

Significance of Legal Norming of Pre-Contractual Disclosure of Information for Franchise Contracting

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Abstract

The needs of capital for new markets through the minimum of investment can be achieved through franchising as a specific investment method of contracting business. Using the methods of successful operations, reduced investment risks and autonomy in operations are among the decisive reasons for joining the franchise network by the potential franchisee. Access to relevant information in the modern market conditions of business operations at global, regional and micro_level is a condition of achieving competitiveness in the market. While the franchisor is in possession of relevant information pertaining to the franchising business, franchisee has access to them only if they are made available by the franchisor. The information that has significance for the franchisee is also those known as "pre-contractual information" – information disclosure, and is related to business operations of the franchisor and the franchise network.

Obligation to disclose pre-contractual information is one of the significant obligations of the franchisor. A franchisor, regardless of the form of franchising business in question, is obliged to make information on business operations available, meaning adequate information to a potential franchisee. The importance of disclosing pre-contractual information is reflected in the fact that a potential franchisee, the economically inferior of the two, is given access to the business operations of the network and the franchisor.

Keywords: *pre-contractual information, pre-contractual disclosure, franchising contracts, franchise, franchisor, franchisee*

I. CONCEPT AND IMPORTANCE OF FRANCHISING

The need for capital to conquer new markets through minimal investments can be made through franchising¹ as a specific investment method of contractual business,² i.e. as a concept of a contractual expansion of business in the target market, whereas in modern market conditions the more aggressively approach is gaining in importance. The reasons that can certainly be identified and that affect the expansion of the business of franchising are: a) the need for the growth of successful business operations and b) the ability to achieve this growth through connecting with others who have the capital and manpower to do so.³

The franchising as an investment method of contractual business allows the franchisor⁴ to expand their business in the target market with a minimum investment and investment risks. The importance of franchising as an investment method is that the franchisee⁵ by contract conclusion is

¹ The term „franchise” was the first time used in the medieval France. At that time the franchise was the name for the contract between the king and the City Council, on the basis of which the City Council was entitled to operate within the framework of its activities, as well as in the relationship between the city and the country, and this franchise city is known as the „Ville French” – Mendelsohn, M., *Franchising in Europe*, and Title, London, 1992, 107.

² Franchising as a specific investment method can be simply characterized as a method for the sale of goods and services.

³ Mendelsohn, M., *Franchising law*, Second edition, Richmond, 2004, 1.

⁴ The author argues that the „franchise” is (represents a set of elements: rights, services and business methods) subject to the franchise agreement, and that the person under the franchise agreement who cedes the item should be named the „franchisor” – Miljković, S., *Legal relationships with franchise agreements*, PhD thesis, Novi Sad, 2014, 2-8.

⁵ The author defines the term „franchise receiver” and not the term „franchise user” (in English both translated as a franchisee) because as a „user” occurs an end user of services and a products consumer whose rights are unidirectional. In contrast to the „franchise user”, the „franchise receiver” means a person who is in a legal relationship with the franchisor, on one side, which means that he/she is in a legal relationship with the service user as a final consumer, on the other

provided with an access to the developed franchising network i.e. franchising system.⁶ The franchisee by joining the franchising network uses all the advantages of the developed and in the practice proven system of the franchisor's business.⁷ Although the franchisee is de facto subordinate to the franchisor, he/she enjoys a legal autonomy, i.e. acts in his/her own name and on his/her own account.⁸ Investment risks are not eliminated and they still exist but they are much smaller than if the franchisee begins independently with the development of his/her own business. Using a successful business method, reduced investment risks and the independence in operations are governing reasons that a potential franchisee accesses the franchising network.⁹

In the period of the commencement of the global economic crisis, i.e. from 2008 onwards, we can talk about the expansion of franchising as a method of an investment with a certain minimal fluctuations. The franchising as an investment method of contractual business showed characteristics of a stable financial instrument to which the global financial crisis had no significant effect. Although this stand seems non-argumentative, and thus,

side. The franchise receiver has certain rights and obligations towards the franchisor, and also has certain rights and obligations towards the service user. Ibid, 8.

⁶ The franchise system consists of the franchisor and all receivers of his/her franchise (franchisees). The franchisor is entitled to ensure the work and the growth of the system as well as the recognition and quality of the brand. With the help of common brands, the franchise system builds identity and reputation in the eyes of their customers. The main sign of reputation, recognition and value is the franchisor. Franchise systems are built on a basis that the franchisor creates with franchisees. – www.pks.rs/fransizing

⁷ The franchisee uses methods of business and technology developed by the franchisor, as well as certain forms of the intellectual property.

