Regulation and Case Law on Business-Format Franchise in the United States: Lessons for the Republic of Azerbaijan

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ABSTRACT

Following the success of the great international franchise companies, from fast food chains like McDonald's and Subway to convenience stores, hotels and gyms, more and more Azerbaijani businessmen see the appeal of the business-format franchise. As a result, the number of local franchise businesses as well as entrepreneurs deciding to buy a franchise as an alternative to the traditional way of doing business increases day by day. Nevertheless, the legislation on franchising has not been upgraded since the enactment of the Civil Code of the Republic of Azerbaijan in 1999. Taking into consideration the importance and need of the legislation to keep up with the constant development of the society and regulate in the best way possible the issues arising from legal relations, as well as the lack of Azerbaijani legal literature in this area, the topic of research is undoubtedly relevant and quite momentous.

In light of the economic potential of business format franchise, the thesis endeavors to pour light on the current regulatory framework of business-format franchise in the Republic of Azerbaijan in order to identify those potential regulatory changes that need to be made to create a more franchise-conducive legal environment in the country. In order to do that, the study of regulations, case law and industrial practices of the United States is resorted to with respect to the country's rich experience on the topic.

The central question this thesis aims to address is whether a proper balance has been found in the Civil Code of Azerbaijan between the position of franchisors and franchisees? Or, rather refinements are needed in order to protect the interests of the franchisor risking its brand and reputation, and the franchisee as the normally inherently weaker party? And if so, what would be proper legal ways to legitimize those provisions; as a part of the Civil Code or rather as distinct and separate act? To answer these questions the focus will be, firstly, on the quality of pre-contractual disclosure and post-conclusion measures as franchisee-protective measures; as franchisor-protective tools, secondly, it will be focused upon whether efficient remedies are

guaranteed to the franchisor in Azerbaijan with respect of controlling the financial health of the franchisee and breach of the franchise contract taking into account the different history, geographic and economic conditions of the countries.

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INTRODUCTION

On the economic importance of franchise

With the development of economic relations, globalization, and expansion of the market various forms of business relations emerge in the society. Franchising is one of the methods of conducting business that has been advertised by many as beneficial for both parties to the agreement, as well as for general public. However, a crucial detail that differentiates franchising from many other civil contracts lays in the power imbalance character of the relation, where franchisor is by far the stronger party, both in terms of information and experience as well as financially, that in many cases imposes its own conditions onto the franchisee. This power imbalance between the parties creates, as evidenced especially by the US regulatory framework, a need for specific regulations of franchise relations, such as requirement of pre-contractual or continuous disclosure. The US regulatory responses are important because US is the birthplace of business format franchising itself and thus has globally the most experiences with this business model.

Why focus upon business format franchise in Azerbaijan?

With the increasing number of growing enterprises Azerbaijani businessmen are trying to find more effective, suitable business models. More and more businesses turn to franchising as it is believed to be more progressive compared to previously used practices. However, to attract potential franchisees, franchisor might conceal some important nuances, that may affect the decision of the other party to contract or not to, as well as the conditions that it would choose to put forward. This problem, as it was mentioned previously, is resolved by the implementation of various disclosure and other requirements. Despite the growing number of franchises and subsequently, a need for a more detailed approach to the regulation of those relations, Azerbaijani legislator has not yet included disclosure requirements into the respective chapter of the Civil Code. Basically, there are no remedies for the franchise power imbalance

in Azerbaijan at the moment. This problem creates the necessity for an urgent analysis of the problem and detection of the best possible solution.

Why compare the United States and Azerbaijan?

United States as the birthplace of the very concept of franchising plays an important role as an object of study; having such a long history of actively using the franchising model it has implemented various regulations, has had several of court cases on different aspects of franchising relations and problems that are likely to arise from its very nature in other countries as well; including Azerbaijan. These factors make the U.S. by far the best object for comparison on the topic. In the process of collation both positive and negative practices and experiences of the States would be taken into consideration, as well as the difference of the whole economic state of the countries as well as the business and legal mindset of the people.

Since Azerbaijani legislation is closer to the one of European countries, first and foremost for it belonging to the group of countries with a civil law system, examples from the Civil Codes of the European countries, such as France and Germany, as well as the court cases are going to be referred to for a fuller and more effective analysis herein, too.

Methodology

The main goal of the thesis is to discover any existing loopholes in the statutory regulation of franchise in Azerbaijan and find suitable solutions for a more effective protection of the interests of the parties as well as for the consistent development of business relations in the country. While there is plenty of literature on the history, current state, and problems of franchising in the US and European countries, the lack of legal literature and the complication of finding appropriate case law when it comes to franchises in Azerbaijani Republic creates certain problems for the analysis. Therefore, current thesis also aims to fill in the gaps in the

legal knowledge on the topic and hopefully become an impulse for a further detailed analysis of the issues mentioned.

Roadmap to the Thesis

To achieve the goals that are put forward in a more effective and structured way, the thesis is split into three chapters. The first chapter is going to focus on the exemplary regulatory framework that is used for the comparative analysis – the U.S. Evolution and history of the franchising in the States, as well as modern federal and state regulations and case law are going to be studied. For a more in depth analysis, European practice in the area of franchising is going to be touched upon as well.

Second chapter will focus on the franchising relations in the Republic of Azerbaijan, their development as well as existing regulations in the area and their affect on the parties to the contract and the overall state of business in the country. The positive and negative aspects of the current regulation of the franchising in Azerbaijan, as well as the rich history and experience of the United States in the topic that is analyzed in the first chapter will create a basis for the final chapter.

The third and final chapter of the thesis focuses on the legislative and administrative changes that the author can suggest to be implemented in the Republic of Azerbaijan in the area of franchising, taking into consideration positive and negative experiences of the analyzed countries, as well as the state of business in each of them.

