. [U]nfair restraints imposed 'up' or 'down' the chain of production and distribution, are traditionally known as vertical restraints ..".

the 'per se' rule[340]. The classification of business practices as horizontal or vertical in nature is therefore very important. As one author wrote:

> "... [I]n this area of antitrust, the determination whether an arrangement is horizontal or vertical will have a great impact upon the risk of antitrust liability"[341].

In the late 1960's, the US position towards vertical restrictions was very strict and they were strictly prohibited. In subsequent years the US courts and enforcement agencies become more tolerant towards business practices in vertical agreements[342]. In 1977 the Supreme Court of the US held in GTE judgement[343], overruling its previous position, that the legality of vertical restrictions depends, in each case, on its economic effect, assessed under a 'rule of reason'[344].

The US Department of Justice, in its "vertical restraints guidelines", stated that certain types of vertical restraints were widely recognized as legal[345] and were subject to very little antitrust uncertainty[346]. Similarly, the US courts rarely

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[340]. See Abell, supra, note 39, at 64 "By and large the horizontal restraints will be judged as per se illegal while vertical restraints are judged in the context of economic consideration".

[341]. Ibid., at 58.

[342]. In the EEC the process was opposite. From a tolerant approach towards vertical restraints in the past, to stricter approach in the present. See B.E., Hawk, United States, Common Market and International Antitrust: A Comparative Guide (New York: Law of Business, 1984), vol. 2, at 403.

[343]. See GTE judgement, supra, note 195.

[344]. Ibid. The case is broadly discussed below.

[345]. See Korah, supra, note 20, at 10; for example "location clauses" establishing or restricting the outlets from which dealers can sell, are generally considered legal; See also the Vertical Restraints Guidelines, supra, note 337, at 177.

[346]. See Vertical Restraints Guidelines, supra, note 337; See also Brown, supra, note 52, at 7-47: "No vertical restraints were challenged by the Antitrust Division or by the FTC under the Reagan Administration ..."; The guidelines were meant to achieve legal certainty in the market so that undertakings would be able to assess the

condemn restrictions in vertical agreements when the economic framework of the market is competitive[347].

3.2 Non-price and price restraints.

Another distinction is made between price restrictions and non-price restrictions. The 'per se' rule applies to price restrictions, even if they are vertical. Non-price restrictions are usually examined under the 'rule of reason'. Territorial exclusivity is considered a non-price restraint because it has no direct effect on price competition in the market[348].

Price maintenance and price fixing have been traditionally considered illegal under US antitrust law. These practices have the potential to force and maintain high prices in the market with regard to the involved products. Price competition is what the antitrust laws were primarily meant to achieve and therefore price restrictions are considered illegal regardless of their economic framework.

The US Department of Justice guidelines in respect of non-price vertical restraints stated that these business practices are examined under the 'rule of reason':

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chances of a business practice to be considered illegal by the federal Department of Justice.

[347]. See the Vertical Restraints Guidelines, Ibid, at 179: Vertical restraints have pro-competitive as well as anti-competitive effects. It is normally and widely recognized in the US that the pro-competitive effects of vertical restrictions outweigh the anti-competitive effects of these restrictions.

[348]. Ibid., at 175; It should be noted that all vertical restraints may have an effect on price even when they have substantial pro-competitive benefits. A business practice or an agreement is considered a price restraint only if it is found to affect the level of prices in the market. An indirect impact of non-price restrictions on prices will usually not be considered a price restraint.

"Because **vertical non-price restraints** held significant potential for generating pro-competitive efficiencies, the Department analyze such restraints under a rule of reason .. the Department will consider whether the anti-competitive harm is outweighed by the efficiencies created by the vertical restraints"[349] (emphasis added).

4. The antitrust law approach towards territorial exclusivity in the franchise method.

The franchise method was not considered qualified for special and separate treatment under US antitrust law, unlike the special consideration given to the method, as such, in the Pronuptia judgement and in the EEC franchise regulation. Franchise agreements are regarded in the US as one of many kinds of vertical distribution agreements. However, in the principal antitrust cases at the federal level, in which the courts have laid down general rules for vertical restrictions in distribution agreements, aspects of the franchise method were involved. The two principal judgements of the US Supreme Court reviewed below reflect the evolution in approache towards vertical non-price restrictions. In the earlier Schwinn[350] judgement, a 'per se' rule was applied to these type of restrictions. In the latter case, GTE[351], the Schwinn precedent was overruled and a 'rule of reason' was applied.

[349]. See the Guidelines for International Operations, supra, note 322, at 42, section 3.5 to the guidelines; It seems that the original 'rule of reason' is different from the "rule of reason" adopted by the EEC in Art. 85(3) to the EEC Treaty. In the US the interbrand and intrabrand competition effects are weighed against one another. These effects are not examined separately as is done in the EEC. In addition, there is no requirement under the US law for minimal level of intrabrand competition to be preserved, as required by one of the conditions of Art. 85(3).

[350]. US v. Schwinn 388 US 363 (1967).

[351]. See GTE judgement, supra, note 195.

The GTE judgement is widely recognized today as the leading US precedent governing non-price vertical restraints but to better understand GTE, the Schwinn judgement has to be first introduced.

4.1 United States v. Schwinn (1967)[352].

In this case, the US Department of Justice commenced an action under Art. 1 of the Sherman Act against a bicycle manufacturer (Schwinn). Under Schwinn's distribution method (the "Schwinn plan")[353], sales to consumers were made through **franchisees.** These franchisees were authorized to sell Schwinn's bicycles only from specific locations allocated to them by Schwinn. The franchisees were supplied by **authorized distributors.** Schwinn gave each distributor a defined geographic area in which it has an exclusive right to supply the franchisees. Schwinn prohibited both the distributors and the franchisees from selling its product to non-franchised retailers, but Schwinn itself sold its products to **wholesalers** who did not participate in the franchise 'Schwinn plan' and granted them territorial exclusivity.

The central issue before the Court was whether or not the territorial exclusivity Schwinn had granted to the wholesalers and to the authorized distributors infringed Art. 1 of the *Sherman Act*. The relationship of Schwinn directly with its

[352]. See Schwinn judgement, supra, note 350.

[353]. Ibid., at 383; The franchise "Schwinn plan" instituted by Schwinn after World War II and was designated to meet the competition of giant chain distributors that threatened to seize control over the bicycle market: "Schwinn believed that proper promotion of its products required an active and stable dealer organization composed of experienced people who could properly promote, assemble and service bicycle".

franchisees was not in question, since in the District Court Schwinn's territorial restriction in terms of allocation of the franchisee location, was declared legal[354], and the District Court decision was not appealed on this particular point.

It is impossible to determine the nature of Schwinn's franchise system when reading the Schwinn judgement. Except for using of the term "franchise" in the judgement there are not many details describing the distribution system.

Several features of a business format franchise were described in Schwinn, especially in the dissenting opinion, for example: ".. the franchisee enjoys **backing in the form of know-how** and financial assistance"[355] (emphasis added). At the same time several characteristics of a product franchise were described, for example, the concentration of the franchisee in distributing small number of products in the bicycle market. It is unclear whether the franchise system had more characteristics of a business format franchise or of a product franchise.

This failure to describe the nature of the franchise system probably reflects the fact that the Court did not attribute any importance to the special features of the franchise method when examining the antitrust law questions in the case. The Court analyzed the questions in the context of vertical distribution agreements in general and not in the context of franchise agreements in particular.

The majority opinion.

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[354]. Ibid., at 368.

[355]. Ibid., at 386.

The Supreme Court's opinion was delivered by Mr. Justice Fortas. The Judge made a clear distinction between the relationship of Schwinn with authorized distributors selling to franchisees and with general wholesalers. Both authorized distributors and regular wholesalers were granted territorial exclusivity for the purpose of increasing Schwinn's competitiveness with other large distribution chains. The Court held that even though both wholesalers and distributors were granted exclusivity for a legitimate business purpose this is not enough to conclude that the two business practices ahould be treated similarly. A difference existed between distributors and wholesalers because:

> "The antitrust outcome does not turn merely on the presence of sound business method or motives"[356].

The Supreme Court held that territorial exclusivity granted to distributors who sell to franchisees should be analyzed under a 'rule of reason' but territorial exclusivity granted to regular wholesalers was 'per se' illegal. In respect of the authorized distributors who sell to franchisees the Court concluded:

> "Where the manufacturer retains title, dominion, and risk with respect to the product and the position and function of the dealer in question are, in fact, indistinguishable from those of an agent or salesman of the manufacturer, it is **only if the impact of the confinement is "unreasonably" restrictive of competition that a violation on Art. 1 results .."**[357] (emphasis added).

Because the **authorized distributors** participating in the franchise plan did not buy the products from Schwinn and title in the products was not transferred to them, their territorial exclusivity was examined under the 'rule of reason' and was declared

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356. Ibid, at 375.

357. Ibid., at 380.

legal[358]. However, because the **wholesalers** bought the products from Schwinn and the title in the products was transferred to them, their territorial exclusivity was considered 'per se' illegal. It should be mentioned again that the territorial exclusivity of the **franchisees** themselves was not analyzed in this judgement[359].

The distinction between authorized distributors included in the franchise plan and regular wholesalers not part of the plan, was not based upon of the special features of the franchise method, even though the participation in the franchise plan was a clear difference between distributors and wholesalers. Instead, the Court applied a technical test made on grounds of the ownership in the distributed product (the 'ownership test').

The dissenting opinion.

In the dissenting opinion delivered by Mr. Justice Stewart, the Judge supported the majority decision to apply a 'rule of reason' with respect of the territorial exclusivity of the authorized distributors. However, Stewart J., applied a different reasoning to reach the same conclusion. In contrast with the majority, Mr. Justice Stewart put forward several considerations directly connected to the nature

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358. Ibid., at 376; "If nothing more is involved than vertical "confinement" of the manufacturer's own sales of the merchandise to selected dealers, and if competitive products are readily available to others, the restriction on these facts alone, would not violate the *Sherman Act*".

359. The territorial exclusivity granted to the franchisees was declared legal by the District Court and this part of its decision was not appealed. In the conclusion of the Supreme Court in respect to territorial exclusivity granted by Schwinn to authorized distributors who sell to franchisees, the Schwinn Judgement, Ibid., at 381, mentioned regular franchisees as well: ".. [W]e cannot .. ourselves conclude that Schwinn's franchising of retailers and its confinement of retail sales to them - so long as it retains all indicia of ownership, including title, dominion and risk, and so long as the dealers in question are indistinguishable in function from agents or salesman constitute an 'unreasonable restraint on trade'" (emphasis added).

of the franchise method.

Mr. Justice Stewart stated:

> "Schwinn accordingly developed a franchising policy that would **assure quality and efficiency** in its distribution system"[360] (emphasis added).

The Judge implied that in order to obtain the quality assurance and efficiency, territorial exclusivity clauses in franchise and related agreements were essential:

> "Of course, **the whole premise** of Schwinn's marketing program was that its product would be **sold to the public only by qualified retailers whom it had franchised**"[361] (emphasis added).

