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THE ISSUE OF WHETHER THE PROVISION OF NON-COMPETITION CLAUSE IN THE AGREEMENT INFRINGES THE FRANCHISEE'S RIGHT OF COMPETITION

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Abstract

In the modern circumstances of market operations, regardless of the form of franchising, companies are subjects of contractual franchising. The obligation of the franchisee to apply the business concept of the franchising network, when running its own franchising unit, is one of the fundamental obligations. By limiting the business dispositive of the franchisee in such a way that it is obliged to use and apply the business method, the franchisor is responsible for its business success. The significance of the paper is that it indicates that the franchisee's business is successful: a) if it fully implements the business concept (business method) of the franchisor, otherwise such business is doomed and b) if the franchisor provides it with relevant information about the expected profit. Deviation from the sales forecast estimated by the franchisor in the submitted pre-contractual information (disclosure information) and the real profit that the franchisee achieves after starting an independent franchise business is the basis for unilateral termination of the contract.

Keywords: franchisor, franchisee, franchise agreement, non-competition clause, franchise, pre-contractual information

1. Introduction Notes

Contemporary market movements and the need of capital to conquer new markets through minimum investments undoubtedly affect to a significant extent the development of contemporary autonomous business operations of commercial law. One of a series of business operations that are the product of movements in the market of goods and capital is a franchising and, consequently, the agreement as an instrument of implementation thereof.

Franchising as a method of contractual investment business is a distribution technique that integrates the distribution system by the agreement instead of the ownership chain managed from one center (Emerson, 1990, p. 1508). With a franchise agreement, one contracting party (franchisor) assigns to the other contracting party, the franchisee, for a certain period of time and in a certain territory, the right to operate under its company name using a franchise package[1] with the obligation to

[1] The package of rights includes: the right to use the franchisor's trademark for a product or service, know-how, business and technological methods, procedural system and other rights to production and

train and provide administrative and marketing services. The franchisee undertakes to use in the business of its franchising unit the assigned franchise package and pay a corresponding franchise fee. Franchising as a specific investment method of contractual business can be most simply characterized as a method of selling goods and services in the target market. The basic characteristic of franchising business, regardless of the form of franchise agreement, is that it must be based on business that has proven successful in practice. Successful franchising is a business that is recognizable by potential consumers of products or users of services as a business that is characterized by developed image and brand. The expansion of franchising business is influenced by: a) the need of successful business operations to grow and b) the ability to achieve such growth by connecting with others who own capital and labor force (Mendelsohn, 2004, p. 1). It should be noted that the production and distribution of goods, and also rendering or providing services at all levels in modern business and commercial operations are largely secured by franchising transactions.[2]

The franchising business concept, and thus the franchising agreement, has gone through the following phases in evolutionary development: a) traditional and b) integral concept (Jović, 1990, p. 4). The traditional concept of franchising business is characterized by the assignment of the right to sell products with the right to use the trade name. Business format franchising as the most representative form of the integral concept of franchising business, is based on the current business cooperation of the franchisor and franchisee, which in addition to services, products, trademark, refers to the entire business, marketing strategies and plans, intellectual property rights, business control, know-how, goodwill and business methods. In addition to business cooperation, continuous personal communication of the contracting parties is another feature of the integral concept of franchising business. (Blair & Lafontaine, 2005, p. 7). The quality of established business and personal relationships significantly affects the functioning and operation of the franchising network and the franchising unit.

intellectual property –"…trade name, and/or trade mark and/or service mark, know-how, business and technical methods, procedural system, and other industrial and/or intellectual property rights…" art. 1. European Code of Ethics for Franchising (2022, May 05). Retrieved from https://eff-franchise.com/code-of-ethics/