Chapter 1: Business-format franchising in the U.S.

1.1. Introduction

The concept of franchising is believed to be beneficial for the franchisor, who aims to enlarge its market, for the franchisee that receives valuable information about the business strategy of the more experienced undertaking, as well as the public, that gets a higher quality product and better service for a more reasonable price. The importance of franchising as a business model and its relevance is undisputable. McDonald's, one of the largest restaurant chains in the world that has been operating as a franchise for decades now, has generated an estimate revenue of over 23 billion dollars in 2021 in over 40000 locations worldwide.[1] This scale of success would be impossible to achieve if McDonald's would attempt to own and single-handedly operate its each and every location.

Clearly, franchisees also see the benefit of buying a franchise to prefer it over establishing an independent business. Smaller enterprises rarely survive the competition with larger, more experienced companies.[2] By purchasing a franchise they can focus solely on running a business with an already established business strategy, marketing campaign, etc.

It is not just the two parties to the contract that benefit from it. The enormous revenue that franchises generate has a valuable impact on the market. International franchising profits the economies of developing countries, creates new work places, as well as introduces advanced standards of employment, workplace behavior, quality of the product, business conduct and many others. Franchisors attach an enormous significance to the compliance with those standards by the franchisees and rightfully so. A failure to provide a proper service by one of the franchisees can affect the business as a whole, since all of the locations share the same

[1] https://www.statista.com/topics/1444/mcdonalds/#dossierKeyfigures
[2] Paul Steinberg & Gerald Lescatre, Beguiling Heresy: Regulating the Franchise Relationship, 109 Penn St. L. Rev. 158 (2004)

branding which in turn unifies and connects all of them in the eyes of the customers. This strong connection that the business format franchise creates between its franchisees is for this reason a double-edged sword. To ensure the abidance with the standards, franchisors impose demanding obligations on franchisees, for instance, McDonald's franchise agreement requires strict "adherence by Licensee to standards and policies and policies of Licensor providing for the uniform operation of all McDonald's restaurants…and to Licensor's prescribed standards of Quality, Service and Cleanliness…".[3]

1.2. Evolution and history of the development of business-format franchising

Franchising in the modern era is understood to be a relation between two parties to a contract, where an originator of the product or a service, a licensor (franchisor) sells to a licensee (franchisee) the right for the sale of the product and/or the use of the trademark.[4] However, franchising has come a long way to become the system that we know it as today.

The term "franchise" originates in the Middle Ages, meaning the exclusive right that the monarch would grant to an individual for a variety of different functions, such as collection of taxes, sell of his products on the particular territory.[5] As it is highlighted in the court cases of the 19th century, such as State v. Real Estate Bank and Bank of Augusta v. Earle[6], the term "franchise" at that time has still been used to indicate a right that was granted to a person by the state or sovereign government. It is quite difficult to identify when exactly the notion of franchising has taken on its modern meaning. Some authors believe that the concept of franchising in its current state has commenced with the distribution of sewing machines by Isaac Singer, founder of Singer Sewing Company.[7] It can be argued that the franchise contracts

[3] Husain v McDonald's Corp, 205 Cal App 4th 860, 869 (2012).
[4] Dicke, T. S., Franchising in America: The Development of a Business Method, 1840–1980 (First Edition). The University of North Carolina Press (1992)
[5] Gurnick, D.; Vieux, S., Case History of the American Business Franchise. Oklahoma City University Law Review, [s. l.], v. 24, n. 1 and 2, p. 37–64, (1999).
[6] Bank of Augusta v. Earle, 38 U.S. 13 Pet. 519 519 (1839).
[7] Honey V. Gandhi, Franchising in the United States, 20 LAW & BUS. REV. AM. 3 (2014)

entered into by Mr. Singer were not necessarily of a business format franchise character, since their aim was mostly to distribute the product over a larger territory in exchange for a fee, and the transfer of business strategy, intellectual property, etc. that are a necessary attribute of a franchise contract nowadays were not such a prominent part of that relationship.[8]

The President of the International Franchise Association William B. Cherkasky has stated in his testimony in the case of Tele-Communications, Inc. v. C.I.R. that business format franchise consists of three elements: 1) licensing of the protected trademark, 2) no negotiability of the terms of the contract on the part of the franchisee and 3) the ongoing interaction between the parties.[9] Although it is hard to determine when the term had been transformed into its modern meaning, the connection to the initial definition is indisputable because modern franchise inevitably involves a 'grant', normally in the form of licensing.

1.3. Regulation of franchising in the U.S.

The issue of power imbalance arose already in the beginning of the 20th century. The case of Ellis v. Dodge Bros.[10] revealed the discriminatory practices that the car manufactures were engaged at the time, reserving the right to a cancellation of franchise agreements at any time that put automobile dealers in a much weaker position. In 1956 the Automobile Dealers' Day in Court Act[11] was enacted as a remedy for this power imbalance between automobile manufacturers and franchise dealers, enabling the latter to bring an action to recover damages sustained as a result of the non-compliance by the manufacturers with the conditions of the franchise contract or a failure on their part to act in good faith. This piece of legislation also enshrined the first definition of franchise, however only limiting it to automobile industry.

[8] Jamos H. Amos Jr., The Complete Idiot's Guide to Franchising (2005).
[9] Tele-Communications, Inc. v. C.I.R., 95 T.C. 495, 511 (1990).
[10] Ellis v. Dodge Bros. (D. C.) 237 F. 860, 867 (N.D. Ga. 1916).
[11] Automobile Dealers' Day in Court Act, 15 U.S.C. § 1221.