⁸ The franchisee in relations with third parties acts independently and responds as an independent legal entity.

⁹ Miljković, S., op. cit. 22.

paradoxical, it is confirmed by analysis conducted by IFA – International Franchise Association for the period 2008 – 2014 (table no. 1).

Table no. 1 Navigation of important indicators of the franchising concept development, in the period from 2008 – 2014.¹⁰

	2008	2009	2010	2011	2012	2013	2014
Number of franchises	774.016	746.646	740.098	736.114	747.359	757.438	770.069
% of change		-3,5%	-0,9%	-0,5%	1,5%	1,3%	1,7%
Number of directly employed	8.028.000	7.800.000	7.780.000	7.940.000	8.127.000	8.327.000	8.548.000
% of change		-2,8%	-0,3%	2,1%	2,3%	2,5%	2,6%
Output	696	674	699	734	768	803	841
% of change		-3,2%	3,6%	5,0%	4,7%	4,6%	4,8%
GDP	410	405	414	434	453	472	494
% of change		-1,2%	2,2%	4,80%	4,4%	4,3%	4,6%

¹⁰ Available at: <http://emarket.franchise.org/FranchiseBusinessOutlookMay.pdf> (date accessed: August 2014).

II. RELEVANT INFORMATION

The access to relevant information under modern market conditions at the global, regional and micro level presents a condition of achieving competitiveness in the market. One of the ways in which the franchisee can achieve competitiveness on the market is through information provided by the franchisor. The franchisor has information concerning the foundation of success of competitiveness of the franchisee in the market. However, between the franchisor and the franchisee there is an asymmetry of disposal of relevant information. The franchisor is the one who has relevant information related to the franchising business, while the franchisee can be in disposal of this same information only if the franchisor makes them available. Data that have significance for the franchisee are the ones known as „disclosure information” and are related to the business of the franchisor and the franchising network.

The obligation to disclose this pre-contractual information is one of the most significant obligations of the franchisor. Regardless of the manifestation form of the franchising business¹¹, the franchisor is under the obligation to make available information about its operations, i.e. adequate information to the potential franchisee. The importance of disclosing pre-contractual information is reflected in the fact that the potential franchisee as the economically inferior side of the relationship is provided by insight into the operations of the franchising network and the franchisor and on the basis of insight into the real situation makes a final decision whether or not to approach the franchising network. The document that the franchisor is obliged to submit to the potential franchisee to inspect and which contains necessary pre-contractual information is known as a „disclosure document”.

Both national¹² and international organizations¹³ have adopted legislation pertaining to the pre-contractual obligation of the franchisor to

¹¹ Manifestation form of franchising are: franchising goods, service franchising, business format franchising, master franchising, etc.

¹² California Franchise Investment Law, California Corporations Code, Div. 5, Parts 1-6, Section 31000et. Seq., CCH Business Franchise Guide 3050; Loi, n. 89-1008 du 31 decembre 1989 relative au developpement des entreprisescommerciales et artisanales et a l'amelioration de leurenvironnementeconomie, juridique et social, JCP 1990; „Legge 6.

make available information concerning the operating of the franchising network. It should be noted that the increased attention to national legal acts is primarily placed on the pre-contractual obligation of disclosure of information (disclosure law) and the contents of the disclosure document that assigns to the potential franchisee. The reason for this stand is the existence of the possibility of fraudulent actions conducted by the franchisor.¹⁴ The franchisor as economically stronger counterparty, with the reinforced and aggressive marketing policy, can „hook an inexperienced potential franchisee on a story about the promised rapid acquisition of wealth” if he/she enters just this exact franchising network. For the existence of possible fraudulent actions on the side of the franchisor, numerous national legislations in developed economies have adopted legal acts regulating the obligation of information disclosure, and thus predict the content of the disclosure document, while the content of franchise agreements are not regulated.¹⁵ The obligation of the franchisor to make available to the potential franchisee the data on the business is also known within the judicial praxis.¹⁶

maggio“ 2004 n. 129 „Norme per la disciplina dell'affiliazione commerciale“ – Law no. 129 Provisions for the discipline of commercial affiliation, etc.

¹³ On 25 September 2002 the *Governing Council of UNIDROIT* adopted the „Model Franchise Disclosure Law“ finalized by a *Committee of Governmental Experts* convened by the organisation to examine a draft prepared by the *UNIDROIT Study Group on Franchising*.

¹⁴The 1950s were the years of the aggressive franchising entering within the territory of Great Britain, while the 1960s represent the slow growth of the franchising business. The reason for the poor growth of franchising business within the territory of the United Kingdom lies in the influence of pyramid selling and other fraudulent marketing scheme that were related to the franchise, bringing to it the negative reputation.

