



Public consultation on the draft revised Regulation on vertical agreements and vertical guidelines

Contribution from the European Franchise Federation

The European Franchise Federation (EFF) represents 17 national franchise associations, serving the interests of both franchisors and franchisees across Europe. The EFF is the voice of the many thousands of small businesses that use franchising as a strategy to grow a brand, providing opportunities for entrepreneurs and workers to find their place in the labour market. Membership of the association is dependent on adherence to the EFF Code of Ethics¹ which sets out core principles for operating franchise concepts in a transparent and fair manner.

Our contribution to the European Commission's consultation on the draft Regulation and draft Guidelines was developed in cooperation with the EuroFranchise Lawyers, a grouping of the leading franchise lawyers in Europe.

Key Messages

- The new draft distribution rules have the potential to significantly undermine the necessary exchange of information between franchisors and franchisees in a single network. Further clarification on vertical information exchange is needed to ensure that SMEs are not required to carry out onerous and complicated market share analyses.
- The protection of know-how for the entire duration of a franchise agreement is to be welcomed. However, the current VBER draft text and/or the Vertical Guidelines could be improved further by aligning the definition of the criteria of secrecy of know-how with the Directive on Trade Secrets.
- The industry welcomes the recognition in the Vertical Guidelines that franchising is a separate distribution system with its own dynamics, requiring its own rules.

1. Dual distribution

Currently, all vertical restraints in a franchise agreement are block exempted unless the parties exceed 30% market share and no hardcore restrictions are in place. Purchase and non-compete obligations must fulfill the criteria laid down in Article 5. These rules also apply to dual distribution where the franchisor sells directly to the customer either online or via outlets, as well as through a distribution network, such as its franchise system. In principle, the situation remains the same under the new draft VBER. All vertical restraints in a franchise agreement remain under the scope of the block exemption provided they meet the requirements on market share levels and hardcore restrictions.

¹ <https://eff-franchise.com/code-of-ethics/>



However, there is one exception with regard to vertical information exchange between supplier and retailer (or franchisor and franchisee) in a dual distribution scenario. That vertical information exchange shall only be exempted if the parties aggregate retail market share does not exceed 10% or more and provided there is no hardcore restriction. It seems that in a franchise scenario the local retail market (franchisee vs end customer) needs to be considered. There is no clarity how retail market shares have to be calculated, be it at national, regional or local level. It seems that in a franchise scenario the local retail market (franchisee v end customer) may have to be considered. It is difficult to establish the franchisee's market share in local markets.

Data on local markets are often not available. Local market shares also depend on the development of the local market. If a competitor is eliminated, the market share quickly increases significantly. There may be cases where the franchisee operates on a local market without any competitors, so that an exemption would be unlikely. This would lead to the result within a franchise system that some franchise contracts would be exempted and some not.

This change creates legal uncertainty with the potential to significantly undermine the daily operation of a franchise system. As the examples contained later in this document outline, both dual distribution and vertical information exchange are common in franchising. Based on our membership's profile, we estimate that more than 60% of franchisors in Europe run their own outlets, vehicles, online shops as well as using a franchise network made up of individual franchisees.

Under the current VBER draft text, the possibility is that hundreds of franchise concepts will be obliged to carry out complicated market share analyses to determine whether or not they are caught by the 10% threshold. This is a cost that someone will have to pay, initially the franchisor but eventually, it will be redistributed to franchisees and then onto the final consumer.

The EFF does not believe this approach is in line with the Commission's objective to simplify the regulatory environment. There is no proven need for this restriction to apply to franchising and the possible gain, if any, in terms of enhanced competition does not equate to the cost and disruption for SMEs.

Information exchange within a franchise network

Continual exchange of information is an essential requirement for a franchisor to run its own corporate outlets, online shops as well as franchise network. Franchisees need to report on a regular basis about local market conditions and about their financial performance. In some cases, franchisees may be required to provide real time remote access to information about market conditions and detailed financial information concerning turnover, margins and growth.

Sharing know-how within a network is not a one-off process. Business format franchising relies on a franchisor providing the franchisee with a brand, products and services, as well as an entire system for running a business. To work correctly, the franchise system is dependent on constant communication and feedback between franchisor and franchisee.