In the 1960's, because of the lack of regulation of franchise relations, as well as media portrayal of franchising as "the wave of the future",[12] the number of franchises increased rapidly. The absence of franchise specific regulation led to many abuses by the franchisors who tried to contract with as many franchisees as possible. First successful franchises created a boom among general population resulting in many investing their lifetime savings into useless franchises.[13] The sudden boom in the popularity of franchises has led to many people being deceived by the smart advertisements and losing all of their savings.[14] During this stage of development of franchising it was first resorted to already existent capital markets and securities laws to govern the relations between the parties. Based on that regulatory framework U.S. Securities and Exchange Commission had the authority to react to possible abuses. However, at this point it was clear that there is a significant power imbalance between the parties calling for stricter laws to be put in place. The most rational way to relatively reduce the information imbalance is to implement remedies, forcing the more powerful party to disclose the valuable information, which is necessary for the weaker party to be able to make a considered decision. The many conflicts and collisions between franchisors and their franchisees that have been the result of the massive growth of the sector along with the lack of regulation have necessitated the implementation of a new regulation, targeted specifically at franchising relations.

The state of California was one of the first states to take actionable steps with the aim of protecting the interests of franchisees. California Franchise Investment Law enacted in 1970 requires potential franchisors to register with the California Department of Business Oversight to be able to sell a franchise in the state. It also imposes strict pre-contractual disclosure

[12] Chisum, State regulation of franchising: The Washington experience, 48 Wash L R 291, 297 (1973).
[13] Howard Yale Lederman, Franchising and Franchise Law – An Introduction, 92-JAN Mitchigan Bar Journal 35 (2013).
[14] Bennett & Babcock, Franchise Times Guide to Selecting, Buying, and Owning a Franchise, New York: Sterling Publishing Co, Inc 136 (2008); US v Bessesen, 433 F2d 861 CA 8 (1970).

requirements, forcing franchisors to provide franchise disclosure documents as well as the final drafts of franchise agreements at least 14 days prior to the conclusion of the contract. The aim in the enactment of California Franchise Investment Law, as well as other following franchise disclosure regulations was to provide the prospective franchisee with all the material information and documentation, necessary for the informed decision-making. It is also important to note that the definition of the franchising given in the law is quite broad to ensure the absence of loopholes. However, the essence of this legislation does not boil down to the requirement for disclosure. Part 3 of the law determines the list of fraudulent, prohibited, and unfair practices to be considered a civil or even a criminal offense.

Another piece of federal legislation intended to create a balance between the rights of the parties to the franchising agreement focuses on the motor fuel industry. Petroleum Marketing Practices Act (1978) regulates the conditions for the termination or refusal to renew the petroleum supply contract. By establishing the standard for the termination of the contract, the Law assures the franchisees that any fraudulent and/or unfair practices by the fuel distributors will be penalized.

In 2007 the Fair Arbitration Act bill[15] was introduced to Congress. The bill would amend the chapter of United States Code on arbitration to prohibit mandatory, binding arbitration in employment, consumer, franchise contracts, as well as civil rights disputes. Big corporations tend to impose their arbitration provisions to the weaker party, often without them even knowing about the existence of the said provisions. The arbitrator that is supposed to be a neutral party often favors the franchisor who selects the arbitral body resolving the issue and getting the payment for its service. Arbitration for those reasons presents ethical challenges

[15] S.1135 - 110th Congress (2007-2008): Fair Arbitration Act of 2007

that in the judicial process are not faced.[16] Moreover, franchisees may just not be financially able to afford very costly arbitration fees. It is important to note that the bill did in no way intend to prohibit arbitration; it only encouraged the voluntary decision of resorting to arbitration as an option for dispute resolution. The fact that franchise as a contract concluded between two businesses is still included in this list showcases how significant of a problem the power imbalance issue is in this type of legal relation. Although the bill did not receive a vote and was not enacted, the suggestion of the bill itself means the possibility of the enactment of the bill's certain provision in the future.

1.4. "The Franchise Rule"

Regulatory framework of franchise relations can be split in three layers: first layer being federal and state level regulations as the most important ones, industrial self-regulation presenting the second layer and the third layer being classical branches of law.[17]

Despite there being legislation governing franchise relations in certain industries, as well as many states enacting laws and regulations specifically targeted at franchising and determining specific authorities that have the power to oversee franchising relations, there was a need for a federal regulation imposing a disclosure requirement on franchisors in all industries. During a very lengthy discussion the evidence for the existence of fraudulent, deceptive and unfair practices was discovered throughout all types of franchising agreements, without any regard to a specific industry or type of product.[18] Thus, it was proven that the power asymmetry issue is one of the features of the franchise relationships that needs a specialized approach. Following the lawmaking process that has started back in 1971, "Disclosure Requirements and

[16] Paul Steinberg & Gerald Lescatre, Beguiling Heresy: Regulating the Franchise Relationship, 109 Penn St. L. Rev. 111 (2004)
[17] Tibor Tajti, Franchise and Contract Asymmetry: A Common Trans-Atlantic Agenda? 37 Loyola of Los Angeles International and Comparative Law Review 258 (2015).
[18] John M Tifford, The Federal Trade Commission Trade Regulation Rule on Franchises and Business Opportunity Ventures, 36 The Business Lawyer 35 (1981).

