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DEVELOPING A MORE ROBUST FILIPINO FRANCHISING INDUSTRY: WHAT THE PHILIPPINES CAN LEARN FROM THE U.S. AND EUROPE

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Abstract

This thesis briefly analyzes the current system of franchise regulations in the Philippines and its reliance on the Rules and Regulations on Voluntary Licensing ("Rules"). It should be noted that such Rules primarily applies to technology transfer arrangements but does not specifically mention franchise agreements. It also assesses the implications of imposing regulatory prohibitions on some clauses in a franchise contract which, on its face, may seem "anti-competitive" but are in fact, actually characteristics of franchise asymmetry, an essential element in franchise arrangements in most jurisdictions. Essentially, the thesis seeks to prove that, in order to develop a more robust and enticing franchise environment in the Philippines, a careful balance must be struck between the rights of the franchisor to its know-how and intellectual property, on one hand, and the rights of the franchisee to be protected economic-wise and make an informed business decision, on the other.

To achieve this objective, laws, regulations and cases in other jurisdictions with thriving economies and franchise industries such as the United States, France and Germany are analyzed and summarized in this thesis. The said countries are selected to highlight the contrasts in their systems of franchise regulations and the differences in the manner by which they respond to different stakeholders in the industry, such as the franchise associations, innovators and the consumers in general. General EU policies on competition are also assessed in this thesis as they may give insight on how to effectively implement anti-competitive policies, without compromising the need to encourage and infuse more innovations and know-how into the local economy. By assessing the pros and cons of the aforementioned foreign systems, one can learn lessons and explore possible policy options on how to further improve the Philippine franchising laws and regulations.

I. Introduction

A. Background of the Philippine Franchising Industry

The Philippine franchise industry is a developing one, owing its growth and development to the proliferation of well-known local and foreign brands in a diverse range of industries. The effective penetration of the said well-known brands to the Philippine market can be attributed to the fact, among others, that Filipinos in general have the propensity to patronize brands that are considered household names or those that have established its business repute for decades. A study conducted by market research firm Nielsen Philippines and published online in the Philippine Inquirer website shows that approximately 80 percent of Filipino consumers who are considered "net-savvy" would buy new products from familiar brands rather than switch to a new brand.[1] The article also mentioned that "the trend reveals a higher level of brand loyalty among locals compared to the global trend which shows 60 percent of consumers around the world with Internet access prefer to buy new products from familiar brands."[2]

Hence, potentially, franchising can be beneficial not only for the franchisor and franchisee but also to Filipinos in general as it will give them a wider and better range of product and service choices. Furthermore, the franchising industry can also generate jobs for thousands of Filipinos, thereby giving them a source of livelihood. This fact has actually been proven in other countries. For example, as stated in the report of the International Trade Administration of the U.S. Department of Commerce, franchising has become "an important driver" in the economy as it has become

[1] Daxim L. Lucas, *Filipino Consumers More Brand Loyal Than Global Peers, Nielsen Study Finds,* Inquirer Online, (February 1, 2019, 2:25 PM), https://business.inquirer.net/104521/filipino-consumers-more-brand-loyal-than-global-peers-nielsen-study-finds.

[2] Ibid.

responsible for one in seven jobs in the U.S. alone.[3] Furthermore, the report also provided that there are over 780,000 franchise businesses that directly employ over 8.8 million people and account for over $890 billion in direct economic output.[4] On the other hand, in Malaysia, John O'Brien, chairman of Asia Pacific Franchise Confederation has recently declared that "the franchising industry in Malaysia is exciting" and that is has been growing at a rapid pace of 12 to 15% in the past five years, contributing around six billion euros to the nation's gross domestic product.[5] Finally, in the Philippines, the Philippine News Agency reported that the local franchising sector has a network of 200,000 stores generating around 1.2 million jobs.[6] As the President of the Philippine Franchising Sector remarked, the franchising sector offers "not just a product but also business and livelihood".[7] Given these data, the potential benefits of business franchising to the economy cannot be denied.

B. Research Problem

Despite the foregoing, delving into the franchising business in the Philippines can still be considered risky for franchisors, given the limitations imposed by the Philippine laws and regulations. Among the challenges and obstacles which prevent the Philippine franchising industry from realizing its fullest potential is the lack of clear and specific rules and regulations which govern franchise agreements. Under Philippine laws, franchise agreements are governed by rules pertaining to technology transfer agreements in general. This would pose a problem since the concept of "technology transfer" is much broader and multi-faceted compared to a franchise agreement which

[3] International Trade Administration, *2016 Top Markets Report Franchising,* ITA Franchising, U.S. Department of Commerce (2016).
[4] Ibid.
[5] Gilles Menguy, *Malaysia is the Ultimate Franchise "Frontier",* GM Avocats and Solicitors (March 22, 2019, 12:12 pm), https://gm-avocats.com/malaysia/?print=pdf.
[6] Aerol John Pateña, *Ph Franchising Sector Seen to Sustain Growth,* Philippine News Agency, (March 22, 2018, 11:31 am) http://www.pna.gov.ph/articles/1040414.
[7] Ibid.

is a distinct type of business arrangement and which consequently gives the parties a distinct set of rights which need to be protected. As will be discussed in the succeeding sections, absent such specific franchise laws, possible abuses committed by either the franchisor or franchisee cannot be effectively regulated and monitored.

Furthermore, the need to balance an effective intellectual property system to promote the development of innovations, on one hand, and the use of intellectual property as a social function (the objective of which is the diffusion of knowledge and information for the promotion of national development and the common good),[8] on the other, may result to the promulgation of policies and rules which the franchisors may find too onerous and threatening to their know-how, trademarks and other intellectual property rights which, most of the time, serve as their main business investments. Given these policies, franchisors may tend to form an impression that starting a franchise business in the Philippines is ultimately risky and unworthy of their investment.

Lastly, the fairness and equitability of the contractual provisions in franchise agreements are governed mostly by general laws on contracts - which can be found in the Civil Code of the Philippines – and related jurisprudence. In the Philippines, there is no disclosure requirement - similar to that imposed in the US or French system – other than the general requirement of good faith and fair dealing.[9] Such reliance on general civil code provisions, without taking into account

[8] Rules and Regulations on Voluntary Licensing, Second Whereas Clause, Intellectual Property Office of the Philippines (1998).

[9] The Civil Code of the Philippines provides generic provisions pertaining to abuse of rights and fair dealing, to wit:

> *"Article 20. Every person who, contrary to law, wilfully or negligently causes damage to another, shall indemnify the latter for the same.*
>
> *Article 21. Any person who wilfully causes loss or injury to another in manner that is contrary to morals, good customs or public policy shall compensate the latter for the damage."*

the nuances of a franchise arrangement, may be insufficient in ensuring that both the franchisor and the franchisee's distinct rights and welfare are legally protected.

C. Thesis Statement

This thesis seeks to prove that in order to develop a robust and healthy franchising industry in the Philippines, franchise agreements should be regulated separately from technology transfer agreements. Such specific regulations will (1) ensure that the intellectual property rights of the franchisor will be sufficiently protected, without prejudice to the diffusion of innovations to the local industry, thus encouraging more innovators and novel business ventures in the country; and (2) guarantee that the franchisee will not be unduly prejudiced by the asymmetrical nature of franchise agreements.

D. Methodology

This thesis seeks to explore possible policy models and recommendations for the regulation of the franchise industry in the Philippines. While most literature on the topic has focused, for the most part, on either the business and economic aspect of the business franchise or the general civil law and anti-competition regulations pertaining to franchise arrangements, this thesis will focus more on the need to enact more franchise-specific policies which will (1) protect both the franchisor's intellectual property rights and the franchisee's economic and business interests; and (2) encourage the diffusion of innovations for the promotion of national development and the common good.

1. Jurisdictions Covered

First, an analysis of the existing legal system in the Philippines will be made, focusing on the laws, rules, regulations and jurisprudence governing franchise agreements. Since the current

Rules[10] governing franchising agreements are those which pertain to technology transfer arrangements in general, an analysis of the concept of technology transfer will also be made. Thereafter, loopholes in the said system will be identified, focusing on the interests of the franchisor and the franchisee. Lastly, a review of literature pertaining to related policies in various jurisdictions will be conducted and summarized in this thesis. Focus will be made on the U.S. and Europe, specifically the systems in France and Germany, in order to compare and contrast their systems. Regulations of the European Union will also be assessed, especially their competition policy.

2. Limitations

Given the limited amount of literature on the topic, this thesis will utilize existing materials, including those drafted by professional associations pertaining to regulations on franchise asymmetries and those that restrict competition. An analysis will thereafter be made on their effectiveness and applicability to the Philippines.

3. Roadmap

After analyzing the countries' laws, regulations and jurisprudence involving business franchises, a comparative analysis will be made on the following: (a) the countries' policies relating to business franchises; (b) the main stakeholders which each of the country's governments aim to protect and prioritize; and (c) the effects of the said laws, regulations and jurisprudence on the franchising industries of each of the countries, particularly on the franchisor and the franchisee. Finally, after the said analysis, possible policy recommendations and solutions will be explored which may be applicable to the Philippine context, taking into account the differences in each of the countries' legal systems and national priorities.

[10] Rules and Regulations on Voluntary Licensing, Intellectual Property Office of the Philippines (1998).

II. Chapter One: The Philippine Franchising Industry

A. Introduction

Ever since its inception, the franchising industry has affected the lives of almost every Filipino. From being a source of living for would-be entrepreneurs and sales personnel, to giving consumers more product choices – be it local or imported, business franchising has opened doors to Filipinos giving them easy access to the global market and economy. Indeed, one can say that the franchising industry in the Philippines has not only become a melting pot of different goods and services from various cultures, it has also become a means by which foreign and innovative brands and/or products would adapt to local Filipino culture in order to cater to the consumers' demands. As eloquently stated by Matejowsky, "contemporary retailing in the urban Philippines reflects nothing so much as a mélange of global and local forms mediated by processes of indigenization and commodification."[11] This reflects the "the transformation of global elements to better suit local conditions" that has become a central characteristic of Philippine modernity, which can be attributed to the diverse global experiences of overseas Filipinos and their kin".[12]

Indeed, as the number of business franchises continue to develop and evolve in the Philippines, so does the exchange of knowledge, skills, technology, and the so-called "cultural borrowing".[13] According to Sikora et. al.,[14] in the current economic and market conditions, "innovativeness of individual companies consists of the ability to build complex relationships and

[11] Ty Matejowski, *Convenience Store Pinoy: Sari-Sari, 7-Eleven, and Retail Localization in the Contemporary Philippines*, Philippine Quarterly of Culture and Society, Vol. 35, No. 4 (2007).
[12] Pertierra, Raul, Eduardo Ugarte, Alicia Pingol, Joel Hernandez and Nikos L. Dacanay, *Txt-ing Selves: Cellphones and Philippine Modernity*. Manila: De La Salle University Press (2002) 1997 as cited in No. 4 (2007).
[13] Ibid.
[14] Jakub Sikora, Marcin Niemiec, Anna Szelag-Sikora, Zofia Grodek-Szostak, *Concepts of Innovation in Technology Transfer on the Example of Selected Countries*, Acta Sci Pol. Oeconomia (2017).

network structures in the local or regional level, as well as to participate in them."[15] The said relationships and network structures are important for small businesses such as business franchisees, which generally do not have the necessary capital and goodwill necessary for them to succeed and flourish in the industry.[16]

B. Risks Involved

While the above-described diversity, liberality and openness of the business franchise system in the Philippines may be a source of profit and success for both the franchisor and franchisee, the same can also open the floodgates to abuse by either the franchisor or the franchisee. This is largely due to the fact that there is no specific set of laws and regulations which would monitor and regulate franchise arrangements in the Philippines.

First, with regard to the rights of franchisee, it should be noted that there are no minimum disclosure requirements (on the part of the franchisor) which would enable the franchisee to make an informed decision in entering franchise arrangements. Furthermore, there are no regulations pertaining to royalties and terminations of franchise agreements by the franchisor, which are present in other jurisdictions. Second, as regards the rights of the franchisor, given the liberality of the current Rules[17] on technology transfer agreements (which are also currently being applied to franchise agreements), franchisees can potentially abuse the rights given to them by the franchisor and take advantage of the transfer of know-how and other intellectual property rights, thereby gaining economic profits for themselves, to the detriment of the franchisors.

[15] Ibid.
[16] Daszkiewicz, N., *Internacjonalizacja małych i średnich przedsiębiorstw we współczesnej gospodarce*. Scientific Publishing Group, Gdańsk (2004), as cited in note 14
[17] Rules and Regulations on Voluntary Licensing, Intellectual Property Office of the Philippines (1998).

Indeed, there is a need to fine-tune the current set of regulations which govern franchise agreements in the Philippines. Given the fact that the objectives of the abovementioned Rules is to achieve a delicate balance between innovation and intellectual property rights on one hand, and the need to assimilate to local culture in order to foster a sustainable franchise industry in the country,[18] the same may actually pose problems in practice. As will be discussed in the subsequent paragraphs, Philippine laws and regulations applicable to franchise arrangements may make it difficult for franchisors to feel economically secure and may even prevent them from effectively protecting their intellectual property rights from infringement not only by the local consumers but by their local business partners as well (i.e., the franchisees).

C. Current Regulations on Franchising Agreements

It must be emphasized that Philippine laws do not define "franchising" per se. As can be seen in the Rules and Regulations on Voluntary Licensing,[19] which merely reiterates most of the provisions of the Intellectual Property Code of the Philippines on voluntary licensing agreements, franchise agreements are subsumed under the broader category of "technology transfer arrangements", as defined in the Intellectual Property Code of the Philippines ("IP Code").[20] Section 4.2 of the IP Code states that technology transfer arrangements are "contracts or agreements involving the transfer of systematic knowledge for the manufacture of a product, the application of a process, or rendering of a service including management contracts and the transfer, assignment or licensing of all forms of intellectual property rights, including licensing of computer software except

[18] Rules and Regulations on Voluntary Licensing, supra note 10.
[19] Ibid.
[20] Ferdinand M. Negre and Samantha Wesley K. Rosales, Bengzon Negre Untalan Intellectual Property Attorneys, *Franchising in Philippines: overview* (October 19, 2018, 2:49 PM), https://uk.practicallaw.thomsonreuters.com/1-632-2126?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1.

computer software developed for mass market." While on its face, one may assume that technology transfers are similar to franchise agreements, this is not really the case. As already stated in the preceding discussion, "technology transfer" is a very broad terminology which may include more sophisticated technology arrangements such as patent license agreements, open source software releases, cooperative research and development agreements, education partnership agreements,[21] and so forth. Hence, as will be discussed later on in the succeeding chapters, franchise agreements are a species of its own which involve a specific set of commercial rights and obligations and hence, should be regulated separately. Given these premise, it is important to analyze the concept of "technology transfer".

D. The Technology Transfer Conundrum

In their article, Salanta et. al., stated that the concept of technology transfer emerged in response to globalization. As economies progress and transcend borders, trade liberalization and building production facilities that operate for customers from other countries developed gradually.[22] As stated by Barton, businesses "need to face international competition, not just local ones, and sometimes they have to find their optimal position in a production structure that is already built at international level.[23] Hence, it can be said that technology transfer is the means through which business organizations meet the challenges brought about by the ever-changing and dynamic needs of the modern global economy. But what exactly is the concept technology transfer? What is subsumed under its scope? And how does it relate to franchise agreements?

[21] National Security Agency, *NSA Office of Research and Technology Applications,* (January 30, 2019, 10:00 am) https://www.nsa.gov/what-we-do/research/technology-transfer/.

[22] Irina Iulia Salanta, Iona Natalia Beleiu, Alin Mihaila, Emil Lucian Crisan, *Technology Transfer Related Concepts.* Review of International Comparative Management. Volume 19, Issue 4, (2018).

[23] Barton, J.H. New Trends in technology Transfer: Implications for National and International Policy: International Centre for Trade and Sustainable Development (2007).

According to Autio and Laamanen[24] "technology comprises the ability to recognize technical problems, the ability to develop new concepts and tangible solutions to technical problems, the concepts and tangibles developed to solve technical problems, and the ability to exploit the concepts and tangibles in an effective way." Given this definition, "technology transfer" is seen as the process in which "technology is carried across the border of two entities, which can be countries, companies or even individuals.[25] However, as stated by Kumar, Kumar & Persaud, "due to its strong interdisciplinary character, it is challenging to find a unitary and universal definition for TT (technology transfer)". [26]

Dissecting semantics, one can see that the term is comprised of two equally multi-faceted concepts, namely "technology" and "transfer". As stated by Kumar et al., "technology consists of two primary components: 1) a physical component which comprises of items such as products, tooling, equipment, blueprints, techniques, and processes; and 2) the informational component which consists of know-how in management, marketing, production, quality control, reliability, skilled labor and functional areas."[27] According to them, the said dichotomy can be further categorized into two components, namely "the hard (prototype and patent) and soft components (process and people)". The interaction of these components can be seen in Figure 1 below:

[24] Autio, E., & Laamanen, T., *Measurement and Evaluation of Technology Transfer: Review of Technology Transfer Mechanisms and indicators*. International Journal of Technology Management (1995).
[25] Albors, J., Sweeney, E., & Hidalgo A. Transnational Technology Transfer Networks for SMEs. A review of the state-of-the-art and an Analysis of the European IRC Network. Production Planning and Control (2005).
[26] Kumar, V., Kumar, U., & Persaud, A. Building technological capability through importing technology: the case of Indonesian Manufacturing industry. *The Journal of Technology Transfer,* (1999) as cited in note 14.
[27] Ibid.