[2] In 2020, there were 753,770 franchise establishments in the United States. In 2020, the economic output of franchise establishments in the United States was about 670 billion U.S. dollars. Contributing to the economic output of franchise establishments in the United States, were about 7.49 million people who worked for a franchise business. (2022, May 17). Retrieved from https://www.statista.com/statistics/190313/estimated-number-of-us-franchise-establishments-since-2007/; According to the records of the Fédération Française de la Franchise (FFF), in 2021 year, the number of franchise networks was 1,965, with turnover of EUR 68,8 billion. (2022, May 17). Retrieved from https://www.franchise-fff.com/franchise/les-chiffres-cles; Sales generated by the German franchising industry. In the second year of the crisis, the current franchise statistics indicate that the franchising economy is developing in a stable manner. 920 franchise systems across the country contained 141,821 franchise partners, 2.2% more than the year before. In total, around 787,207 employees work at these 180,984 (+ 2.7%) franchise operations. These numbers suggest that the foundations of the economy are stable. And the total revenues for franchises across Germany also indicate this: they have improved in the second year of the crisis, with a slight uptick to 135.8 billion euros. (2022, May 17). Retrieved from https://en.franchiseverband.com/german-market

The franchising provides the franchisor with the opportunity to expand its business in the target market with minimal investment and minimal investment risks, and provides the franchisee with access to a developed franchise network. By joining the franchising network, the franchisee uses all the benefits and advantages of the developed, proven in practice system of business of the franchisor (Miljković, 2018, p. 43-55). Successful franchising business is characterized by a developed image and brand, but it is also necessary that it be recognized as such by potential consumers of products or services. Although it joins a developed business system, investment risks for the franchisee are not excluded, they still exist, but the degree of their presence is much lower than when developing their own business. The use of a successful business method, reduced investment risks and business independence[3] are essential reasons for a potential franchisee to join a franchising network.

2. Franchising agreement and Competition law

To gain better understanding of the effects of the implementation of the franchise agreement as a vertical agreement, special attention should be paid to the general principles of competition law at the EU level and whether the provision of non-competition clause in the franchise agreement restricts franchisee's competition.

2.1. EU Competition Law

Competition, and thus the rights that derive therefrom, is one of the basic drivers of economic development. The main goal of competition is to provide greater efficacy in business while enabling greater social justice and fairness. These goals can be achieved by providing and creating conditions for fair and free market competition between legally and economically independent economic entities. Only then and in such market circumstances can we talk about the existence of healthy competition (Brodley, 1987, p. 79-80). Healthy competition can exist only within the ethics of market behavior with the stability of market institutions and with the existence of appropriate legal acts that prevent the creation of monopolies (Mlikotin–Tomić, Horak, Šoljan & Pecotić-Caufman, 2006, p. 61-62).

2.1.1. Basic principles of competition law in the European Union

In order to provide more favorable conditions for the operation of independent economic entities and create better and fair conditions on the market for healthy competition, the European Union (EU) has established competition law (free trade) in Article 28[4] and Article 29[5] of the Treaty of Rome (*Treaty establishing the European*

[3] Although the franchisee is *de facto* subordinate to the franchisor, it enjoys legal independence (acts in its own name and for its own account) in relations with third parties acts independently and is responsible as an independent legal entity.

[4] Quantitative restrictions on imports and all measures having equivalent effect, notwithstanding the following provisions, shall be prohibited among Member States.

[5] Quantitative restrictions on exports and all measures having equivalent effect shall be prohibited among Member States.

Economic Community (EEC) on 25 March 1957), and later by the provisions of the Lisbon Treaty.[6] The rules of conduct for market participants are regulated in more detail by Articles 101[7] and 102 of the Lisbon Treaty. Article 101 prohibits contracts – agreements aimed at or with the effects of restricting competition, and such an agreement is annulled *ab initio*. In order for the prohibition referred to in Article 101 (1) to apply, there must be some form of agreed practice between undertakings[8] which restricts competition or has the intention and possibility of restricting competition and which may affect trade between Member States (Mlikotin–Tomić, Horak, Šoljan & Pecotić-Caufman, 2006, p. 61-64). Prohibitions of restrictions of competition stipulated by the provisions of Article 101. (1) are of a relative nature, reflected in the fact that the European Commission in each case analyzes each contract - agreement, practices and decisions, while assessing the degree of limitation of the *de minimis* rule.[9]