Prohibitions Concerning Franchising and Business Opportunity Ventures - 16 C.F.R § 436 ("the FTC Rule" or "The Franchise Rule") that entered into force in October 1979. The aim of the regulation was to protect the prospective franchisees and the industry as a whole through the power of disclosure.[19]

In 2007 the revised Rule has been adopted. The amended Rule had a phased-in effective date, [20] meaning that the franchisors could chose to follow the requirements of 1) the original Rule, 2) the amended Rule or 3) the Uniform Franchise Offering Circular ("UFOC") for one year after the amendments became effective on July 1, 2007, however, starting July 1, 2008 they are required to abide only by the provision of the amended Rule.[21]

The amended Rule specifically permits the use of electronic means, such as emails for the delivery of disclosure documents,[22] which reduces the cost of contracting. This amendment is especially useful when the parties are not in the same state or even country, thus promoting and encouraging international franchising.[23]

The Franchise Rule disclosure provisions require franchisors to provide potential franchisees with the Franchise Disclosure Document (FDD),[24] before signing the franchise agreement. The FDD requires disclosure of material information based on the list of 23 items characterizing franchisors present state of business and post conduct.[25]

[19] *See* Gandhi, *supra* note 7, at 7.
[20] https://www.ftc.gov/news-events/news/press-releases/2007/01/ftc-issues-updated-franchise-rule
[21] Franchise Rule 16 C.F.R. Part 436: Compliance Guide, https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf.
[22] Franchise Rule 16 C.F.R. part 436.2(c)
[23] Carl E Zwisler, New Franchise Rule Eases International Franchising, 26 Franchise Law Journal 168 (200).
[24] In the original Rule of 1979 the disclosure was required in the form of a Uniform Franchise Offeriing Circular the title of which has been changed to the current Franchise Disclosure Document with the adoption of the amended Rule.
[25] *See* Judith M . Bailey & Dennis E. Wieczorek, Franchise Disclosure Issues, F u n d a m e n ta l s o f F r a n c h is in g 95, 96 (Rupert M. Barkoff & Andrew C. Selden eds., 3d ed. 2008), for the history of the Franchise Rule and an overview of the FDD items.

Information on encroachment is a significant part of the disclosure document. Steinberg and Lescatre define encroachment as an establishment by the franchisor of a second outlet taking profits that would otherwise belong to the first outlet.[26] In relation to franchisor's opportunistic territorial encroachment it must clearly state in its Disclosure Document whether it grants the franchisee an exclusive territory, if not, clearly state the dangers of such a purchase;[27] if yes, then the terms and condition of future modification of that right.[28] Some other informationi that must be disclosed by the franchisor in the FDD include the business experience of the franchisor, identity of its key persons, litigation history or whether any of whether the franchisor and its executives have been convicted of a felony or involved in bankruptcy proceedings, franchise fees, expenses and overall estimated initial investment of the franchisee, rights and obligations of the parties, intellectual property rights, restriction of goods and services offered by the franchisee, renewal and termination conditions of the franchise contract, financial statements and a list and contacts of existing franchisees. Disclosure of the existing franchisees is significant in two aspects: it allows for the potential franchisee to contact the already existent ones to investigate for itself whether they have had a positive experience with the franchisor so far as well as to know the locations of the outlets to estimate the possible profits in its area, taking into consideration the proximity of the closest outlet.

It is crucial to note that the FTC Rule only imposes pre-contractual disclosure provision on the franchisors providing them with the material information necessary to make an informed and weighed purchase decision and does not require a filing, registration or approval as opposed to some state laws' provisions. This fact makes it less strict of a regulation compared to those certain state franchise laws, however the fact that not every state has franchise regulations in

[26] Paul Steinberg & Gerald Lescatre, Beguiling Heresy: Regulating the Franchise Relationship, 109 DICK. L. REV. 105 78 (2004).
[27] Disclosure Requirements and Prohibitions, Concerning Franchising and Business Opportunities, 72 Fed. Reg. 15,444,15,491 (Mar. 30, 2007) (to be codified at 16 C.F.R. pts. 436 & 437).
[28] § 436.5(l)(5)(ii).

place makes it an extremely valuable piece of legislation for the protection of franchisees on the entire territory of the country.

1.5. State franchise regulations

The Franchise Rule that is the main federal regulation governing franchise relations does not preempt the state regulations, which are often times way stricter in relation to the obligations of the franchisor. Following California Franchise Investment Law several other states, such as Connecticut, Minnesota, Indiana, Hawaii and many others have implemented franchise regulations. Michigan, for example, has passed Michigan Franchise Investment Law, very closely resembling the California Law in 1974.

Undoubtedly, for a regulation to govern any relation, the latter should fit the definition of the relation given in that regulation. This fact makes the way that the definition is formulated extremely important to assure the proper functioning of the provisions given and to minimize the risk of avoidance of the regulations by the fraudulent parties. Subsection a of section 31005 of California Franchise Investment Law states that "franchise" is a contract that meets the following conditions:

"(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 franchise fee."[29]

[29] California Franchise Investment Law, CAL. CORP. CODE § 31005 (1971).

Besides this general definition § 31005 also lists additional conditions that define a certain contract as a franchise contract, as well as lists certain types of agreements that cannot be considered franchise.[30] Part 1 of the Law titled "Definitions" defines other common terms used in franchise contracts, such as of the parties to the contract, those being "franchisor" and "franchisee", "franchise fee", "sale", etc., as well as of "fraud" and "deceit", which are extremely important in the context of franchise relations, since minimizing cases of fraudulent behavior of franchisors is one of the main goals of California Franchise Investment Act, as well as certain other state franchise regulations.

In addition of already existing franchise regulations state of California has also enacted Section 680 of New York General Business Law states that for the reason of deceit of the New York residents by the franchisor representatives who do not provide full and truthful information about the purchase of franchises and significant losses endured by the citizens makes the matter of franchising affected with the public interest and prohibits the fraudulent sale of franchises, as well as the sale that could lead to the unfulfillment of franchisor's promises. For the reasons stated in the Section 680 the New York Franchise Sales Act was enacted to impose liability on the franchisors acting in violation of state requirements.