¹⁵ The contracting parties, guided by the principles of equality and autonomy, regulate the content of the franchise agreement, i.e. mutual rights and obligations.

¹⁶ „The franchisee sought annulment of the contract due to the fact that the contract was made under the mistake. He claimed that the commercial benefits were much lower than those predicted by the franchisor and which were therefore expected. The Court concluded that the franchisor had not fulfilled its obligation to send to the franchisee results of market research based on a

III. LEGAL STANDARDIZING OF PRE-CONTRACTUAL DISCLOSURE OF INFORMATION

3.1. United States – Federal State Commission

On the basis of the Law on the Federal Trade Commission¹⁷ and in accordance with the section 5 of the Law which prohibits unfair and deceptive acts and practice,¹⁸ the Federal Trade Commission regulates the franchising.

By adopting the Franchise Rules, it has taken considerable step forward in the legal regulation of the franchising business on the federal level. However, despite the best intentions to prevent deceptive behavior of franchisors through information disclosure, the Franchise Rules has caused some confusion. The confusion that arose mainly refers to the „publishing format i.e. the format of information disclosure”. The FTC Franchise Rules presented its own format of information disclosure that is mandatory for all states. The reason for not applying the FTC format of information disclosure is because states¹⁹ have for many years used the format of the information

serious criteria” – Cass.com. 04. 12. 1990, JCP 1991, n. 39, p. 305; „The franchisee sought annulment of the contract based on mistake related to the characteristics of the brand and the know-how, as well as the potential success of the franchise business. The Court confirmed the lack of the market research, but concluded that the franchisor had fulfilled its obligation to send the information emphasizing that the information sent (demographic studies, information on competitors and the provisional budget) were sufficient for the franchisee to enter into a contract with the full knowledge of the relevant facts” – CA Colmar 09. 03. 1990, D. 1990, 232, Somme.

¹⁷Federal Trade Commission Act of 1914 (15 U.S.C §§ 41-58, as amended) (FTC Act).

¹⁸ Section 5 of the Federal Trade Commission Act (FTC Act) (15 USC 45) prohibits „unfair or deceptive acts or practices in or affecting commerce.” Available at <http://www.federalreserve.gov/boarddocs/supmanual/cch/ftca.pdf>.(date accessed: July 2014).; 16 CFR Parts 436 and 437 Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities.Billing Code 6750-01-P. Available at: <http://www.ftc.gov>. (date accessed: August 2014).

¹⁹Federal states have their own laws, for example: California Franchise Investment Law, California Corporations Code, Div. 5, Parts 1-6, Section 31000et. seq.,

disclosure known as a Uniform Franchise Offering Circular – Guidelines UFOC.²⁰

3.1.1. Uniform Franchise Offering Circular – Guidelines UFOC

The usage of the UFOC Guidelines while disclosing information of the franchisor is significant because of the high degree of the uniformity of documents required by the federal government. The franchisor, on the basis of the UFOC Guidelines is obligated to make available information to the potential franchisee in 23 areas, including:

1) The Franchisor, its Predecessors and Affiliates; 2) Business experience; 3) Litigation; 4) Bankruptcy; 5) Initial franchise fee; 6) Other fees; 7) Initial investment; 8) Restrictions on sources of products and services; 9) Franchisee's obligations; 10) Financing; 11) Franchiser's obligations; 12) Territory; 13) Trademarks; 14) Patents, copyrights and proprietary information; 15) Obligation to participate in the actual operation of the franchise business; 16) Restriction on what the franchisee may sell; 17) Renewal, termination, transfer and dispute resolution; 18) Public figures; 19)

CCH Business Franchise Guide je 3050; Washington Franchise Investment Protection Act, Revised Code Washington, Title 19, Ch. 19.100, Section 19.100.010 et. seq. CCH Business Franchise Guide 3470; Virginia Retail Franchising Act, Virginia Code, Title 13.1, Ch. 8, Section 13.1-557 et. seq., CCH Business Franchise Guide 3460; Illinois Franchise Disclosure Act, Illinois Compiled Statutes, Ch. 815, Section 705/1 et. seq., CCH Business Franchise Guide 3130; Michigan Franchise Investment Law, Michigan Compiled Laws, Ch. 445, Section 445.1501 et. seq., CCH Business Franchise Guide 3220; New York General Business Law, Art. 33, Section 680 et. seq., 3320.

²⁰Uniform Franchise Offering Circular – UFOC Guidelines developed by the North American Securities Administrators Association (NASAA) and the Midwest Securities Commissioners Association (MSCA). UFOC Guidelines were adopted by the MSCA 1974, last revised in 1993 by NASA.