[6] Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, signed at Lisbon, 13 December 2007, *OJ 2007/C 306/1*. (2022, May 20). Retrieved from https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2007:306:FULL:EN:PDF

[7] Art. 101 (1) All agreements between undertakings, decisions by associations of undertakings and agreed practices which may affect trade between Member States aimed at or with effect of the prevention, restriction or distortion of competition within the common market, shall be prohibited as incompatible with the common market, and in particular those which: (a) directly or indirectly determine purchase or selling prices or any other trading conditions; (b) restrict or control production, markets, technical development or investment; (c) share markets or sources of supply; (d) apply different terms of business to equivalent transactions with different trading parties, thereby placing them in a different competitive position; (e) enter into contracts with an obligation on the other party to enter into additional obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

[8] In case of *Imperial Chemical Industries Ltd. v Commission of the European Communities*, Case 48-69, ECLI identifier: ECLI:EU:C:1972:70 – the concerted action is a form of coordination between the undertakings where, although no agreement has been reached in the legal-formal sense that was concluded knowingly, it restricts competition. (2022, May 21). Retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A61969CJ0048; In case of *Coöperatieve Vereniging "Suiker Unie" UA and others v Commission of the European Communities*., Joined cases 40 to 48, 50, 54 to 56, 111, 113 and 114-73, European Court Reports 1975 -01663, ECLI identifier: ECLI:EU:C:1975:174 – the court gave a closer interpretation of the term coordination and cooperation 'implying the relationship of the undertaking which does not mean the development of a joint plan of action, but that each economic entity must independently determine its business policy, and therefore there should be no direct or indirect contact between such economic operators, the aim of which is to influence the behavior of current or future competitors or to reveal to those competitors the manner of conduct which they have accepted or intend to accept in the market. (2022, May 21). Retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:61973CJ0040&from=EN

[9] The European Commission has passed "Notice on Agreements of Minor Importance" – 1986 *OJ C 231/2,* later replaced with a new notice *OJ C 372, 9. 12. 1997*, and the applicable notice is *OJ C 368, 22. 12. 2001.* p. 13-15. (2022, May 23). Retrieved from https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52001XC1222(03)

2.1.2. Significance of Article 81 of the Treaty of Rome and the case *Pronuptio de Paris*

At the time of the adoption of the Treaty of Rome, the question arose as to whether the franchise agreement, which is a vertical agreement and given the fact that it contains a set of restrictive clauses (exclusive purchases, exclusive territories, non-competition, etc.), violates competition law. The ruling of the Court of Justice of the European Union, in the case of *Pronuptio de Paris,*[10] makes a significant step forward in terms of answering this question by providing a starting point for regulating franchising.[11]

With the ruling in the case *Pronuptio de Paris,*[12] the European Court of Justice made a significant step forward in answering this question. Based on the ruling, it is concluded that the court takes the position that most of the vertical restrictive restrictions contained in the franchise agreement, which make it a *sui generis* agreement: a) should not fall under Article 81 (1) of the Treaty of Rome and b) there are no grounds for restriction of competition, but there is the possibility of a new competitor entering the market. By this ruling, the European Commission took the view that the franchise agreement was exempt from the prohibition of Article 81 (1)(2), (now Article 101 (1)(2) of the Lisbon Treaty), and because certain clauses[13] contained in the agreement are necessary to preserve the identity and reputation of the business system, as well as to prevent know-how and assistance provided to

[10] Judgment of the Court of 28 January 1986, *Pronuptia de Paris GmbH v Pronuptia de Paris Irmgard Schillgallis*, Reference for a preliminary ruling: Bundesgerichtshof – Germany, Competition - Franchise agreements, Case 161/84, *European Court Reports 1986-00353*, ECLI identifier: ECLI:EU:C:1986:41 (2022, May 24). Retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A61984CJ0161

[11] The ruling of the Court of Justice of the European Union in the case of *Pronuptio de Paris* is the basis for the adoption of the Exemption Block. The purpose of the Block Exemption is to specify which restrictions must not be in the agreement, which may, as well as which conditions must be met. The full effect of the Exemption Block is achieved when a certain agreement (vertical agreement) can be subsumed under a category covered by a certain Exemption Block, provided that the agreement must be drawn up in accordance with the instructions contained in the exemption. Only then does the exemption apply ex regulation, i.e. no notification is required to the Commission approving such an agreement.