The dissenting Judge also mentioned several advantages of the franchise method, and indicated that franchising had social and economic benefits since it helps independent merchants and small businesses to survive in face of competition from the distribution giants[362]. The Judge concluded that:

> "indiscriminate invalidation **of franchising arrangements** would eliminate their creative contribution to competition"[363] (emphasis added).

Therefore, it appears that the Mr. Justice Stewart acceptance of the 'rule of reason' approach taken by the majority towards territorial exclusivity was made **in light of the nature of the franchise method and its advantages** and in light of the importance of territorial exclusivity for "quality and efficiency assurance". In addition the Judge rejected the ownership test applied by the majority to wholesalers:

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[360]. Ibid., at 383.

[361]. Ibid., at 385, and in footnote 6 at 385 the Judge comments that "This premise is common to all forms of franchising".

[362]. Ibid., 386, and see also at 387, this argument resembles the arguments of the COJ with regard to the advantages of the franchise method in the Common Market.

[363]. Ibid., at 387.

> "Centuries ago it could perhaps be assumed that a manufacturer had no legitimate interest in what happened to his products when he has sold them to a middleman .. But this assumption no longer holds true in a day of sophisticated market policies"[364].

A comparison between the majority opinion and the dissenting opinion.

In the majority judgement, the rationale was that vertical territorial exclusivity in general should be examined under the 'rule of reason' only when a supplier did not transfer the ownership in the product to the dealer. A technical 'ownership test' was applied.

In the dissenting opinion the rationale was that in view of the franchise method advantages, territorial exclusivity should be analyzed under the 'rule of reason' both in the event of a sale transaction (when title in the product was transferred to the buyer) and a non-sale transaction (when the title in the product was not transferred to the buyer).

4.2 Continental T.V. Inc. v. GTE Sylvania Inc. (1977).[365]

The GTE judgement of the US Supreme Court represents the current US antitrust treatment of non-price restrictions in vertical agreements in general,

[364]. Ibid., at 392.

[365]. Continental T.V. Inc. v. GTE Sylvania Inc. 433 US 36 (1977).

including territorial restrictions in franchise agreements[366]. The GTE judgement overruled the ownership test invented in Schwinn.

GTE was a manufacturer of television sets. It adopted a franchise plan in 1962, the year it began to sell its television sets directly to a selected group of franchisees.

The judgement, again, does not offer many details about the nature of the GTE franchise plan. The main indication of the existence of a franchise system is the use of franchising terminology, such as franchisee and franchise plan[367].

GTE limited the number of franchises granted for given areas. Each franchisee was required to sell franchised products only from the location allocated to him by GTE; however, GTE reserved the right to increase the number of franchisees in each geographical area according to its own discretion[368].

The litigation in GTE was a result of a dispute between a franchisor and a franchisee (i.e. between private parties). The franchisee argued that the restrictions on territorial location in the franchise agreement were 'per se' illegal, relying on the Schwinn[369] precedent. The main question in GTE was whether or not the

[366]. Even though the result of the GTE judgement is applicable to vertical agreements in general, the facts of the case itself related to a franchise system and the territorial restriction in question was directly imposed on the franchisee.

[367]. See GTE judgement, supra, note 195, at 38

[368]. Ibid., at 39; In contrast to Pronuptia case, the location clause was not combined with a territorial protection clause. In GTE the location clause mainly benefited the franchisor since the franchisor was able to without consulting the franchisees to change the number of franchises in a given territory.

[369]. The way the GTE case came to the US Supreme Court is to a large extent similar to the way the Pronuptia case arrived of the COJ.

restrictions on the franchisee's location, should be examined under the 'rule of reason' or be considered 'per-se' illegal.

The District Court, in the first instance, accepted the franchisee's argument and applied Schwinn's ownership test to the franchise agreement. The Court of Appeal, in the second instance, overruled the District Court judgement and held:

> "Sylvania [GTE] location restriction has less potential for competitive harm than the restrictions involved in schwinn and thus **should be judged under a 'rule of reason'**"[370] (emphasis added).

When the case reached to the Supreme Court of the US, the Court assumed that in principle Schwinn's ownership test was applicable to franchisees citing from the Schwinn judgement, where the majority, referring to the ownership test wrote:

> "The principle is of course, equally applicable to **sales to retailers**, and the decree should similarly enjoin the making of any sales to retailers upon any condition"[371] (emphasis added).

Franchise agreements (i.e agreements with retailers) were not discussed in Schwinn. Therefore, to this writer view, the statement of the majority in Schwinn is an *obiter dictum* and the findings of Schwinn (i.e. the 'ownership test') should not have been treated as automatically applicable to franchise agreements[372].

In the beginning of the GTE judgement the Supreme Court reviewed the

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[370]. Ibid., at 41

[371]. Was cited in the GTE judgement from the Schwinn judgement. see GTE, Ibid, at 45. See also Schwinn, supra, note 350, at 378.

[372]. Obviously the territorial exclusivity in the franchise agreement in Schwinn judgement was examined under a 'rule of reason'. If the ownership test had been applied to the territorial exclusivity it should have been subjected to the 'per se' rule since, as the Court wrote in GTE judgement, Ibid., at 43, when reviewing Schwinn case facts - ".. retailers, of course acquired title to all of the bicycles ordered by them".

Schwinn judgement and then concluded:

> "... [W]e are convinced that the need for clarification of the law in this area justifies reconsideration"[373].

Thus, the GTE court found that while theoretically the ownership test was applicable to franchise agreements, this possibility should be reconsidered. The Court also emphasized that as a general principle, a business practice should be held 'per-se' illegal only when sound grounds exist to justify this approach.

The Court wrote that the market impact of non-price vertical restrictions[374] was complex because they had the potential to simultaneously reduce interbrand competition and enhance interbrand competition. Several examples to demonstrate the contradictory effects of territorial restrictions on competition were put forward by the Court[375]. To demonstrate **the negative effect** of territorial restrictions on intrabrand competition, the Court used only one argument: that as a result of these restrictions the number of sellers of a particular product was smaller than it would have been if the restrictions did not exist. The Court emphasized, though, that even when territorial exclusivity existed, the ability of the selected sellers to exploit the market was limited because consumers may travel to other franchised outlets or

[373]. Ibid., at 47.

[374]. The Court limited itself in its judgement to non-price vertical restrictions only.

[375]. See GTE judgement, supra, note 195, at 54-55;It is important to mention that even though the subject of the judgement is a franchise system, the specific effects of a franchise method in the market are not mentioned at all.

purchase competing products[376].

The two principal arguments the Court used to demonstrate **the positive effects** of territorial restrictions on interbrand competition were: 1. Territorial exclusivity induces competent and aggressive retailers to make the investment of capital and labour that is often required in the distribution of products[377]. 2. Territorial exclusivity induces retailers to engage in promotional activities and to provide pre-sale and post-sale services[378].

Having reviewed these potentially competing intrabrand and interbrand effects on competition, the GTE Court found that the conflict between them was not reflected in Schwinn's ownership test[379]. The Court held that the existence of these conflicting effects as a result of non-price vertical restrictions must be evaluated and therefore a 'per se' rule was not appropriate[380]. Thus, the Court affirmed the Judgement of the Court of Appeals and concluded that:

> "... the 'per se' rule stated in Schwinn must be overruled ... departure from the 'rule of reason' standard must be based upon demonstrable economic effect

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[376]. Thus, in a way the Court stressed the role of 'limited' territorial exclusivity as opposed to 'open' territorial exclusivity restrictions. Similar reasoning was employed by the EEC Commission.

[377]. This is the equivalent of the 'investment consideration' that was rejected by the COJ in the Pronuptia judgement, under Art 85(1), but was accepted by the Commission in its individual exemptions.

[378]. See GTE judgement, supra, note 195, at 55.

[379]. Ibid., at 56. In GTE, the Court found that the Schwinn judgement implicitly balanced interbrand effects and intrabrand effects using the distinction between non-sale transactions (when ownership was not transferred to the buyer) and sale transactions (when ownership was transferred to the buyer). The Court also found that the ownership test in Schwinn: "is inconsistent with its articulated concern for the ability of smaller firms to compete effectively with larger ones".

[380]. Ibid., at 50-51

rather than as in Schwinn - upon formalist line drawing"[381].

In its comparison of interbrand and intrabrand effects on competition the GTE Court emphasized the enhancement of interbrand competition when non-price restrictions were concerned. It appears, therefore, that the Court considered that vertical restrictions should seldom be held illegal under the *Sherman Act*.

While the Court did not discuss the specific advantages of the franchise method itself, its favourable attitude towards the legality of non-price restrictions in vertical agreements in general, could only have become stronger it the franchise method characteristics had been examined.

Two general comments can be made in view of the reasoning of the GTE court:

1. Since the Schwinn judgement did not discuss franchise agreements, it is questionable if the ownership test should have, at all, been perceived by the GTE Court as being applicable to regular franchise agreements.

2. Even allowing that the ownership test was theoretically applicable to regular franchises agreements, the Court in GTE could have distinguished the Schwinn judgement without overruling it. The Court could have done this in two ways; first, the Court could have used the special features of the franchise method to conclude that it is eligible for special treatment under antitrust law. This line of reasoning was applied in the previous Schwinn case by the dissenting Judge; second, the Court

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[381]. Ibid., at 58.

could have held Schwinn precedent applicable only to intermediate agreements, such as the authorized distributors who sold to franchisees and the wholesalers who sold to retailers, but not applicable to agreements with retailers, such as agreement with franchisees who sold directly to consumers.

5. The state antitrust laws and territorial exclusivity.

When analyzed from a territorial exclusivity perspective, state antitrust legislation can be divided into three main groups: first, antitrust laws which include a general prohibition against restraints of trade but do not have prohibition of territorial exclusivity in particular; second, antitrust laws which explicitly prohibit territorial exclusivity only in agreements between competitors, that is, in horizontal agreements; Third, antitrust laws which prohibit territorial exclusivity in general; the prohibition is not limited to agreements between competitors.

Several state antitrust laws include a provision that subordinates the interpretation of these laws to the federal law (an 'interpretation provision'). When an explicit interpretation provision is not found in the law the extent to which the state courts will rely on federal precedents, or rather invent new principles, is not certain.

5.1 General prohibition against restraints of trade.

A general prohibition against restraints of trade usually takes a similar form in state antitrust statutes, for example under the Antitrust Law of Louisiana:

> "Every contract, combination in the form of trust or otherwise, or conspiracy, **in restraint of trade or commerce** in this state is illegal"[382] (emphasis added).

Both vertical and horizontal territorial exclusivity fall within the wide scope of the general prohibition against restraints on trade.