Earnings claims; 20) List of outlets; 21) Financial statements; 22) Contracts; 23) Receipt.²¹

3.2. France – Loi Doubin²²

The Act on Pre-contractual Disclosures or *Loi Doubin* is significant because it represents the first legal act within the continental Europe regulating the pre-contractual obligations to disclose information i.e. liability of the franchisor to make available to the franchisee true information about the franchising business (franchising network). In addition to its importance, the specificity of *Loi Doubin* is that the obligation of pre-contractual information disclosure does not apply exclusively to the franchising business, but to all those contracts whose subject is „intellectual property rights”. However, in order to make one party obligated to execute the pre-contractual disclosure of information, it is essential that the counterparty that is given the intellectual rights commit on the exclusive basis.

Article 1. of *Loi Doubin* and Article L.330-3 of the *Code de Commerce*²³ concerning the pre-contractual duty of disclosure of information provide as follows:

²¹The UFOC Guidelines in each of the 23 areas of information that are predicted to be made available to the franchisee provides detailed instructions, i.e. it is provided the elaborated content of information. See more about: Uniform Franchise Offering Circular (UFOC) Guidelines.

²²Loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commerciales et artisanales et à l'amélioration de leur environnement économique, juridique et social, JCP 1990, III, 63449; The Law is within the business practice known as *Loi Doubin* named after the Minister of Trade who introduced the Law to the Parliament; The Law is applicable to all new contracts concluded as from 8 April 1991.

²³ Article L.330-3 Code de Commerce (ancien – Loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commerciales et artisanales et à l'amélioration de leur environnement économique, juridique et social, JCP 1990, III, 63449)

„The person who grants to another person a license to use a trade name, trademark or logo, that is a subject to exclusivity or quasi-exclusivity to perform the activities of another person, before performing any negotiated contract in the mutual interest of both parties, shall submit to the other side the document, which will forward the correct information on the basis of which the other party may make a decision.

This document, which content is prescribed by the decree, shall contain, among other things, information on the age and experience of the business licensor, the status and opportunities of the market growth, the importance of the retail network, the duration of the renewal, the termination and conditions of the contract transmission and the range of allocated exclusivity.

When you request any money payment before the execution of the above contract, especially for the granting of exclusivity over the territory, ventures for such payment shall be stated in a written form, together with the reciprocal obligations of the parties in a case of losses. The document provided in the Article 1, as well as the proposed contract should be submitted at least 20 days prior to the execution of the contract or prior to the payment of money described in the previous paragraph.”²⁴

On the basis of the Article L. 330-3 of the *Code de Commerce* the franchisor has the pre-contractual obligation to forward information to the franchisee (*L'obligation précontractuelle de renseignement*).

By entering into force of the *Loi Doubin*, for the first time French courts in their judgments, in accordance with the provisions of the *Loi Doubin*, require the pre-contractual obligation of the franchisor to disclose information. Several outstanding judgments on this matter include the *Cour de Cassation* from the 4th of December 1990²⁵ and *Colmar Cour d'appel* from

²⁴ Available at: <http://www.eff-franchise.com/francenationallevel.html#loidoubin> (date accessed: July 2014).

²⁵ „Franchisees sought the annulment of the contract due to the fact that the contract was made under the mistake. He claimed that the commercial benefits were much lower than those predicted by the franchisor and which were therefore expected. The Court concluded that the franchisor had not fulfilled its

the 9th of March 1990²⁶ that represent the first court decisions to establish the obligation of disclosure of pre-contractual information on the side of the franchisor.

3.2.1. Décret n° 91-337 du 4 avril 1991²⁷

In addition to the articles of the *Loi Doubin*, i.e. the article L. 330-3 of the *Code de Commerce* which determine the content of the disclosed document that is mandatory for every franchisor, the adoption of *Décret no. 97-337 du 4 avril 1991* – Decree on the Implementation of Law no. 89-1008 from the 31st December 1989 represents another step forward in terms of the more detailed and precise regulation on this information – data that the franchisor must make available to the franchisee. The Decree on implementation presents six main categories of information that must be contained within the disclosed document. Six major categories of information relates to:

„1) the company address or headquarters, the nature of activity, the legal form, the management identity and the amount of company capital; 2)

obligation towards the franchisee to send the results of market research based on a serious criteria.” – Cass. com. 04th December 1990, JCP 1991, n. 39, p. 305.