Several states also have passed laws that affect franchises in certain industries. For instance, in addition to Petroleum Marketing Practices Act states of Michigan and Virginia have adopted state laws governing franchise fuel distribution practices;[31] other states have regulations of

[30] California Franchise Investment Law, CAL. CORP. CODE § 31005 (1971).
[31] Motor Fuel Distribution Act, MCL 445. 1801; Virginia Petroleum Products Franchise Act, Va Code Ann § 59. 1-21.8

franchise motor vehicle dealership,[32] as well as legislation regulating dealing of alcoholic beverages.[3334]

1.6. Case law

The notion of good faith, such a crucial part of every legal agreement plays a significant role in franchise contracts as well. Exactly the abuse of the power and failure to act in good faith on the part of franchisors has created a necessity for implementation of franchise-specific regulations. Although there is a clear disadvantage of the franchisee that is an inevitable attribute of franchise relations franchisor and franchisee are independent contractors that are chasing their own commercial interest that do not always align with the interest of the opposite party. For that reason, the deceitful approach of some franchisor representatives calling franchisees their "partners" and even "family" is misleading, however widely used because of its effectiveness.[35] The franchisee in Minnesota has been given approval for the location of its business despite the fact that it did not meet franchisor's requirements, however later refused franchisee's request to add several goods and items in the store leading to the failure of the franchisee. Subsequently franchisor sued the latter for the non-payment of the franchise fees.[36]

Accepting the fact that there is a clear disadvantage of the franchisee the court acknowledges the fact that franchisee is an independent legal entity that is responsible itself for its violations of labor law and conduct at workplace. Supreme Court of California held that Domino's was not responsible for the sexual harassment of the employee of one of its franchisees, since it did not retain "the right of general control over the relevant day-to-day operations at its franchised

[32] E.g., Illinois Motor Vehicle Franchise Act, 815 lll Comp Stat 710/1 through 710/14; Maine Motor Vehicle Dealer's Act, Me Rev Stat An tit 10, § 1171
[33] E.g., Maine Malt Liquors and Wine Wholesaler Act, Me Rev Stat tit 28A § 1451 through § 1465
[34] Howard Yale Lederman, Franchising and Franchise Law – An Introduction, 92-JAN Mitchigan Bar Journal 37 (2013).
[35] Losco, Joseph. "Review of 'The Sociobiology of Ethnocentrism.'" 7 Politics and the Life Sciences, pp. 114–16 (1988).
[36] 33 F.3d 925-927 (8th Cir. 1994).

locations". This decision has reaffirmed the importance of the business model for the economy of the state and public interest.[37]

The problem of encroachment is one that creates a lot of collisions and conflicts between the parties. There are many ways by which this invasion of franchisee's territory where it conducts its business and basically a theft of potential profits is possible. Franchisor may encroach deliberately or inadvertently, in some cases encroachment may even have personal motives. In a court case from 1989, franchisor opened another location in a mile from the franchisee who the Chairman of the Board of the franchisor had previously had an affair with.[38]

The abuse of power of franchisor as a result of its personal clashes and dislike of a franchisee is not a one-time appearance. Franchisees that attempt to resist franchisor opportunism are dealt by very simply; they are either encroached or their contracts are being terminated.[39] Patrick Abramowich notes that not only the franchisees themselves, but even their spouses can be controlled through spousal guarantees and covenants.[40]

The more experienced franchisor can drive the franchisee that is objectionable to him into a complete bankruptcy and debt. Assuring the franchisee that encroachment would contradict its own personal interests it pushes the encroachment provision upon the franchisee and later uses it against him if he objects its abuse of power. By saturating the market and leaving the franchisee with no options but to get out of business, the franchisor afterwards engages him into lengthy and costly litigation making it impossible for him to protect his interests, since he cannot afford an attorney.[41]

[37] Taylor Patterson v. Domino's Pizza LLC, et. Al., 60 CAL.4TH 474, 333 P.3D 723 (2014).
[38] Vylene Enterprises, Inc. v. Naugles, Inc., 105 B.R. 42, 45-46 (Bankr. C.D. Cal. 1989).
[39] Far Horizons Pty Ltd. v. McDonald's Australia Ltd. (2000) V.S.C. 310; BC200004860.
[40] Patrick L. Abramowich, Spousal guaranty Q&A for franchisors, Franchise Times 39 (2002).
[41] Harford Donuts, Inc. v. Dunkin Donuts, Inc., No. CIV. L-98-3668, 2001 WL 403473, at *3-6 (D. Md. 2001).

It is important to note, that information is an extremely valuable asset in franchising world, that is why it is crucial to impose disclosure requirement on franchisors who would otherwise never voluntarily provide that information to weaker franchisees. Franchisors are also extremely concerned with keeping this information from the third parties. Therefore, when franchisees facing unfair treatment decide to speak up franchisors do not only sue them for defamation,[42] but also may use that same strategy of encroachment as a punitive remedy.

1.7. Franchising in Europe

Considering the fact that franchising as a business model did not develop in Europe but was imported from the States,[43] it should come as no surprise that the regulatory framework of business format franchising in Europe is lagging behind.[44]

The different approaches to the business model are way more diverse in Europe compared to the U.S.[45] The development of the franchising relations as well as their regulation is also not consistent throughout EU. The countries with the biggest concentration of franchises, namely UK and Germany rely on self-regulation.[46] Mark Abell has noted that EU has not used franchising to its full potential, the reason behind that being the failure of implementing proper regulation of the matter.[47]

Although there had been attempts to unify the European franchise law, the acts that have been adopted in that regard are only of advisory nature. For example, Draft Common Frame of Reference ("DCFR") has a pretty promising model of franchise regulation.[48]

[42] Magnetic Marketing Ltd. v. Print Three Franchising Corp., [1991] 38 C.P.R. (3d) 540, 568-569 (B.C.S.C.)
[43] Philip Mark Abell, The Regulation of Franchising in the European Union 59, published thesis, Queen Mary, Univ. of London 12 (2011).
[44] *See* Tajti, *supra* note 17, at 252.
[45] *See* Tajti, *supra* note 17, at 261.
[46] *See* Tajti, *supra* note 17, at 261.
[47] Mark Abell, The Law and Regulation of Franchising in the EU, Edward Elgar 286 (2013)
[48] Study Group on a European Civil Code & the Research Group on Existing Ec Private Law, Principles, Definitions and Model Rules of European Private Law 2395, Christian von Bar & Eric Clive eds., (2010).