The federal precedent set in GTE, placing vertical territorial exclusivity under a 'rule of reason' analysis will, no doubt, apply in the state jurisdiction when in addition to a general prohibition against restraints of trade, an explicit and clear interpretation provision is found. For example, in New Mexico, the Antitrust Act explicitly states that:

> "The Antitrust Act requires adherence to judicial interpretation of the federal Antitrust laws"[383]

In other states the interpretation provision is not as clear. In Rhode Island, for example, the interpretation provision states that the state antitrust law should be construed in harmony with the federal antitrust cases "**insofar as practicable**"[384]; in New Hampshire the state legislator has declared that the state courts "**may be guided**

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382. See La. Rev. Stat. Ann. s. 51:122; and see also Ala. Code s. 8-10-3; Alaska stat. s. 45.50.562; Ariz. Rev. Stat. Ann. s. 44-1402; Col. Rev. Stat. s. 6-4-101; Del. Code Ann. s. 6-2101; Haw. Rev. Stat. s. 480-4(a); Idaho Code s. 48-101; Ind. Code Ann. s. 24-1-2-1; Md. Bus. Reg. Code Ann. s. 11-204 (A)(1); Miss. Code Ann. s. 75-21-1(a); N.J. Stat. Ann. s. 56:98-3.

383. N.M. Stat. Ann. s. 57-1-15; See also Md. Bus. Reg. Code Ann. s. 11-202(A)(2).

384. R.I. Gen. Laws s. 6-36-2(c).

by interpretations of the United States antitrust laws"[385].

In other US states, an interpretation provision is absent from the state antitrust legislation. The courts in these states usually rely on federal precedents even though they are not obligated to do so, for example, in Idaho, the state Supreme Court held that federal precedents interpreting Art. 1 of the *Sherman Act* offer "persuasive guidelines"[386] for purposes of interpreting Idaho's prohibition against restraints on trade.

In states in which the interpretation of the general prohibition against 'restraints of trade' is not subordinated to the federal antitrust law, or where the interpretation provision does not require strict adherence to the federal law, it is **likely but not certain** that the state court would follow the GTE precedent and apply a 'rule of reason' to vertical clauses of territorial exclusivity[387]. Another legal approach towards territorial exclusivity is also possible.

In New York state, the Appellate Division of the Supreme Court applied the 'per se' legality approach to territorial exclusivity clauses in vertical agreements:

> "We agree with the petitioners that the weight of authority, such as it is, holds vertically arranged exclusive territorial distributorship **to be legal** under the

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[385]. N.H. Rev. Stat. Ann. s. 536:14.

[386]. Pope v. Intermountain Gas Co. 646 P. 2d 988 (1982).

[387]. See in New Jersey the case of the Lawn King franchise system where the Court upheld territorial restrictions saying: "The restrictions that the franchisor imposes, including the exclusive territorial franchise, are intended to encourage a new franchisee to compete on the interbrand level without the harassment of competition on the intrabrand level" State v. Lawn King 417 A. 2d 1025 (N.J. Sup. Ct. 1980), 1034; See also the Californian example of a state court which applying a 'rule of reason' to a vertical territorial restraint in a franchise agreement - Dayton Time Lock Inc. v. Silent Watchman Corp. 52 Cal. App. 3d 1 (Ct. App. 2d Dis. 1975), 6-7.

Donnelly Act **regardless of their effect on competition**"[388] (emphasis added).

This opinion was not upheld by the New York Court of Appeals:

> "Petitioners efforts to extract a **rule of per se legality** from the case law dealing with vertical territorial arrangements are unveiling for several reasons"[389] (emphasis added).

The 'per se' legality approach was rejected by the Court of Appeals, but the fact that it was considered illustrates that the reliance of state courts on the federal 'rule of reason' approach towards vertical territorial exclusivity is not certain[390]. The Appellate Division opinion is an innovative approach toward territorial exclusivity and it might be considered again in another state in the future.

5.2 Prohibition of territorial exclusivity agreements between competitors.

It would appear that provisions which prohibit territorial exclusivity in horizontal agreements are out of the scope of this thesis since the thesis examines only franchise agreements and these agreements are vertical in nature. However, the fact that a provision governing territorial exclusivity in horizontal agreements is included in an antitrust law may be interpreted in a way affecting the examination of vertical territorial exclusivity under this law.

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388. Anheuser Busch Inc. v. Abrams 512 N.Y.S. 2d 802 (A.D.1 Dept. 1987), 805; *Donelly Act* is New York's Antitrust A t.

389. Anheuser Busch Inc. v. Abrams 525 N.Y.S. 2d 816 (Ct. App. 1989), 819.

390. See Kolinowski, supra, note 333, at 142.4 "It is not clear how they will be approached under Georgia antitrust prohibitions"; See also at 169-4: "Vertical market division, on the other hand, is more likely to be judged under the 'rule of reason' in view of the US precedent" (the author refers to the GTE case).

One possible interpretation is, that since horizontal territorial exclusivity is 'per se' prohibited, vertical territorial exclusivity **must always be analyzed under the 'rule of reason'** in the concerned state.

Another possible interpretation is that since horizontal territorial exclusivity is explicitly prohibited in the antitrust law, vertical territorial exclusivity is altogether outside the scope of this law and **should be considered 'per se' legal** in the concerned state[391].

The first interpretation is more likely to be adopted by the state courts because it is less revolutionary. This assessment is especially valid in those jurisdictions where an 'interpretation provision' is found beside a prohibition of horizontal territorial exclusivity[392].

In Illinois, Nevada and Utah, legislatures included provisions prohibiting horizontal territorial exclusivity in their state antitrust laws. In Illinois for example, section 3(1)(c) of the Illinois Antitrust Act states[393]:

> "Every person shall be **deemed** to have committed a violation of this act who shall:(1) Make a **contract with .. a competitor of such person** ...(c) allocating or **dividing** customers, **territories** ... functional or geographical, for any commodity or service." (emphasis added).

It is clear that the prohibition applies only to horizontal restrictions. It is possible that vertical territorial restrictions would be analyzed under the general prohibition

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391. The *Sherman Act* would still govern these restrictions.

392. The interpretation provision dictates adherence with the federal law under which a 'rule of reason' is applied to vertical territorial exclusivity.

393. 38 Ill. Rev. Stat. s. 60-3(1)(c).

against restraints of trade found in Art. 3(2) of the *Antitrust Act* of Illinois, or, be considered outside the scope of the act according the second of the interpretations suggested above[394].

In Utah, the prohibition against territorial exclusivity is especially interesting. Art. 76-10-920 of Utah's *Antitrust Act* states[395]:

> "(a).. agreeing among competitors to divide consumers or territories .. with specific intent of eliminating competition shall be punished...
> (b) Subsection (a) may not be construed to include vertical agreements between a manufacturer, its distributors, or their subdistributors ... where the manufacturer distributes its commodity or service both directly and **through distributors or subdistributors in competition with himself.**" (emphasis added).

This statute not only states that vertical territorial exclusivity is outside the scope of the prohibition, but also states that when a supplier competes with a dealer (for example when a franchisor competes with his franchisees[396]) the territorial exclusivity granted by the supplier is still considered outside the scope of the prohibition. The territorial exclusivity is considered vertical under the state law, even though, theoretically, the supplier and the dealer compete on the same level of commerce (i.e. horizontally).

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[394]. Nevada's *Unfair Trade Practices Act* Nev. Rev. Stat. s. 598A. 060(2) prohibits division of markets in general: "..[C]onstitutes a contract .. in restraint on trade .. (2) division of markets, consisting of agreements between competitors to divide territories and to refrain from soliciting or selling in certain area". Since the provision defines what is a restraint on trade under the Act, it is clear that division of markets not included in this definition can logically be considered outside the scope of the Act; See also Kalinowski, supra, note 333, at 160-5.

[395]. Utah Code Ann. s. 76-10-920.

[396]. This might be the situation if a franchisor is operating a company-owned outlet which competes with a franchised outlet in the same market.

5.3 A general prohibition of territorial exclusivity agreements.

It is not clear how vertical territorial exclusivity in franchise agreements would be treated in states with an antitrust law prohibition of territorial exclusivity in general. Four US states have such a general prohibition: Connecticut, New Hampshire, Montana and West Virginia.

In Connecticut the general prohibition states:

> ".. **every contract** .. **is unlawful** when the same are for the purpose, or have the effect of .. (c) **allocating or dividing** consumers or **markets**, either functional or geographical, in any part of trade or commerce"[397] (emphasis added).

The broad language used in the section seems to encompass vertical market activities within a 'per se' prohibition[398]. The reason for this comprehensive 'per se' prohibition found in Connecticut is that the state's *Antitrust Law* was enacted in 1971, immediately after the Schwinn judgement but before the GTE judgement and the state legislature incorporated in the antitrust law what it perceived as the federal law at that time[399].

In a non-franchise case, the Connecticut Supreme Court held that a 'per se' rule should be applied only where the conduct in question is "manifestly anticompetitive"[400]. It is therefore possible that vertical territorial restrictions will

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397. Conn. Gen. Stat. s. 35-28(c).

398. See Kalinowski, supra, note 333, at 139-6.

399. Ibid.

400. Elida, Inc. v. Harmor Realty Comp. 413 A. 2d 1226 (Conn. Sup. Ct. 1979), at 1232.

eventually be evaluated under the 'rule of reason' in this state, despite the existence of a 'per se' prohibition in its Law[401].

In New Hampshire, one of the prohibited restraints of trade listed in the antitrust law is:

> "(II) **Every contract** .. **is unlawful** which has the purpose or the effect of .. (c) **Allocating or dividing** consumers or **markets** in any part of trade or commerce"[402]

The New Hampshire's act includes an interpretation provision stating that the Antitrust Act "**may be** guided by the interpretations of the United States antitrust laws"[403]. It is therefore likely that vertical territorial exclusivity will be analyzed under the 'rule of reason' despite the broad language of the prohibition[404].

In West Virginia, the status of territorial exclusivity in vertical agreements is also uncertain[405]. From the language of the antitrust prohibition it appears that a 'per se' rule applies both to horizontal and vertical territorial arrangements. Section 3(b)(1)(c) of the West Virginia *Antitrust Law* declares:

> "(b) .. the following **shall be deemed** to restrain trade or commerce unreasonably and are unlawful: (1) A contract .. between two or more persons

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[401]. See Kalinowski, supra, note 333, at 139-7.

[402]. N.H. Rev. Stat. Ann. s. 356:2(II)(c).

[403]. Ibid., at s. 356:14.

[404]. The same situation can be found in Montana: Mont. Rev. Code. Ann. s. 30-14-205-2(c), Territorial allocations are included in the listing of Montana's unlawful restraints on trade. Vertical territorial exclusivity falls within the scope of the prohibition. It is not clear how territorial exclusivity in franchise agreements would be dealt in this state. The language of the prohibition is: "It is unlawful .. (2) for the purpose of creating or carrying out any restriction on trade to .. (c) prevent competition in the distribution or sale of merchandise or commodities".

[405]. See Kolinowski, supra, note 333, at 180-6.

.. (c) Allocating or dividing consumers or markets, functional or geographic, for any commodity or service"[406]

5.4 Summary.

The review of state antitrust laws above leads to the conclusion that in state jurisdictions, the GTE precedent will not necessarily apply to vertical territorial exclusivity in franchise agreements.

Only when the state law includes a strict interpretation provision is it safe to assume that the state courts will apply the GTE precedent. In other states, it is possible that the courts will apply a 'per se' legality rule to territorial exclusivity in franchise agreements; it is also possible, though not probable, that the state courts would apply a 'per se' illegality rule.