²⁶ „Franchisees sought annulment of the contract on the basis of mistake related to the characteristics of the brand and the know-how, as well as the potential success of the franchise business. The Court confirmed the lack of market research but concluded that the franchisor had fulfilled its obligation to send the information emphasizing that the sent information (demographic studies, information on competitors and temporary budget) were sufficient for the franchisee to enter into a contract with full knowledge of the relevant facts” – CA Colmar 09. 03. 1990, D. 1990, 232, Somme.

²⁷Décret n° 91-337 du 4 avril 1991 portant application de l'article premier de la loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commerciales et artisanales et à l'amélioration de leur environnement économique, juridique et social.

the registration number within the Register of trading companies or the Register of independent entrepreneurs, in a case that the brand is the object of the contract it is necessary to provide all the documents with regard to the registration of all commercial (commodity) brands or licenses that are used by the licensor and introduced within the National Registry of brands; 3) the address of the bank (banks) that are used in business whereby this information may be limited to five branches; 4) the date of establishment of the company with regard to the main stages of its evolution, the history of the network as well as information relating to the acquired professional experience (this information is related to the previous five years from the moment of the document delivery), the presentation of the general market, the domestic market and prospects of market development; 5) information relating to the franchising network: a) the list of franchisees, b) addresses of franchisees and contract closing dates and dates when contract has been restored, whereby if the network has more than fifty franchisees information contained herein is provided for a maximum of fifty franchisees closest to the place of the potential franchisee, the number of franchisees that are connected to the network on the basis of contracts of the same nature which is offered to the potential franchisee and 6) the duration of the contract, the terms of the contract renewal, the contract termination or the contract transfer, the scope of exclusivity and costs and initial investment borne by the individual franchisee.”²⁸

3.3. Principles of European Law on Commercial Agency, Franchise and Distribution Contracts – PEL CAFDC²⁹

The obligation of the franchisor to provide pre-contractual information is also provided by the PEL CAFDC.³⁰ The franchisor has a pre-contractual

²⁸Article 1. Décret n° 91-337 du 4 avril 1991.

²⁹Principles of European Law on Commercial Agency, Franchise and Distribution Contracts - PEL CAFDC 2006, adopted by the Study Group on a European Civil Code (SGECC) in the form of the draft of the uniform European regulation which content relates to: 1) commercial agency; 2) franchising and 3) distribution contracts.

obligation towards the franchisee in accordance with the rules established for both contracting parties to send adequate information³¹ that are of importance for the contract conclusion.

Article 3: 102 requires the following contents of the disclosed document:

„ 1. the obligation to publish pre-contractual information (Article 1: 201) requires from the franchisor to send to the franchisee adequate and timely information regarding:

- a. the company and business experience of the franchisor;
- b. the relevant intellectual property rights;
- c. characteristics of the relevant commercial sector;
- d. the market conditions;
- e. special franchise methods of its functioning;

³⁰Art. 3:102 PEL CAFDC.

³¹ Art. 1: 201 PEL CAFDC:

„ (1) each party shall transmit to other party adequate information within a reasonable time prior to the conclusion of the contract. In case of failure, paragraph (3) applies.

(2) adequate information means information that is sufficient to inform the other party to decide whether he/she wishes to enter into a contract of this kind, and under such conditions, or not.

(3) if the failure of one party to harmonize to paragraph one cause the other party to conclude a contract, whereas the first party knew or could reasonably be expected to have known that if the other party have received adequate information on time, would not have entered into the contract, or they would have entered into the contract under fundamentally different conditions, remedies for mistakes by PEL CAFDC chapter 4 apply.

(4) parties may not derogate from this provision.”

- f. the structure and the scope of the franchising network;
- g. commissions, bonuses and any other periodic payments;
- h. the contract period.”³²

In the event that the contents of the disclosed document is not in accordance with the first paragraph of the Article 3: 102 „whereby this kind of document disclosure does not cause the mistake”³³ to the franchisee, the franchisee is entitled to the indemnity.³⁴ However, the franchisee will not be entitled to the indemnity if the franchisor had reason to believe that information contained in the disclosed document were adequate and timely. When signing the franchise agreement „the contracting parties may not derogate from this provision”.³⁵

IV. TENDENCIES IN LEGAL NORMING/CODIFICATION OF FRANCHISING IN REPUBLIC OF SERBIA

4.1. Solution provided by the pre-draft of the Civil Code of the Republic of Serbia

One of the most frequent questions among national experts is whether a legislative act to regulate franchising is necessary. It is particularly important to decide whether a separate legislative act (Law on franchising) should be adopted or whether legal provisions that would regulate franchising would be included in some of the other legislative acts.

³² Art. 3:102(1) PEL CAFDC.

³³ It refers to the basics of fundamental mistakes in accordance with art. 4: 103 PEL CAFDC.

