

Sydney

19 April 2017

Dear Dutch Minister

I write as a former law practitioner who acted for franchisors, franchisees and shop premises owners for 19 years. During this time I was involved in the drafting of Australia's 1993 voluntary Franchising Code of Practice. Since 2002 I have been an academic researching legal aspects of the franchise business model and teaching franchise law and international franchise law at the University of New South Wales, Sydney, Australia. I am an appointed member of the Australian regulator's Small Business and Franchising Consultative Committee <https://www.accc.gov.au/about-us/consultative-committees/small-business-franchising-consultative-committee>

My specific areas of franchise law research are consumer protection (viewing franchisees as consumers of the franchisor's offering), dispute resolution and insolvency. Globally, franchisees are very exposed to financial loss if the franchisor's business fails. Given the significant sunk costs involved this is a serious problem for any economy where franchising is a prominent business model.

Please accept my apologies for sending this in English. I do not speak/read/write Dutch. I have read an English version of the draft NFC. Of course the NFC sits within the context of Dutch and EU law so if any of my comments seem to demonstrate a lack of context then that is probably because I am not an expert on your legal system.

I have numerous small observations that I hope you might find useful. I will mostly comment only on the actual words in the English version of the NFC (in the left hand column), not the explanations. I'll start with page 3.

Please feel free to ask me for any more input including copies of any of my papers that you consider might be informative as you finalise the Dutch Franchise Code.

Yours faithfully

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Page Para Clause	Problem(s)	Suggestion / note
Page 3, para 1	<p>The NFC is a legal document. The franchisor is NEVER in a legal relationship of '<b>partnership</b>' with any of its master franchisees/ area developers/franchisees.</p> <p><b>Partnership</b> is a very specific legal relationship that should never be implied in a legal document if the relationship that is created is something else. It is misleading for regulators to use the term partnership here. It sends a message that both parties are always pulling in the same direction which is not the case. The franchisor and franchisee run different businesses and make their money in different ways.</p> <p>The relationship between a franchisor and its master franchisees/ area developers/ franchisees moves through 2 main phases. In both phases the franchisor has far greater power and knowledge</p> <ul style="list-style-type: none"> <li>i) The party dealing with the franchisor is a consumer of the franchisor's offering</li> <li>ii) Once they have signed an agreement they</li> </ul>	<p>Remove the word 'partnership' throughout the HFC.</p> <p>Replace with relationship, franchise, brand and other appropriate words as appropriate in the context.</p>

	<p>are in a business to business relationship where the franchisor remains the dominant party</p> <p>The franchisor is referred to as 'his'. I don't know Dutch but in English the franchisor should be referred to as 'its' as it is very rare for a franchisor to be a sole male. It is almost always a company, which is ungendered.</p>	
Page 3, para 2	<p>This refers to '<b><u>self-regulating rules</u></b>' but the link to the gmsadvocaten site says 'the draft franchise law, the – much criticized – Dutch Franchise Code (version of 2016) will be <b><u>mandatory</u></b> to apply for franchise formulas'. It appears to me from the reading that franchisors will have the right to contract out of much of the NFC and so part is 'self regulation' and part is mandatory.</p> <p>'ideas about good franchiseeeship and franchisorship are constantly changing' – I disagree. They are not changing, ever. The model itself is evolving but not the idea of what is a good franchise, a good franchisor and a good franchisee.</p> <p>franchiseeeship and franchisorship are not words in English – is</p>	<p>Self-regulating implies voluntary so I am not sure how to interpret this.</p> <p>Australia tried voluntary 1993 – 1998 and it was useless. The good franchisors did not sign up to comply – they followed their lawyers' advice that there was no need to hand a weapon to an unhappy franchisee. The franchisors that had something to hide did not sign up either – for the opposite</p>