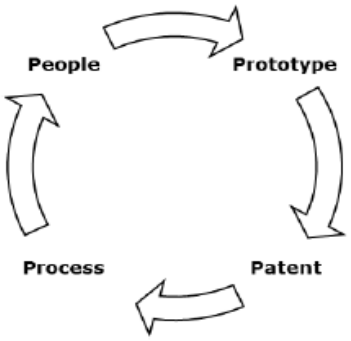

Figure 1. The 4Ps of Technology Transfer
Source: (Andonova, 2015)[28]

Hence, based on the above model, it can be assumed that technology is the process by which any existing knowledge or know-how is transformed by people into any physical manifestation such as the prototype of a product or service, which, in turn, contributes to an any activity.

Furthermore, legally speaking, "technology" means "more than just some sophisticated equipment or physical goods usable in the production or supply of a customer service".[29] For Salanta et. al., technology is actually "the process through which an organization transforms work, capital, material, resources, and information into products and services of a greater value."[30]

Technology thus refers to the whole process of organizations that create products and services generating greater value, and is considered to be a prerequisite for the sole existence of these organizations."[31] Given this definition, it can be assumed that technology is something that adds an economic value or profit to a business enterprise, be it income generated from the sale of its goods or services, the royalties derived from the use of its know-how and other intellectual property or even something that makes its process of production efficient and effective. This is

[28] Supra note 14
[29] Ibid.
[30] Ibid.
[31] Ibid.

connected to the fact that behind every product or service that a company produces are "several activities that together form a process." It is also important to note that almost every enterprise have technologies that need not include technical, engineering or production elements. Technology can be said to be present in seemingly basic and rudimentary processes such as marketing, financial, management, human resources, customer relations, logistics, etc. Hence, given this premise, any innovator can claim that any change, alteration or modification upon a certain "technology" can be considered an innovation of technology. As stated by Salanta et. al., it can be concluded that "technology transfer is a much wider concept than the simple handling of advanced technologies".[32]

On the other hand, the term "transfer" does not strictly refer to the "movement of goods from point A to point B, but it encompasses the transference of the right of use."[33] Le Grange and Buys illustrate this by using the example of a computer program. The purchase by a consumer of a computer program does not necessarily entail the transfer (to the consumer) of the intended functionality of the said computer program. Neither does the installation of the computer program in the hardware of the buyer bring about the transfer of the functionality of the same. It is only when the buyer actually uses the program when it can be considered that the said certain functionality has been transferred.[34]

Applying the aforementioned doctrines to intellectual property law which mostly governs franchise agreements in the Philippines, as can be seen in the succeeding section, technology transfers may indeed subsume contracts or arrangements with similar characteristics such as franchise contracts and licensing contracts, among other forms of agreements in the broad

[32] Ibid.
[33] Ibid.
[34] Le Grange, L., & Buys, A.J. A Review of Technology Transfer Mechanisms. *South African Journal of Industrial Engineering* (2002).

spectrum of IP-related contracts. This can be disadvantageous on the part of both the franchisor and the franchisee since, as will be discussed in the succeeding section, a franchise contract is a distinct type of business arrangement with an equally unique set of rights and obligations.

E. Franchise Contracts: Definition and Specific Characteristics

Black's Law Dictionary defines a "franchise" as a "license from the owner of a trademark or trade name permitting another to sell a product or service under that name or mark."[35] The elements of a franchise can be more fully understood by analyzing laws and cases. In the case of *T-Bird Nevada LLC, et al., vs. Outback Steakhouse, Inc*.[36] which cited the California Franchise Investment Act, the concept of "franchise" was described as "a contract or agreement, either expressed or implied, whether oral or written, between two more or more persons by which: (1) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and (2) the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and (3) the franchisee is required to pay, directly or indirectly, a franchisee fee."[37]

Given the above definitions of a "franchise", it can be concluded that the essence of a franchise is the right of the franchisor to require the franchisee to "comply with certain standards and methods of sale for the product in question".[38] The standards and methods are essential as the franchisee's failure to comply with them can harm both the franchisor and the franchisee by

[35] Black's Law Dictionary, as cited in Folsom, Gordon & Spangle, International Business Transactions, West (2001).
[36] 2010 WL 1951145 (Cal.App 2 Dist.), citing the California Franchise Investment Act (1970).
[37] Ibid.
[38] Paul Craig & Grainne de Burca, *EU Law,* Oxford (2003).

damaging the reputation of the product and the trade name of the franchise. Likewise, it is also essential that the franchisor be entitled to impose terms to protect the intellectual property rights which it assigns to the franchisee.

As aptly stated by Barkoff and Selden, franchising is a "marketing channel, a business structure, a legal relationship and a form of governance".[39] According to them, it is considered a marketing channel and business structure because it is a means by which an owner of a trademark or intellectual property can obtain revenue from his/her intellectual property without giving up control (in the operation of the business) to preserve and enhance its quality. It is a legal relationship because it concerns a transfer of right (to use intellectual property and business know-how) from the franchisor to a franchisee by virtue of a contractual agreement. Lastly, it is a form of governance as it is a "legal structure used to manage and control the interactions of people engaged in a commercial activity".[40] To illustrate this, in a franchise arrangement, the franchisor can regulate and control the business activities of the franchisee to the extent permitted by the franchise agreement.

A franchise contract can be differentiated from other types of contracts based on the following factors: (1) parties and object of the contract; and (2) consideration/form of payment. In a franchise contract, the parties are the franchisor (who gives the right to the franchisee the right to use his/her business know-how, trademarks and other intellectual property) and the franchisee (who acquires such right, conditioned on the payment of fees, usually in the form of royalties). As already stated, the object of a franchise is the licensing of the right to use the franchisor's business know-how and intellectual property to the franchisee in order for the latter to be able to market

[39] Barkoff and Selden, *Fundamentals of Franchising* (2007); M. Mendelsohn, *The Guide to Franchising* (6th ed, 1999), as cited in Elizabeth Crawford Spencer, the Regulation of Franchise in the New Global Economy, Edward Elgor, (2010).
[40] Ibid.

and sell the franchisor's products or services under the franchisor's trademark. Under a franchise contact, the franchisor retains a certain degree of control in the operation of the franchise business by the franchisee in order to maintain the quality of the goods and services which are the products of the franchise. As for the consideration, the franchisee usually pays a royalty fee to the franchisor (for the right to use the intellectual property and be a part of the franchise system in general) and other fees (such as advertising, training and other administrative fees).

F. Rules and Regulations on Voluntary Licensing

To summarize the process involved in starting a franchise business in the Philippines, one must refer to the Rules and Regulations on Voluntary Licensing[41] ("Rules") which is a more detailed reiteration of the Intellectual Property Code provisions pertaining to voluntary licensing agreements. From the outset, it should be noted that the objective of the said Rules is to achieve an equilibrium between an effective intellectual and industrial property system on one hand and the diffusion of knowledge and information, on the other.[42]

Under the Rules, for new agreements (both trademark license and technology transfer agreements), the application shall be filed within thirty (30) days from the date of execution or

[41] Rules and Regulations on Voluntary Licensing, Intellectual Property Office (1998).

[42] This can be clearly seen in the "Whereas" clauses of the Rules and Regulations on Voluntary Licensing, to wit:

> ***Whereas**, the State recognizes that an effective intellectual and industrial property system is vital to the development of domestic creativity, facilitates transfer of technology, attracts foreign investments and ensures market access for our products;*
>
> ***Whereas**, the State recognizes that the use of intellectual property bears a social function and to this end, the State shall promote the diffusion of knowledge and information for the promotion of national development and progress and the common good;*
>
> ***Whereas**, it is the policy of the State to liberalize the registration of the transfer of technology and enhance the enforcement of intellectual property rights in the Philippines;*
>
> ***Whereas**, there is a need to encourage the transfer of technology, prevent or control practices and conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition and trade;*[42]
>
> Xxx xxx xxx

effectivity of the agreement. The purpose of the said filing of an application is to ensure that the provisions in the franchise agreement are not anti-competitive and comply with the prescribed Mandatory Provisions and do not contain the Prohibited Clauses as specified by the Intellectual Property Code (and reiterated in the said Rules).

1. Mandatory Provisions

The mandatory provisions pertain to boilerplate clauses relating to the applicable law, the prescribed arbitration clause, and the licensor's obligation to pay taxes relating to technology transfer arrangements. Furthermore, it is also mandatory to put a provision in a franchise contract which states that "continued access to improvements in techniques and processes related to technology shall be made available during the period of the technology transfer arrangement.[43]

2. Prohibited Clauses

On the other hand, the prohibited clauses pertain to those provisions which are considered adverse to competition and trade and which may prevent the diffusion of the innovation (involved

[43] To quite the Rules, the Mandatory Provisions are as follows:

> *Mandatory Provisions. Pursuant to Section 88 of the IP Code, the following provisions shall be included in voluntary license contracts:*
>
> *(1) That the laws of the Philippines shall govern the interpretation of the same and in the event of litigation, the venue shall be the proper court in the place where the licensee has its principal office;*
>
> *(2) Continued access to improvements in techniques and processes related to technology shall be made available during the period of the technology transfer arrangement;*
>
> *(3) In the event the technology transfer arrangement shall provide for arbitration, the Procedure of Arbitration of the Arbitration Law of the Philippines or the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL) or Rules of Conciliation and Arbitration of the International Chamber of Commerce (ICC) shall apply and the venue of arbitration shall be the Philippines or any neutral country; and*
>
> *(4) The Philippine taxes on all payments relating to the technology transfer arrangement shall be borne by the licensor.*

in the technology transfer arrangement) to the local economy. Under the Rules, the prohibited clauses can be grouped to the following categories:[44]

2.1 Limits on the production and sale process

The first set of prohibited clauses pertain to the limitations imposed by the franchisor to the franchisee relating to the sourcing, production, pricing and exportation of the licensed product. The said clauses are as follows:

> *Prohibited Clauses. Pursuant to Section 87 of the IP Code, the following provisions and other clauses with equivalent effect shall be deemed prima facie to have an adverse effect on competition and trade:*
>
> *(1) Those which impose upon the licensee the obligation to acquire from a specific source capital goods, intermediate products, raw materials, and other technologies, or of permanently employing personnel indicated by the licensor;*
> *(2) Those pursuant to which the licensor reserves the right to fix the sale or resale prices of the products manufactured on the basis of the license;*
> *(3) Those that contain restrictions regarding the volume and structure of production.*
>
> *Xxx*
>
> *(8) Those that prohibit the licensee to export the licensed product unless justified for the protection of the legitimate interest of the licensor such as exports to countries where exclusive licenses to manufacture and/or distribute the licensed product(s) have already been granted;*

2.2 Prohibitions on grant-back provisions, undue payment of royalties, and other IP-related restrictions

The second set of prohibited clauses pertain to patent and intellectual property matters such as the prohibitions on the use of competitive technologies and grant-back clauses or the those under

[44] For ease of reference, notwithstanding the division of the clauses into categories, the item numbers of each of the Prohibited Clauses, as can be seen in the Rules and Regulations on Voluntary Licensing are retained.

which the licensee/franchisee is required to disclose and transfer to the licensor/franchisor all improvements made (including related know-how acquired) in the licensed technology during the licensing period. The said clauses are as follows: [45]

> *(5) Those that establish a full or partial purchase option in favor of the licensor;*
> *(6) Those that obligate the licensee to transfer for free to the licensor the inventions or improvements that may be obtained through the use of the licensed technology;*
> *(7) Those that require payment of royalties to the owners of patents for patents which are not used;*
>
> *Xxx*
>
> *(10) Those which require payments for patents and other industrial property rights after their expiration or termination of the technology transfer arrangement;*
> *(11) Those which require that the technology recipient shall not contest the validity of any patents of the technology supplier;*
>
> *Xxx*
>
> *(14) Those which exempt the licensor from liability for non-fulfillment of his responsibilities under the technology transfer arrangement and/or liability arising from third party suits brought about by the use of the licensed product or the licensed technology.*[46]

2.3. Prohibitions on the use of technology

The third set of prohibited clauses relate to those by which the franchisor/licensor restricts either the franchisee's use of competitive technologies in the production process or the licensed technology itself after the expiration of the technology transfer arrangement. The following are examples of such restrictions:

[45] The Business Dictionary (March 22, 2019, 8:00 am) http://www.businessdictionary.com/definition/grant-back-clause.html.
[46] Rules and Regulations on Voluntary Licensing, Part I, Intellectual Property Office (1998).

(4) Those that prohibit the use of competitive technologies in a non-exclusive technology transfer arrangement;

Xxx

(9) Those which restrict the use of the technology supplied after the expiration of technology transfer arrangement, except in cases of early termination of the technology transfer arrangement due to reason(s) attributable to the licensee;

2.4 Restrictions on research and development

Finally, the last set of prohibited clauses pertain to those which restrict further research and development pertaining to the licensed technology and its adaptation to local conditions.

(12) Those which restrict the research and development activities of the licensee designed to absorb and adapt the transferred technology to local conditions or to initiate research and development programs in connection with new products, processes or equipment;
(13) Those which prevent the licensee from adapting the imported technology to local conditions, or introducing innovation to it, as long as it does not impair the quality standards prescribed by the licensor.

3. Exemptions under the Rules

Trademark license agreements and technology transfer arrangements that conform with the above mandatory provisions and prohibited clauses need not be registered with the Documentation, Information and Technology Transfer Bureau of the Intellectual Property Office of the Philippines. However, according to the Rules and the IP Code, "non-conformance with any of the above provisions, however, shall automatically render the technology transfer arrangements

unenforceable, unless said technology transfer arrangement is approved and registered with the Documentation, Information and Technology Transfer Bureau under exceptional cases."[47]

Rule 9 of the said Rules states that requests for exemption from compliance with the above mandatory provisions shall be evaluated based on the agreement's probable adverse effects on competition and trade. The exemption from the Prohibited Clauses and Mandatory Provisions of the IP Code will only be granted in exceptional or meritorious cases where substantial benefits will accrue to the economy, such as:

"1. high technology content;
2. increase in foreign exchange earnings;
3. employment generation;
4. regional dispersal of industries;
5. substitution with or use of local raw materials;
6. pioneer status registration with the Board of Investments."[48]

An analysis of the above-enumerated prohibited clauses would show that the Rules prohibit provisions that are considered anti-competitive i.e., those that may have an adverse effect on competition, trade and diffusion and adaptation of technologies to local uses and resources.

G. Philippine Contractual Law and Jurisprudence as Supplemental Sources of Law

Since the rights, obligations and legal relations formed in a franchise arrangement is essentially based on a contract, the principles governing contractual validity, construction and interpretation, as can be seen in general Civil Code provisions and jurisprudence are also applicable in assessing whether a specific franchise agreement is enforceable in the Philippines. Hence, in addition to the aforementioned Rules, the principles from the said supplemental sources of laws and regulations may also be used in deciding cases involving franchise agreements. Some of the said principles are discussed below:

[47] Rules and Regulations on Voluntary Licensing, Part I, Intellectual Property Office (1998).
[48] Ibid.