6. Franchise protective legislation and territorial exclusivity.

Legislation to protect the franchisees was discussed in the first chapter of this thesis. This section presents the legislators' treatment of territorial exclusivity under protective legislation. The section will examine the definition of a franchise agreement in protective legislation. It will than survey the status of territorial exclusivity under franchise disclosure and registration legislation. The section

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[406]. W.Va. Code, s. 47-18-3(b)(1)(c).

concludes with a discussion of territorial exclusivity under franchise relationship legislation.

6.1 Definition of a franchise in protective legislation.

When surveying the federal and state legislation designed to protect the franchisees, several approaches in defining franchise agreements are found. While the definitions, of course, are not identical, there are clear similarities among them.

In most of the laws, the franchise definition combines one or more of the following elements[407]:

1. either a marketing plan or a community of interest element;

2. a trade mark, a trade name or other identifying mark element;

3. a franchise fee element.

The key element in the definition, in the context of franchisee's protective legislation, seems to be either the marketing plan or the community of interest . Each of these elements is briefly discussed below.

Marketing plan. Maryland's *Franchise Registration and Disclosure Act*[408] is one example of a franchise definition which includes a marketing plan element:

> " 'Franchise' means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which: (1). A franchise or distributorship granting the right to engage in the business

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[407]. See Pitegoff, supra, note 66, at 293.

[408]. Md. Bus. Reg. Code Ann. s. 56-345(d). A fee element is also part of this definition; For another example see Conn. Gen. Stat. s. Tit. 42 Ch. 739, at 133e(b)(1).

offering, selling or distributing goods or services **under a marketing plan or system prescribed in substantial part by a franchisor** or a distributor; and (2). The operation of the franchisee's and distributee's business pursuant to a plan or system is **substantially associated with the franchisor's trademark** ...."[409](emphasis added).

The concept of a marketing plan refers to the business method of a franchise. The business method is not only the business knowledge, that is, the commercial know-how, but it is also the way by which this knowledge is transferred to the franchisees (franchise services) and the ways to ensure that this knowledge is apllied by them (quality control measures).

There is a significant difference between the marketing plan element in the US franchise legislation and the commercial know-how element in the franchise definition of the EEC 'block exemption' regulation[410]. In the US, the emphasis is on the overall franchise plan including both the commercial know-how and the method through which the know-how is delivered to and enforced on the franchisees. In the EEC the focus is on the commercial know-how itself and an attempt was made to define it as precise as possible. In both jurisdictions, though, the US 'marketing plan' and the EEC commercial know-how element are found mainly in business format franchise systems.

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[409]. An example for a definition of a "marketing plan" can be found in the Illinois *Franchise Disclosure Act of 1987* (Ill. Rev. Stat. Ch. 121 1/2) s. 345(d): "'Marketing plan or system' means a plan or system relating to some aspect of the conduct of a party to a contract in conducting business, including but not limited to: (a). specification of price, or special pricing system or discount plans, (b). use of particular sales or display equipment .., (c). use of specific sales techniques, (d). use of advertising or promotional materials or cooperation in advertising efforts.

[410]. See supra, chapter II, at paragraph 2.8.1.

Community of interest. The term community of interest is usually interpreted by the courts of the concerned states as broader than the term 'marketing plan'. The broad scope of the term might cause the definition to include other business relationships than business format franchises[411] (i.e. other types of franchise agreements or other types of distribution agreements in general).

In Wisconsin, for example, a community of interest has been said to exist whenever the parties to an agreement have a continuing financial interest in a business, whether franchised or not, and each of them has a degree of independence[412]. This broad interpretation covers many types of continuous business relationships[413].

Other elements in the franchise definition. In most franchise legislation, the definition of franchise does not restrict franchisees from selling products to wholesalers or force franchisees to sell to end users only. For example, in the District of Columbia *Franchising Act*, the possibility of sales to wholesalers is explicitly mentioned:

"A community of interest in the marketing of goods or services at **wholesale,**

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[411]. See Pitegoff, supra, note 66, at 294.

[412]. Lakefield Tel. Co. v. Northern Telecom 696 F. Supp. 413 (E.D. Wis. 1988).

[413]. See Pitegoff, supra, note 66, at 294; A different example can be found in New Jersey. In this state the courts have construed the phrase community of interest much more narrowly. The courts held that a community of interest exists only when a high degree of quality control is maintained in the business. By this interpretation the state courts narrowed the definition to cover franchises only.

retail, by lease agreement, or otherwise is established"[414] (emphasis added). Sales to wholesalers is a clear difference between the franchise definition in the US and the franchise definition in the EEC 'block exemption'. If an EEC franchisor allows his franchisees to sell franchised products to wholesalers, the franchise system is not covered by the 'block exemption'.

An exclusive territory element and an independence element are not commonly found in the definition of a franchise in US franchisee's protection laws, even though these are two main features in a franchise relationship. There is only one franchise law example with a direct reference to the possible inclusion of exclusive territory in a franchise agreement:

> " .. a person grants another person a licence to use a trademark, .. **within an exclusive or non exclusive territory** or to sell or distribute goods or services, within an exclusive or non exclusive territory ..."[415] (emphasis added).

Another state franchise law makes in the franchise definition a reference to the franchisee's independence from the franchisor:

> "Wherein the **franchisee as an independent business** constitutes a component of franchiser's distribution system"[416] (emphasis added).

Although the independence of franchisees is a main characteristic of the franchise relationship, this is the only law in the legislation reviewed that mention this factor.

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[414]. District of Columbia, *Franchising Act of 1988*, D.C. Code (1989 Supp.) Til. 29, Ch.12; It is possible to find other definitions that refer only to franchise sales in retail: See Del. Cod. Ann. Tit. 6, s. 2551(1)(b): "Selling in or through retail outlets products which bear the trademark or tradename of no more than 3 manufacturers."

[415]. *Franchise Practices Act*, Ark. Stat. Ann. s. 4-72-202.

[416]. Fla. Stat. Ann. s. 817.416.

6.2 Territorial exclusivity in franchise legislation requiring disclosure or registration.

Disclosure and registration legislation is basically similar. The main difference between the two is that in the former the disclosure document is supplied directly to the franchisee; in the latter, the disclosure document has to be approved first by a public official and only then it is supplied to the franchisee[417].

While the *Franchise Rule*[418] and the suggested model law - the *Uniform Franchise and Business Opportunities Act*[419], are forms of disclosure legislation, most of the franchisee protective legislation in the states is of the registration type[420] and so is the recently suggested *Model Franchise Investment Act*[421]. The two types of protective legislation are referred to below collectively as 'disclosure legislation'.

The fact that the franchisees may be granted an exclusive territory is recognized in virtually all of the disclosure legislation reviewed. The scope of the exclusive territory is one of the details required in the disclosure document, or alternatively, it is a required detail in the application for registration which becomes the disclosure document after its approval.

The fact that a territorial exclusivity element appears consistently in disclosure

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[417]. The approval process makes it more difficult to start a franchise in a jurisdiction which has this type of legislation.

[418]. See chapter I, at paragraph 2.2.2; See supra, note 86.

[419]. See supra, note 98.

[420]. That is, in addition to franchise relationship legislation found in several states.

[421]. See supra, note 100.

legislation indicates the dominant role territorial exclusivity plays in the franchise method. The explicit legislative intention written into several disclosure laws supports the above claim. For example, in the *Illinois Disclosure Act of 1987:*

> "(2). It is the intent of this act .. (b) to protect the franchisee and the franchisor by **providing a better understanding of the business and legal relationship** between the franchisee and the franchisor"[422] (emphasis added).

Since one of the intentions of the disclosure legislation is to provide better understanding of the franchise method and since territorial exclusivity is mentioned in most of the laws, it follows that territorial exclusivity is one of the dominant elements in franchise agreements.

Information on territorial exclusivity is required under the federal *Franchise Rule*[423], in the list of details to be furnished by the franchisor to the franchisee:

> " 436.1(a)(13) A statement describing the material fact of whether, by the terms of the franchise agreement or other device or practice the franchisee is:
> .. (iii) Limited in the geographic area in which he or she may offer for sale or sale goods or services; or (iv) Granted territorial protection by the franchisor, by which, with respect to a territory area, (A) the franchisor will not establish another, or more than any fixed number of, franchises or company owned outlets, either operating under, or selling, offering or distributing goods, commodities or services .. or (B) the franchisor or his parent will not establish other franchises or company owned outlets selling or leasing the same or similar products or services under a different trademark, service mark, or other commercial symbol".

This provision is very detailed. It appears to be directed to the FTC view about the preferable scope of any territorial exclusivity granted in franchise agreements, in addition to the issue of disclosure of information. A reading of this provision suggests

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422. Ill. Rev. Stat. Ch. 121 1/2, section 1702(2).

423. See the *Franchise Rule*, supra, note 86.

that the FTC seems to prefer a granting of a wide scope of territorial protection to the franchisees rather than a narrow scope.

The UFOC, adopted by the states as a uniform format for a disclosure document, requires disclosure of the scope of the exclusive territory granted to franchisees[424]. As under the *Franchise Rule*, the franchisor is required to disclose whether or not he reserves the right to establish other franchises or company-owned outlets in the franchised territory and whether or not the franchised product might be sold in the franchised territory under another trademark or trade name.

One detail contained in the UFOC disclosure requirements regarding territorial exclusivity is not found in the *Franchise Rule*. The franchisor has to disclose, whether or not:

> "Continuation of the franchisee's area or territorial exclusivity is dependent upon achievement of a certain sales volume, market penetration or other contingency and under what circumstances the franchisee's area or territory may be altered"[425].

Thus, in the UFOC, a greater degree of franchisee protection is mandated as the franchisor is not only required to disclose the scope of the exclusive territory granted, but also to disclose the conditions under which exclusivity may be withdrawn or changed.

In many state franchise laws, however, the requirement for disclosure of territorial exclusivity is usually only briefly described and is not detailed. For example, the *Franchise Investment Law* of Hawaii requires:

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[424]. See the UFOC, supra, note 95, at s. 12.

[425]. Ibid., at 12(D).

"A statement as to whether franchisees or sub-franchisors receive an exclusive area or territory"[426]

In other state laws the required disclosure is more detailed. For example, the *Franchise Disclosure act* of Indiana requires:

"A statement as to whether franchisees are granted an area or territory in which the franchisor agrees not to operate or to grant additional franchises for the operation of the franchise business or in which the franchisor will operate or grant franchises for operation of no more than a specific number of additional franchise businesses"[427]

In most of the franchise disclosure laws there is no distinction made between franchisees and master franchisees. Both franchisees and master franchisees are equally eligible to receive information related to their agreement with the franchisor including information about territorial exclusivity[428].

It is reasonable to conclude that the federal and state legislatures are aware of the important role of territorial exclusivity in the franchise method. While

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[426]. Hawaii, *Franchise Investment Law*; Hawaii Rev. Stat. section 482E-3(20); See also Mich. Comp. Laws. sec. 445.1508(2)(s); Minn. Stat. s. 80.c.04(t) and also Minnesota's Rules and Regulations pursuing to franchise law, at s. 2860.3500 for a broader explanation; N.Y. Gen. Bus. Law s. 33-683(r); N.D. Cent. Code Tit. 51, s. 15-19-06-23; R.I. Gen. Laws s. 19-28-5(19).