[12] The Court rules that "... (1) the compatibility of distribution franchise agreements with Article 85 (1) - now Article 81 (1) depends on the clauses of such agreements and their economic character; (2) the provisions that are crucial to prevent the transferred know-how and assistance provided by the franchisor from benefiting competition do not constitute a restriction of competition under Article 85 (1) - now Article 81 (1); (3) the provisions determining the level of control necessary to preserve the identity and reputation of a distribution network symbolized by a brand name do not constitute a restriction of competition under Article 85 (1) - now Article 81 (1); (4) the provisions resulting from the division of the market between the franchisor and the franchisee, or among the franchisees, constitute a restriction of competition under Article 85 (1) - now Article 81 (1); (5) the fact that the franchisor makes price recommendations to the franchisee does not constitute a restriction of competition as long as there is no agreed practice between the franchisor and the franchisee, or among the franchisees, for the actual application of those prices."– *Pronuptia de Paris GmbH v Pronuptia de Paris Irmgard Schillgalis,* Case 161/84 (1986) ECR 353, (1986) 1CMLR 414, ECJ.

[13] The European Commission accepts that non-competition clause is allowed to protect know-how.

the franchisee from falling into the hands of competitors (Parivodić, 2003, p. 205). After the ruling in the case of *Pronuptia de Paris* and the decision of the European Commission in the cases of *Service Master*[14] and *Charles Jourdan,*[15] the position on the status of franchise agreements in the field of competition law became clearer, i.e. these cases can serve as an example for deciding whether the conditions of Article 81 of the Treaty of Rome, i.e. now Article 101 of the Lisbon Treaty are met.

3. Non-competition obligation

Joining a franchising agreement, i.e. the entry of the franchisee into the business system of the franchisor is regulated by the introduction of certain restrictive clauses. Restrictive clauses that are included in the agreement, primarily refer to the restriction of the freedom of the franchisee within the business system. One of the restrictions on the rights of the franchisee is manifested by the introduction of a non-competition clause. By introduction of the non-competition clause, the franchisee is restricted from conducting competitive business during the term and after the termination of the franchise agreement (Mendelsohn, 2004, p. 218). Provision of a non-competition clause prevents the franchisee from entering into business.

[14] See Decision 88/604 (EEC) 1988 OJ L332 (1989) 4 CMLR 58188/604/EEC: Commission Decision of 14 November 1988 relating to a proceeding under Article 85 of the EEC Treaty (IV/32.358 – ServiceMaster) *OJ L 332,* 3.12.1988*,* 38–42. (2022, May 24). Retrieved from https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A31988D0604

[15] See Decision 89/94/EEC: Commission Decision of 2 December 1988 relating to a proceeding under Article 85 of the EEC Treaty (IV/31.697, Charles Jourdan) *OJ L 35,* 7.2.1989, 31–39. *Charles Jourdan* is engaged in the production and distribution of footwear, leather goods and handbags. However, its main activity is the production and sale of footwear, especially in the range of medium and high quality. Its share in the French market is one percent, while in the EU market it is negligible. On the other hand, if medium and high quality footwear is taken into account as a relevant market, its share is 10% of the French market and 2% of the EU market. The distribution of goods is done in four ways, through: branches, franchise shops, franchise stalls in department stores and in traditional retail stores. These two types of franchising are based on an agreement that contains the following clauses: (a) limiting staff and transfers; (b) exclusive territory granted by granting the franchisees the exclusive right to use the relevant trademark within the defined territory, and requiring the franchisee to operate exclusively on approved business premises; (c) providing management and know-how assistance; (g) an intellectual property license subject to *Charles Jourdan's* exclusive right to determine its use; (d) the right of inspection by the franchisor; (e) advances and further fees; (f) obligations of the franchisee not to trade in competing products; and (g) recommended prices. Franchisees were free to purchase goods directly, then from a group branch, from another member of the group, either from the franchisee or from a retail store. This freedom has been extended to customers of distribution stores in other Member States. The Commission has taken the view that the combined impact of such provisions of the franchise agreement will improve product distribution. The pressure on competition within the sector and the freedom of customers to buy products in any store within the franchising network forces franchisees to pass on to customers a solid part of the benefits derived from streamlined distribution. The franchisees were in competition with each other because they were allowed to sell goods to any customer inside or outside their assigned territory and were free to set their own selling price. The Commission decided that all the conditions for the application of Article 81 (3) were met and therefore the Commission granted an individual exemption. (2022, May 25). Retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A31989D0094