1. Party Autonomy and Reasonableness of Contract

It is well-settled in Philippine jurisprudence that "party autonomy shall not be unreasonably abridged".[49] A contract will be upheld if the Court finds it reasonable. As stated in the case of Rivera vs. Solidbank Corporation, "*There are two principal grounds on which the doctrine is founded that a contract in restraint of trade is void as against public policy. One is, the injury to the public by being deprived of the restricted party's industry; and the other is, the injury to the party himself by being precluded from pursuing his occupation, and thus being prevented from supporting himself and his family".*[50]

Applying the above doctrine to the assessment of the validity franchise contract, the court, in examining the contractual provisions, usually consider the following factors: : "(a) whether the covenant protects a legitimate business interest of the employer; (b) whether the covenant creates an undue burden on the employee; (c) whether the covenant is injurious to the public welfare; (d) whether the time and territorial limitations contained in the covenant are reasonable; and (e) whether the restraint is reasonable from the standpoint of public policy."[51]

However, one major issue in the application of this doctrine is the fact that the determination of whether a contract is injurious to the public welfare or if its provisions are reasonable is highly subjective and may be subject to numerous interpretations. Hence, this could potentially cause conflict with the Rules prohibiting anti-competitive provisions as already stated above. For example, it is not uncommon for franchisors to put a grant-back clause in their franchise contracts. To reiterate, grant-back clauses are those under which the licensee/franchisee is required to disclose and transfer to the licensor/franchisor all improvements made (including related know-

[49] Rolando C. Rivera vs. Solidbank Corporation. G.R. No. 163269, April 19, 2006.
[50] Ibid.
[51] Ibid.

how acquired) in the licensed technology during the licensing period.[52] On its face, the Intellectual Property Office may consider the said provision as anti-competitive, applying one of the Prohibited Clauses under the Rules and Regulations on Voluntary Licensing, to wit: "*those that obligate the licensee to transfer for free to the licensor the inventions or improvements that may be obtained through the use of the licensed technology".* However, applying the doctrines of "party autonomy" and "reasonableness of contract" as aforementioned, the Philippine Supreme Court, at the appeal stage, may sometimes adapt a more liberal position and tolerate such grant-back provisions, which are usually blocked at the first instance by the Intellectual Property Office. This can potentially cause confusion and unnecessary burden on the part of the franchisor (i.e., unnecessary costs on legal fees, interests, lengthy litigation processes in the Philippines which may take years), making them question whether the Philippines gives a suitable environment for them to develop their business franchises.

2. Reasonable Restraints to the Franchisee

To reiterate, one of the prohibited clauses under the Rules is that which prohibits the licensor from restricting the licensee from engaging in a business similar to the licensor's business after the termination of the Agreement. However, under Philippine jurisprudence, this rule is not absolute. As provided in the case of Tiu vs. Platinum Plans,[53]a provision in a contract which may be considered in restraint of trade can be enforceable, provided that there is a limitation upon either time or place. Hence, the in the said case, the Philippine Supreme Court held a non-involvement clause (i.e., a clause prohibiting an employee to be involved with or employed by a

[52] The Business Dictionary (Last accessed: March 22, 2019), http://www.businessdictionary.com/definition/grant-back-clause.html

[53] *Daisy Tiu vs. Platinum Plans*, G.R. No. 163512, February 28, 2007.

company engaged in the same business) to be valid since the same has a limit of two years and that the suppression or restraint is only partial or limited in scope and in duration.

Notwithstanding the jurisprudential doctrines cited above, it still cannot be denied that there is still a high propensity for the Intellectual Property Office of the Philippines (where franchise agreements are registered) to merely rely on the Rules and Regulations on Voluntary Licensing and completely disregard jurisprudence. Once an IPO examiner sees that a franchise contract contains one or more prohibited provisions, it will reject outright the registration of the said contract or, alternatively, require the franchisor to delete the said provision in order to make the contract legally enforceable. The jurisprudential doctrines mentioned above will only come into play once a dispute has occurred and the decision of the IPO is appealed to court (it should be noted that during the registration phase, the IPO examiners will only conduct a facial review of the documents presented to them, without conducting a comprehensive adversarial proceeding akin to those employed in regular courts).

As already aforementioned, this can pose an obstacles and costs to attracting more foreign investors and franchisors to enter the Philippine market. Any franchisor who has invested a substantial amount of time developing, fine-tuning and perfecting his or her product or know-how would of course want to preserve his economic rights even if he/she decides to expand his business internationally. Thus, there is a need to study more the implications of the Rules to the franchising industry in order to make it more attractive to foreign investors (by giving them incentives to introduce new innovations or technologies to the country) without compromising the obligation to contribute to local economy and diffusion of knowledge.

H. Loopholes in the current system

1. Outright prohibition on franchise asymmetry

From an objective viewpoint, it may seem that the Rules prohibit contract asymmetry in which the franchisor is given more leeway to control the business, a feature which is common in franchise arrangements in other countries. For example, under Item 1 of the Prohibited Clauses, the Licensor (or Franchisor) cannot prohibit the licensee to acquire from a specific supplier its raw materials, capital or intermediate products. Under Items 2 and 3, the Licensor (or Franchisor) is not only deprived of the right to fix the sale or resale prices of the output of the franchise business, it is also deprived of the right to control the volume and structure of production. A plain reading of the first three prohibited provisions under the Rules would show that the same contradicts the entire essence of a franchise agreement which, as discussed above, is the right of the franchisor to protect its reputation and goodwill by prescribing the standards and methods of production, marketing, distribution and sale of the products of the franchise. As will be seen in the succeeding sections, such franchise asymmetry is actually common and is often the defining characteristic of a franchise arrangement in most jurisdictions. For example in Poland, the court held that "asymmetry is a constituent element of franchise."[54] In assessing the fairness of the said arrangement typical in franchise contract, the court held that it is not only the franchisee who will be burdened by the commercial risks of the business undertaking but the franchisor as well, "who shares with their partners its schemes of conducting business activity, allows the use of its business name, trademark, logotypes, professional experience, etc. Failures in the pursuit of such activity cannot remain

[54] Krzystof Kaxmierczyk & Filip Kijowski, *Enforcement of Contracts in Poland* in The Case Law of Central and Eastern Europe, Stefan Messmann and Tibor Tajti (eds), European University Press (2007).

without any impact on the general image of the franchisor on the market, its commercial standing, competitiveness, etc."[55]

2. Inconsistency of the Rules with the other IP Code Provisions

The Rules may also cause inconsistencies with the IP Code. Under Item 4 of the Prohibited Clauses, the Licensor is prohibited to restrict the use of the technology developed in the franchise (in a non-exclusive technology transfer arrangement). If there are registered patents or know-how involved in the franchise, this may pose an issue since under most legal systems (including the Philippines), the inventor or the owner of a patent shall be entitled to "prevent any unauthorized person or entity from making, using, offering for sale, selling or importing that product".[56] Furthermore, where the subject matter of a patent is a process, the owner of the patent has the right "to restrain, prevent, or prohibit any unauthorized person or entity from using the process and from manufacturing, dealing in, using, selling or offering for sale or importing any product obtained directly or indirectly from such process."[57] Lastly, the registered owner of a patent shall have the right to "assign, or transfer by succession the patent, and to conclude licensing contracts for the same."[58] Hence, given the above-enumerated IP Code provisions, it is clear that the law still protects and recognizes the rights of the patent owner as regards the use and disposition of the patented product or process. The only limitations provided by the IP Code on the above rights of the patent holder are the following:

Section 72. Limitations of Patent Rights

> *The owner of a patent has no right to prevent third parties from performing, without his authorization, the acts referred to in section 71 hereof in the following circumstances:*

[55] Ibid.
[56] Section 71.1 (a), Intellectual Property Code of the Philippines (1998).
[57] Section 71.1 (b), Intellectual Property Code of the Philippines (1998).
[58] Section 71.2, Intellectual Property Code of the Philippines (1998).

> *72.1. Using a patented product which has been put on the market in the Philippines by the owner of the product, or with his express consent, insofar as such use is performed after that product has been so put on the said market;*
> *72.2. Where the act is done privately and on a non-commercial scale or for a non-commercial purpose: Provided, That it does not significantly prejudice the economic interests of the owner of the patent;*
> *72.3. Where the act consists of making or using exclusively for the purpose of experiments that relate to the subject matter of the patented invention;*
> *72.4. Where the act consists of the preparation for individual cases, in a pharmacy or by a medical professional, of a medicine in accordance with a medical prescription or acts concerning the medicine so prepared;*
> *72.5. Where the invention is used in any ship, vessel, aircraft, or land vehicle of any other country entering the territory of the Philippines temporarily or accidentally: Provided, That such invention is used exclusively for the needs of the ship, vessel, aircraft, or land vehicle and not used for the manufacturing of anything to be sold within the Philippines.*[59]

Based on the above-cited provisions, it is clear that while the law considers public interest and welfare (such as those involved in the preparation and development of medicines and pharmaceutical products) as exceptions to the general rule, the preservation of the economic and moral rights of the patent holder still reigns supreme and is still very much recognized. Hence, given these IP Code provisions, it is quite ironic that the Rules pertaining to registration of technology transfer arrangements (which include trademark license and franchise agreements) would prescribe a set of prohibitions which are inconsistent with the intellectual property rights of the patent owner.

One risk to this dilemma could be the outright infringement of the patent, know-how or other intellectual property rights of the franchisor. If the licensee or franchisee is given an unfettered right to use the patented technology which was invented, developed and marketed by

[59] Section 72, Intellectual Property Code of the Philippines (1998).

the licensor/ franchisor using its own resources, the economic rights of the licensor/franchisor may be in danger of being diluted or worst, completely violated. Hence, instead of promoting an effective intellectual and industrial property system, the imposition of the above Rules may cause a chilling effect on the introduction of new technology and innovations to the domestic economy. It can also impede the growth of foreign investments which forms a huge factor in the economic success of the country.

3. Difficulty of the process for exemption

To reiterate, under the Rules, to be exempted from compliance with the prescribed/prohibited provisions, it should be proven, at the registration stage, that substantial benefits will accrue to the economy (i.e., increase in the foreign exchange earnings of the country, employment generation, regional dispersal of industries, etc.). However, any franchisor or investor would know that it is difficult to forecast the future profits of a business, much more, its impact on the national economy when it is just getting started. Given not just the economic but also political, social and cultural nuances of each country, it is very difficult to foresee how the operation of a franchise business will affect the national economy in general. To require proof of the exempting circumstances enumerated above (i.e., that exempting the franchise from complying with the prohibited clauses will benefit the economy in the long run) would be very difficult and onerous on the part of the franchisor. Hence, given these restrictions, it is not uncommon for the franchisors to think twice about putting up a franchise business or expanding its market base in the Philippines.

4. Lack of Franchise-Specific Protections

Finally, in contrast with the rules and regulations prevailing in other jurisdictions, in the Philippines, there are no laws or rules mandating or prescribing minimum disclosure requirements

by the franchisor which will enable the franchisee to make an informed decision on whether to enter into a franchise arrangement or not.

There are also no limitations on the right of the franchisor to terminate the franchise contract, other than those provided by the general civil code provisions on good faith and fair dealing as already mentioned above. The application of such provisions to franchise contracts may not take into account the nuances of a franchise arrangement, i.e., the amount of investments which the parties have put into the franchise, the intellectual property involved, etc., which needs a greater amount of protection.

I. Conclusion

Given the above-discussed scenario, perhaps it is high time to amend and formulate a new set of policies and rules which would specifically govern franchise arrangements in the Philippines. To reiterate, what the Philippine regulations lack are franchise-specific protections and competition policies which also take into account the risks inherent in a franchise arrangement. In the succeeding chapters, franchise regulation systems from other jurisdictions with successful franchise industries will be explored as possible models from which the Philippines can learn.

III. Chapter Two: Franchise Regulations in the U.S.

A. Introduction

There can be no doubt that modern business franchises started developing in the United States. As stated by Gurnick and Vieux, the roots of franchising can be traced to the necessity for uniformity of products and services distributed across the expansive territory of the country.[60] From its common law roots as a special grant of rights from the sovereign[61] to its development into a diverse network of business franchises in a wide spectrum of industries, the success of business franchising in the U.S. has become a significant part of its economic growth. Naturally, as can be seen in the succeeding sections, the laws and regulations on franchise agreements have developed organically and extensively in the United States compared to any other country in the world.

As stated by Professor Tibor Tajti, the U.S. system on franchise regulations has developed into a "complex web of federal-cum-state supplementary regulations" which exist to prevent abuses by the franchisor.[62] Likewise, the United States employs a regulatory system wherein specialized governmental agencies implement and give effect to the mandatory provisions in the administrative proceedings.[63] Indeed, one can say that the U.S. system is the most developed one and offers the widest coverage of protections especially to the franchisee. Aside from the active participation of the said specialized agencies, as can be seen in the succeeding sections, there are

[60] David Gurnick and Steve Vieux, *Case History of the American Business Franchise,* Oklahoma City University Law Review, American Business Franchise (1999).
[61] Ibid.
[62] Tibor Tajti, *Systemic and Topical Mapping of the Relationship of the Draft Common Frame of Reference and Arbitration,* SSRN Electronic Journal (last accessed: March 25, 2019, 3:43 PM), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2512790.
[63] Ibid.

various layers of regulatory interventions in the U.S. system, namely: pre-sale disclosure, the "relationship laws" and the registration requirements.[64]

This chapter will tackle the history and evolution of franchise laws in the United States as well as the levels of regulations imposed on the franchise industry. By doing so, one can see how the civil society, and in particular the various stakeholders in different industries, affected the actions of the lawmakers in shaping franchise policies and how the state became a reactionary mechanism in addressing the various problems faced by the franchise industry over time.

B. Evolution of Franchising in the United States

The term "franchise" originated from the old French word *franche* which means "free or exempt".[65] As vividly recounted by Lafontaine and Blair, a franchise is basically "a right or privilege granted by a sovereign power: king, church or local government for the right to maintain civil order, collect taxes, and promote various activities such as building roads, holding fairs, and organizing markets."[66] These set of monopoly rights were granted by the sovereign over a particular activity in a particular location for a particular period of time. In return for such grant, the grantee was required to make a payment to the sovereign power, in the form of a share of the product or profit. This payment is called a "royalty", a term which is still used today.[67]

By the 1930s, the term "franchise" has evolved into private agreements between individuals and businesses.[68] In the modern era, a franchise agreement is understood to be "a contractual

[64] Ibid.
[65] American Heritage Dictionary of the English Language, https://ahdictionary.com/word/search.html?q=franchise, (last accessed: March 23, 2019, 4:31 pm).
[66] Francine Lafontaine and Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States,* Entrepreneurial Business Law Journal (2009).
[67] Ibid.
[68] Bendix Home Appliances v. Radio Accessories Co., 129 F.2d 177, 197 (9th Cir.1942); *see also* Susser v. Carvel Corp., 206 F. Supp. 636, 639 (S.D.N.Y. 1962), *affd,* 382 F.2d 505 (2d Cir. 1964) *cert. dismissed,* 381 U.S. 125 (1965); Rolley, Inc., v. MerleNorman Cosmetics, 278 P.2d 63 (Cal. Ct. App. 1954) as cited in Francine Lafontaine

arrangement between two legally independent firms in which one firm, the franchisee, pays the other firm, the franchisor, for the right to sell the franchisor's product, the right to use its trademarks and business format in a certain location for a certain period of time, or both".[69] According to Dicke, the term "franchise" entered the English business lexicon in 1959 to describe a method of doing business or distributing goods and services.[70]

Throughout the decades, two types of franchising have developed. The first is product franchising which involves "a franchisee concentrating on one manufacturer's product, and acquiring the manufacturer's identity to some extent."[71] This type of franchising is akin to a distribution agreement, albeit in a product franchising, the franchisee, who distributes the products, is also given the license to use the trademark of the manufacturer. The second type is the business-format franchising wherein the franchisee is obliged to follow strict guidelines pertaining to product development and marketing. As stated by Gurnick, in business-format franchising, "the franchise itself is the product".[72]

Currently, the concept of "franchising" has evolved into a strictly defined business arrangement which vests specific rights to both the franchisor and the franchisee. As specified by the Federal Trade Commission ("FTC"), the U.S. agency that has jurisdiction in the United States over federal disclosure rules for franchisors, a business franchise has three elements, to wit:[73]

and Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States,* Entrepreneurial Business Law Journal (2009).

[69] Supra note 60.

[70] Thomas S. Dicke, *Franchising in America: The Development of a Business Method, 1840-1980* (1992), as cited in Francine Lafontaine and Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States,* Entrepreneurial Business Law Journal (2009).

[71] David Gurnick and Steve Vieux, *Case History of the American Business Franchise,* American Business Franchise (1999).

[72] Ibid.

[73] Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors,* 45 **BUS. LAW.** 289, 292 (1989) as cited in Francine Lafontaine and Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States,* Entrepreneurial Business Law Journal (2009).