[427]. Indiana *Franchise Disclosure Act*, Ind. Code, s. 23-2-2.5-10(s); See also *Franchise Law*, Or. Rev. Stat. Tit. 50, s. 650.007, and s. 441-325-020 of the administrative rules enacted pursuant to this law: "Describe any exclusive area or territory granted the franchisee and within such area or territory state whether: (A) The franchisor may establish another franchisee who would also be permitted to use the franchisor's trademark associated with the franchise being offered to sold, (B) The franchisor may establish a company owned outlet using franchisor's trade name or trademark associated with the franchise being offered to be sold, (C) The franchisor or his parent or affiliate may establish other franchises or company-owned outlets selling or leasing similar products or services under a different trade name or trademark".

[428]. See for example in *Franchise Investment Act* N.D. Cent. Code 51:19-02-5(b) "Where used in this chapter, unless specifically stated otherwise, 'franchise' includes 'area franchise'"; See also in Md. Bus. Reg. Code Ann. s. 56-349, in the description of the application for registration a requirement is found for: "(19) A statement as to whether franchisees or subfranchisor receive an exclusive area franchise or territory"; See also S.D. Codified Laws, s. 37-5A-5-5(5).

territorial exclusivity is not treated as an essential element in the definition of franchises, it is mentioned in the protective disclosure legislation as information that must be disclosed. This is evidence that the legislatures not only consider territorial exclusivity to be a natural element in franchise relationship but also a fundamental part of it.

6.3 Territorial exclusivity in franchise relationship legislation.

In this section, the tendency of state legislatures to protect the territorial exclusivity of the franchisees is examined. Under relationship legislation, the franchisee is provided with protection more comprehensive than mere disclosure.

The territorial exclusivity provisions in franchise relationship legislation can divided into two groups. In the first, the extent of territorial exclusivity clauses **already granted** in existing franchise agreements is regulated; in the second group, which is less explicit and relatively rare, an obligation on the franchisor to provide territorial exclusivity to the franchisee is imposed, even when **no such clause appears** in the franchise agreement.

6.3.1 The extent of existing territorial clauses.

Franchise relationship legislation regulating the scope of exclusive territory already granted to a franchisee in the agreement; exists in four relationship laws[429]:

Washington. The *Franchise Investment Protection Act* in section 19.100.180 provides:

> "Relation between franchisor and franchisee - rights and prohibitions - ...., the following specific rights and prohibitions shall govern the relations between the franchisor or sub franchisor and the franchisee .. (2.) .. **it shall be unfair or deceptive practice** or an unfair method of competition and therefore unlawful and violation of this chapter for any person to .. (f). **If the franchise provides that the franchisee has an exclusive territory**, which exclusive territory shall be specified in the franchise agreement, **for the franchisor or the subfranchisor to compete with the franchisee in an exclusive territory or to grant competitive franchises in the exclusive territory** area previously granted to another franchisee"[430] (emphasis added).

Minnesota. Its franchise legislation includes a general prohibition against "unfair practices"[431] in the franchise relationship including unfair practices related to territorial exclusivity. The scope of this prohibition is explained in the Minnesota Rules and Regulations issued under the franchise statute[432], in section 2860.4400:

> "Unfair and inequitable practices: All franchise contracts or agreements and any other device or practice of a franchisor, shall conform to the following provisions. It shall be unfair and inequitable for any person to: ..(c). **compete with the franchisee in the exclusive territory previously granted to another franchisee if the terms of the franchisee agreement provide that an exclusive**

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[429]. The territorial exclusivity provisions in the relationship laws were cited in full text, since the writer consider the existence of these provisions an indication of the role territorial exclusivity has in the protection of franchisees.

[430]. Wash. Rev. Code Tit. 19 s. 100.180.

[431]. Minn. Stat. s. 80c.14.

[432]. See Glickman, supra, note 98, at 211. 22-23.

territory has been specially granted to the franchisee" (emphasis added).

Hawaii. Hawaii's Franchise Investment Law, section 482E-6, contains a provision regulating the relationship between the parties of a franchise agreement[433]. In subsection 2(E) of this provision it is stated:

> " ... it shall be an unfair or deceptive act or practice or an unfair method of competition for a franchisor or a sub-franchisor to: .. (E) **Establish a similar business or to grant a franchisee for the establishment of a similar business at a location within a geographical area specifically designated as the exclusive territory in a franchise previously granted to another franchisee** in a currently effective agreement..., The fact that other franchisees or the franchisor may solicit business or sell goods or services to people residing in such geographical territory shall not constitute the establishment of a similar business within the exclusive territory" (emphasis added).

Florida. In the rules enacted under the *Florida Misrepresentation Law*[434]Fla. Stat. Ann. s. 817.416. section 2-17 states[435]:

> "It shall be an unfair or deceptive act or practice for any person in the trade or commerce of establishing a franchise or distributorship to: .. (10) **Assign a so called exclusive territory encompassing the same area to more than one franchisee**" (emphasis added).

6.3.2 Compulsory territorial exclusivity in franchise agreements.

There is relationship legislation that can be interpreted as requiring the franchisor to grant a certain degree of territorial protection to the franchisee

433. Haw. Rev. Stat., s. 482.E-6.

434. Fla. Stat. Ann. s. 817.416.

435. "Rules of the Department of Legal Affairs" in Glickman, supra, note 98, at Hawaii Chapter.

regardless of the content of the franchise agreement. In Wisconsin, for example, the *Fair Dealership Law* states in section 135.03[436]:

> "No grantor, directly or through any officer, agent or employee, may ... **change the competitive circumstances** of a dealership agreement" (emphasis added).

Under this legislation the franchisee could argue that when the franchisor establishes a new franchised (or company-owned) outlet within A short distance of the franchisee's own outlet, it should be considered a substantial change in the "competitive circumstances" and therefore violates the prohibition.

6.3.3 General prohibition against unfair practices.

General prohibitions against unfair practices are found in several franchise relationship laws; they are also found in general non-franchise legislation.

An example of such a prohibition in a franchise relationship law is found in South Dakota. In section 37-51-51 of the law regulating franchises[437], it is stated:

> "Unfair and inequitable practices - injunction. No person, whether by means of a term or condition of a franchise or otherwise, **shall engage in any unfair or unequitable practice** in contravention of such rules as the director may adopt defining the words "unfair and unequitable" as applies to franchises .. " (emphasis added).

A general prohibition against 'unfair practices' may be narrowly construed in that a practice is only deemed unfair if exclusivity has already been granted in a franchise agreement, and its scope is unreasonably limited. Or, it may be widely

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[436]. Wis. Stat. s. 135.03.

[437]. S.D. Codified Laws Ann. s. 37-5A-51.

interpreted so that a franchisee is allowed a certain degree of territorial exclusivity regardless of the content of the franchise agreement.

When unfair practices are not explicitly defined in the state's legislation, their interpretation can be influenced by other states' legislation and their inclusion of a reference to territorial exclusivity in the statutory definition of 'unfair' or 'inequitable' practices.

6.4 Summary.

In the US, franchise protective legislation tends to define franchise agreements by referring to the features of business format franchising. With one excption, mentioned above, territorial exclusivity in franchise agreements is not considered to be one the method's essential features.

Even though territorial exclusivity is not part of the franchise definition, it does have a dominant role in franchise agreements in that most US disclosure laws require information to be given to the franchisees regarding their territorial exclusivity. This claim is supported by the fact that the state and federal legislatures perceived franchise legislation as serving to guide the structuring of franchise agreements, in addition to its role of protecting franchisees.

The assumption in disclosure legislation is that, along with other information, the franchisee should receive details about the scope of his territorial exclusivity so that he will be protected. The assumption in relationship legislation is that disclosure is not enough when seeking the protection of franchisees and the scope of the territorial exclusivity itself should be regulated.

7. Summary and Conclusions of the US chapter.

Under US antitrust legislation, franchising has not been given special treatment on the basis of its special features so that, in contrast with the EEC Pronuptia judgement, in the American antitrust cases there was no need to characterize the method. By way of contrast, under US franchisee's protective legislation, a characterization of franchise agreements was required since franchise agreements were considered eligible for a treatment different from that granted to other types of agreements; there the emphasis was on the characteristics of business format franchises.

Territorial exclusivity in franchise agreements, as in vertical agreements in general, is analyzed within the current US federal antitrust law, following the GTE precedent, under the 'rule of reason'. In the section on state antitrust laws, it was suggested that the adherence of state courts to the GTE precedent is not certain and that it is possible that territorial exclusivity in franchise agreements will be considered 'per se' legal. This suggestion has been made based upon the writer's opinion that state laws usually allow a deviation from the GTE 'rule of reason', and that if the important role of territorial exclusivity in franchise agreements is recognized, a 'per se' legality rule is logical.

Out of the review of the state protection legislation, two conclusions can be drawn; first, that territorial exclusivity is considered a common part of a franchise agreement, and second that several state legislatures consider territorial exclusivity as one of the means to protect franchisees' investments, so that, in these states, franchisors are forced to grant franchisees a minimal degree of territorial protection.

A link can be made between franchise protective legislation and antitrust law in the US. The federal *Franchise Rule* issued by the FTC is a good example because it is a **protective law** issued by an **antitrust enforcement body**.

It is suggested that more consideration should be given in the US (and in other jurisdictions) to the protective role of territorial exclusivity when franchises are analyzed in antitrust law cases. This is suggested because the investment consideration may deter **new franchisees** from entering the market and thereby eliminate this potential new competition. In addition, if territorial exclusivity is not allowed, **existing franchisees** may be deterred from investing in the promotion of new products and from improving their services.

When examining franchisee's protective legislation from an antitrust law viewpoint, it may be observed that this legislation serves to reduce free competition, because it makes entry into the market more difficult and expensive for new franchisors or young franchise systems.

In the final analysis, this writer submits that the legislators of franchise protective legislation should consider antitrust law aspects of franchises, and the legislators of antitrust legislation and its interpreters should consider franchisee's protective aspects[438].

[438]. The premise of free competition is that the market will balance itself without governmental interference. By protecting legislation the government contributes to the "arrangement" of the market so it is not completely free any more. This is the fact that should be considered in antitrust cases.

Chapter IV

A COMPARISON AND CONCLUSIONS

A comparison of franchise specific legislation in the US and in the EEC reveals differences in approaches and practices between the two.

In the US, the policy to protect the franchisees is dominant. In the franchise legislation of the US, the central interest is in the franchise method as a separate business method. The aim is to regulate franchise agreements and not to regulate the impact of these agreements on third parties or on the economy in general. The main issue is the **internal** difficulties in the franchise method and how to avoid them.

In the EEC, the legal framework of the franchise legislation is totally different. In this jurisdiction the main concern was how to protect free competition in the Common Market. The aim was to prevent private parties from redividing the Common Market through private franchise agreements and from undoing the great efforts to integrate the 12 national economies. The interest in franchising for itself, that is, as a separate business method, is only secondary.