3.1. Justification for provision of non-competition clause

3.1.1. Interest of the franchisor and the franchising network

The franchisor resorts to negotiating a non-competition clause[16] whenever it needs to protect its legitimate business interests. By providing for a non-competition clause in the franchise agreement, the franchisor secures itself or another potential franchisee from possible competition of the current or former franchisee.

The obligation of non-competition refers to the restriction of the use and publication of certain information. It is in the franchisor's interest to restrict the franchisee's use of confidential information because it is information that the franchisor has developed independently and that is at the core of the franchising business. With the non-competition clause, the franchisor protects the know-how, goodwill and confidential information that it has made available to the franchisee at the time of joining the agreement.

In addition to the reasons related to protection of business interests and protection of the information provided, one of the reasons why the non-competition clause can also be considered justified is the relationship that exists between the franchisor and the franchisee. One of the basic characteristics of a franchising agreement is that it is an *intuitu personae* agreement, and that a specific relationship is established between the franchisor and the franchisee, based on the principle of conflicting business interests. Behavior of the franchisee, i.e. how it sees itself in this contractual relationship and its relationship with the franchisor affects the implementation of the agreement. From the point of view of the franchisee, the introduction of the non-competition clause represents a restriction of business freedom and trade, which is contrary to the basic principle of free trade. Agreements aimed at or the effects they produce have the effect of restricting competition, such agreements are automatically void, i.e. the agreement is annulled *ab initio* (Adams, Hickey, & Jones, 2006, p. 59). However, although it is right that the non-competition clause restricts its freedom of business, and therefore, no matter how much it thinks it has succeeded in business on its own, the franchisee should be aware of the circumstances that it would have failed without the help of the franchisor that at the moment of joining the agreement - franchising network assigned to it all the rights that make up the content of the franchise package, which allowed it easier market positioning. Regardless of whether the franchisee has certain experience in business and thus contributes to the development of business, it is necessary to emphasize that the interest of the franchising network is always above individual interests. It is the existence of the franchisor's interest and the collective interest that is reflected through the business of the franchising network, and regardless of the requirements and objections of the former franchisee, that makes the non-competition clause permissible and justified. The admissibility of the non-competition clause is also contained in the judgment of

[16] The non-competition clause has a wide range of applications and can be applied to all existing agreements in the field of trade.

the Court of Justice of the European Community of 28 January 1986, which explicitly provides for the validity of contracting such clauses. (Bessis, 103-115).

3.2. Non-competition clause and standard of reasonableness

Although the non-competition clause has its justification in business and court practice, it must meet a certain condition in order to be provided for in the agreement, i.e. it must meet the "condition of reasonableness". A non-competition clause is reasonable only if "...a restriction prohibiting a person from trading either with certain customers or certain products, or within certain areas or otherwise, will be considered inapplicable under a trade restriction, unless the person seeking this provision to be used may prove that the restriction is reasonable. This requires evidence that the provision is reasonable in terms of the interests of the persons involved as well as the public interest". (Mendelsohn, 2004, p. 325).