"(1.) the franchisor must license a trade name and trademark that the franchisee operates under, or the franchisee must sell products or services identified by this trademark; (2) the franchisor must exert significant control over the operation of the franchisee or provide significant assistance to the franchisee; and (3) the franchisee must pay at least $500 to the franchisor at any time before or within the first six months of operation."[74]

The huge success of franchising is due to the fact that it is a highly effective strategy for business growth, job creation and economic development in both the U.S. and in world markets.[75] Once a specific franchise has established its reputation and market base in a specific location, its expansion through business franchising will enable it to reach broader consumer base. In this regard, franchisees take a very important role in ensuring that the quality of products and services offered by the franchise remain consistent. As stated by Preble, business-format franchising is "designed to have the franchisee replicate, in different locations, the entire franchisor's business concept including the marketing strategy and plan, the operating manuals and standards, and quality control."[76]

C. Historical Development of Franchise Laws and Regulations

1. Antitrust Developments

To reiterate, the essence of a franchise is the right of the franchisor to require the franchisee to "comply with certain standards and methods of sale for the product in question, the aim of which is standardization which is achieved through uniformity of the quality of product or service and its

[74] Supra note 60.
[75] Hoffman Richard C., and John F. Preble, *Franchising: Selecting a Strategy for Rapid Growth,* Long Range Planning Franchising into the Twenty-First Century, Business Horizons (1993) as cited in John F. Preble, *Franchising Systems Around the Globe: A Status Report,* Journal of Small Business Management (1995).
[76] John F. Preble, *Franchising Systems Around the Globe: A Status Report,* Journal of Small Business Management (1995).

distribution."[77] Given this premise, franchisors employ a substantial degree of control over the quality and uniformity of goods and services offered by the franchisees. Absent such control, under federal trademark law, the franchisor can be deemed to have abandoned a licensed mark.[78]

However, franchise arrangements can be prone to abuse by the franchisor due to the aforementioned franchise asymmetry. Hence, franchise contracts which contain provisions which enable the franchisor to exercise extensive controls over the franchisee's business operations have been attacked as constituting restraints of trade.[79] Notwithstanding such attacks, in most of the cases filed, the court upheld the validity of the franchisor's extensive controls as reasonable restraints.[80] For example, in the case of *U.S. vs. Arnold, Schwinn & Co.*,[81] a civil antitrust suit under § 1 of the Sherman Act was filed against Arnold, Schwinn & Co., and they were charged by the Government with a continuing conspiracy, with others, to fix prices, to allocate exclusive territories to wholesalers and jobbers, and to confine merchandise to franchised dealers. Ultimately, the U.S. Supreme Court held that "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 that 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 of § 1 of the Sherman Act results from such confinement, absent culpable price-fixing".[82] Furthermore, the decision stated that "as long as Schwinn retains all indicia of ownership and the dealers' activities are

[77] Supra note 38.

[78] David Laufer & David Gurnick, *Minimizing Vicarious Liability of Franchisors for Acts of Their Franchisees,* 6 A.B.A. FRANCHISING L. J. 3 (1987), as cited in David Gurnick and Steve Vieux, *Case History of the American Business Franchise,* Oklahoma City University Law Review, American Business Franchise (1999).

[79] *See, e.g.,* United States v. Arnold Schwinn & Co., 388 U.S. 365, 370 (1966); Susser v. Carvel Corp., 206 F. Supp. 636 (S.D.N.Y. 1962); Engbrecht v. Dairy Queen Co. of Mexico, Missouri, 203 F. Supp. 714 (D. Kan. 1962), as cited in *Case History of the American Business Franchise,* Oklahoma City University Law Review, American Business Franchise (1999).

[80] *Ibid.*

[81] United States v. Arnold Schwinn & Co., 388 U.S. 365, 370 (1966).

[82] Ibid.

indistinguishable from those of agents or salesmen, Schwinn's franchising of retailers and confinement of retail sales to them do not constitute an 'unreasonable' restraint of trade."[83]

Another similar judgment is the case of *Engbrecht vs. Dairy Queen Company of Mexico, Missouri.*[84] In the said case, the franchise contracts between plaintiffs and Dairy Queen contain many detailed prohibitions and conditions by which the parties agreed to abide. One of these is the rights to the exclusive use of particular freezers which shall be purchased at the cost and expense of the plaintiffs. Upon termination of the franchise, the defendants are granted the option to purchase all freezers, based on a price schedule. The franchises further provide that no product other than Dairy Queen may be sold by the plaintiffs at any Dairy Queen store. In deciding whether the restrictions imposed by the defendants "go further than reasonably necessary to insure the integrity and quality of the product and whether they unduly restrain trade in violation of the antitrust laws",[85] the court held:

> *"An agreement in restraint of trade is illegal at common law and under the Sherman and Clayton Acts only if the restraint is unreasonable. The test as to whether or not a restraint of trade is unreasonable has been stated in this manner:*
>
> *'A restraint of trade is unreasonable, in the absence of statutory authorization or dominant social or economic justification if it*
>
> *(a) is greater than is required for the protection of the person for whose benefit the restraint is imposed, or*
> *(b) imposes undue hardship upon the person restricted, or*
> *(c) tends to create, or has for its purpose to create, a monopoly, or to control prices or to limit production artificially, or*
> *(d) unreasonably restricts the alienation or use of anything that is a subject of property, or*
> *(e) is based on a promise to refrain from competition and is not ancillary either to a contract for the transfer of good-will or other subject of property or to an existing employment or contract of employment." Restatement, Contracts, § 515*

[83] Ibid.
[84] Engbrecht vs. Dairy Queen Company of Mexico, Missouri., 203 F. Supp. 714 (D. Kan. 1962)
[85] Ibid.

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> *The ground on which agreements in restraint of trade are held illegal is that they are contrary to public policy, but before the parties can be absolved from their agreement on this ground it must be clearly evident that the agreement is injurious to public welfare since it is also a principle of law to hold persons to their contracts. See 17 C.J.S. Contracts § 238."*[86]

The court then found that "it is extremely doubtful that the Dairy Queen processing, in the light of Tasti-Freeze, Artik, and sundry and divers other soft-mix freeze now available, materially restrains commerce or could be considered as a monopoly in the channels of interstate commerce.[87] The court also took into account the fact that the parties entered the contract voluntarily.

2. Business Practices Developments

In the 1960s, due to the popularity of franchising, false and misleading promises on the part of the franchisors became prevalent.[88] Examples of such misrepresentations are claims regarding earnings that the franchisee could get, business assistance that the franchisor would provide, amount of capital required to succeed in the particular franchise program being advertised, the franchisor's experience, expertise and financial capacity, and involvement of celebrities in the program.[89]

Other types of abuses included those franchise arrangements and sales programs which were "designed to yield projects only from initial franchise fees, rather than from continual operation,

[86] Ibid.
[87] Ibid.
[88] David Gurnick and Steve Vieux, *Case History of the American Business Franchise,* Oklahoma City University Law Review, American Business Franchise (1999).
[89] *See* Statement of Basis and Purpose, 43 Fed. Reg. 59614, 59628-59638; *The Impact of Franchising in Small Business: Hearings Before the Subcommittee on Urban and Rural Economic Development of the US., Senate Select Committee on Small Business,* 91 st Cong. 2d Sess. Pt. 2 at 525 (1970) (report to Hon. Louis J. Lefkowitz, Att'y Gen. of N.Y.)[hereinafter *Hearings]*. *See also* Axelrad, *supra* note 59, at 704; Hemsa Mattes, *The Franchise Concept,* 47 CAL. S.B.J. 300, 302 (1972) as cited in 1 David Gurnick and Steve Vieux, *Case History of the American Business Franchise,* Oklahoma City University Law Review, American Business Franchise (1999).

and programs tempting people to invest life savings into worthless franchises".[90] According to Gurnick et. al., "given these abuses by the franchisors, in 1969, the Securities and Exchange Commission and the Attorneys General of California and New York initiated actions against franchise promoters[91] and by 1970, numerous highly publicized suits had also been initiated by franchisees against franchisors".[92]

Another long-standing problem in franchising is the termination, cancellation and non-renewal of contracts by the franchisor. This is detrimental to the franchisee who would invest time and money to develop the franchise business. Hence, terminated and nonrenewed franchisees often claimed to have been wronged because of the loss of this investment. As a result, the U.S. federal and state governments increased their attention to franchise practices.[93] Other developments in the regulation of franchising are as follows:

2.1 Industry-specific Regulations

In the mid-1950s, due to the prevalent abusive practices by the manufacturers, automobile dealer associations sought relief. Consequently, the federal Automobile Dealers Day in Court Act in 1956 was promulgated.[94] The Act was "intended to equalize the bargaining position between individual automobile dealers and manufacturers and created a new cause of action for automobile dealers and manufacturers, and to correct abuses in unfairly terminating automobile dealer franchises".[95] Through this development, "dealers can sue in federal court for damages, costs and

[90] Ibid.
[91] *See* Don Augustine & Ronald R. Hrusoff, *Franchise Regulation,* 21 HASTINGS L.J. 1347, 1349 (1970) as cited in n88.
[92] Ibid.
[93] Supra note 88.
[94] *See* **15** U.S.C. **§§** 1221-1225 (1997). *See* New Motor Vehicle Bd. of California v. Orrin W. Fox Co., 439 U.S. 96, 101 (1978) as cited in David Gurnick and Steve Vieux, *Case History of the American Business Franchise,* Oklahoma City University Law Review, American Business Franchise (1999).
[95] *See, e.g.,* Randy's Studebaker Sales, Inc., v. Nissan Motor Corp., 533 F.2d 510, **515 (I** 0th Cir. 1976); Hanley v. Chrysler Motors Corp., 433 F.2d **708, 710** (10th Cir. 1970); *see also* Note, *Hope Yet for the Automobile Dealers'*

attorneys' fees for a manufacturers failure to act in good faith in performing under the dealership agreement, or in terminating, canceling, or failing to renew the agreement".[96]

Likewise, in 1978, Congress enacted the Petroleum Marketing Practices Act as a result of "events that began in the franchise context years earlier, including the control of service station franchisees by oil companies, unfairness in the termination of contracts, and failure to review service station franchises".[97] "Oil companies and dealers alike then lobbied for the enactment of a federal legislation addressing this issue. Specifically, the said stakeholders wanted a uniform federal standard for termination and nonrenewal. Dealers supported the goal of federal protection against unfairness. The Act is substantially more comprehensive than the Automobile Dealers Day in Court Act such that it addresses three concerns namely: (I) that franchisee independence could be undermined by threat of termination or nonrenewal; (2) that there was unfairness in franchise relationships because of gross disparity in bargaining power between petroleum franchisees and franchisors; and (3) that terminations or nonrenewals could disrupt the expectations of a continuing relationship".[98]

2.2 Business Opportunities

Business opportunities to establish independently owned businesses which resemble franchises have also been commonplace in the United States. These business set-ups, now known as "business opportunity ventures," or "seller assisted marketing plans," often include "vending

Day in Court Act: Marquis v. Chrysler Corp., 1979 DUKE L.J. 1185 (1979) [hereinafter *Hope Yet]* as cited in David Gurnick and Steve Vieux, *Case History of the American Business Franchise,* Oklahoma City University Law Review, American Business Franchise (1999).

[96] David Gurnick and Steve Vieux, *Case History of the American Business Franchise,* Oklahoma City University Law Review, American Business Franchise (1999).

[97] Ibid.

[98] *See* Brach v. Amoco Oil, 677 F.2d 1213 (7th Cir. 1982); Farm Stores, Inc. v. Texaco, Inc., 577 F. Supp. 682, 688-89 (S.D. Fla. 1983) as cited in N82.

machine routes, direct sales of consumer products such as cosmetics and pet foods, and animal breeding programs".[99]

The first state to enact a law which addresses the misrepresentations in the sale of these nonfranchise business ventures is North Carolina.[100] The said law applies to certain business offerings which enable purchasers to start a business when the offeror makes certain representations specified in the statute. These representations include: "(i) promises to provide locations for vending machines, racks or similar point-of-sale equipment; (ii) promises to repurchase products of the investor; (iii) guarantees of profits; or (iv) assurances that revenues derived from the venture will exceed the investment.[101] Several states followed this model, namely: Alabama, Arkansas, California, Connecticut, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Nebraska, New Hampshire, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah,Virginia, and Washington".[102]

As stated by Gurnick, business opportunity laws are similar to franchise disclosure laws such that they are designed to guarantee safeguards for consumer investors by assuming they receive full pre-sale disclosure of the terms of the agreement and certain rights afforded to them by these laws. Typically, these statutes enable the investor to have a "cooling off period" when they can cancel the agreement.[103] As Gurnick states, "violations of these laws entitle the investor to rescind, and often to recover multiple damages and attorneys' fees".[104]

[99] Supra note 87.
[100] N.C. GEN. STAT. §§ 66-94 to 66-100 (1997), as cited in N 87.
[101] For a discussion of the North Carolina Law, see Comment, *Regulating the Sale of Franchises: The Business Opportunity Approach,* 17 WAKE FOREST L. REV. 623 (1981) as cited in N87.
[102] Supra note 87.
[103] OHIO REV. CODE ANN. § 1334.09 as cited in N 87.
[104] Ibid.

2.3 The Federal Trade Commission

Gurnick et. al., provided a comprehensive account of the activities done by the FTC over the years, to wit: "in 1970, the FTC began investigating practices in franchising and hearing complaints about franchising".[105] As a result, "it discovered fraudulent misrepresentations and omissions by the franchisors to disclose material facts to the franchisees. As declared by the FTC, this constituted serious informational imbalance in favor of franchisors. It also found that franchises had been marketed through unfair and deceptive practices. Hence, in 1971, the FTC, pursuant to its authority under the Federal Trade Commission Act, initiated rule making proceedings to promulgate a trade regulation rule on disclosure requirements and prohibitions concerning franchising."[106]

In the same article, Gurnick further provided that "the said rule making proceedings continued until 1978, when the FTC's final version of a proposed trade regulation rule was promulgated. The said rule became effective on October 21, 1979. Essentially, to remedy abuses stemming from the informational asymmetry found by the FTC, the rule required franchises to disclose a minimum amount of information. The said information can be utilized by the franchisees to make informed decisions whether to enter franchise relationships".[107]

D. Franchise Regulations in the United States

On the other hand, Gandhi, in her article provided a detailed account of the evolution of franchise regulations in the United States. In her article, she states that: "currently, in the United

[105] Norman D. Axelrad, *Franchising: Changing Legal Skirmish Lines or Armageddon,* 26 Bus. **LAW.** 695 (1971) (private business context); John T. Chadwell & Richard S. *Rhodes, Antitrust Aspects of Dealer Licensing and Franchising,* 62 Nw. U. L. REv. 1(1967) (private business context); Martin D. Fern, *The Overbroad Scope of Franchise Regulation,*34 BUS. LAW. 1387 (1979) as cited in N 88.

[106] Ibid.

[107] *See* Bus. Franchise Guide (CCH) 6313 as cited in N 88.

States, there are two levels of franchising laws which regulate two areas of franchise practice".[108] "First is the disclosure requirements prescribed at the federal level and the registration, notice and additional disclosure requirements prescribed at the state level for the offer and sale of the franchise. Second is the set of relationship laws adopted by some states that govern the on-going relationship between the franchisor and the franchisee".[109] "In order to start a business franchise, the franchisor has to comply with both federal and state laws, on top of any industry-specific regulations".[110]

1. Federal Laws and Regulations on Franchising – The FTC Rule[111]

1.1 FTC Rule of 1979

As stated by Gandhi, "at the federal level, the FTC Rule, which was enacted in 1979, governs franchise arrangements in the United States. Basically, it required the franchisor to make disclosures of twenty-three items to the franchisee by way of the Uniform Franchise Offering Circular (UFOC) at the first face-to-face meeting or at least ten days before the execution or signing of the franchise agreement by both parties".[112] Furthermore, she recounts that "the FTC Rule was enacted in response to the prevalent fraudulent, deceptive and unfair trade practices committed by franchisors across the U.S".[113] Under the said rule, "the franchisor should disclose,

[108] Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[109] William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship (2008),* Franchise (2008) as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[110] Howard Yale Lederman, *Franchising and the Franchise Law – An Introduction,* MIch. Bar J., http://www.michbar.org/journal/pdf/pdf4article2150.pdf (2013) as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[111] This part (Section Nos. 1-4) relied heavily on Gandhi's article, *Franchising in the United States,* Law and Business Review of the Americas (2014), which reiterated and summarized the provisions of the FTC Rule of 1979 and its amendment.
[112] Howard Yale Lederman, *Franchising and the Franchise Law – An Introduction,* Mich Bar J., (2013) cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[113] Supra note 69.

in a timely manner, information on the franchised business and its operations, the franchisor's litigation history, the franchisor's financial representation, and past and present franchisees".[114] The main purpose for such disclosures was "(1) to ensure that the prospective franchisee has all the available information and resources needed to make an informed decision about investing in a particular franchise; and (2) to discourage the franchisor from engaging in high-pressure tactics and provide the franchisee with a 'cooling-off' period before signing the franchise agreement".[115]

1.2 Amended FTC Rule of 2007

Likewise, as stated in Gandhi's article, "on July 1, 2008, the Amended FTC Rule of 2007 came into effect.[116] One of the purposes of the said amendment was to align the disclosure requirements with those of the states".[117] Under the Amended FTC Rule, "the franchisor should disclose information in twenty-three specific categories under a disclosure document called the Franchise Disclosure Document" (FDD).[118] The franchisor should "make such disclosures fourteen days before the execution of any agreement or paying any consideration".[119] The amendment further "provided for additional protection on the part of the franchisee by requiring the franchisor to furnish executed copies of the agreement at least seven days before signing where the franchisor has made changes to the agreement not initiated by the franchisee".[120] Finally, the franchisor is also mandated to "make supplemental disclosures in order to update his disclosure