Information exchange is a vice-versa process of a fundamental nature for the entire sector, and the Vertical Guidelines recognizes the importance of safeguarding the transfer of know-how, for instance, via non-compete obligations throughout the duration of an agreement (Vertical Guidelines, paragraph 300). Furthermore, paragraph 149 states *“the franchisor usually provides the franchisee during the lifetime of the agreement with commercial or technical assistance. The licence and the assistance are integral components of the business method being franchised”*.

The franchisor must have the experience and knowledge to pass on to franchisees not only at the beginning of the franchise, but on a continuing basis and, generally, the only way franchisors can have that knowledge is to have their own business operating in the same sector. Simply put, franchisors cannot advise franchisees about what they are doing wrong without knowledge about the franchisee’s business. Franchising is about a consistent approach so that consumers will obtain the same quality of product/goods at any franchised outlet.

A continuous exchange of information between franchisor and franchisee is such an important feature of the system across EU Member States that it was also recognised in the Draft Common Frame of Reference (DCFR)².

Proposal from the EFF

In order to maintain the Commission’s current approach to vertical information exchange, while providing legal certainty for SMEs, the EFF would suggest further clarification in the Vertical Guidelines could specify that in a franchise network, vertical information exchange is an essential core element and therefore not a restriction of competition as set out in the ECJ Judgement on Pronuptia³. Franchising is a particular situation where vertical information exchange does not pose any competition concerns.

We suggest a clarifying paragraph within the VGL as follows (*in paragraphs 83ss or 149ss*):

“As stated in paragraph 149, during the lifetime of the franchise agreement the franchisor usually provides the franchisee with commercial or technical assistance which is an integral component of the business method in a franchise scenario. An information exchange between franchisor and franchisee is therefore usually necessary to ensure the uniform appearance of the franchise system, the protection and provision of know-how and the further development of the system and thereby enhances interbrand competition. In a franchise scenario a vertical information exchange, even in a dual distribution scenario, does not usually fall inside Art 101(1).”

Alternatively, privileged treatment of small and medium-sized enterprises (SMEs) and start up franchise systems and franchise systems in local markets should be provided for. Or, in franchise systems the VBER could only rely on the franchisor’s market share to be below 30%, leaving the franchisee’s market share outside the picture.

² Study Group on a European Civil Code, *Principles, Definitions and Model Rules of European Private Law* Draft Common Frame of Reference (DCFR), Sellier, 2009, pp. 357 ff.

³ Judgment of the Court of 28 January 1986. - Pronuptia de Paris GmbH v Pronuptia de Paris Irmgard Schillgallis



2. Know-How

The EFF would also suggest greater clarity on the issue of know-how could be achieved by aligning the existing definition of the criteria of secrecy set out in Article 2 (1) (a) of EU Directive 2016/943 on the protection of undisclosed know-how and business information (trade secrets) with new the VBER text.

The 2016 Directive provides the following definition:

- (1) *'trade secret' means information which meets all of the following requirements:*
- (a) *it is secret in the sense that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons within the circles that normally deal with the kind of information in question;*
 - (b) *it has commercial value because it is secret;*
 - (c) *it has been subject to reasonable steps under the circumstances, by the person lawfully in control of the information, to keep it secret;*

This definition of the criteria of secrecy set out in Article 2 (1) (a) is extremely important as it recognises that the individual elements may well be publicly available but what is crucial, is that the manner in which they are combined is secret. As a result, the combination of known elements is covered by Directive 2016/943.

The EFF would suggest that a further clarification of this point in the new VBER text and/or the Vertical Guidelines would give reassurance to franchisors who seek to share know how within the franchise system.

3. Non-compete clauses

While the EFF welcomes recognition that the transfer of substantial know-how justifies a non-compete obligation for the whole duration of the supply agreement, further clarification around post term non-compete contracts could also clarify that it extends to the exclusive territory granted by a franchisor.

This is particularly important for services-based franchises which are usually provided from vans or vehicles and not entitled to any post termination non-compete clauses.