Another piece of EU franchise regulation is the EU Regulations on Franchise Agreements.[49] The regulations provide for an exemption from the provision of EU Competition Law,[50] as well as present a valuable source for the drafting of the franchise agreements.

European Franchise Federation has presented a document called "European Code of Ethics for Franchising" originally in 1971 and the updated version of the Code was enacted in 2016. The document determines the conditions and prepositions for a successful and fair franchisor-franchisee relationship. The Code is binding for the national franchise associations that are members of the Federation; it can also be used as a guide for the legislators in the drafting of national franchise regulations.[51]

Another European organization that is directly involved in the development of franchise regulations is World Franchise Council. Both member and non-member states of the Council are encouraged to use its declarations, such as "Clarifying the Structure of Employment in Franchised Business" and "Urging restraint in government intervention in franchised business" while drafting franchise regulations.[52]

While reviewing national franchise legislations of EU member states one might find themselves interested in the context of German legislation, as one of the states with more developed franchising relationships. As it was mentioned above, there is no specific franchise regulation in the German Civil Code per se, as for the national legislation, the franchise relations are more so governed by general provisions of contract and commercial law, principles of good faith and fair dealing. Provision of the European competition law also play an important part in regulation of franchising in the country. Mandatory pre-contractual

[49] 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.
[50] Treaty Establishing the European Economic Community, Art. 85 (1958)
[51] https://eff-franchise.com/code-of-ethics/
[52] https://worldfranchisecouncil.net/declarations/

disclosure obligations are also not found in German national legislation. Parties to the contract are encouraged to research the market and act at their own discretion. French legal system, in regards to franchising, is based on similar principles as German and does not have a franchise-specific regulation in place.

1.8. Conclusion

United States is believed to have two main franchise-regulatory models: disclosure laws and 'franchise relationship' laws.[53] Prof. Tibor Tajti names the following differences between the two: first, the disclosure laws only cover the pre-contractual period of the relationship between the parties, whereas franchise relationship laws cover the post-sale stage as well; second, franchise relationship laws provide for a fuller and stronger protection of the franchisee.[54] Disclosure laws in general can be characterized by merely providing the franchisee with necessary material information for making of an informed purchase decision.[55] Although disclosure laws may not be as effective as franchise relationship laws, the Franchise Rule is effective in establishing a minimum standard of pre-contractual disclosure necessary for the proper functioning of the system.

[53] Larry A. DiMatteo, Strategic Contracting: Contract Law as a Source of Competitive Advantage, 47 Am. Bus. L.J. 727, 749 (2010).
[54] *See* Tajti, *supra* note 17, at 257.
[55] *See* Tajti, *supra* note 17, at 257.

Chapter 2: Business-format franchising in the Republic of Azerbaijan.

2.1. Introduction

As a civil law country Republic of Azerbaijan heavily relies on its legislative acts. The legal acts adopted by the parliament are principal and more or less sole source of law. The decisions of higher courts only play an advisory role in the litigation process. The Civil Code of Azerbaijan, as a unified source of civil law in the country governs the franchise relationships as well. Since Azerbaijani legal literature lacks when it comes to studies made in the area of franchising, the main source of information for the purposes of this chapter is going to be the Civil Code. Legislative acts are also of stronger influence in Azerbaijan rather than the U.S., since the courts are obliged to follow the statutes verbatim, whereas in the common law countries the courts are relatively free to interpret the meaning of legislative acts and elaborate them when needed. During the court proceedings the judges aim to follow the word of the law as closely as possible and use the commentary to the Codes whenever the provisions of the have any impreciseness or double-meaning to them.

Taking into consideration this feature of the legal system of Azerbaijan it becomes clear that since the jurisdiction does not provide for nor encourage judicial lawmaking the most obvious and proper step in ensuring the protection of the rights and interests of the franchisees is to enshrine those rights into the Civil Code of the country.

2.2. The relevance of franchising in Azerbaijan

The sudden jump in popularity of franchise as a business model in the last 5 to 10 years in Azerbaijan is undeniable. Although the author of this paper has failed to find any relevant legal literature or statistics reflecting this growth, it becomes apparent from the establishment of new governmental authorities that have the regulation of franchising specifically stated as one of their powers, as well as from the news coverage of franchising related events and forums. For

instance, Agency for the Development of Small and Medium-sized Businesses of the Republic of Azerbaijan[56] is a public legal entity that has been established in 2017, with the primary function of participation in the development of the regulation of the industry and franchise relationships in particular. The agency has participated in the organizing of Azerbaijan International Franchise Forum - Caspian Franchise in March of 2020, with the aim of attracting new investments into the country, creating a platform for the meeting of the investors and potential franchisees and enlightening entrepreneurs and all the interested parties on the features of franchising relations.[57]

2.3. The issue of franchise asymmetry

The author of the paper at first has struggled with determining whether franchise asymmetry even takes place in Azerbaijan. This task was not of an easy one since franchising has just now stepped on its way of development in the country and very little to no court cases have emerged. To determine whether franchise asymmetry is present in Azerbaijan and if the franchisees in the country need that same level of protection that the American system provides, the author decided to research the issue of franchise asymmetry from the theoretical standpoint.