[114] 16 C.F.R. S436 (1979), Lederman, supra note 72, as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[115] Franchise Rule, 64 Fed. Reg. 57, 294, 57, 301 (proposed Oct. 22, 1999), as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[116] Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. S436 (2007); Lederman, supra note 72, as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[117] 16 C.F.R. S436-37.
[118] Ibid at 436
[119] Id. at 436.2(a)
[120] Id. at 436.2(b)

within one hundred twenty days after the close of the franchisor's fiscal year and quarterly, where there have been any material changes to the information disclosed under the FDD".[121] The FDD requests for information on the following:

> *a. Background on the franchisor, its parents, predecessors, and affiliates; business experience; and litigation and bankruptcy history*
> *b. Fees to be paid to the franchisor and estimate of initial investment*
> *c. Restrictions on sources of products & services and territorial restrictions; franchisor's obligations; assistance by franchisor, training, advertising; financing*
> *d. Intellectual property; trademarks, copyrights, and patents*
> *e. Franchisee's obligations, restrictions on sales; provisions regarding renewal, termination, transfer, and dispute resolution; and public figures*
> *f. Financial performance representations*
> *g. Franchisee information*
> *h. Financial statements*
> *i. Contracts*
> *j. Receipts*[122]

With regard to the "financial performance representations, the same mainly deals with the sales or earnings projections made by the franchisor with respect to the franchised business. The disclosure of this information is optional on the part of the franchisor. However, should the franchisor choose not to disclose such information, then the franchisor is strictly prohibited from making these representations in any other place or form – be it in the form of negotiations, marketing materials or even sales discussions."[123] On the other hand, "if the franchisor chooses to disclose financial performance information, the franchisor is required to have made them on a 'reasonable basis' and support the same with written substantiations upon request".[124] This adds an additional layer of protection to the franchisee since the aforementioned requirement seeks to

[121] Id. at 436.7
[122] Ibid.
[123] N. Am Sec Adm'rs Ass'n Inc., 2008 Franchise Registration and Disclosure Guidelines 58 (August 6, 2011), http://nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[124] Ibid.

ensure that "the franchisors do not relay any misleading information, misrepresentations or false promises to the franchisees".[125]

"All franchisors are mandated to make the mandated disclosures under the Amended FTC Rule before the sale of the franchise to the franchisee is consummated. Failure to comply with the same will result in civil penalties of up to $16,000 per violation".[126] It should be noted however that under federal law, there are no registration requirements.[127]

2. State-level Regulation

Most states have stricter disclosure laws which are not preempted by the Amended FTC Rule. Hence, if the state which has jurisdiction over a particular franchise offering has stricter disclosure requirements compared to the Amended FTC, then the franchisor is required to make additional disclosures and comply with other formalities, in addition to the requirements imposed by the Amended FTC Rule.[128]

In determining which state laws and regulations will govern the franchise offering, the following factors shall be considered: (a) whether the offer to sell originates in the state; (b) whether the offer to sell is directed to the state; (c) whether the acceptance of the offer is made in the state; (d) whether the franchisor's domicile is in the state; (e) whether the franchisee resides in the state; (f) whether the proposed franchise will be located or operated in the state or the sales territory granted to the franchisee will fall within the state.[129]

[125] Supra note 69.
[126] 16 C.F.R. S1.98
[127] 16 C.F.R. S436.
[128] 16 C.F.R. S436.10
[129] Rochelle B. Spandorf & Mark B. Forseth, *Franchise Registration,* Fundamentals of Franchising (Rupert M. Barkoff & Andres C. Selden eds., (2008), as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).

States requiring registration (or "registration states") usually require a pre-offer review and approval process of a registration application.[130] The application for registration shall be in the FDD format as prescribed under the Amended FTC Rule.[131] Some states are even stricter and prescribe more specific disclosures in addition to those mandated under the Amended FTC Rule.[132] The examiners of the governing state authority will then examine and conduct a "merit review" of the application and inform the franchisor of their decision (i.e., whether they approved the application or prescribe an amendment of the same).[133] The states which require registration of the franchise offering are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia and Washington.[134]

On the other hand, states which merely require notice ("notice states") require the franchisor to accomplish and file the respective state's notice application form. No filing of the FDD is required.[135] Furthermore, unlike in the registration states, there is no merit review of applications in the notice states. The states following this system are Connecticut, Florida, Kentucky, Nebraska, Texas and Utah.[136] In such states, the franchisor is prohibited from selling or offering for sale any franchise offering until the notice application forms are filed properly.[137] It is also possible that the franchise offering will be under the jurisdiction of more than one state,

[130] Joel R. Buckberg & David J. Kaufman, *Franchise Sales and Disclosure Laws at 49th Annual Convention of the International Franchising Association6 (Feb. 14-17, 2009)* http://www.franchise.org/uploadedFiles/Franchise_Industr20Compliance%20Summit.pdf as cited Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[131] Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[132] Supra note 89.
[133] Ibid.
[134] Ibid
[135] Ibid.
[136] Ibid.
[137] Ibid.

in which case, the franchisor is responsible for complying with registration, disclosure and/or notice requirements of multiple states to avoid penalties.[138]

3. Exemptions from Disclosures

The above-mentioned federal and state-level regulations also provide for exemptions from the required disclosures. However, these exemptions may not always be consistent with each other. Hence, there may be situations where the franchisor can seek exemption at the state level but is still required to comply with the FTC disclosure requirements or vice versa.[139] Under the Amended FTC Rule, the following franchise sales are exempted: "(a) sale to a large franchisee that has a net worth of at least $5 million and has been in the business for at least five years; (2) sale to a party related to franchisors, i.e., where the franchisee has been part of the franchisor's management for at least two years, and either owns at least fifty percent interest in the franchise and/or twenty-five percent equity interest in the franchisor; and (c) sales in which the franchisee has a large initial investment of $1 million or more.[140]

At the state level, some state laws also offer exemptions to "large, experienced franchisors, franchisees that are part of the franchisor's management, and sophisticated franchisees such as financial institutions or high net worth or net income individuals.[141] Furthermore, some states exempt transactions for sale, renewal or extension of an existing franchise, where there are no material changes in the agreement terms or where the franchisee sells on his account.[142]

[138] Ibid.
[139] Judith M. Bailey & Dennis E. Wieczorek, *Franchise Disclosure Issues* in Fundamentals of Franchising 97-98 (Rupert M. Barkoff & Andrew C. Selden eds., (2008) as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014
[140] 16 C.F.R. S436.8
[141] Buckberg and Kaufman, supra note 91, as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014).
[142] Ibid.

4. Franchising Relationship Laws

Some states have enacted relationship laws which "govern post-sale relationship and franchise contract issues".[143] The purpose of these relationship laws is to provide better protection for the franchisees against the abuses of the franchisor, who has the upper hand and is usually the party that would draft the franchise agreement, often with the assistance of a legal counsel.[144] The said relationship laws essentially deal with various issues which may come up during the lifetime of a franchise agreement, such as termination and renewal provisions, assignment and transfer of a franchise, restriction of free association of franchisees, repurchase of the remaining inventory by the franchisor upon the termination of the franchise, encroachment by the franchisor, and termination only with good cause.[145] The states and U.S. territories which have enacted relationship laws are: Arkansas, California, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Dakota, Rhode Island, South Dakota, Virginia, Washington, Wisconsin, Puerto Rico and the Virgin Islands.[146] Failure to comply with such relationship laws may expose the franchisor to disputes and charges of unfair practices.

E. Criticisms on the U.S. Model

Notwithstanding the fact that the U.S. franchise regulations have developed into an extensive web of laws and rules designed to protect the franchisees from the unscrupulous practices of the franchisors, the U.S. system is not without criticism.

[143] Buckberg & Kaufmann, supra note 91 as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014

[144] Thomas M. Pitegoff & W. Michael Garner, *Brief History and Overview of Franchise Relationship Laws,* Fundamentals of Franchising, Rupert M. Barkoff & Andres c. Selden eds. (2008) as cited in Honey V. Gandhi, *Franchising in the United States,* Law and Business Review of the Americas (2014

[145] Ibid.

[146] Ibid.

1. Criticisms on Effectivity of the U.S. Model

The first criticism is the lack of a federal cause of action for violation of the FTC Disclosure Rule.[147] Hence, in the non-registration states, the individual franchisee cannot rely on franchise-specific remedies and must resort to common law fraud claims in order to prevail over any injustices. As noted earlier, the challenge of proving fraud can be difficult to surmount.[148]

The second criticism is the limited resources to be utilized in implementing the mandate of the FTC. As eloquently stated by Barkoff, the FTC has been given a "gigantic mission, but limited resources to carry out its mandate".[149] Thus, the FTC had no choice but to adapt a trial and error strategy in the area of franchise sales regulation enforcement. It merely looks for situations where the fraud is blatant and where there is widespread injury to the public. The individual franchisee that has been injured typically is left on his own to pursue justice. The registration states have provided a cure for this problem, but only fourteen out of fifty states provide statutory protection."[150]

The third criticism, specifically on the franchise disclosure regime states that disclosure is too narrow an approach.[151] As stated by Barkoff, advocates of this theory argue that franchise relationship issues are as essential a part of franchise regulation as are rules governing disclosure. Basically these advocates are not contented with the fact that the FTC did not expand its Franchise Disclosure Rule when the rule was recently amended. Furthermore, they also are critical with respect to the state relationship laws. They view these laws as being too little, and geared to abuses

[147] Mon-Shore Mgmt., Inc. v. Family Media, Inc., 584 F. Supp. 186 (S.D.N.Y., 1984) as cited in Rupert Barkoff, *Franchise Sales Regulation Reform: Taking the Noose Off the Golden Goose,* Entrepreneurial Business Law Journal (2009).
[148] Rupert Barkoff, *Franchise Sales Regulation Reform: Taking the Noose Off the Golden Goose,* Entrepreneurial Business Law Journal (2009).
[149] Ibid.
[150] Ibid.
[151] Ibid

that may have been the main source of attention in the 1970s, but do not adequately address the problems of today.[152]

2. Criticisms on the Efficiency of the U.S. Model

The various levels of regulations of the franchise industry in the United States can also lead to perceived inefficiency of the system. Some of these inefficiencies, as perceived by the stakeholders involved, are the following:

2.1 The Dual Level of Regulation

Regulation at both the federal and state level can be perceived as duplicative and inefficient. Furthermore, it should be noted that state laws do not provide the same scope of protection to the franchisees. While there are similarities in the disclosure and registration laws of the Registration States, the differences cannot be neglected. For example: statutes have different definitions for a "franchise," different statutes of limitations,[153] and different exemptions, to name only a few areas where there may be differences. Different administrative rules or internal informal procedures provide even more opportunities to destroy uniformity.[154] Whatever the source, the lack of uniformity in statutes and regulations clearly makes the process more cumbersome, and, consequently, less efficient.

2.2 The Differences in the Registration Laws

[152] Ibid.

[153] *See* CAL. CORP. CODE § 31303 (West 1971) (generally four years for making fraudulent representations); § 31304 (two years for failure to register). The Washington Registration Law has no specified statute of limitation; the general statute of limitation is two years. *See* WASH. REV. CODE § 4.16.080 (West 2008) (three years after the date of discovery for fraud); § 4.16.040 (six years for contract claims); § 4.16.130 (two years for claims where a statute of limitation is not specified) – as cited in n141.

[154] Most if not all, of the other Registration States grant the state authorities the right to exempt certain transactions from the registration on disclosure obligations under the state's Registration Law. *See, e.g.,* ILL – as cited in n141.

As aforementioned, while there are great similarities among the state statutes governing franchise sales, there are also significant differences. The differences range from the definition of a franchise to other factors in the registration processes such as exemptions, etc. For example, the basic definition of a "franchise" varies among these statutes. In most statutes, there are three prerequisites for a distribution arrangement to be characterized as a franchise: trademark association, control, and payment of a fee.[155] However, in New York, there is only one element, which is the fee element, and either the trademark association or control tests are necessary for an arrangement to be called a franchise.[156]

With regard to the exemptions, the same may vary considerably among jurisdictions. California, for example, has implemented an investor exemption[157] as well as a fractional franchise exemption.[158] However, the other states do not have these options. Hence, on the part of the franchisors, the advantage of relying on partial franchise exemption is minimal if that exemption is not available in all jurisdictions. Other factors contributing to the inefficiency of the U.S. system have been enumerated in detail by Barkoff as follows:

(i) Differences in the required substantive disclosures among states.

As noted above, most of the Registration States will require the disclosure document to include certain information about applicable state law. For example, in California, franchisors should subject themselves to the jurisdiction of the declared state law and are not permitted to require out of state dispute resolution.[159]

[155] Supra note 148.
[156] N.Y. GEN. BUS. § 681.3 (McKinney 1981).
[157] CAL. CORP. CODE § 31106 (West 1996).
[158] In essence, a "fractional franchise" refers to an opportunity to add a product or service line of a similar nature to an existing franchise where the additional product or service will result in a relatively small proportion of the franchisee's overall sales. *See, e.g.,* CAL. CORP. CODE § 31108 (West 2000); FTC Disclosure Requirements and Prohibitions Concerning Franchising Rule, 16 C.F.R. § 436.1(g) (2008) – cited in n141.
[159] CAL. BUS. & PROF. CODE § 20040.5 (West 2008), as cited in N141

(ii) Regulations that exacerbate the underlying differences among the states' regulatory schemes.

Some states implement regulations which exacerbate the differences, rather than coordinate the states' regulations. One example of this is Minnesota. In Minnesota, one-off sales are exempted under the state regulations. However, the other states have no equivalent exemptions for isolated transactions, albeit some will exempt isolated sales pursuant to individual requests for exemptions.[160]

(iii) Administrative discretion also presents challenges.

Franchise examiners are granted broad discretion in the interpretation of their statutes and regulations. Hence, there is a huge propensity for their opinions or judgments to be inconsistent with those of the other examiners. Consequently, this would result to the inconsistency among the application of the states' respective franchise disclosure regulatory schemes.[161]

(iv) The level of scrutiny given to franchise disclosure document review varies enormously among the states.

As Barkoff reported, one examiner informally told him that that if State X has already reviewed a registration statement and had issued an effective order, their subsequent review would be more relaxed and merely perfunctory than might otherwise have been the case. Furthermore, since the examiners in different states may require modifications to the disclosure documents during the process of examination, the same may make the process even more cumbersome and may even compromise efficiency. Likewise, even within a single state agency, examiners

[160] Supra note 148.
[161] Ibid.

may take different positions. For example, one office within the California Department of Corporations required franchisors who wanted to make "financial performance representations"[162] to provide several levels of information concerning expenses (such as labor, costs of goods sold and occupancy), while another office would permit financial performance representations that only disclosed gross revenues.[163]

(v) Consideration must be given to the "Human Factor."

Lastly, it cannot be denied that examiners are also human. They can change their opinions over time. As stated by Barkoff, reviews are sometimes endorsed from one examiner to another, and examiners come and go. Hence disclosures previously made and found acceptable by state officials in the past may no longer be found acceptable by new state officials who succeeded the old. This human element of the franchise registration process may be the greatest of all these barriers. If uniformity in disclosure is an admirable goal, all of the above barriers make that goal a nearly impossible dream".[164]

[162] "Financial performance representations," known as "earnings claims" prior to the implementation of the Amended FTC Disclosure Rule, are a story unto themselves. Generally, franchisors are not allowed to use information that indicates a specific level of sales or income unless there is a reasonable basis for the information to be provided, and that information is included in the FDD. See U.F.O.C. Guidelines, Bus. Franchise Guide (CCH) P 5919. While the Amended FTC Disclosure Rule changed the name of this kind of disclosure, it did not materially change the nature of the required disclosures themselves. A franchisor is not required to make financial performance representations, which in itself has been a subject of intense debate. See Revised Statement of Basis and Purpose, 73 Fed. Reg. 15,445 (March 30, 2007). *See also* Rupert M. Barkoff, *Earnings Claims and the Amended FTC Disclosure Rule: Lamenting a Lost Opportunity,* L.J. NEWSL's FRANCHISING BUS. & L. ALERT No. 3 (Mar. 2007).

[163] Supra note 148

[164] Ibid.

3. Analysis and Conclusion

As can be seen from the above discussion, while the multi-tier levels of franchise regulations in the United States can provide comprehensive protection to the franchisee, the same may pose problems in terms of consistency, efficiency and effectiveness. However, this issue may not be applicable to the Philippines since its government operates under the centralized system (and not federal). Furthermore, in assessing if the U.S. system can be a possible model for the Philippines, it should be noted that most U.S. regulations focus more on protecting the rights of the franchisee, without saying much on the economic and intellectual property rights of the franchisor. As stated by Spiedel, all franchise protection legislation "unduly curbs the franchisors' power to control dealers and to end relationships with them".[165] Furthermore, Epstein provides that franchisors and good franchisees often share an interest in protecting the reputation carried by the trademark of the franchisor and that the franchisor defends itself by terminating its relationship with poor performers, the termination threat serving as an incentive for better performance by all franchisees. Hence, he adapts the position that franchise protection legislation "destroys" these incentives.[166]

Likewise, according to Lockerby, the statutes "achieve little more than burdening franchisor with litigation costs."[167] Franchisors, he says, are not going to cancel without cause because the franchisor and franchisee are mutually dependent."[168] Indeed, franchisors give a

[165] Spiedel, Arbitration of Statutory Rights Under the Federal Arbitrtion Act: The Case for Reform, 4 Ohio State Journal on Dispute Resolution 157 (1989).