The main features of what is perceived as the franchise method are similar in the US and in the EEC. Both jurisdictions use the special characteristics of business format franchises in their franchise specific legislation to make a distinction between businesses included in the legislation and those considered outside it. However in contrast with the EEC, where the features of franchising were used in the competition law analysis, in the American antitrust cases, the specific features of the franchise method were not considered important and were not discussed.

Both the US and the EEC have found the franchise method beneficial to their economies in light of the method's advantages. Both jurisdictions found that even though the franchise method should be regulated its advantages should be preserved.

1. Suggested explanations for the difference in approaches between the jurisdictions.

Despite the fact that the regulated business method is similar in both jurisdictions, their franchise specific legislation took completely different directions. In this part of the thesis two main explanations to the difference are suggested: the historical explanation and the economic union explanation.

The historical reasons that led to protective legislation. As discussed earlier, the reason for the franchisee's protective legislation in the US was the history of fraud in the 1970's. This period was also called the "franchise boom" era because franchising flourished and the amount of franchise businesses grew rapidly in that time.

Most of the franchise legislation in the US was enacted within 10 years from the beginning of the "franchise boom" era and were intended as a remedy against franchisees' abuse. From this time on the franchise legislation was developed and expanded[439].

The history of franchising in the EEC is totally different. There was no "franchise boom" and franchise systems entered Europe gradually. There was no radical growth but a slow development of the franchises market. In contrast with the US, in the EEC there were no big fraud scandals that brought franchising to the public agenda or which led to pressure on politicians to enact special legislation to protect franchisees.

Another important factor in Europe was the establishment of franchisors' associations which contributed by their existence to the prevention of fraud and unfairness in franchise systems.

The historical differences in the development of the franchise method in the US and in the EEC, are a possible explanation for virtually total absence of franchisee's protective legislation in the EEC, as compared with the highly regulated market of the US.

The function of competition law in an Economic Union. The economic union in the EEC is constantly in the centre of the public agenda. Any practice that might create trade barriers is treated with utmost suspicion. As one author wrote:

> "If the common market was to be, as its name implies, a market where economic progress would come from the efforts of independent undertakings, large and small, from any of the member states, then the individual territorial

[439]. The question could be raised wether the reasons that justified franchise legislation in the 70's and 80's still exist today with a new generation of franchisees who generally understand the risks and benefits of the franchise method and who have become used to consulting lawyers, economists and accountants. The paternalism in protective franchise legislation is, in many cases, not justified today.

> markets of member states had to be made open and kept available to them. If these were prevented, than to a great extent the other important political and economic aims of the treaty would be rendered abortive"[440]

Franchising was not dealt with in the EEC until it was alleged, by a private party, that a franchise agreement restricts competition in the Common Market. Only then, in 1986, were both the advantages of the franchise method and its risk to free trade in the EEC market "discovered". A compromise had to be found between free trade among the EEC member states and the preservation of existing franchise systems in the EEC. When this compromise was considered, the parameters of franchisee's protection were not seriously taken into account by the COJ or by the Commission.

In the US, in contrast with the EEC, the economic union is not in its early stages of establishment. The economic union in the US is now a fact. There is much less sensitivity to issues concerning barriers to trade among the different states as compared with the EEC. As one author has written:

> "US competition law does not have as its foremost policy objective of free movement of goods among states of the union as does common market's competition policy"[441]

When a franchise agreement was analyzed in the GTE judgement, the territorial exclusivity clauses were not subjected to the same suspicion as it was in the Pronuptia judgement.

When the Pronuptia Court had to decide the status of territorial exclusivity

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[440]. D.G., Goyder, EEC Competition Law (Oxford: Clarendon press, 1988), at 13.

[441]. R.C., Ridgeway, "Franchising in the European Common Market Under the New Franchise Agreement Regulation" (Summer 1989) 9 Franchise Law Journal 7, at 38.

in a franchise agreement under competition law, it ignored non-competition aspects of the question, since the risk that private parties would establish trade barriers prevailed over any other possible considerations. The possible effect of territorial exclusivity as a means of protecting the franchisee's investment was one of the considerations the Court failed to address.

The GTE Court, as well, did not consider the effects of territorial exclusivity on the protection of franchisees. This consideration was not discussed because the GTE agreement was not analyzed by the Court as a franchise agreement but rather as a vertical agreement in general.

In the EEC, the effects of territorial exclusivity in the franchise method were not discussed because the main concern was the potential barriers to trade; in the US, the subject was not discussed because no aspect of the franchise method, as such, was considered.

The EEC franchise regulation is about competition law. The block exemption regulation is another example of the EEC's tendency to first regulate practices which might result in barriers between the states that belong to the economic union. The same tendency does not exist in the US.

2. Comments concerning the franchise method in general:

Standardization. In both the US and the EEC a movement towards standardization of the franchise agreement was identified. The protective and the competition legislation regulate the content of franchise agreements. Franchisors who want to avoid legal difficulties will have to comply with the content of the rules prescribed in the specific legislation. Since all the franchisors comply with similar detailed rules, the result is standardization of franchise agreements.

In the US, the standardization is achieved through the UFOC and the federal *Franchise Rule*. In the EEC, the standardization is an outcome of the 'block exemption' regulation on franchising and of the adoption of European code of ethics by the EFF.

Another aspect of a movement towards standardization is the model Franchise acts found in the US and in Canada. In both countries it was accepted that different laws in states or provinces may cause trade difficulties. The EEC should perhaps consider enactment of franchisee's protective legislation to prevent differences between member states in the event that individual states decide in the future to enact this type of legislation, such as the legislation enactment in France.

Master franchisees. Master franchisee agreements and franchise agreements are discussed under the same laws both in the EEC competition legislation and in the US protective legislation.

A significant difference exists between a franchise agreement and a master franchise agreement. The superiority of the franchisor's bargaining powers and business experience does not exist to the same extent in his relationship with franchisees and master franchisees. Also, when considering the amount of financial investment against the degree of risk, the proportion of risk experienced by a master franchisee is less than that experienced by a regular franchisee.

The difference between franchise agreements and master franchisee agreements should have led the legislators of the US and the EEC to regulate each type of agreement separately, or, at least, to exclude master franchisee agreements from the franchise specific legislation.

In the US, where protective legislation exists, this suggestion is even more valid, because there are no reasonable grounds to protect master franchisees to the same degree as regular franchisees.

Given the tendency of the EEC Commission to specify and regulate each type of business in a separate regulation, it is somewhat peculiar that master franchisee agreements were discussed in the same regulation with franchise agreements.

Closeness of relationship. The franchisee is in continuous contact with the franchisor. The latter generally exercises tight quality control measures over the business and expects the franchisee to adhere to the business format dictated in the operating manual and in the franchise agreement.

The closeness of their relationship may cause the franchisor and the franchisee, regularly considered independent undertakings, to be considered one entity, similar to that of company and its manager of its company-owned outlet. This possibility has a significant effect on the application of competition/antitrust law for the concerned agreement. Art. 85 to the *EEC Treaty* and Art. 1 of the *Sherman Act* will no longer apply it the franchisor and the franchisee are considered the same entity.

Another reason to consider franchisor and franchisee as the same entity is the interest of the franchisor in the success of the franchisee's outlet, as if it was its own outlet, for two central reasons:

First, the franchisor collects royalties from the franchisee; therefore, if the franchisee's outlet does not succeed, the franchisor collects less royalties.

Secondly, the franchisor is usually interested in selling more franchises in more locations. If the franchisees do not succeed the franchisor will find it more difficult to sell more franchises because the reputation of the franchise system would probably be damaged.

It is, therefore, suggested that in light of the special relationship between the franchisor and the franchisee, the possibility that they form one legal entity should be considered when antitrust/competition law questions are considered. This possibility was not examined by the COJ in Pronuptia or by the Supreme Court in GTE.

3. Comments about territorial exclusivity in franchise agreements.

Competition vs. Protection. From the viewpoint of free competition in the market, territorial exclusivity provides an incentive for individuals to invest in a franchise, when they would not have done so otherwise. It also permits franchisees to concentrate their efforts on their own territory and induces them to invest in the improvement of services provided in their outlets. The only disadvantage of territorial exclusivity is that it reduces competition among the members of the same distribution system. It can, therefore, be concluded that in general, territorial exclusivity enhances competition in the market rather than reduces it.

From the viewpoint of franchisee's protection, territorial exclusivity protects the investment the franchisees make. The franchisee generally possesses inferior bargaining powers and could not, in many cases, persuade the franchisor to grant him territorial exclusivity. A legislature interested in the protection of franchisees should consider a compulsory requirement for territorial exclusivity in franchisee's protective legislation.

In the US relationship legislation, the emphasis is on termination and non-renewal of franchise agreements. Protection against termination is not complete without territorial exclusivity. A franchisor prevented from terminating an agreement with a franchisee under a relationship law will probably look for ways to bypass the prohibition. The franchisor may simply sell another franchise in the franchisee's territory or a small distance from the franchisee's outlet, that is, if the exclusive territory of the franchisee is not protected. When the franchisor is able to pressure the franchisee in this way, the regulation of termination of franchise agreements is less effective.

Per-se legality. On several occasions it was suggested or implied that territorial exclusivity in franchise agreements should be treated as 'per se' legal.

In the US there is no reason not to accept this suggestion, given the protective role of territorial exclusivity and its potential to enhance competition in the market.

In the EEC the situation is more complicated since, as demonstrated above, competition law has a political role in addition to its economic role. Yet, the absolute ban of close territorial exclusivity, as developed in the individual exemptions issued by the Commission for franchise systems and implemented in the franchise regulation, is not justified without an analysis of the economic framework of the system in the market.

The distinction mentioned by the COJ in the Pronuptia judgement, between young and mature franchise systems, may serve to permit young franchise systems to apply absolute territorial exclusivity. Another parameter that may serve to allow absolute territorial exclusivity is when the size of the granted territory is relatively small. A third parameter may be the fact that the territory allocated to the franchisees encompasses cross national borders.

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Appendix I: Central articles of the EEC Treaty.

ARTICLE 2

The Community shall have as its task, by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States belonging to it.

ARTICLE 3

For the purposes set out in Article 2, the activities of the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein:

(*a*) the elimination, as between Member States, of customs duties and of quantitative restrictions on the import and export of goods, and of all other measures having equivalent effect;

(*b*) the establishment of a common customs tariff and of a common commercial policy towards third countries;

(*c*) the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital;

(*d*) the adoption of a common policy in the sphere of agriculture;

(*e*) the adoption of a common policy in the sphere of transport;

(*f*) the institution of a system ensuring that competition in the common market is not distorted;

(*g*) the application of procedures by which the economic policies of Member States can be coordinated and disequilibria in their balances of payments remedied;

(*h*) the approximation of the laws of Member States to the extent required for the proper functioning of the common market;

(*i*) the creation of a European Social Fund in order to improve employment opportunities for workers and to contribute to the raising of their standard of living;

(*j*) the establishment of a European Investment Bank to facilitate the economic expansion of the Community by opening up fresh resources;

(*k*) the association of the overseas countries and territories in order to increase trade and to promote jointly economic and social development.