The main purpose of all franchise regulations throughout history was to address the issue of asymmetry of rights and obligations of the parties that is a feature of franchise contracts. However, the question arises as to what are the attributes that deem a contract as asymmetric. The issue arises from the fact that there has been no test designed to determine what conditions exactly make the contract asymmetric, define the level of asymmetry in a contract in general and in a franchise contract in particular or spot that line by crossing of which the contract becomes imbalanced.[58]

[56] https://smb.gov.az/en
[57] https://www.azernews.az/business/162588.html
[58] *See generally*, Tajti, *supra* note 17.

While deconstructing the notion of contract asymmetry three types of asymmetries can be distinguished: law-based asymmetries that primarily arise from the existence of specific legal tools, informational asymmetry, and financial asymmetry.[59]

It may be argued that information asymmetry is inevitable in the context of transfer of intellectual property rights, as well as knowledge, business strategy, etc.,[60] but also necessary for the proper protection of those rights.[61]

The inevitably asymmetric nature of franchising contracts put the legislator in such a position when they do not aim to eliminate the imbalance per se, but rather try to create such legal framework that would prevent the franchisor from abusing its power.[62]

Additionally, since franchise contracts are generally "take-it-or-leave-it"[63] type of contracts that do not involve any kind of negotiation on the part of the franchisee the regulation of those relations by general principles of freedom of contract would be improper, as freedom of contract implies the freedom to negotiate the terms of the contract and therefore would not present the most suitable solution.

2.4. Franchise-specific clauses of the Civil Code and recommendations for legislative changes.

Unfortunately, there is no official English translation of the Civil Code of Azerbaijan available and the unofficial translations do not properly transfer the meaning of the provisions. Therefore, the author of the paper will attempt to translate the relevant provision of the Code to the best of her ability.

[59] *See* Abell, *supra* note 47, at 76.
[60] *See generally* Philip Mark Abell, The Regulation of Franchising in the European Union, published thesis, Queen Mary, Univ. of London 55 (2011)
[61] *See* Tajti, *supra* note 17, at 249
[62] E. Allan Farnsworth, Contracts, 4th edition 533-534 (2004)
[63] *See generally* Tajti, *supra* note 16.

Franchise-specific clauses of the Civil Code of Azerbaijan[64] are enshrined in its Chapter 35 titled "Franchising". The chapter consists of nine articles, starting with article 723 and finishing with 731. The very limited number of provisions of the chapter requires for additional regulations, which the legislator has mentioned in the last article of the chapter, noting that various other provisions of the Code may apply,[65] namely stating that if the subject of the franchising agreement consists of the transfer of intellectual property rights then provisions of the legislation on copyright and related rights, as well as patent law shall apply;[66] if the franchisee is constantly engaged in the distribution of the goods of the franchisor or any enterprise related to the franchisor, the provisions of this Code on trade representation and concession agreement shall apply;[67] if the parties to a franchising agreement take on other obligations (in particular sale agreements, lease of property, provision of services), the provisions of this Code on the relevant types of agreements shall apply to the legal relations of the participants.[68]

Parts 2 and 3 of the Article are understandable, since franchising agreements are concluded in many different industries, however part 1 of the Article seems to be contradicting the very nature of franchising relations, since any franchising agreement involves the transfer of intellectual property rights. It would be appropriate to mention that the provisions of intellectual property rights law may apply to franchising relations where appropriate, without specifying that those franchise relations should involve the transfer of intellectual property, since it is a feature of any franchise agreement. Therefore, a better formulation of Article 731.1. could be a following one: "Provisions of the legislation on copyright and related rights, as well

[64] https://www.e-qanun.az/framework/46944
[65] Art. 731 of the Civil Code of the Republic of Azerbaijan (2000).
[66] Art. 731.1. of the Civil Code of the Republic of Azerbaijan (2000).
[67] Art. 731.2 of the Civil Code of the Republic of Azerbaijan (2000).
[68] Art. 731.3 of the Civil Code of the Republic of Azerbaijan (2000).

as patent law may apply where appropriate to the legal relations between the parties to the franchising contract".

Chapter 35 starts with Article 723 giving the following definition of the franchise agreement: "A franchise agreement is such type of a long-term legal relation under which independent enterprises mutually undertake to assist in the production and sale of goods and provision of services through the performance of very specific obligations as necessary." This article fails to reflect the asymmetric nature of the franchise agreement as well as does not mention the necessary features of it that we can find in California Franchise Investment Law, for instance, namely the transfer of intellectual property and the payment of franchise fee. Article 723 of the Code however notes that franchise relations are long term, which is not a necessary, however a common feature of franchise relations. However, since the courts tend to follow the provisions literally, taking into consideration the power of franchisors to terminate the contract based on various conditions that they include in the franchise agreements it would be more appropriate to not specify the duration of the contract. The author of this thesis would suggest a use of a definition that would more clearly identify franchise relations and allow to distinguish them from other types of contractual relations, which the current Article fails to provide. A suggested definition in this case would be the following: "A franchise agreement is such type of a legal relation under which the franchisor is paid for the transfer of its intellectual property to the franchisee in exchange for a franchise fee for the right of the latter to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor."

Further, the articles determining the duties and obligations of each of the parties are included.[69] The fact that the Articles are named "Obligations of the franchisor" and the "Obligations of the

[69] Art. 724: Obligations of the franchisor; Art. 725: Obligations of the franchisee.

Franchisee" once again showcases the fact that Azerbaijani legislator does not put enough focus on the issue of asymmetry of franchise relations. Although the author of this article agrees with Prof. Tibor Tajti on the fact that most European countries have passed their franchise regulations primarily for the protection of the franchisees, the idea that Mark Abell had put forward actually finds its reflection in the franchise provisions of Civil Code.[70] Namely, not just from the titles of Articles 724 and 725, but also from their content we can observe the attempt of the legislator to provide a protection for the franchisors as well. Article 724 on the obligations of the franchisor states the following:

724.1. The franchisor is obliged to provide the franchisee with standard non-material property rights, trademarks, samples of goods, containers, the strategy of production, acquisition, sale and organization of activities, as well as other information necessary to assist in the sale.