4. Resale Price Maintenance

The setting of fixed and minimum prices is prohibited under the VBER, however, maximum price commitments and price recommendations are permitted, provided these do not actually have the same effect as fixed or minimum sales prices. The Vertical Guidelines provide exemptions for the introduction of a new product and price promotions over a short period (2 to 6 weeks).

The EFF believes that further flexibility for RPM for franchise systems would benefit consumers as this would allow brands more opportunity to position themselves in the market in terms of price and quality. It would also be more equitable and balance the disproportionate effort of carrying out advertising promotions in franchise systems with independent franchise companies compared to branch systems.



Franchise systems that position themselves as high quality / luxurious should be protected from freeriding by franchisees focusing on internet sales and offering products at a reduced price on the internet, thereby taking sales away from other franchisees who are concentrating on the bricks and mortar retailing of products.



Annex

Examples to demonstrate information sharing within a dual distribution framework

In order to highlight how vital vertical information exchange is within a franchise system, and the type and frequency of information shared between businesses, the following section details real life examples from within our association's membership.

Example 1: Food Retail – National retailer with 900 stores with 260+ franchisee outlets (Netherlands)

Reporting systems

Real time monitoring of point of sale information in franchisee outlets allows for the tracking of turnover, gross profit margins, losses and stock differences on a daily basis. Using digitized systems, the franchisor can support franchisees in the sales and purchasing process, inventory management and in managing future orders. This allows franchisees to focus on operating their stores in accordance with the franchise formula and delivering value for their customers. That franchisees could focus on operating their stores, allows them for example to dedicate more time to improve customer service.

The franchisee benefits greatly from new stock being replenished rapidly, precisely and on time. This can take place as often as twice a day. As a result, turnover is maximized without high inventory costs and with minimal waste. In addition, it is important to guarantee that the customer experience is the same in all stores of the franchise formula. This guarantees the uniformity of the formula. Rapid replenishment is beneficial to customers as it guarantees product availability in store.

Franchisees are not required to provide information about the market and competitive situations. The franchisor does not have any insights into the franchisees' net profit and has no oversight of costs such as personnel or rent.

Information sharing

Franchisees have their own turnover and gross profit margin data, alongside stock differences on a daily basis and turnover reports on a weekly basis. The franchisor shares anonymized turnover data prior to concluding a franchise agreement for a new store and issues a Location Survey Report with an overall forecast. In it, upper and lower limits of total revenue potential on the basis of comparable projects are highlighted.

A lot of information is shared with franchisees, this takes place on a one to one basis between franchisee and a centrally based account manager. There are also franchisee committee sessions for various topics to improve the formula. New components for the formula or formula changes, business cases and pilots are discussed to gather all input to ultimately come up with the best proposition for the formula and for the customer.



Example 2: Pharmacy chain with 151 corporate owned outlets and 41 franchised outlets plus centralized e-commerce run by the franchisor with deliveries directly to customers (Sweden).

Reporting system

Common financial business system where franchisor has full insight into the franchisees' sales and earnings report. The franchisees are bound to join a specific accounting firm that is also integrated into the franchisor's financial business system, from which it has full insight into the franchisees' results report in real time. The franchisees in turn have access to the same system where they can follow up sales for their own units. The franchisees therefore do not need to report anything back to the centre, as full transparency already exists.

Managing information exchange

Feedback from sales and earnings guides the level of service fee to be invoiced from the franchisor to the franchisee. It also allows the franchisor to support franchisees by being a type of control function. There are many examples where the franchisor has received a red flag from the business environment, which the franchisee has not observed, allowing proactive support to mitigate any potential problems. These insights help ensure the right product mix, and any extra bonuses payable to franchisees from external suppliers.

The franchisor must monitor the franchisees' financial situation to ensure it does not jeopardize the company's equity ratio.

Franchisees are provided with data on how the chain is doing as a whole and compare how their region compares with others. Regular meetings are held to inform the entire network, going through the chain's status in the market, sales, market shares or presenting new ideas to implement and get feedback from the network.