ARTICLE 85

1. The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:

(a) directly or indirectly fix purchase or selling prices or any other trading conditions;

(b) limit or control production, markets, technical development, or investment;

(c) share markets or sources of supply;

(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

2. Any agreements or decisions prohibited pursuant to this Article shall be automatically void.

3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:

- any agreement or category of agreements between undertakings;
- any decision or category of decisions by associations of undertakings;
- any concerted practice or category of concerted practices;

which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:

(a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;

(b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

ARTICLE 86

Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in:

(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

(b) limiting production, markets or technical development to the prejudice of consumers;

(c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

Article 100

The Council shall, acting unanimously on a proposal from the Commission, issue directives for the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the common market.

The Assembly and the Economic and Social Committee shall be consulted in the case of directives whose implementation would, in one or more Member States, involve the amendment of legislation.

Article 164

The Court of Justice shall ensure that in the interpretation and application of this Treaty the law is observed.

Article 173

The Court of Justice shall review the legality of acts of the Council and the Commission other than recommendations or opinions. It shall for this purpose have jurisdiction in actions brought by a Member State, the Council or the Commission on grounds of lack of competence, infringement of an essential procedural requirement, infringement of this Treaty or of any rule of law relating to its application, or misuse of powers.

Any natural or legal person may, under the same conditions, institute proceedings against a decision addressed to that person or against a decision which, although in the form of a regulation or a decision addressed to another person, is of direct and individual concern to the former.

The proceedings provided for in this Article shall be instituted within two months of the publication of the measure, or of its notification to the plaintiff, or, in the absence thereof, of the day on which it came to the knowledge of the latter, as the case may be.

Article 177

The Court of Justice shall have jurisdiction to give preliminary rulings concerning:

(*a*) the interpretation of this Treaty;

(*b*) the validity and interpretation of acts of the institutions of the Community;

(*c*) the interpretation of the statutes of bodies established by an act of the Council, where those statutes so provide.

Where such a question is raised before any court or tribunal of a Member State, that court or tribunal may, if it considers that a decision on the question is necessary to enable it to give judgment, request the Court of Justice to give a ruling thereon.

Where any such question is raised in a case pending before a court or tribunal of a Member State, against whose decisions there is no judicial remedy under national law, that court or tribunal shall bring the matter before the Court of Justice.

Article 189

In order to carry out their task the Council and the Commission shall, in accordance with the provisions of this Treaty, make regulations, issue directives, take decisions, make recommendations or deliver opinions.

A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States.

A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.

A decision shall be binding in its entirety upon those to whom it is addressed.

Recommendations and opinions shall have no binding force.

Appendix II: EEC Regulation 4087/88.

Commission Regulation 4087/88 of November 30, 1988
On the Application of Article 85(3) of the Treaty to Categories of Franchise Agreements

(O.J. 1988, L359/46)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Regulation 19/65 of March 2, 1965 on the applications Article 85(3) of the Treaty to certain categories of agreements and concerted practices (O.J. 1965, 36/533), as last amended by the Act of Accession of Spain and Portugal, and in particular Article 1 thereof,

Having published a draft of this Regulation,

Having consulted the Advisory Committee on Restrictive Practices and Dominant Positions,

Whereas:

(1) Regulation 19/65 empowers the Commission to apply Article 85(3) of the Treaty by Regulation to certain categories of bilateral exclusive agreements falling within the scope of Article 85(1) which either have as their object the exclusive distribution or exclusive purchase of goods, or include restrictions imposed in relation to the assignment or use of industrial property rights.

(2) Franchise agreements consist essentially of licences of industrial or intellectual property rights relating to trade marks or signs and know-how, which can be combined with restrictions relating to supply or purchase of goods.

(3) Several types of franchise can be distinguished according to their object: industrial franchise concerns the manufacturing of goods, distribution franchise concerns the sale of goods, and service franchise concerns the supply of services.

(4) It is possible on the basis of the experience of the Commission to define categories of franchise agreements which fall under Article 85(1) but can normally be regarded as satisfying the conditions laid down in Article 85(3). This is the case for franchise agreements whereby one of the parties supplies goods or provides services to end users. On the other hand, industrial franchise agreements should not be covered by this Regulation. Such agreements, which usually govern relationships between producers, present different characteristics from the other types of franchise. They consist of manufacturing licenses based on patents and/or technical know-how, combined with trade-mark licences. Some of them may benefit from other block exemptions if they fulfil the necessary conditions.

(5) This Regulation covers franchise agreements between two undertakings, the franchisor and the franchisee, for the retailing of goods or the provision of services to end users, or a combination of these activities, such as the processing or adaptation of goods to fit specific needs of their customers. It also covers cases where the relationship between franchisor and franchisees is made through a third undertaking, the master franchisee. It does not cover wholesale franchise agreements because of the lack of experience of the Commission in that field.

(6) Franchise agreements as defined in this Regulation can fall under Article 85(1). They may in particular affect intra-Community trade where they are concluded between undertakings from different Member States or where they form the basis of a network which extends beyond the boundaries of a single Member State.

(7) Franchise agreements as defined in this Regulation normally improve the distribution of goods and/or the provision of services as they give franchisors the possibility of establishing a uniform network with limited investments, which may assist the entry of new competitors on the market, particularly in the case of small and medium-sized undertakings, thus increasing interbrand competition. They also allow independent traders to set up outlets more rapidly and with higher chance of success than if they had to do so without the franchisor's experience and assistance. They have therefore the possibility of competing more efficiently with large distribution undertakings.

(8) As a rule, franchise agreements also allow consumers and other end users a fair share of the resulting benefit, as they combine the advantage of a uniform network with the existence of traders personally interested in the efficient operation of their business. The homogeneity of the network and the constant co-operative between the franchisor and the franchisees ensures a constant quality of the products and services. The favourable effect of franchising on interbrand competition and the fact that consumers are free to deal with any franchisee in the network guarantees that a reasonable part of the resulting benefit will be passed on to the consumers.

(9) This Regulation must define the obligations restrictive of competition which may be included in franchise agreements. This is the case in particular for the granting of an exclusive territory to the franchisees combined with the prohibition on actively seeking customers outside the territory, which allows them to concentrate their efforts on their allotted territory. The same applies to the granting of an exclusive territory to a master franchisee combined with the obligation not to conclude franchise agreements with third parties outside that territory. Where the franchisees sell or use in the process of providing services, goods manufactured by the franchisor or according to its instructions and or bearing its trade mark, an obligation on the franchisees not to sell, or use in the process of the provision of services, competing goods makes it possible to establish a coherent network which is identified with the franchised goods. However, this obligation should only be accepted with respect to the goods which form the essential subject-matter of the franchise. It should notably not relate to accessories or spare parts for these goods.

(10) The obligations referred to above thus do not impose restrictions which are not necessary for the attainment of the above mentioned objectives. In particular, the limited territorial protection granted to the franchisees is indispensable to protect their investment.

(11) It is desirable to list in the Regulation a number of obligations that are commonly found in franchise agreements and are normally not restrictive of competition and to provide that if, because of the particular

economic or legal circumstances, they fall under Article 85(1) they are also covered by the exemption. This list, which is not exhaustive, includes in particular clauses which are essential either to preserve the common identity and reputation of the network or to prevent the know-how made available and the assistance given by the franchisor from benefiting competitors.

(12) The Regulation must specify the conditions which must be satisfied for the exemption to apply. To guarantee that competition is not eliminated for a substantial part of the goods which are the subject to the franchise, it is necessary that parallel imports remain possible. Therefore, cross deliveries between franchisees should always be possible. Furthermore, where a franchise network is combined with another distribution system, franchisees should be free to obtain supplies from authorised distributors. To better inform consumers, thereby helping to ensure that they receive a fair share of the resulting benefits, it must be provided that the franchisee shall be obliged to indicate its status as an independent undertaking, by any appropriate means which does not jeopardise the common identity of the franchised network. Furthermore, where the franchisees have to honour guarantees for the franchisor's goods, this obligation should also apply to goods supplied by the franchisor, other franchisees or other agreed dealers.

(13) The Regulation must also specify restrictions which may not be included in franchise agreements if these are to benefit from the exemption granted by the Regulation, by virtue of the fact that such provisions are restrictions falling under Article 85(1) for which there is no general presumption that they will lead to the positive effects required by Article 85(3). This applies in particular to market sharing between competing manufacturers, to clauses unduly limiting the franchisee's choice of suppliers or customers and to cases where the franchisee is restricted in determining its prices. However, the franchisor should be free to recommend prices to the franchisees, where it is not prohibited by national laws and to the extent that it does not lead to concerted practices for the effective application of these prices.

(14) Agreements which are not automatically covered by the exemption because they contain provisions that are not expressly exempted by the Regulation and not expressly excluded from exemption may nonetheless generally be presumed to be eligible for application of Article 85(3). It will be possible for the Commission rapidly to establish whether this is the case for a particular agreement. Such agreements should therefore be deemed to be covered by the exemption provided for in this Regulation where they are notified to the Commission and the Commission does not oppose the application of the exemption within a specified period of time.

(15) If individual agreements exempted by this Regulation nevertheless have effects which are incompatible with Article 85(3), in particular as interpreted by the administrative practice of the Commission and the case law of the Court of Justice, the Commission may withdraw the benefit of the block exemption. This applies in particular where competition is significantly restricted because of the structure of the relevant market.

(16) Agreements which are automatically exempted pursuant to this Regulation need not be notified. Undertakings may nevertheless in a particular case request a decision pursuant to Council Regulation 17 (O.J. 1962, 13/204) as last amended by the Act of Accession of Spain and Portugal.

(17) Agreements may benefit from the provisions either of this Regulation or of another Regulation, according to their particular nature and provided that they fulfil the necessary conditions of application. They may not benefit from a combination of the provisions of this Regulation with those of another block exemption Regulation.

HAS ADOPTED THIS REGULATION:

ARTICLE 1

1. Pursuant to Article 85(3) of the Treaty and subject to the provisions of this Regulation, it is hereby declared that Article 85(1) of the Treaty shall not apply to franchise agreements to which two undertakings are party, which include one or more of the restrictions listed in Article 2.

2. The exemption provided for in paragraph 1 shall also apply to master franchise agreements to which two undertakings are party. Where applicable, the provisions of this Regulation concerning the relationship between franchisor and franchisee shall apply *mutatis mutandis* to the relationship between franchisor and master franchisee and between master franchisee and franchisee.