[166] Epstein, Unconscionability: A Critical Reappraisal, 18 Journal of Law and Economics (1975), as cited in Stewart McCaulay, *Long-Term Continuing Relations The American Experience Regulating Dealerships and Franchises* in Christian Joerges (Ed), *Franchising and the Law Theoretical and Comparative Approaches in Europe and the United States.*Nomos Verlagsgesellschaft, Baden-Baden (1991).

[167] Lockerby, *Franchise Termination Restrictions*, A Guide for Practitioners and Policy Antitrust Bulletin (1985) as cited in Stewart McCaulay, *Long-Term Continuing Relations The American Experience Regulating Dealerships and Franchises* in Christian Joerges (Ed), *Franchising and the Law Theoretical and Comparative Approaches in Europe and the United States.*Nomos Verlagsgesellschaft, Baden-Baden (1991).

[168] Ibid.

premium to skilled and experienced franchisees. Given the abovementioned web of regulations, most contract terminations would cause franchisors substantial costs. Hence, there is a need to establish deductively whether despite the absence of the abovementioned statutes, there would be enough arbitrary, bad faith or foolish terminations to justify imposing the abovementioned costs to the franchisors.[169]

On the other side of the coin, one must also take into account the financial and resource asymmetry tilted towards the franchisor. In Galanter's words, "Franchisors are repeat players while dealers usually are one-time shooters. Repeat players enjoy economies of scale in handling common disputes and litigation. The costs of preparing a basic legal argument and strategy can be spread over many transactions. Their lawyers become expert in this type of case. Dealers, on the other hand, often have to use lawyers who must research and plan without prior experience".[170] Hence the aforementioned "burdens" on the part of the franchisors may be more imagined than real.

Lastly, the existence of statutes protecting franchisees do not remove from the franchisors their incentives to reward the franchisees who perform their duties. Some rewards are symbolic, such as awarding ceremonies and plaques and medals to hang on the wall. Others are more tangible. For example, an automobile manufacturer may have a selection of easy-to-sell popular cars and hard-to-sell popular ones. It can allocate more of the popular models to dealers who sell more of the least popular ones. The franchisors may also impose sanctions. For example, General

[169] Stewart McCaulay, *Long-Term Continuing Relations The American Experience Regulating Dealerships and Franchises* in Christian Joerges (Ed), *Franchising and the Law Theoretical and Comparative Approaches in Europe and the United States.*Nomos Verlagsgesellschaft, Baden-Baden (1991).

[170] See Gallanter, Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change, 9 Law & Society Review 95 (1975) as cited in Stewart McCaulay, *Long-Term Continuing Relations The American Experience Regulating Dealerships and Franchises* in Christian Joerges (Ed), *Franchising and the Law Theoretical and Comparative Approaches in Europe and the United States.*Nomos Verlagsgesellschaft, Baden-Baden (1991).

Motors puts dealers who are selling only 65% of their sales target into a Dealer Improvement Program. Such dealers are offered assistance in improving sales, customer satisfaction, and facilities, but they know that they are being monitored and records are being prepared to justify termination of the franchise contract. Such being singled out for this unwanted attention is itself a sanction.[171]

Given the above positions, a careful balance should be struck between protecting the business investments of the franchisors on one hand, and the economic rights of the franchisees, on the other. To conclude, it can be said that the U.S. Model gives more emphasis on the franchise relationship between the franchisor and franchisee and ensuring that the franchisor do not abuse its rights. With regard to antitrust and competition issues, as already discussed above there have been cases where the Supreme Court upheld the franchisor's extensive controls over the franchisee as reasonable restraints. However, these cases are governed primarily by U.S. Antitrust laws such as the Sherman Antitrust Act of 1980 and the Clayton Antitrust Act of 1914.

Given this scenario, perhaps a good mix of franchisee-protection laws and antitrust elements, as exemplified by the U.S. Model, should be taken into consideration in enacting a specific set of regulations which will govern franchisee agreements in the Philippines.

IV. Chapter Three: Franchise Regulations in Europe

A. Introduction

[171] See Krebs, GM Maps Franchise for the '90s, Automotive News, April 3, 1989, at 1. See also Automotive News, March 13, 1989, at 1, as cited in Stewart McCaulay, *Long-Term Continuing Relations The American Experience Regulating Dealerships and Franchises* in Christian Joerges (Ed), *Franchising and the Law Theoretical and Comparative Approaches in Europe and the United States.*Nomos Verlagsgesellschaft, Baden-Baden (1991).

It is well-settled in literature that in Continental Europe, franchise regulations are "presumed to be enshrined" in civil or commercial codes or other related statutes.[172] Most European countries have no clear-cut set of laws specifically applicable to franchise agreements and would adapt policies addressing various issues related to franchise on a piece-meal basis. As such, these countries would rely on private law remedies, through the provisions of similar contracts, which they would apply analogously to franchise agreements, in order to protect the rights of the franchisor and franchisee. As Professor Tajti stated in his article, under this "private law-based model", franchise-related provisions – including the mandatory ones, "are to be enforced entirely by the parties to whom only traditional private law remedies are available."[173]

To solve the inconsistencies, gaps, and overlaps resulting from the divergent national contract laws (which could have detrimental impacts on cross-border trade), the Draft Common Frame of Reference ("DCFR") was actually created by a network of academics in the EU, creating "model" rules which can be used as a basis by the European institutions to produce a common frame of reference in future.[174] However, the DCFR is merely an academic text and does not bind the Members.

Notwithstanding the scarcity of franchise-specific laws and regulations in most European states, it cannot be denied that some European countries still regulate specific aspects of the franchise arrangement, albeit the policies and doctrines they adopt pertaining to franchise arrangements may vary.

[172] Tibor Tajti, *Systemic and Topical Mapping of the Relationship of the Draft Common Frame of Reference and Arbitration,* SSRN Electronic Journal (last accessed: March 25, 2019, 3:43 PM), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2512790.

[173] Ibid.

[174] Lorna Richardson, *The DCFR, anyone?* The Journal of the Law Society of Scotland (March 25, 2019). http://www.journalonline.co.uk/magazine/59-1/1013494.aspx#.XJj9WihKjIU.

For example, in France, which treats a franchise contract as a type of distributorship, the courts would tend to protect the franchisee upon the termination of the contract. Consequently, the franchisee, upon the termination of the franchise contract, would be entitled to the same rights that are vested upon the distributor in a distributorship contract.[175] On the other hand, in Germany, EU anti-competitive policies are adapted and the laws relating to franchise are aimed at protecting the weaker contracting party or the franchisee. Lastly, in Poland, as discussed previously,[176] franchise asymmetry has been accepted to be an essential element of a franchise arrangement.[177]

This chapter will explore the franchise-related laws and regulations of some European countries. While the structure of the chapter will be on a capita selecta basis, focus will be given to France and Germany, given the fact that the franchise industry has grown significantly over the past decades in those countries, among others.[178] By analyzing the strengths and weaknesses of the regulations employed by such countries relating to franchise arrangements, lessons could be learned which could be applicable to the Philippine context.

B. France

1. Definitions of Franchising

1.1 Professional Associations

Franchising per se is not governed by a specific set of laws or rules in France. In fact, French courts consider franchising as a type of distributorship and hence, the franchisee is entitled to the

[175] Roberto Baldi, *Distributorship, Franchising, Agency, Community and National Laws and Practice in the EEC,* Kluwer Law and Taxation Publishers (1987).
[176] See Section H Item 1 of the Chapter One (Philippine Franchise Regulations).
[177] Krzystof Kaxmierczyk & Filip Kijowski, *Enforcement of Contracts in Poland* in The Case Law of Central and Eastern Europe, Stefan Messmann and Tibor Tajti (eds), European University Press (2007).
[178] Franchise Europe, *Top 500 European Franchises* – Ranking, March 25, 2019, 4:47 pm). https://www.franchiseeurope.com/top-500/

same rights as that of the distributor.[179] However, while there is no legal definition of the term "franchising", principles may be drawn from the rules of the French Federation of Franchising, the AFNOR specification, case law and commentaries.[180] The Rules of the French Federation of Franchising defines "franchising" as follows:

> *"a means of cooperation between two undertakings, a franchisor on the one part, and one or several franchisees, on the other part. It implies on the franchisor's part:*
>
> - *propriety of a company's name, of a trade name, of distinctive signs and symbols, of a trademark or of a service mark as well as of know-how which are provided to the franchisees;*
> - *an assortment of goods and/or services;*
> - *offered for sale in an original and specific way;*
> - *necessarily and entirely traded according to commercial techniques, which are uniform and have been previously tested and constantly improved and controlled.*
>
> *The purpose of the said cooperation is to increase rapidly the number of contracting parties, through common action from the association of individuals and capitals, but simultaneously preserving their respective independence within exclusive agreements."*[181]

On the other hand, the Asociation Francaise de Normalisation (AFNOR) gives a similar definition, albeit it gives more emphasis to know-how and the parties' independence. Together, these non-legal and non-binding documents serve as reference for both professionals and for case law because they are the only documents which specifically defines "franchising" in France.[182] However, since the two sets of documents still have differences between them, their authoritative value is limited.[183]

[179] Jacques-Philippe Gunther, Chapter on France in Commercial Agency and Distribution Agreements, Law and Practice in the Member States of the European Union by Geert Bogaert and Ulrich Lohmann (eds), Kluwer Law International (2000).
[180] Ibid.
[181] Definition of 1971 as amended and completed in 1987, as cited in N 178.
[182] Supra note 178.
[183] Ibid.

1.2 Case Law

The Paris Court of Appeal provided a definition of the franchise agreement in the case of *Morvan Intercontinent.*[184] The said case outlines the characteristics of a franchise contract in comparison with a licence agreement. In essence, it involves the provision of assistance and know-how. French legal writers also often refer to the definition of the elements of franchise given by the Commission. For example, on 2 December 1988, the Commission, in the *Charles Jourdan case,* accepted a pluralist system of distribution and enumerated substantial elements of the franchise agreement namely: "exclusivity, license of a trade mark, a right to use the franchisor's shop signs, assistance, know-how and an assortment of goods and/or services.[185]

1.3 Macron Law

On 6 August 2015, the law on economic growth, activity and equal opportunities or the so-called Macron law was enacted.[186] The aim of such law was to develop all factors of promoting the economy such as consumer buying power and employment. While some of its more controversial features include extending business hours until the evenings and Sundays and the opening up of coach routs, the said law also includes the following provisions on franchise agreements:

- The terms of franchise agreements and all ancillary agreements shall be coterminous. The lawmakers' aim is to avoid the situation wherein franchisees are held bound by such ancillary agreements when the franchise agreement itself is terminated. However, the Macron Law does not contain a definition of "ancillary agreements", the same may cause uncertainty (although supply agreements for goods may fall under that category.[187]

[184] Paris Court of Appeal, *Morvan Intercontinent,* Bull. Transp., 1978, 277.
[185] Charles Jourdan case of 1 December 1988, OJ L 35,7, 7 January 1989.
[186] Governement.Fr, Law on Economic Growth and Activity (March 27, 2019, 5:00 pm) https://www.gouvernement.fr/en/law-on-economic-growth-and-activity.
[187] Vicky Reinhardt, Franchising in France- the Macroon Law, (March 15, 2019, 1:00) https://franchiseandcommerciallawblog.fieldfisher.com/2015/franchising-in-france-the-macron-lawv.

- Post termination restrictions on competition will be considered void, subject to certain exceptions:

    a. Are limited to the premises where the franchisee conducted its franchise business
    b. Are necessary for the protection of substantial, secret and specific know-how of the franchisor; and
    c. Have a maximum period of one (1) year following the termination or expiry of the franchise agreement.[188]

- The Macron Law will apply to all franchise agreements irrespective of the size of the parties.[189]

2. Pre-Contractual Requirements

2.1 Loi Doubin

Prior to 1989, there were no specific formal requirements imposed concerning the conclusion of the franchise contract. However, on December 31, 1989, the Loi Doubin was enacted, regulating all pre-contractual stages of commercial agreements, and in particular those relating to distribution and franchise.[190] The said law is applicable if two conditions are met: "(a) the franchisor grants the agreement to use his trademark or trade name to the franchisee; and (b) the franchisee is required to sell the franchisor's products exclusively or quasi-exclusively."[191]

Under the said law, the franchisor is required to furnish the franchisee with specific information at least 20 days before execution of the contract in order to enable the franchisee to enter into the agreement fully informed of the facts. The scope of such information which must be provided by the franchisor to the franchisee is further specified in the Decree of April 4, 1991.[192] Such information includes, "extensive information on the franchisor (corporate formalities,

[188] Ibid.
[189] Ibid.
[190] Supra note 178.
[191] Ibid.
[192] Ibid.

financial statements, experience of the franchisor), the status of its distribution network, the state of the market and its potential growth, and the conditions of its renewal, the termination provision and assignments clauses, and the scope of exclusivity, if any."[193] The failure of the franchisor to timely provide such information will subject him/her to fines.

2.2 Case Law

In the *Turco case*[194] and the *Couturier case,*[195] the Court of Cassation adopted a liberal view and refused to recognise a fault on the part of the franchisor in respect of the lack of pre-contractual information. In the said cases, the court held that it was the task of the seeker of the information to make the effort to verify the information given to him by the franchisor.[196] However, in December 4, 1990, the Supreme Court (Commercial Chamber) modified this position pursuant to a new legislation (Law of 31 December 1989) and held that the franchisor is liable when he "encouraged the franchisee, prior to the signature of the contract, by presenting him with a market study which contain inaccurate information.

On April 7, 1998, the Paris Court of Appeal rendered its first decision on the *Loi Doubin,*[197] upholding the judgment of the Commercial Court,[198]except regarding the plaintiff's claim for damages. The case held that the Loi Doubin has immediate effect (even before the decree of application was issued), that the supply of pre-contractual information should be associated with "a confidentiality clause binding on the beneficiary and that this information must be communicated at least 20 days before the signature of the contract and in the form of a document

[193] Ibid.
[194] 1996 Bull. Civ., No. 33, February 25, 1986.
[195] 1987 Bull. Civ., No. 43, 10 February 1987.
[196] Ibid.
[197] *Ste Aspac vM. Coupet* , Paris Court of Appeal, April 7, 1993.
[198] Paris Commercial Court, November 25, 1991.

annexed to the contract".[199] The decision also affirms that rescission of the contract is the only sanction that may be imposed and no damages can be claimed by the franchisee.[200]

2.3 Order (arrêté) of February 21, 1991 Relating to Consumer Information in the Franchise Sector

Article 1 of this Order provides that "any person selling products or supplying services, bound by a franchise agreement with a franchisor, must inform the consumer of his status as an independent business." Given this enactment the franchisor must not only disclose the economic standing of the enterprise, it should also disclose its legal status as a business.

3. Duties of the Franchisor

Taking into account the essence of a franchise agreement as aforementioned, legal practitioners, and in general, the franchise industry in France have developed a standardized set of provisions relating to the obligations of the franchisor. Some of these provisions are as follows:[201]

3.1 Obligation to license the trademark

In order to license the trademark, the franchisor should guarantee that he is the owner of the trademark which he/she will assign to the franchisee, in return for the payment of royalties.[202] Furthermore, the franchisor shall be the duly registered owner of the trademark. Therefore, he should have filed and registered with the National Institute of Industrial Property (INPI) or with

[199] Supra note 178.
[200] Ibid.
[201] Supra note 178.
[202] Ibid.

the competent authority within the contract territory, in order for the license to be enforceable against third parties.[203]

Likewise, in the codified rules of the French Federation of Franchising (FFF), it was mandated that the "franchisor shall warrant the validity of his rights on the signs attracting end-users, such as trademarks, signs, emblems, and grant to the franchisee a peaceful use of the same provided to hire." Upon failure of the franchisor to sufficiently maintain the trademark registration (i.e., non-renewal of the registration), the franchisee will have the right to request the cancellation of the contract based on the franchisor's default.[204] As the trademark owner, the franchisor also has the duty to protect the mark against infringement.

3.2 Obligation to communicate know-how

As already discussed previously, the franchisor must relay the business know-how to the franchisee in order to maintain the consistency of the quality of the franchise's products and/or services. Professor Mousseron defines know-how as "a package of technical information not immediately assignable which is easily accessible and not patented".[205] As regards franchising, this pertains to the "package of information concerning methods of manufacturing, trading, managing, and financing goods and services."[206] The performance of this obligation will enable the franchisee to replicate the franchisor's successful formula.