	there a better translation from the Dutch?	reason. In the end some franchisors threatened to sue the government appointees administering the voluntary code and the government refused to indemnify them so the whole thing fell apart and the mandatory code was introduced in 1998.
Page 3, para 7	The franchisor will always be the more powerful party in the relationship. The NFC seems to be voluntary – Any franchisor that takes legal advice will carve out any obligation that it can not strictly adhere to – so the NFC will not do its job.	
1.1	<b>A franchise:</b> is a type of <del>partnership</del> relationship between natural or legal persons that are legally and financially independent, and where the <u>franchisee is functionally dependent on the franchisor</u> . One party (franchisor) grants to the other party (franchisee) the right to operate <del>his</del> <u>its</u> formula to <u>acquire, make</u>	Interesting that there is no reference to intellectual property or brand in this definition  In <i>the explanation column</i> the last sentence is wrong. Some franchises are a small part of a larger non-franchised business –

		<p>eg in Australia plumbers supplies businesses (not franchised) offer plumbers the opportunity to buy diagrams of where the pipes run across the land the plumber will be working on (drainage diagrams). The drainage diagram business is a franchise and it is a minor part of the plumbers supply business, but it is still a franchise.</p>
1.2	<p><b>Franchise formula:</b> needs to also include '<u>making</u>' as many franchise systems require franchisees to make/ manufacture things like food items, coffee, even big things like garages/ houses.</p> <p>Last 3 words 'a suitable fee' is a reflection only of one component of the money that passes between franchisors and franchisees. There is typically also an ongoing royalty that is paid periodically, and may be calculated in several different ways.</p> <p><b>Note also</b> that in Australia some (quite a</p>	

	<p>few) franchised businesses operate like a commission agency – the franchisee’s customers pay the franchisee but the € does not go into the franchisee’s account, it goes to the franchisor. The franchisor then pays the franchisee a commission on sales. This makes the franchisees hyper vulnerable as all their income comes from the franchisor but all their obligations (rent, wages, warranties, electricity, marketing) are payable directly by them (the franchisee).</p> <p>See <b>Figure 1</b> at the end of this submission for the 2 ways money can flow between franchisor and franchisee. In <b>scenario 2</b> the franchisee is very vulnerable if the franchisor does not pay regularly and fully.</p>	
1.3	... direct/indirect fee <u>AND ongoing payments</u>	
1.4	<p>It would be clearer to either leave out reference to <u>risk</u>, or to acknowledge that the risk of success is shared.</p> <p>The risk a franchisee takes on are numerous. It is not limited to the risk of its own business but all franchisees also take on the risk of the franchisor running its own business (the business of being a franchisor) unprofitably,</p>	<p>It could be argued that the franchisor is the franchisee’s biggest risk and is the one risk the franchisee is powerless to mitigate.</p>

	even to the point of insolvency, establishing an exploitative supply chain that earns the brand a bad reputation and costs sales, making poor expansion decisions, etc.	
1.6	<p>... non patented... This is not the case in Australia where about 10% of franchisors have registered patents.</p> <p>'substantial' I suggest that the word <del>applicable</del> should be replaced with <u>essential</u></p>	
1.7	<p>Why would the <b>non competition clause</b> be limited to the franchisees?</p> <p>Can the franchisor compete with its franchisees, eg in the online space or by opening a new part of the market and damage the franchisee's business with impunity?</p> <p>Normally the franchisor might reserve 'carve outs' up front eg the right to operate at certain events (say, football venue) that might be inside a franchisee's territory – but they should agree this right at the start.</p> <p>Consideration here must be given to online sales – who can make them, who gets credit, how are calculations made to ensure franchisees and franchisors split online sales revenue fairly?</p>	
1.8.a	<b>Exclusivity clauses:</b>	