3. For the purposes of this Regulation:

(*a*) 'franchise' means a package of industrial or intellectual property rights relating to trade marks, trade names, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or the provision of services to end users;

(*b*) 'franchise agreement' means an agreement whereby one undertaking, the franchisor, grants the other, the franchisee, in exchange for direct or indirect financial consideration, the right to exploit a franchise for the purposes of marketing specified types of goods and/or services; it includes at least obligations relating to:

—the use of a common name or shop sign and a uniform presentation of contract premises and/or means of transport,

—the communication by the franchisor to the franchisee of know-how,

—the continuing provision by the franchisor to the franchisee of commercial or technical assistance during the life of the agreement;

(*c*) 'master franchise agreement' means an agreement whereby one undertaking, the franchisor, grants the other, the master franchisee, in exchange direct or indirect financial consideration, the right to exploit a franchise for the purposes of concluding franchise agreements with third parties, the franchisees;

(*d*) 'franchisor's goods' means goods produced by the franchisor or according to its instructions, and/or bearing the franchisor's name or trade mark;

(*e*) 'contract premises' means the premises used for the exploitation of the franchise or, when the franchise is exploited outside those premises, the base from which the franchisee operates the means of transport used for the exploitation of the franchise (contract means of transport);

(*f*) 'know-how' means a package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identined;

(*g*) 'secret' means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily accessible; it is not limited in the narrow sense that each individual component of the know-how should be totally unknown or unobtainable outside the franchisor's business;

(*h*) 'substantial' means that the know-how includes information which is of importance for the sale of goods or the provisions of services to end users, and in particular for the presentation of goods for sale, the processing of goods in connection which the provision of services, methods of dealing with customers, and administration and financial management; the know-how must be useful for the franchise by being capable, at the date of conclusion of the agreement, of improving the competitive position of the franchisee, in particular by improving the franchisee's performance or helping it to enter a new market;

(*i*) 'identified' means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality; the description of the know-how can either be set out in the franchise agreement or in a separate document or recorded in any other appropriate form.

Article 2

The exemption provided for in Article 1 shall apply to the following restrictions of competition:

(*a*) an obligation on the franchisor, in a defined area of the common market, the contract territory, not to:
- —grant the right to exploit all or part of the franchise to third parties,
- —itself exploit the franchise, or itself market the goods or services which are the subject-matter of the franchise under a similar formula.
- —itself supply the franchisor's goods to third parties;

(*b*) an obligation on the master franchisee not to conclude franchise agreement with third parties outside its contract territory;

(*c*) an obligation on the franchisee to exploit the franchise only from the contract premises;

(*d*) an obligation on the franchisee to refrain, outside the contract territory, from seeking customers for the goods or the services which are the subject-matter of the franchise;

(*e*) an obligation on the franchisee not to manufacture, sell or use in the course of the provision of services, goods competing with the franchisor's goods which are the subject-matter of the franchise; where the subject-matter of the franchise is the sale or use in the course of the provision of services both certain types of goods and spare parts or accessories therefor, that obligation may not be imposed in respect of these spare parts or accessories.

Article 3

1. Article 1 shall apply notwithstanding the presence of any of the following obligations on the franchisee, in so far as they are necessary to protect the franchisor's industrial or intellectual property rights or to maintain the common identity and reputation of the franchised network:

(*a*) to sell, or use in the course of the provision of services, exclusively goods matching minimum objective quality specifications laid down by the franchisor;

(*b*) to sell, or use in the course of the provision of services, goods which are manufactured only by the franchisor or by third parties designed by it, where it is impracticable, owing to the nature of the goods which are the subject-matter of the franchise, to apply objective quality specifications;

(*c*) not to engage, directly or indirectly, in any similar business in a territory where it would compete with a member of the franchised network, including the franchisor; the franchisee may be held to this obligation after termination of the agreement, for a reasonable period which may not exceed one year, in the territory where it has exploited the franchise;

(*d*) not to acquire financial interests in the capital of a competing undertaking, which would give the franchisee the power to influence the economic conduct of such undertaking;

(*e*) to sell the goods which are the subject-matter of the franchise only to end users, to other franchisees and to resellers within other channels of distribution supplied by the manufacturer of these goods or with its consent;

(*f*) to use its best endeavours to sell the goods or provide the services that are the subject-matter of the franchise; to offer for sale a minimum range of goods, achieve a minimum turnover, plan its orders in advance, keep minimum stocks and provide customer and warranty services;

(*g*) to pay to the franchisor a specified proportion of its revenue for advertising and itself carry out advertising for the nature of which it shall obtain the franchisor's approval.

2. Article 1 shall apply notwithstanding the presence of any of the following obligations on the franchisee:

(*a*) not to disclose to third parties the know-how provided by the franchisor; the franchisee may be held to this obligation after termination of the agreement;

(*b*) to communicate to the franchisor any experience gained in exploiting the franchise and to grant it, and other franchisees, a non-exclusive licence for the know-how resulting from that experience;

(*c*) to inform the franchisor of infringements of licensed industrial or intellectual property rights, to take legal action against infringers or to assist the franchisor in any legal actions against infringers;

(*d*) not to use know-how licensed by the franchisor for purposes other than the exploitation of the franchise; the franchisee may be held to this obligation after termination of the agreement;

(*e*) to attend or have its staff attend training courses arranged by the franchisor;

(*f*) to apply the commercial methods devised by the franchisor, including any subsequent modification thereof, and use the licensed industrial or intellectual property rights;

(*g*) to comply with the franchisor's standards for the equipment and presentation of the contract premises and/or means of transport;

(*h*) to allow the franchisor to carry out checks of the contract premises and/or means of transport, including the goods sold and the services provided, and the inventory and accounts of the franchisee;

(*i*) not without the franchisor's consent to change the location of the contract premises;

(*j*) not without the franchisor's consent to assign the rights and obligations under the franchise agreement.

3. In the event that, because of particular circumstances, obligations referred to in paragraph 2 fall within the scope of Article 85(1), they shall also be exempted even if they are not accompanied by any of the obligations exempted by Article 1.

ARTICLE 4

The exemption provided for in Article 1 shall apply on condition that:

(*a*) the franchisee is free to obtain the goods that are the subject-matter of the franchise from other franchisees; where such goods are also distributed through another network of authorised distributors, the franchisee must be free to obtain the goods from the latter;

(*b*) where the franchisor obliges the franchisee to honour guarantees for the franchisor's goods, that obligation shall apply in respect of such goods supplied by any member of the franchised network or other distributors which give a similar guarantee, in the common market;

(*c*) the franchisee is obliged to indicate its status as an independent undertaking; this indication shall however not interfere with the common identity of the franchised network resulting in particular from the common name or shop sign and uniform appearance of the contract premises and/or means of transport.

ARTICLE 5

The exemption granted by Article 1 shall not apply where:

(*a*) undertakings producing goods or providing services which are identical or are considered by users as equivalent in view of their characteristics, price and intended use, enter into franchise agreements in respect of such goods or services;

(*b*) without prejudice to Article 2(*e*) and Article 3(1)(*b*), the franchisee is prevented from obtaining supplies of goods of a quality equivalent to those offered by the franchisor;

(*c*) without prejudice to Article 2(*e*), the franchisee is obliged to sell, or use in the process of providing services, goods manufactured by the franchisor or third parties designated by the franchisor and the franchisor refuses, for reasons other than protecting the franchisor's industrial or intellectual property rights, or maintaining the common identity and reputation of the franchised network, to designate as authorised manufacturers third parties proposed by the franchisee;

(*d*) the franchisee is prevented from continuing to use the licensed know-how after termination of the agreement where the know-how has become generally known or easily accessible, other than by breach of an obligation by the franchisee;

(*e*) the franchisee is restricted by the franchisor, directly or indirectly, in the determination of sale prices for the goods or services which are the subject-matter of the franchise, without prejudice to the possibility for the franchisor of recommending sale prices;

(*f*) the franchisor prohibits the franchisee from challenging the validity of the industrial or intellectual property rights which form part of the franchise, without prejudice to the possibility for the franchisor of terminating the agreement in such a case;

(*g*) franchisees are obliged not to supply within the common market the goods or services which are the subject-matter of the franchise to end users because of their place of residence.

Article 6

1. The exemption provided for in Article 1 shall also apply to franchise agreements which fulfil the conditions laid down in Article 4 and include obligations restrictive of competition which are not covered by Articles 2 and 3(3) and do not fall within the scope of Article 5, on condition that the agreements in question are notified to the Commission in accordance with the provisions of Commission Regulation 27 (O.J. 1962, 35/1118) and that the Commission does not oppose such exemption within a period of six months.

2. The period of six months shall run from the date on which the notification is received by the Commission. Where, however, the notification is made by registered post, the period shall run from the date shown on the postmark of the place of posting.

3. Paragraph 1 shall apply only if:

(*a*) express reference is made to this Article in the notification or in a communication accompanying it; and

(*b*) the information furnished with the notification is complete and in accordance with the facts.

4. The benefit of paragraph 1 can be claimed for agreements notified before the entry into force of this Regulation by submitting a communication to the Commission referring expressly to this Article and to the notification. Paragraphs 2 and 3(*b*) shall apply *mutatis mutandis*.

5. The Commission may oppose exemption. It shall oppose exemption if it receives a request to do so from a Member State within three months of the forwarding to the Member State of the notification referred to in paragraph 1 or the communication referred to in paragraph 4. This request must be justified on the basis of considerations relating to the competition rules of the Treaty.

6. The Commission may withdraw its opposition to the exemption at any time. However, where that opposition was raised at the request of a Member State, it may be withdrawn only after consultation of the advisory Committee on Restrictive Practices and Dominant Positions.

7. If the opposition is withdrawn because the undertakings concerned have shown that the conditions of Article 85(3) are fulfilled, the exemption shall apply from the date of the notification.

8. If the opposition is withdrawn because the undertakings concerned have amended the agreement so that the conditions of Article 85(3) are fulfilled, the exemption shall apply from the date on which the amendments take effect.

9. If the Commission opposes exemption and its opposition is not withdrawn, the effects of the notification shall be governed by the provisions of Regulation 17.

Article 7

1. Information acquired pursuant to Article 6 shall be used only for the purposes of this Regulation.

2. The Commission and the authorities of the Member States, their officials and other servants shall not disclose information acquired by them pursuant to this Regulation of a kind that is covered by the obligation of professional secrecy.

3. Paragraphs 1 and 2 shall not prevent publication of general information or surveys which do not contain information relating to particular undertakings or associations of undertakings.

Article 8

The Commission may withdraw the benefit of this Regulation, pursuant to Article 7 of Regulation 19/65, where it finds in a particular case that an agreement exempted by this Regulation nevertheless has certain effects which are incompatible with the conditions laid down in Article 85(3) of the EEC Treaty, and in particular where territorial protection is awarded to the franchisee and:

(*a*) access to the relevant market or competition therein is significantly restricted by the cumulative effect of parallel networks of similar agreements established by competing manufacturers or distributors;

(*b*) the goods or services which are the subject-matter of the franchise do not face, in a substantial part of the common market, effective competition from goods or services which are identical or considered by users as equivalent in view of their characteristics, price and intended use;

(*c*) the parties, or one of them, prevent end users, because of their place of residence, from obtaining, directly or through intermediaries, the goods or services which are the subject-matter of the franchise within the common market, or use differences in specifications concerning those goods or services in different Member States, to isolate markets;

(*d*) franchisees engage in concerted practices relating to the sale prices of the goods or services which are the subject-matter of the franchise;

(*e*) the franchisor uses its right to check the contract premises and means of transport, or refuses its agreement to requests by the franchisee to move the contract premises or assign its rights and obligations under the franchise agreement, for reasons other than protecting the franchisor's industrial or intellectual property rights, maintaining the common identity and reputation of the franchised network or verifying that the franchisee abides by its obligations under the agreement.

Article 9

This Regulation shall enter into force on February 1, 1989.

It shall remain in force until December 31, 1999.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels November 30, 1988.