3.3 Obligations linked to assistance

[203] Supra note 178.
[204] Versailles Court of Appeal, December 9, 1987.
[205] J.M. Mousseron, 'Problems Juridiques du Know-how', Cahiers Droit Enterprise (1972), No. 1., as cited in n 178.
[206] Supra note 178.

During the term of the franchise, the franchisor has the obligation to provide commercial, technical, financial, etc. assistance to the franchisee. As stated in the *Pronuptia case,*[207] assistance may occur at three stages:

- *Before opening the unit, the franchisor shall furnish the franchisee with advice as to the location of and finding a suitable unit. He shall communicate to the franchise the manual procedures concerning the franchisee's unit. He shall advise the franchisee on advertising and the introduction of products, and shall provide all documents relating management.*
- *When opening the unit, full technical assistance shall be provided to the franchisee for the first days of the unit's operation in order to help the franchisee to familiarize himself with the know-how*
- *After opening the unit, the franchisor is in charge of advertising on a national and international level, and determines the assortment of goods and/or services on display. Information concerning the working of the network, the improvement of goods or the better performance of services shall be given to the franchisee. The franchisor ensures that the know-how is well applied by franchisee but avoids interfering with the franchisee's management.*[208]

3.4 Assistance under exceptional circumstances

If justified by particular circumstances, and upon franchisee's request, the franchisor shall provide him with assistance which he would otherwise not give. Examples are: if the franchisee is seriously ill, the franchisor may appoint a member of his staff to supervise the franchisee's shop or may engage a salaried employee on behalf of the franchisee.

4. Duties of the Franchisee

4.1 Non-competition obligations

[207] *Pronuptia de Paris GmbH v Pronuptia de Paris Irmgard Schillgallis*, ECJ Case 161/84, January 28, 1986.
[208] Ibid

This obligation is connected to the essence of a franchise contract and the need to preserve the franchisor's trade secrets. As stated in the Pronuptia case,[209] "the franchisor must be able to communicate his know-how to franchisees and provide them with the necessary assistance in order to enable them to apply his methods without running the risk that the said know-how and assistance might benefit competitors indirectly." In the said case, the ECJ held that the following clauses do not constitute restraints of competition:

- *Clauses prohibiting the franchisee, during the term of the contract and for a reasonable period after its termination, from opening a shop of the same or of a similar type in an area where he may compete with a member of the network; and*
- *Clauses prohibiting the franchisee from transferring his shop without the franchisor's agreement, provided the said provision is intended to prevent competitors from indirectly benefitting from the know-how and assistance provided.*[210]

Likewise, the Court de Cassation, in its Decision of January 12, 1988[211] set out three conditions relating to non-competition clauses:

- *the clause must be limited in time; and this respect, Community law tends to limit its applicability to one year after termination of the contract;*
- *the clause must be limited as to its geographical extent: generally, it should be limited to the area previously considered as the franchised area; and*
- *the clause must be limited to a determined field of activity.*

4.2 Confidentiality obligation

[209] Pronuptia de Paris GmbH v Pronuptia de Paris Irmgard Schillgallis, ECJ Case 161/84, January 28, 1986.
[210] Ibid.
[211] Cass.Com., January 12, 1988 as cited in N178

This obligation is also for the protection of the trade secrets and the business of the franchisor and exists not only during the term of the contract but even after its termination.

4.3 Obligation to comply with commercial methods and to use communicated know-how under the franchisor's supervision

According to the AFNOR specification,[212] "provided it is necessary in order to repeat the successful formula and provided the said obligations shall not amount to the franchisor interfering with the franchisee's management, the contract must provide, as part of the terms and conditions of supervision, that the franchisor has the right to information and documents from the franchisee and to visit premises, etc."

The only restraint which can be imposed on the right of the franchisor to supervise the franchisee is that the supervision must not be "an abuse which would amount to interfering with the franchisee's activities and lead to a risk of confusion between the identities of the franchisor and the franchisee."[213] It is also important to note that if the franchisor fails to supervise the franchise, he may be contractually liable towards other members of the network.[214]

4.4 Obligation to Carry Out Adequate Advertising

Local advertising, while assumed by the franchisee, can also be shouldered by the franchisor in exceptional cases, such as the opening of the franchisee's unit, where the franchisor may grant local advertising aid.[215]

4.5 Financial Obligations

[212] See 4.1.1.1 as cited in n 178.
[213] Supra note 178.
[214] Ibid.
[215] Supra note 178.

The fees to be paid by the franchisee to the franchisor is usually divided into two parts:

- The *redevance initiale forfaitaire* (franchise fee) *(droit d'entrée)* paid on the signing of the agreement; and

- The *redevance d'exploitation proportionnelle* (royalties) payable during the term of the agreement.[216]

4.6 Price Clause

Pursuant to the Decree of December 1, 1986, Article 34, clauses imposing minimum resale prices are prohibited. While recommended or indicated resale prices are allowed, the same should not lead to a uniform price being adopted by all franchisees in the network. However, after 1991, based on case law, "a franchise agreement which neither determines nor renders determinable the price of goods which the franchisee must purchase, will be null and void, to wit:

- *in accordance with Article 1129 of the Civil Code[217] in the case of exclusive purchase from the franchisor, if the price is not freely discussed and accepted by the parties;[218]*
- *when the quantity and the quality of the goods purchased from the approved suppliers depend on the sole discretion of the franchisor, in such a way that the prices cannot be freely discussed and accepted by the parties.[219]*

With regard to the negotiation of the pricing, the applicability of the Civil Code will be based on the following rules:

- *If the price cannot be determined, nor rendered determinable by the framework contract, there must be freedom of negotiation of prices for the parties and the contract will not be subject to article 1129 of the Civil Code.*
- *The contract will be subject to article 1129 of the Civil Code if there is no freedom of negotiation of prices; in this case the contract must therefore from the outset determine or render determinable the price of the goods which must subsequently*

[216] Ibid.
[217] Article 1129 of the French Civil Code deals with consent. It states that "In accordance with article 414-1, one must be of sound mind to give valid consent to a contract."
[218] *Natalys case,* Cass. Com., 19 November 1991; Cass Com., 24 May 1994, No. 92-17.007, Contrats, conc., cons. 1994 No. 190.
[219] *Halles Capone case,* Cass. Com., 5 November 1991.

be purchased by the franchisee (by reference to objective factors not depending on the discretion of the parties).[220]

5. Liabilities of the Franchisor

5.1 Liabilities of the Franchisor to the Franchisee

Basically, the franchisor may be held liable to the franchisee based on the contract of franchise every time the franchisor fails to fulfil his contractual obligations. In such case, the franchisor is required to remedy the damage resulting from the non-performance of the franchise contract. The franchisee may also bring a legal action against the franchisor under tortious liability based on Article 1382 of the Civil Code whether based on fault or negligence.[221]

5.2 Other Liabilities of the Franchisor

The franchisor will be liable to the other members of the franchise network if the franchisor finds irregularities at one particular franchisee and does not demand the franchisee to remedy the same immediately. If the franchisee does not comply with the franchisor's request within a prescribed time, the franchisor must take enforcement action against the franchisee, failing which, he may be sued under the contract by other members of the franchise network.

The franchisor may also be liable to consumers if it manufactures goods, based on his warranty as manufacturer of the goods (in case the said goods are defective or inadequate for their intended use).[222]

[220] Supra note 178.
[221] Cf. Civil Code art 1383.
[222] See Theory of hidden defects: Civil Code, arts 1641 et seq.

6. Liabilities of the Franchisee

6.1 Franchisee's liability to the Franchisor

The franchisee's liability to the Franchisor is also based on the franchise contract. An example of this is the obligation of confidentiality. Should the Franchisee breach this obligation, he/she will be liable for damages.[223]

6.2 Franchisee's liability to the Consumers

If the consumer is harmed by the action of the franchisee, the latter may also be held liable. This liability maybe based on the fact that the franchisee is a trader or independent manufacturer who shall be liable for his actions.

7. Termination of the Franchise Contract

Both parties may terminate the contract upon breach of its provisions. Generally, the franchisee is not entitled to damages upon termination of the contract if there is sufficient notice. Damages will only be awarded if there is an element of abuse. In deciding such cases, the Court looks at the following factors: "(a) the other party's breach; (b) causal link between the breach and the damage; and (c) the quantum of each item of the damage, carefully valued and the mode of valuation thereof being justified."[224]

[223] Supra note 178.
[224] Ibid.

C. Germany

1. Regulations on Franchising

As stated by Lohmann, in Germany, franchising is considered a "stepchild of distribution."[225] Similar to France, there is no specific set of statutes under German Law which specifically applies to franchise arrangements.

2. Definition of Franchise

In Germany, a franchise agreement is defined as an arrangement where in "one party obtains from the other a franchise package, which normally includes the right to use a certain trademark and certain know-how regarding the organisation of the business and the presentation of the contract goods, with the object of ensuring the consistency of the quality of the product/service of the franchise.[226] The specific characteristics of franchise agreements which make it different from other contracts are enumerated by Lohmann as follows:

> - *Compared to distribution agreements, the emphasis of the franchise agreement is on the franchisee's using the whole franchise package, as described above, which does not necessarily include the supply of goods from the franchisor. Typically, the franchisee is required to pay a franchise fee whether or not it purchases contract goods from the franchisor, while the distributor is required to pay only for goods which it purchases. In addition, the franchisee's entire business is dedicated to the franchise, often to the point that the franchisor provides part of the necessary capital. This makes it likely that the franchisee is dependent on the franchisor for the purposes of the non-discrimination rules of German competition law,[227] while the distributor is normally selling different brands and thus less likely to be dependent to the supplier…[228]*

[225] Ulrich Lohmann, Germany, in Commercial Agency and Distribution Agreements, Law and Practice in the Member States of the European Union by Geert Bogaert and Ulrich Lohmann (eds), Kluwer Law International (2000).
[226] Ibid.
[227] See GWB, S20(2), described at 2.1.3 above.
[228] Supra note 224.

- *Contrary to the commercial agency agreements, the franchisee is normally acting in its own name rather than procuring orders from the supplier. However, the law of commercial agency is often used as a model in franchising cases where, as under the Standard Business Terms Act, the provisions of a franchising agreement are to be compared to statutory provisions in the same field in order to assess the fairness of the contractual terms.*
- *There may be an issue of distinguishing a franchise agreement from an employment agreement, but normally a franchise agreement is not covered by labour law."*[229]

While generally, the parties are free to agree on the terms of the franchising agreement, there are limits to the parties' freedom to contract under competition law and other consumer protection law. Under German law the franchisor's recommendation on the pricing would be permitted only if it refers to products branded with the franchisor's trademark.[230] There is no exemption from this prohibition.

The liabilities of the parties to a franchise agreement are similar to those of the parties to a distribution agreement.[231] One case which gained popularity in Germany was the Benetton case.[232] In the said case, the German franchisees of an Italian clothing manufacturer which promoted its products in Germany, among other countries, with unusual advertisements. The franchisees claimed that due to the "shocking character of the advertisements, their sales suffered losses. The court dismissed the complaints stating that it was the franchisor's privilege to test new and unusual advertising, even if it caused the reduction of sales made by the franchisees.

3. Pre-sale Disclosure Obligations

Case law in Germany has stated that as a general rule, the franchisee is obliged to obtain information pertaining to the general market conditions and their impact on the prospective

[229] See LAG Dusseldorf, NJW 1988, 725; and Bauder, NJW 1989, 78., as cited in note 224.
[230] GWB, S 23
[231] Supra note 210.
[232] BGH, 23 July 1997, NJW 1997, 3304.

franchise business, at its own initiative.[233] However, if there are information of which only the franchisor is aware and which is important to the potential franchisee's decision as to whether entering into the franchising contract or not, the franchisor is obliged to disclose such information.[234]

If the franchisor infringes its duty on disclosure, the franchisee is entitled to claim damages and the franchisor is obliged to restore the status quo, i.e., it the franchisor should place the franchisee in the position it would have been in if the franchisor had fulfilled its disclosure obligation.[235]

4. Code of Ethics of the German Franchise Association

While there are no strict requirements that a franchisor must comply with prior to offering franchises, the German Franchise Association (GFA) enumerated guiding principles in its Code of Ethics:

- *The franchisor must have successfully run a business concept for an appropriate period of time and with at least one pilot project before founding its franchise network;*
- *The franchisor must be the owner or legitimate user of the company name, trademark or any other special labelling of its network; and*
- *The franchisor must carry out initial training of the individual franchisee and must assure ongoing commercial and/or technical support to the franchisee during the entire t*erm of the contract.[236]

5. Competition Policies

It should be noted that in 2005, Germany completely harmonized its antitrust laws with the European Antitrust Law which will be discussed in the succeeding chapter.[237] Hence, all franchise

[233] ICLG, Germany: Franchise 2019, (March 28, 2019, 5:00 pm), https://iclg.com/practice-areas/franchise-laws-and-regulations/germany.
[234] Ibid.
[235] Ibid.
[236] Ibid.
[237] Ibid.

agreements in Germany shall comply with the said EU Antitrust laws which prohibit anti-competitive clauses such as price-fixing, guaranteed exclusive areas, and purchasing restrictions.

D. Conclusion

As can be seen in the franchise laws and regulations in France and in Germany, parties to a franchise contract would rely more on general civil laws on contract and jurisprudence pertaining to competition policies. Compared to the United States, French and German franchise policies are not yet well-developed and are still continuously evolving. Part of the said evolution process is the adaptation of certain European Law Doctrines on competition which will be discussed in the succeeding section. Hence, in addition to the U.S. model illustrated above, another good model for the Philippines to emulate is a good mix of civil law provisions and competition policies as espoused by the European Union. The influence of civil society in France and Germany, particularly the franchise associations, is also noteworthy, as they were able to shape substantial policies (including the definition of a franchise arrangement) that serve as guidelines to practitioners. Such feature is also beneficial to both the franchisor and franchisee as they can be ensured that their interests are protected by those who have sufficient knowledge of the franchise business and can relate to their experiences.

V. Chapter Four: EU Regulations on Competition

A. Introduction

European Community laws also affect the regulation of distribution and commercial agency agreements, including franchise arrangements, in the Member-States by restricting the contents of the said commercial agreements from the point of view of competition policy.[238] While national laws may require the inclusion of specific provisions in the franchise or other forms of distribution agreements, European competition law mainly prevents the inclusion of specific clauses which are considered anti-competitive.[239]

As stated by Gorrie and Palshammar, Council Directive 86/653/EEC of December 18, 1986 on the Coordination of the Laws of the Members Relating to Self-Employed Commercial Agents[240] obliges the Member States to adapt their legislation on agency agreements.[241] However, as stated above, this legislation is already included in most of the Member-states' civil codes or is part of their civil law.[242]

Given the fact that one of the main proposals of this thesis is the possible amendment of the Philippine Rules governing franchise agreements which addresses, among others, the need to balance anti-competitive policies with the intellectual rights of the franchisor, the European Community laws and judgments may offer a good example for the Philippines to emulate. This

[238] C. Bellamy and G. Child, *Common Market Law of Competition* (ed. By V. Rose, 4th ed, Sweet and Maxwell, London 1993); and V. Korah and W.A. Rothnie, *Exclusive Distribution and the EEC Competition Rules: Regulations 1983/83 and 1984/83* (2nd ed, Sweet and Maxwell, London, 1992) as cited in Commercial Agency and Distribution Agreements, Law and Practice in the Member States of the European Union by Geert Bogaert and Ulrich Lohmann (eds), Kluwer Law International (2000).

[239] Alastair Gorrie and Jonas Palshammar, *Distribution and Commercial Agency and EC Law* in Commercial Agency and Distribution Agreements, Law and Practice in the Member States of the European Union by Geert Bogaert and Ulrich Lohmann (eds), Kluwer Law International (2000).

[240] OJ L382/17, 1986.

[241] Supra note 218.

[242] Ibid.

chapter will summarize and review relevant provisions of the EC Treaty, as well as the Pronuptia judgment which is a landmark case relating to EU competition policy.

B. Article 81 of the EC Treaty

Article 81 of the EC Treaty is the most significant provision relating to European competition law. It provides that agreements between undertakings, decisions by associations of undertakings and concerted practices are prohibited as incompatible with the Common Market if they may restrict competition within the Common Market and may affect trade between Member States, to wit:

> *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.[243]

While the above restrictions are similar to the Prohibited Clauses in the Rules and Regulations on Voluntary Licensing, as discussed in Chapter One relating to Philippine regulations, it is important to note that the EU provided a block exemption to franchise agreements. The said exemption will be discussed in the succeeding section.