	<p>unrealistic as</p> <p>(1) assumes the franchisee is actually operating the business. Many franchised businesses now are owned by an investor franchisee who hires managers and never sets foot themselves inside the franchise(s) they own.</p> <p>(2) assumes the existence of set territories – many franchisors(including MacDonald's) do not grant defined territories</p> <p>(3) 80% might be OK if it referred to the branded goods/ services but not all. 80% of things that are basically generic is onerous. I'm not sure what the EU block exemptions require but in Australia if the franchisor prescribes 3rd party suppliers they need to satisfy the regulator (Australian Competition and Consumer Commission) that the agreement is a not a breach of Australia's competition laws.</p>	
1.8.b	<p>This will have to be carefully reworded to address the reality of online sales by either franchisor or franchisee or both.</p>	
2.1	<p><b>The partnership:</b>  <b>Under no circumstances should a franchise relationship ever be described as a partnership within a legal document.</b> It is not a relationship that</p>	<p>The franchisor has roles that differ from a franchisee's roles. Franchisor sets the direction of</p>



	<p>fits the legal definition of partnership.</p> <p>A 4<sup>th</sup> bullet point should be added to acknowledge</p> <ul style="list-style-type: none"> <li>The franchisee's dependence on its franchisor</li> </ul>	<p>the brand, protects the brand from imposters, selects and trains franchisees, establishes supplier contracts, creates the blueprint for the business the franchisee will run. The franchisee trusts the franchisor to know what they are doing – often misplaced trust as many franchisors fail in business.</p>
2.2	<p><b>Reasonableness and fairness:</b> As worded this is limited to parties involved in a franchise agreement. The challenge for the law will be to interpret how far '<i>involved in</i>' extends. See <b>Figure 2</b> at end of this document which shows how many companies are involved in the <b>franchisor's</b> empire. The franchisee often knows nothing about these companies but they will be affected if any of them is not run well.</p>	
2.3	<p>a. how long is a reasonable time? It should be at least one full year. China has a 2+1 rule (see Canadian lawyer Paul Jones for</p>	

	<p>an explanation) In Australia up to 40% of franchisors have been operating for <u>less than</u> 12 months when they start signing up franchisees. It beggars belief that they can claim to be selling a 'proven' business.</p> <p><b>b.</b> should be amended to read ... or be entitled to <u>sole and exclusive</u> rights to use and permit the re-use of ... If someone other than the franchisor has a right to use the IP rights and grant right to sue them then the franchisees can find themselves competing with businesses that have an interest in the franchisees' businesses failing.</p> <p><b>g. Does this breach European antitrust laws?</b></p> <p><b>i. and j.</b> I think <b>not unreasonably refuse</b> would be better but the current ambiguity might be a translation issue.</p> <p><b>o. Obey the law always.</b> This should be added as a positive obligation on franchisors. In Australia there are examples of <i>franchisors</i> breaching tax, employment, occupational health and safety, corporations laws and the franchisees can't do a thing about it because there is no concrete obligation on franchisors to obey the law.</p>	
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	It must always be remembered that one bad franchisee can only do limited damage to a brand but one bad franchisor can damage every franchisee's business in its chain.	
2.4	<p><b>c.</b> this would be clear to the franchisor possibly before the franchisee realises as the franchisor can receive earnings information (even instantaneous through point of sale system) for all franchisees in the system so they can see if one is weak.</p> <p><b>e.</b> 'within reason' is subjective. A franchisee with 12 months to go before their term ends might see it as reasonable not to update all its branding unless the franchisor is prepared to grant them an extension of their term and/ or pay for some of the upgrade. A single unit franchisee will not be able to justify the expenditure and probably won't be able to argue that it is unreasonable for the franchisor to require it.</p>	
2.6	<p><b>b.</b> Yes this is a good idea but the wording is clunky – hopefully a translation issue. Andrew Selden of the US is an expert in this – I have more information if required.</p> <p><b>c. – h.</b> Aren't b. and c. part of the same thing? Would c. extend to</p>	Some systems have a franchisee association (FAC) for each country/ state/ function – so this one might need to be thought