The contractual provision of the non-competition clause prevents the franchisee from "...engaging in business similar to the franchisor's or which represents competition to the franchisor within a certain area of business during a certain period". (Mendelsohn, 2004, p. 219). From the above definition of the non-competition clause, it is concluded that it refers to three elements of the restriction of trade of the franchisee, specifically: 1) performing a certain activity; 2) in a certain area (geographical area) and 3) for a certain period.

The restriction stipulated by the introduction of a non-competition clause in the first part primarily refers to the "activity" of the franchisee. The clause specifies the activities that the franchisee cannot perform during the term and after the termination of the agreement (primarily the activity(s) that the franchisee performs while running an independent franchise unit). The agreement specifies in detail and precisely the sector of activities that the franchisee cannot perform, provided that the restriction does not have to apply to all potential activities of the franchisee (Bessis, 91).

The second element that must be precisely determined by the agreement is the "geographical element", i.e. the geographical area. The term geographical area is considered to be the area in which the franchisee has the right to perform the activity on the basis of the franchise agreement. Determining the geographical area is also important for the termination of the agreement, because the franchisor does not want to independently or through a new franchisee operate in the area where the former franchisee continues to operate. In the case of *Kall Kwik Printing Ltd v Bell* (1994) FSR 674, a geographical restriction in the form of a circle 700 meters in diameter from the press center previously run by the defendant was considered reasonable at first. Also in the case of *Kall Kwik Printing (U.K.) Ltd v Frank Clarence Rush*, the limit was 10 miles within the company in Southend, which was also considered reasonable. In the latter case, most of the areas within the diameter, as well as outside and around Southend, were rural, when drafting a district provision, it should be so narrow that it does not exceed what is necessary to protect goodwill business (Mendelsohn, 2009,

p. 193-194). When determining the geographical area, the franchisor may determine the area that is larger than the area provided by the agreement (in which the franchisee operates), provided that such a specific geographical area is considered justified if reasonable. It is not possible to talk about a single metric system that would be taken into account when determining the geographical area. It should be noted that factors such as: 1) type of franchising; 2) the size of the target market and 3) the interest of the franchisor, affect the determination of the size of the geographical area, i.e. business practice solves this *ad hoc* on a case-by-case basis.

Finally, the third element that is at the same time the most important is "temporal", i.e. the period in which the franchisee must not have information obtained while running an independent franchising unit. Although the franchisor restricts the activities of the former franchisee in a certain territory, the clause must meet the third condition, which is that these restrictions must have the term. A non-competition clause regarding the duration of the restriction is considered reasonable only if that term is not longer than the period within which it is necessary to protect the legitimate interests of the franchisor (Mendelsohn, 2004, p. 328). Although there is no single time period within which the franchisee is not entitled to have information, business practice has tacitly taken the view that the time limit ranges from a few months to several years from the termination of the franchise agreement. In the case of *Office Overload v Gunn (1977) FSR 39*, the provision is prescribed for one year by a decision from the temporary judicial assistance. In the case of *Prontaprint plc v Landon Litho* the period was three years from the date of termination. In the mentioned case, *Kall Kwik Printing (U.K.) Ltd v Bell*, a period of 18 months was determined after the termination, i.e. seeking temporary judicial assistance, bearing in mind the fact that there was goodwill in the possession of the plaintiff and requested by the plaintiff for the continuing conduct of business (Mendelsohn, 2009, p. 183-192).

In addition to the cumulative fulfillment of the previous three elements in order for the non-competition clause to be considered reasonable, the clause often restricts (prohibits) the former franchisee's right to contact and do business with former clients (customers, users) after termination of the agreement. However, although the franchisee is prohibited from making contact and thus from doing business with former clients, the question arises as to whether this prohibition applies to contacts made during the entire business period or only to those contacts made during a certain period of business. We consider it justified that the ban of the franchisor can only apply to those clients, i.e. contacts made by the franchisee within a certain period of time before the termination of the agreement (from several months to several years). Given the type of franchising business, economic importance and size of the target market, the franchisor *ad hoc* determines the time period of limitation of this right.

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