C. Exempted Restrictions

Notably, the above-enumerated restrictions laid out by Article 81 are not without exemptions. Regulation 4087/88, or the so-called franchise block exemption was issued on November 30, 1988 which gave franchisors preferential treatment over other forms of distribution and as a result, encouraged the development of franchising in the European Union.[244]

Under the said Regulations, the following are exempted from the "anti-competitive provisions" scrutiny in Article 81:

(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,

[243] European Union, Consolidated Versions of the Treaty on European Union and of the Treaty Establishing the European Community, Article 81, (March 27, 2019, 5:00 pm) https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12002E/TXT&from=EN

[244] International Law Office, *The New EU Block Exemption* (March 26, 2019) https://www.internationallawoffice.com/Newsletters/Franchising/United-Kingdom/Field-Fisher-Waterhouse/The-New-EU-Block-Exemption-Regulation

- 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.

D. Black List

Notwithstanding the above exemptions, certain agreements are excluded a priori from benefitting from the Regulation since they are considered "too dangerous" from the point of view of competition policy.[245] The list of these agreements is called the "Black List" and can be seen in Article 5 of the Regulation, to wit:

- Horizontal agreements between competitors. The entering into franchise agreements by competitors would enable them to allocate markets and agree to keep out of each other's territory;[246]

[245] Irish Centre for European Law, *Distribution and Franchising Agreements Corporate Needs and Competition Rules Papers from the I.C.E.L. Conference,* Trinity College, Dublin (1990).
[246] European Commission, Commission Regulation (EEC) No 4087/88 of 30 November 1988 on the application of Article 85 (3) of the Treaty to categories of franchise agreements, Article 5(a**) (**1988).

- Circumstances where there is unjustified foreclosure of suppliers competing with the franchisor or with its authorized manufacturers

  * Note: Notwithstanding this, the Regulation allows the franchisor to exert rigid controls on the selection of goods offered by the franchisee because, pursuant to the Pronuptia case, "a provision requiring the franchisee to sell only products supplied by the franchisor or by suppliers selected by him may be considered necessary for the protection of the network's reputation". Hence, this exception is only likely to apply in very few cases, where the franchisor cannot justify a particular purchasing tie imposed on the franchisee with the need to maintain the common identity and reputation of the franchised network.[247]

- Post-term use bans when the know-how has become public otherwise than through the fault of the franchisee;[248]

- Clauses providing for resale price maintenance

  *Note: As cited in the Pronuptia case, there is no restriction of competition "where the franchisor simply provides franchisees with price guidelines, so long as there is no concerted practice between the franchisor and the franchisees or between the franchisees themselves for the actual application of such prices".[249]

- No challenge clauses – the franchisor may however provide in the agreement that the challenging by the franchisee of the validity of the commercial or intellectual property rights which constitute the franchise may entitle the franchisor to terminate the agreement.[250]

- A clause prohibiting the franchisee from making passive sales to end users whose place of residence is located outside his allotted territory and within the common market.[251]

The Commission will only grant exemptions if their benefits will outweigh their disadvantages.[252]

[247] Article 5 (b) and (c), cited in note 238
[248] Article 5(d)
[249] Article 5(e) of the Regulations
[250] Article 5(f) of the Regulations
[251] Article 5(g)
[252] Supra note 238.

E. Pronuptia Judgment

The Court of Justice rendered its first ruling concerning franchise networks on January 28, 1986 in the Prunuptia Judgment.[253] In the said case, the Court of Justice defined "a system of distribution franchises as a network of agreements whereby an undertaking which has established itself as a distributor on a given market and this developed certain business methods, granted independent traders, for a fee, the right to establish themselves in other markets using its business name and the business methods which have made it successful".[254]

With regard to competition policies, the Court of Justice held that "the franchisor must be able to communicate his know-how to the franchisees and provide them with the necessary assistance in order to enable them to apply his methods, without running the risk that the know-how and the assistance might benefit competitors"[255] A plain reading of this statement would show that the Community gives primacy to the industrial value of the franchisor's know-how. It also shows the policy towards protecting the franchisor against infringement of its intellectual property. Consequently, provisions in a franchise agreement which are "essential in order to avoid that risk do not constitute restrictions on competition for purposes of Article 85(1).[256] This includes clauses prohibiting the franchisee from opening a shop of the same or similar nature in an area where he may compete with a member of the network during the period validity of the contract and for a reasonable period after its expiry. Likewise the same doctrine applies to the franchisee's obligation not to transfer his shop to another party without the prior approval of the franchisor.[257]

[253] *Pronuptia de Paris. Pronuptia de Paris Irmgard Schillgalis,* Case No. 161/84 (1986) ECR 353.
[254] Supra note 208
[255] Ibid., Emphasis supplied.
[256] Supra note 208.
[257] Ibid.

Secondly, the case also imposed upon the franchisor the obligation "to take the measures necessary for maintaining the identity and reputation of the network bearing his business name or symbol".[258] Hence, provisions which establish the means of control in order to attain the purposes aforementioned are not considered anti-competitive under Article 85(1). [259] Other provisions which the Court allowed and considered as not restrictive of competition are:[260]

- The franchisee's obligation to apply the business methods developed by the franchisor and to use the know-how provided.[261]
- The franchisee's obligation to sell the goods covered by the contract only in premises laid out and decorated according to the franchisor's instructions, which is intended to ensure uniform presentation in conformity with certain requirements The same requirements apply to the location of the shop, the choice of which is also likely to affect the network's reputation. It is thus understandable that the franchisee cannot transfer his shop to another location without the franchisor's approval.[262]
- The prohibition of the assignment by the franchisee of his rights and obligations under the contract without the franchisor's approval protects the latter's right freely to choose the franchisees, on whose business qualifications the establishment and maintenance of the network's reputation depend.[263]

[258] Ibid.
[259] Ibid, as cited in Supra note N208.
[260] Ibid.
[261] Ibid.
[262] Ibid.
[263] Ibid.

- A provision requiring the franchisee to obtain the franchisor's approval for all advertising is also essential for the maintenance of the network's identity, so long as that provision concerns only the nature of advertising.[264]

As one would notice, the provisions cited above bear resemblance to the essence of franchise which is, to reiterate, the right of the franchisor to require the franchisee to "comply with certain standards and methods of sale for the product in question in order to maintain the quality and reputation of the product or service". The decision does not stop there, the Court also held that the franchisor has the right to control the supply source of the franchisee since the same is necessary to protect the franchisor's reputation, to wit:

> *By means of the control exerted by the franchisor on the selection of goods offered by the franchisee, the public is able to obtain goods of the same quality from each franchisee. It may in certain cases — for instance, the distribution of fashion articles — be impractical to lay down objective quality specifications. Because of the large number of franchisees it may also be too expensive to ensure that such specifications are observed. In such circumstances a provision requiring the franchisee to sell only products supplied by the franchisor or by suppliers selected by him may be considered necessary for the protection of the network's reputation. Such a provision may not however have the effect of preventing the franchisee from obtaining those products from other franchisees.*[265]

On the other hand, the Court held that the provisions which "share markets between the franchisor and franchisees or between franchisees or prevent franchisees from engaging in price competition with each other" are considered anti-competitive since it is not necessary for the protection of know-how provided or the maintenance of the network's identity and reputation.[266]

Lastly, with regard to pricing, the Court held that "although provisions which impair the franchisee's freedom to determine his own prices are restrictive of competition", the said principle

[264] Supra note 222.
[265] Ibid.
[266] Ibid.

is not applicable in cases where the franchisor simply provides franchisees with price guidelines, as long as there is no concerted practice between the franchisor and the franchisees or between the franchisees themselves for the actual application of such prices. In this regard, the ECJ gave the national courts discretion for the determination of this fact in their respective jurisdictions.[267]

G. Conclusion

From an IP perspective, the EU model may seem the most franchisor-sensitive in terms of enforcing competition policies and regulating the supervision imposed by the franchisor to the franchisee. Aside from taking into account the essence of a franchise arrangement, the ECJ also gave importance to the importance of "know-how" to the business of the franchisor. Hence, only those anti-competitive policies which are not related to the preservation of the said know-how are considered restrictive of competition (e.g., market sharing).

[267] Ibid.

VI. Recommendations and Conclusion

In summation, one can conclude that each of the jurisdictions assessed in the preceding chapters has its own set of policies and priorities in regulating franchise arrangements. While the need to disclose crucial information about the franchise is recognized in all jurisdictions in order to ensure that the franchisee makes an informed business decision before it concludes a franchise agreement, each country still has its own nuances in regulating their respective franchise industries.

With regard to the United States, its multi-level disclosure requirement would show that its policymakers give primacy to the welfare of the franchisee, taking into account the huge economic and informational advantage of the franchisor, or the so-called franchise asymmetry. Indeed, compared to the franchisee, which, more often than not, is a typical mom-and-pop store with limited resources, the franchisor, who often is the party who drafts the franchise agreement, is almost always assisted by legal counsel. It also has the upper hand in terms of knowledge asymmetry, i.e., it knows more about the strengths and weaknesses of the franchise business. Given this perspective, U.S. state government officials play an active role in enforcing their respective disclosure regulations. Both the registration and disclosure states establish their own set of enforcement structures which vest a wide scope of investigatory and prosecuting power to the state administrator. Such state administrators not only actively prosecute cases on behalf of the franchisees, they also have the power to issue ex parte injunction orders prohibiting the activities of the franchisors whom the state administrator believes to have transgressed the franchise statute (until a hearing can be conducted).[268]

[268] Philip F. Zeidman and Richard Greenstein, Getting them Through, *Franchise (March 28, 2019, 9:00 am)* https://gettingthedealthrough.com/area/14/jurisdiction/23/franchise-2019-united-states/.

With regard to its competition policy, compared to the Philippines which adopts a strict prohibitive approach, it can be said that the U.S. adapts a more liberal and macroeconomic approach in assessing whether specific provisions in a franchise agreement are anti-competitive. As can be seen in the Dairy Queen case, it looks at the whole picture, i.e., it assesses whether the industry within which the franchisor is situated is robust and if the competition among different enterprises is healthy (so as to foreclose the question of the franchise provisions being anti-competitive).

In drafting its policies, U.S. law also recognizes franchise asymmetry tilted towards the franchisor, an element which is missing and should be emphasized in improving Philippine franchise regulations. As already discussed previously, control by the franchisor is a very common in franchise arrangements, due to the fact that it is essential in maintaining the quality and uniformity of goods and services offered by the franchise. The franchising relationship laws in the U.S. is also worth emulating since abuses by the franchisors are not only committed prior to the sale of the franchise, they could also occur during the term of the franchise itself. In the Philippines, unilateral terminations of franchise contracts and inequitable assignment or transfer of the franchise business is not uncommon (e.g., in the Philippines, in 2011, Jollibee Foods Corporation, a leading fast food chain acquired the Chowking franchise). While the economic benefits to the Chowking franchise and effectivity of management by Jollibee has yet to be seen over time, it is notable that such move by Jollibee was not scrutinized by the government on the ground that it might have detrimental effects to the franchisee.

On the other side of the Atlantic, despite their lack of franchise-specific regulations, France and Germany's stance with regard to franchise arrangements is also worth noting. While the analogous application of their civil codes to franchise issues is an element which is also present in

the Philippines, France and Germany have strong franchise associations. Hence, the said countries also observe, as guidelines, the Rules promulgated by the said associations. As regards pre-contractual disclosures, the Court of Cassation would tend to adopt a liberal approach in favor of the franchisor and would only held him/her liable if he actively made misrepresentations (as opposed to just omissions to disclose), which would encourage the franchisee to enter into a franchise contract.[269] In the said case, the court also held that the only remedy is rescission of the contract, i.e., the parties will be restored to the status quo (as if the franchise contract was not executed) and damages cannot be claimed by the franchisee.[270] Given this legal environment, it can be observed that French policy makers give importance to the positions of franchise associations and the freedom to contract by the parties (instead of just presuming the existence of franchise asymmetry and drafting policies based on that premise).

On the other hand, in Germany, the regulations are more lenient in favor of the franchisor. In fact as discussed above as a general rule, the burden to obtain relevant business information is imposed on the franchisee which is obliged to obtain, at its own initiative, information on the general market conditions, their effect on the prospective franchise business and other relevant information. Furthermore, in accordance with the regulations imposed by the German Franchise Association, before a franchisor can offer a franchise business to the franchisee, it must have established a successful business concept first for an appropriate period of time. This gives an additional layer of protection to the franchisee since the risk of investing in unprofitable franchise business is diminished. Finally, with regard to competition policies, as stated above, Germany has completely harmonized its antitrust laws with the EU Competition Law.

[269] *Ste Aspac vM. Coupet.,* Paris Court of Appeal, April 7, 1993
[270] Ibid.

The European Antitrust Law, while recognizing the importance of maintaining healthy competition in the market, also gives importance to the know-how and business of the franchisor and hence, it adopts a protective stance (against the competitors of the franchisor) in shaping policies. Accordingly, provisions in a franchise agreement which are essential in order to avoid infringement by competitors do not constitute restrictions on competition for purposes of Article 81 of the EC Treaty. In relation to the foregoing, EU competition policies would also exempt provisions which establish the means of control in order to maintain the quality and consistency of the product/service offered by the franchise. The only provisions which the ECJ consider as anti-competitive are those that bear no relation at all to the protection of the franchise know-how or other intellectual property, such as market-sharing and price-fixing.

Ultimately, in formulating a new set of policies and regulations in the Philippines which would govern franchise arrangements, one must take into account some elements in the foreign systems mentioned above which would be applicable to the Philippine setting. Some policy recommendations based on the lessons learned from the systems in U.S., France, Germany and EU are as follows:

a. Franchise arrangements should be regulated separately from technology transfer agreements. The concept of franchise asymmetry should be injected as well into the policies, taking into account the essence of a franchise contract as discussed above. Hence, similar to the European system, business control imposed by the franchisor to the franchisee shall be tolerated, as long as it is necessary for the protection of the former's know-how and other intellectual property rights. Only those provisions which are unduly restrictive of competition, without bearing any relation to the franchise know-how or IP should be penalized. Given this premise, the following clauses

prohibited by the Philippine Rules and Regulations on Voluntary Licensing shall be tolerated as not being unduly restrictive of competition:

> *(1) Those which impose upon the licensee the obligation to acquire from a specific source capital goods, intermediate products, raw materials, and other technologies, or of permanently employing personnel indicated by the licensor;*
>
> *Xxx*
>
> *(3) Those that contain restrictions regarding the volume and structure of production.*[271]

b. Minimum disclosure requirements, similar to those implemented in the United States, shall be implemented as well in the Philippines, given the fact that most of the new franchises starting up business in the country are foreign brands. Hence, there is a need to disclose, prior to the consummation of a franchise sale to the franchisee, at least the following information to enable the franchisee to manage its business expectations on the franchise:

- Background on the franchisor, its parents, predecessors, and affiliates; business experience; and litigation and bankruptcy history
- Fees to be paid to the franchisor and estimate of initial investment
- Financial performance representations
- Financial states
- Other information which will enable the franchisee to know the risks involved in starting the franchise business.

While the aforementioned information can be available online and can be searchable on the part of the franchisee, the inclusion of disclosure requirements in the laws and

[271] Intellectual Property Office, Rules and Regulations on Voluntary Licensing (1998).

regulations itself would make the franchisor more accountable and consequently, wary in making business representations to the franchisee prior to selling the franchise.

c. Franchise relationship laws (similar to those implemented in the United States) shall likewise be enacted in order to ensure that the franchisor will not abuse its rights (such as the unilateral and premature termination of contract, imposition of unnecessary control and intervention to the operations of the business by the franchisee etc.). This is necessary because, while the general civil code provisions on contractual relations may be sufficient in some cases, more complicated and franchise-specific issues might need a more specific set of regulations as well.

d. Enforcement mechanisms must be strengthened in order to ensure that the aforementioned policies will be effectively and efficiently implemented. Perhaps an independent franchise commission can be created by the government to monitor disclosure compliances, and review franchise contract provisions which may be considered anti-competitive (taking into account franchise asymmetry, which is an essential element of a franchise arrangement and the limitations on anti-competitive restrictions as discussed above).

e. Civil society must be strengthened as well, particularly franchise associations which represent the franchise sector. Perhaps memberships in franchise associations should be made mandatory so that the policies and rules enacted by those who have already gained substantial experience and knowledge in the franchise industry will benefit those who are just starting out in the franchise business.

Furthermore, while the protection of the know-how and other intellectual property rights of the franchisor may be considered as anti-competitive, the benefits may outweigh the costs. Successful innovations may turn into successful businesses which will in turn, contribute to the country's GDP. Furthermore, IP rights are not absolute. They have expiration dates as well. Hence, it is not uncommon for other innovators to "borrow" from previous inventions or technologies in a way that is not infringing or damaging to the original innovator. Furthermore, such innovation may have been made public already upon the passing of time, making it available for further development by other innovators. Indeed, everyone will benefit if innovators will be given incentives instead of restrictions.

Ultimately, the choice of franchise policies that will be promulgated in the Philippines will depend on the value system of the incumbent administration. Currently, foreign investment is a prime driver of economic success in the country. Hence, if the administration would focus more on its economic policy, the Philippine laws on franchise must also adapt to international practices in franchise regulation in order to give the business enterprises, both foreign and local, a level playing field.

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