	<p>decisions like whether the franchisor should list publicly? Whether the franchisor should sell its business?</p> <p>Great ideas but scary potential consequences. Would it be better to allow the franchisor to make major changes only if a super majority (say 2/3 of the franchisees agreed)?</p>	<p>through a bit more as it contemplates all franchisees being members (might not be necessary) and there only being one FAC for the whole system.</p>
3.1	<p><b>This should also extend to any buyer of the entire franchise business from the franchisor.</b> There are plenty of tales of woe in franchising of the franchisor selling their operation to someone or a company or a venture capitalist that had no idea about the brand and no interest in franchisees success.</p>	
3.6	<p><b>a.</b> Should also require information about the solvency of all the franchisor's related entities plus their legal entity name and registration details so the franchisee can check for itself. Assumes the franchisor is always a company – is it? Must all companies in the Netherlands publish annual reports? What if the franchisor has not been trading for 3 years? Remember this is all good information but it is backward looking. A franchisor can start to trade badly in the future so how are the</p>	

	<p>franchisees protected then?</p> <p><b>c.</b> Current? Or current and former? The past/former franchisees will offer a different but also valuable perspective to intending franchisees.</p> <p><b>d.</b> Most franchisors will refuse to offer this. What remedy is available to franchisees if the information is incorrect?</p> <p><b>e.</b> If the franchisor took back an outlet and traded it back to profitability it would be more valuable for an incoming person to see the trading figures from the 2 prior operators. Too tempting for a franchisor to do a cover-up job. Also important for the incoming franchisee to have explicit information about any changes to the system or the trading environment of the outlet between then and now. Eg arrangements re online sales, road changes, shopping mall redesign that adversely or positively affect the outlet, etc. ie CONTEXT</p> <p><b>h.</b> and the registration details of any registered rights so the franchisee can check that the registration is current and the status of any securities given over the rights.</p>	
3.7	Is it easy and not too	

	expensive for the franchisee in the Netherlands to check from public data sources on the information the franchisor has provided?	
3.8	I presume this is about the franchisee considering becoming a franchisee – replace the word <del>partnership</del> with 'entering a franchise relationship'.	
4.2	What is industrial property? Up to now all references are to intellectual property so if it's the same thing then delete industrial property.	
4.3	Which language version will prevail if there is a dispute?	
4.4	Get rid of the word 'partnership' everywhere it occurs.  The rules on failure to meet obligations should acknowledge that either party could fail to meet obligations and both parties need rights and remedies.	
4.6	<b>e.</b> Plus a description of ALL other set up and ongoing fees payable by franchisor or franchisee to each other or required as a consequence of entering the relationship (eg premises fit out/ opening promotion/ ongoing marketing levy/ lease of fit out items	

	<p>like shelves from franchisor-owned or controlled entity) and how they are calculated.</p> <p><b>r.</b> This includes penalty clauses applying to the franchisor as well as the franchisee – it is not always the franchisee who is in breach.</p> <p><b>s.</b> Acknowledgement that if the franchisor fails (bankruptcy/ insolvency) the franchisee has the right to serve notice and terminate the franchise agreement without penalty if the franchisor's administrator has not found a suitable buyer for the system within a reasonable period.</p>	
5.2	<p>What is the <b>Franchise Disputes Committee</b>?</p> <p>Is it</p> <ul style="list-style-type: none"> <li>• an independent government funded body? Good idea</li> <li>• part of the franchise system? Bad idea</li> <li>• part of the Netherlands Franchise Association? Bad idea</li> </ul>	<p>Important things to consider in resolving franchise disputes are:</p> <p>Speed of resolution – court too slow for most as term has elapsed by the time matter comes to court + far too expensive</p> <p>Possibility of remaining in business if dispute can be resolved without spilling too much blood!</p> <p>Ability for</p>