³⁴ Art. 4:117(2) and (3) PEL CAFDC.

³⁵ Art. 3:102(3) PEL CAFDC.

Work on the Civil Code, i.e. the pre-draft of the Civil Code of the Republic of Serbia³⁶ is characterized by inclusion of new legal institutes. Provision of franchising agreement in a legislative act such as the Code is, even in the form of a pre-draft, is a milestone and a tendency of the modern legislation in R. Serbia to follow the direction dictated at the capital market.

With the pre-draft of the Code³⁷ the legislature attempted to regulate legal relations among contracting parties in a comprehensive manner. The pre-draft of the Code regulates the following: 1) definition of agreement;³⁸ 2) content of agreement;³⁹ 3) form of agreement;⁴⁰ 4) registration of agreements;⁴¹ 5) sub-franchising;⁴² 6) obligations and responsibilities of the franchisor;⁴³ 7) obligations of the franchisee;⁴⁴ 8) limitation of rights;⁴⁵ 9)

³⁶Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

³⁷Chapter XLVII; article 1257–1273. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

³⁸ Art. 1257. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

³⁹ Art. 1258. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁴⁰ Art. 1259. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁴¹ Art. 1260. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁴² Art. 1261. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁴³Article 1262-1263. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁴⁴ Art. 1264. of Pre-Draft the Civil Code of the Republic of Serbia, 2009.

⁴⁵ Art. 1265. of Pre-Draft the Civil Code of the Republic of Serbia, 2009.

duration and renewal of agreement;⁴⁶ 10) termination of agreement;⁴⁷ 11) obligation of loyal competition⁴⁸ and 12) protection of business secret.⁴⁹

4.2. Some of the solutions put forward by the pre-draft of the Code

4.2.1. Registration of Agreement

The system of registration encoded in the pre-draft is a significant novelty. According to the provisions of the pre-draft of the Civil Code, „a franchising agreement, amendments and the termination of agreement are registered in the Registry of the Agency for Business Registries, in line with the special law“.⁵⁰ The right to registration and the obligation of registration can be attached to both the franchisor⁵¹ and the franchisee.⁵² Franchisor is given a time limit of seven days from the day of conclusion of contract or its amendments or the termination to file registration with the competent office.⁵³ In contrast to an obligation of the franchisor to register franchising agreement, i.e. all contractual amendments or the termination, a franchisee has only an obligation to register the agreement, pursuant to provisions of the

⁴⁶Article 1267-1268. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁴⁷Article 1269-1270. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁴⁸ Art. 1272. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁴⁹ Art. 1273. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁵⁰ Art. 1260. Paragraph 1. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁵¹ Art. 1260. Paragraph 2. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁵² Art. 1260. Paragraph 3. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁵³ Art. 1260. Paragraph 2. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

pre-draft Code. We believe that it is necessary to foresee a possibility for a franchisee, apart from registration of franchising agreement, to file registration for the amendments of the agreement. The franchisee could, with consent of the franchisor, undertake the mentioned registration if the franchisor is prevented to register. A question arises as to what will happen if the agreement is amended in favor of a franchisee and the franchisor fails to register within the set time limit. The franchisor can intentionally or unintentionally fail to register or could be prevented from registering the amendments to the agreement, where a franchisee would be an aggrieved party. In order to avoid such a situation, we consider that it is necessary that a franchisee is given an opportunity to register amendments to the agreement with the consent of the franchisor or when it is obvious that the franchisor does not want to register amendments to agreement.

The provisions of the pre-draft foresee that registration in the Registry of franchising does not have a constitutive effect, but rather an evidentiary character.⁵⁴ The redactor states that the registration of the agreement is of informative character, and it does not affect the constitution of agreement between the parties. Regardless of whether the agreement is registered or not, legal relations between the parties do exist, obligating both franchisor and a franchisee. Even though registration is not a condition for the validity of agreement, the agreement is obligatory for parties. We are of the opinion that the registration in the Registry should have a constitutive effect, rather than evidentiary (informative) and that the competent office must control the compliance with the formal and material conditions of the agreement. This opinion stems from a fact that the competent office, before registration, has to conduct control of the compliance with the mentioned conditions as the agreement can influence the freedom of competition. We are justifying our opinion with argument that in the absence of a business practice, franchising agreement can be a means of achieving a silent monopoly in the market of goods, services and capital. Only when the competent office establishes that all formal and material conditions are met, will the consent for the registration be given.