724.2. The franchisor is obliged to protect the system of joint activities from third party interference, to constantly improve it and to support the franchisee by acquainting him with business skills, providing information and professional development.

Although Article 724.1. requires the franchisor to disclose necessary information for the conclusion of the contract, it is insufficient since it does not clearly state the categories of material information that need to be disclosed to the franchisor. Since the power imbalance issue is a crucial one in franchise relations disclosure of the level that would be required for the conclusion of another type of civil contract does not seem to be adequate. Therefore, the author would suggest firstly, giving a concrete list of types of material information that the franchisor is obliged to provide the franchisee with, as well as stating clearly that the information should be provided before the conclusion of the contract, as well as giving a certain period of time for the disclosure of the material information; secondly, rewriting the article

[70] *See* Tajti, *supra* note 17, at 262.

taking into consideration the suggestions given for the definition of franchise agreement, and additionally, adding the abidance with the principles of good faith and fair dealing as one of the obligations of the franchisor.

Article 725 – "Obligations of the franchisee" is written as follows:

725.1. The franchisee must pay a fee based on the amount of work that he has put into the functioning of the franchise and act as an honest entrepreneur, accept services and purchase goods through the franchisor or his agents in cases directly related to the purpose of the contract.

725.2. If at the time of concluding the contract the franchisee paid the entry fee and this fee was not included in the franchise fee, then the franchisor is obliged to return this fee to him upon termination of the contract.

It seems to be unfair that acting in good faith ("being an honest entrepreneur") is directly mentioned as an obligation of the franchisee and is not listed as a duty of the opposite party that is usually the one that tends to violate this principle. Article 725.2 on the other hand, is very beneficial for the franchisee, however the placement of it in the previous Article seems to be more appropriate, although the author supposes that the reason for its inclusion here is for the number of obligations of the parties to be the same, which is a general trend when it comes to Azerbaijani legislator.

Article 726 determines the obligation of both parties to not disclose the entrusted information, even if the contract is not yet concluded. Although, as it will has already been mentioned previously, there are no disclosure requirements for franchisors in the legislation, this specific provision incentivizes the franchisor to provide full and adequate information for the needs of franchise contract, assuring that the information provided will not be disclosed to third parties

and creating a legal basis for its claim for the compensation of the harm that was inflicted upon its business by the unlawful disclosure of its entrusted information.

Article 727 calls for a complete description of the franchise agreement, however only specifying a couple of elements that are required to be present in the contract. However, the way that the Article is formulated once again hints at the preposition of the legislator that the franchise contract is negotiable: In the text of the agreement, the parties must fully describe the organization of the franchise relations, as well as clearly stating the bilateral obligations, the terms of the contract, the terms of termination or extension and other important elements of the contract.

Since the model of franchising is quite a new one for Azerbaijan, the author supposes that local franchisors, not yet achieving such a level of experience and financial superiority to their franchisees might be more inclined to negotiate the terms of the contract. The business environment in Azerbaijan also does not incentivize entrepreneurs nearly as much as the American system does, so it would be of no surprise that there are way less enterpreneurs on the market wanting to enter a franchise contract. Thus, for the current development of the capital markets in Azerbaijan the existent formulation of the Article seems appropriate.

Article 728 on the term of the contract states that in case the term of the contract is more than ten years, either party has the right to terminate the contract on the condition of giving a notice to the other part one year prior. If neither party uses this right to terminate the contract, the contract is extended for two years.

Article 729 calls for a fair trading between the parties, noting that the franchisee may be prohibited from competing within a certain area for a maximum period of one year. This notion may seem similar to encroachment, however if encroachment is presented throughout American regulation and legal literature as a right of the franchisor to intrude on the certain

territory that the franchisee operates on, Azerbaijani legislator mentions the right of the franchisor to prohibit the franchisee from a competition on a certain territory. It is not necessarily clear what the parliament meant exactly in this case and if it is related to encroachment. However, if it is, certain changes must be made for the Article to reflect that.

Finally, Article 730 imposes a liability on the franchisor, stating that the franchisor is responsible for the rights and information within the franchise. The wording of the Article seems odd and noting that the franchisor is responsible for the provision of full and accurate information is more appropriate. Additionally, the Article notes the right of the franchisee to reduce the franchise fee in case of the violation of the conditions of the agreement by the franchisor. The amount to be reduced must be determined by an independent expert. In the case of bigger corporations that work with independent experts long-term, the experts tend to become biased, which we can link to the arbitration problem that was discussed in Chapter 1.

CONCLUSION

Although the legal systems of the U.S. and the Republic of Azerbaijan as well as business environment in those countries are so different, the positive experience of the U.S. regarding the regulation of franchising can be an extremely valuable source of inspiration for Azerbaijani legislators. The European experience in this regard does not seem to be the most appropriate because of the nature of the franchise regulation in those countries which consists mostly of bits and pieces and is regulated via many different legal acts and industries.

Although the Franchise Rule does not provide for the strongest protection of the franchisees among all of the regulatory pieces in the U.S., it is an amazingly drafted piece of legislation that takes into consideration all types of material information that can be necessary for the franchisee's decision-making in the process of purchase of the franchise.

The fact that there have not yet been many collisions between the participants of the franchise contract in Azerbaijan is mostly due to the fact that it has just now started its development and not associated with the quality of the regulation in that area.

As the analysis of the franchise-specific regulations of the Civil Code of Azerbaijan had showed, the legislator has tried to encompass the power imbalance issue between the parties, however the Civil Code might use some perfection to assure the proper functioning of the system in the near future.

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