		new franchisees doing due diligence to be able to access a minimum level of information to determine how disputes are resolved within the system.
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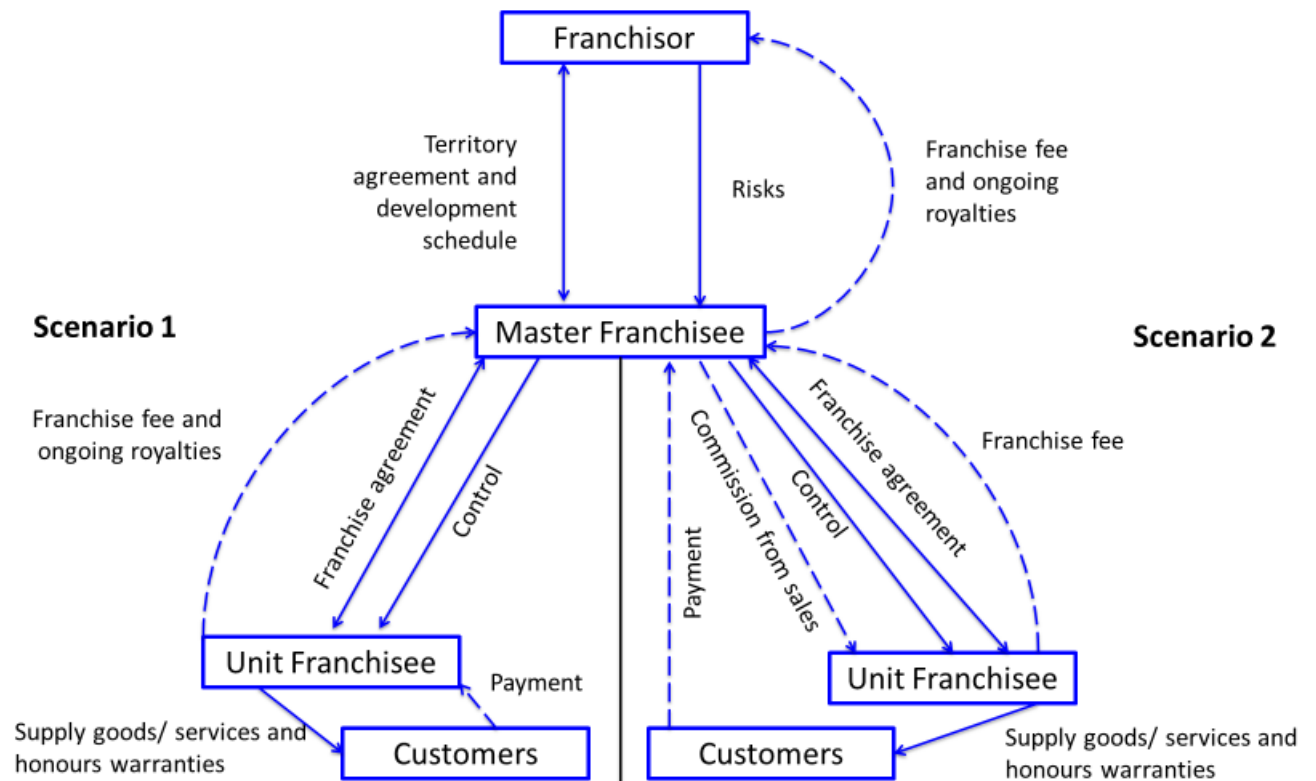
In conclusion – the Australian Code was drafted in 1998 and has only changed slightly but the franchise model has evolved considerably in past 19 years. Some of the greatest legal challenges for franchisees remain:

- i) getting information *ex ante*, and ongoing, about the franchisor's business –there is no public data base of disclosure documents, franchise agreements in Australia. There should be as this would greatly assist advisers and prospective franchisees to compare different franchise opportunities.
- ii) setting themselves free if the franchisor goes into administration/ becomes insolvent.
- iii) getting decent professional advice before signing – most of the competent franchise advisers work for big firms that act for franchisors – and franchisees can't afford their fees.
- iv) absence of rights when the franchisor decides to make a major change that will potentially harm franchisees – maybe the NFC has addressed this.
- v) Understanding the extreme complexity and seemingly infinite variation from system to system in the 21<sup>st</sup>– as seen in Figures 1 and 2 below.
- vi) Online sales

**Figure 1: Money flows between franchisor and franchisees**



# Control and Money flows



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Figure 2: REDgroup organization chart.

## RED Group