⁵⁴ Art. 1260. Paragraph 4. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

4.2.2. Sub-franchising

The provisions of the pre-draft also foresee the institution of the sub-franchise. Franchisee has the right „... to transfer to another person exclusive rights or part of them, acquired by the agreement, with the consent of the franchisor“.⁵⁵ Apart from the provision that gives an opportunity to a franchisee to transfer rights – to conclude an agreement with a sub-franchisee only with the consent of the franchisor, while the provisions also foresee an obligation of a franchisee to transfer rights to a particular person for a particular period of time.⁵⁶ Transfer of contractual rights by a franchisor to a third person can be determined as a right, while, on the other side, it can be a contractual obligation set by the franchisor. The provisions of the pre-draft do not foresee the legal fate of the sub-franchise agreement in case of termination of a franchising agreement. In some legal systems it is accepted that in case of termination of a franchising agreement, sub-franchise agreement is automatically terminated too,⁵⁷ while in other legal systems is foreseen that in case of termination of franchising agreement, a franchisor from a franchising agreement is given an opportunity to conclude a franchising agreement with the franchisee of the sub-franchise agreement, when a sub-franchise agreement becomes a franchise agreement.⁵⁸ In the second case, a complete three-party relation is established, although the franchisor and the franchisee from the sub-franchise agreement are not in direct legal relation.⁵⁹

⁵⁵ Art. 1261. Paragraph 1. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁵⁶ Art. 1261. Paragraph 2. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁵⁷ Formoreonthissee in Miljković, S., op.cit., 228.

⁵⁸ Ibid, 228.

⁵⁹ The possibility that the sub-franchisee enters into the legal status of the franchisee is important, on the one hand, to the franchisor, because it can be shown that the sub-franchisee operates economically justified, while, on the other hand, the sub-franchisee can still continue to operate in within the franchise network and thereby generate profit stepping into the legal status of a Franchisee.

4.1.3. Responsibility

The pre-draft foresees that the franchisor is responsible „... for the existence and the content of transferred rights and for the information given to a franchisee in order to fulfill the program of transferred rights“.⁶⁰ Establishing responsibility of the franchisor for the content of transferred rights and given information is important for business operations of the franchisee. Franchisee is in most cases economically inferior party (although not always the case), and the franchise agreement is formulary and adhesive, so establishing a responsibility of a franchisor is significant since the legal protection is provided to a franchisee. Business practice and court practice in economies with a developed franchising business show that the most frequent grounds for the terminations of agreement are error or fallacy of the franchisee, such as giving inaccurate and incomplete information and transferred rights. Based on the provisions of the pre-draft, it is foreseen that a franchisee has a right to give a statement on termination of agreement, or to reduce the indemnity owed to a franchisor, in proportion determined by an independent expert.⁶¹ In the case of a responsibility of a franchisor, there a possibility of choice to terminate the agreement or to continue business operation in the franchising system, with the obligation to pay reduced franchise indemnity (royalty). Based on the assessment of economical justification on further business operation, in case of being given inaccurate or incomplete information or transferred rights, a franchisee decides about the further destiny of the franchise agreement. Based on the provisions, franchisee has an optional dispositive right, i.e. the right to choose to terminate the agreement or to continue business operation with the reduced franchise royalty.

⁶⁰ Art. 1263. Paragraph 1. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁶¹ Art. 1263. Paragraph 2. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

4.3. Critical review

The legal regulation the franchise agreement it is incomplete in the Republic of Serbia, while the laws containing legal provisions which can be directly applied to a franchise agreement do not offer legal certainty to parties in the agreement. The franchisee, as economically inferior party in the agreement is particularly aware of this lack of legal certainty. The current applicable laws do not provide for instruments to protect a franchisee from eventual abuses that could be done by the franchisor. Restrictive clauses⁶² which are the essence of the franchise agreement⁶³ and the absence of a legal act by which certain restrictive clauses (meaning the restrictive clauses on the „black list“)⁶⁴ would be declared null and void, and which a franchisor may incorporate in the franchise agreement to aggravate the position of a franchisee are the major cause of this lack of protection.

Optional implementation is another aggravating circumstance that occurs, i.e. non-implementation of laws enacted by the European Commission – European Commission (EC). Regulation⁶⁵ and the EC Guidelines⁶⁶ are legally binding on member states. Though for countries that are not EU members these laws are not legally binding.

⁶² Art. 1265. Paragraph 1. of Pre-Draft of the Civil Code of the Republic of Serbia, 2009.

⁶³EC Regulation on Vertical Agreements, available at: <http://ec.europa.eu/competition/antitrust/legislation/vertical.html> (date of access: August 2014) and http://ec.europa.eu/competition/antitrust/legislation/guidelines_vertical_en.pdf (date of access: August 2014).

⁶⁴Commission Regulation (EC) No. 1475/95, available at: http://ec.europa.eu/competition/antitrust/legislation/1475an2_en.html (date of access: August 2014).

⁶⁵Guidelines on Vertical Restraints, OJ C130, 19. 05. 2010.

⁶⁶Commission Regulation (EC) No. 330/2010 of 20 April on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices, OJ No. L 102/, 23. 4. 2010.

In addition to the lack of development of legislation and poorly developed case law, it should be noted that the third and perhaps most important factor influencing the occurrence of abuses is a poorly developed business practice. Franchising business practices in the Republic of Serbia are under-developed or appear only in outlines, although at one time there were attempts to sign a franchise agreement (currently there are works on its promotion). Under-developed business practice initiates undeveloped business ethics, which participants would follow in franchising business. We believe that if developed business ethics prevailed in the capital market of the Republic of Serbia in the field of franchising business, there would be no need for legal regulation of franchising. This attitude is justified by the fact that in Germany the franchise agreement, i.e. business, which is based on this contract is highly developed,⁶⁷ and while legal regulations do not contain specific legal acts (whether in the form of laws, regulations, etc.), but the applicable provisions of other legislation and regulations in the EU are applied to the franchise agreement.

What might pose a dilemma in the legal codification of franchising in Serbia is whether a law should be passed to regulate: a) Contract and legal relations between the Parties or b) The substance of pre-contractual disclosure of information (disclosure law). Following the example of legislative acts of countries with developed franchising, we argue in favor of passing a law that would regulate the matter of pre-contractual disclosure directly (disclosure law).

One of the crucial reasons to adopt a law on disclosure of the pre-contractual information is the under-developed jurisprudence that is implied by a poorly developed business practices in the field of franchising business in the Republic of Serbia. The jurisprudence of countries with developed franchising has proven and indicated that in most cases, the termination of the

⁶⁷In 2012, in Germany, on the basis of franchising business operations, turnover in amount of 61.2 billion euro was achieved, and in approximately 72,700 independent franchises, nearly 546,000 people were employed. Predictions are that during 2015, the franchise industry will generate a turnover of around 70 billion euro. Available at: <http://www.gtai.de/GTAI/Navigation/EN/Invest/Industries/Consumer-industries/franchising.html>(date of access: August 2014).

agreement is a result of the misconception or error of the franchisee, as he or she was not informed in detail about the business of the franchisor. Information relevant to the decision to join the franchising network can include: 1) the size of the franchise network; 2) the conditions under which other franchisees operate; 3) what are the financial obligations of the other franchisees; 4) is a bankruptcy proceedings installed against the franchisor; 5) whether intellectual property rights are legally protected; 6) realized profit in a given period of time; 7) the expected profit, etc. referring to the fact of being mistaken, in the case of inability to be informed in details about the business of the franchisor, franchisee decides to terminate the agreement.

The basis for a termination of the contract on the franchisee side exists when unfavorable contract terms unlike other franchisees who are already operating within the franchise network are imposed over him or her which can greatly affect the franchise's market competitiveness. Foreign or domestic entities with the developed franchise network overseas may appear as a franchisor. A foreign franchisor is obliged to operate abroad in accordance with the regulations that regulate pre-contractual disclosure of information, and which prevents favoritism of one of the franchisee. When such a potential franchisor comes on the market of the R. Serbia, where the business of franchising is poorly developed, and therefore there is no legal framework, more difficult contract terms may be imposed upon a domestic franchisee and he or she provided with scant information about its business operations and franchising network, in contrast to other franchisees who operate within the franchising network and originate from the region where the franchising business, jurisprudence and legal framework (disclosure law) are developed.

We believe that the legislator, perhaps out of ignorance, and perhaps out of a desire to have franchising legally standardized, overlooks the fact that even countries with developed franchise operations have not standardized the content of franchise agreements. The question is whether to take the phrase to „*charta non erubescit*“ so it is necessary to legally standardize franchise agreements without detailed analysis, or whether such standardization has the purpose or should ever resort to legal pragmatism guided by the experience of countries with developed legal regulation of franchising and based on such experiences and in accordance with the circumstances existing in a particular market, to try legally standardize business of franchising, which is a novelty and largely unknown to the

business and legal system of the Republic of Serbia. We represent the position, and from the above, according to developed legislation and existing international regulations, however, that a special law on pre-contractual disclosure – disclosure law, shall be passed.

We also proposing that in the later stages of the development of franchise business practices and ethics, we can commence with the enactment of legislation to regulate franchising agreement in whole or part which would contain provisions on the regulation of legal relations within the agreement. For now, though, we believe that it would be more expedient, for the mentioned and justifiable reasons, a law that would regulate the matter pre-contractual disclosure shall be passed.

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