Example 3: Coffee shop chain – 150 outlets (Sweden and eight other European markets, both corporate owned and franchised)

Reporting system

Every franchisee has the same point of sale system which delivers individual financial reports on a daily basis. Franchisees are able to provide data on sales, products and the financial status of their business on an opt-in basis. This assists franchisees in comparing sales and profitability and to determine best practice within the system. Data is crucial to follow franchisees' development and help to increase sales or measure different marketing activities. The purpose is to help franchisees to compare with their fellow franchisees and see where they can improve. It is also important for the franchisees to see the overall development of the system.



Example 4: Food and beverage – 200+ outlets (Belgium)

Reporting system

Cash register systems are connected centrally to manage data collection with the agreement of franchisees. This data allows the franchisor to analyze performance and set up dashboards for reporting back to franchisees. Accounting data is also subject to reporting in the form of a modeled dashboard for franchisees to complete. This ensures the network is able to optimize performance and benchmarking. Reporting takes place over weekly, monthly and quarterly frequencies.

Legal obligations

The end goal is to continuously assess the performance of the concept and the overall health of the network. The franchisor's contractual obligation is to assist franchisees on an ongoing basis be it a technical or in a commercial sense. Indeed, failing to exchange information would mean the franchisor is in contravention of the contract signed with its franchisees, and would be open to legal proceedings.

Information exchange

Franchise committees are organized by the franchisor on a periodic basis for the presentation of commercial reporting tables and network performance. Advisory committees are organized to share reflections on the necessary changes in assortment, product quality, communication actions and management methods. In reporting to the network (Committees, Advisory Committees etc.), commercial and accounting data are aggregated and anonymized. Plenary meetings are also organized using working groups to examine certain expertise and opportunities for the development of the concept and / or technological innovations.

Example 5 – Food and beverage restaurant – 300+ outlets (Spain)

Information exchange

Supply Chain: there is an information exchange across a whole range of activities: purchasing, planning, inventory management, the development of future products, including promotional products and marketing campaigns. Specifically, access to information on daily sales help the franchisor ensure the right amount of product and raw materials in restaurants, matching supply to demand whilst guaranteeing product safety and quality. All of these factors directly benefit consumers, allowing them to choose between a wide range of products at a low price.

Store level data: lack of access to store level data would significantly impact franchisees' ability to make sound data driven decisions and understand the implications of developments within stores due to their inability to gather and analyze the sort of data that franchisor can collect today. Without this exchange of information, this would ultimately negatively impact the customer experience and generate an increase in product costs. Development of new products, menu change and innovation: information exchange helps market research devise the right product portfolio mix with the goal of creating a



standardized approach that generates a better customer experience and overall product quality. The franchise agreement obliges the franchisor to provide assistance to franchisees (in accordance with Royal Decree 210/2010) and adapt / develop the franchise.

Customer feedback: centrally managed customer feedback and information exchange with franchisees allows the entire system to understand customer needs, identify any area for improvements (for example, speed of service, waiting times), and ultimately improve the overall customer experience.

Pricing and Promotions: Access to real time data is a vital component of keeping up with intense inter-brand competition. Targeted promotional campaigns can only be properly planned by evaluating transactions at guest level in store.

Financial controls and field service: analysis of financial data helps the franchisor support franchisees in optimizing operational processes and ensuring sustainability. The support and advice that franchisors provide enable franchisees to improve and optimize their performance. Each optimization in turn benefits the customer experience and the overall brand reputation.

Operations Metrics: Restaurant quality, service and cleanliness are at the core of franchising systems as this directly affects the customers' experience. The franchisor can only perform this advisory and control function properly if there is sufficient information exchange with the franchisees.

Security: Security-relevant information exchange in relation to any public health or safety issue is essential to inform and align all restaurants about what needs to be done and to inform guests appropriately.

Example 6: Car repair servicing (Spain, France, Belgium, Italy)

Reporting systems

All outlets have the same point of sale system, which delivers individual reports on a daily basis. Franchisees are able to provide data on average of sales, margins, products and stock turnover and provide a financial overview on quality of sales. This helps compare sales and profitability and to determine optimum results. Data is crucial to follow franchisees' development and help increase sales or measure different marketing activities. The purpose is to help franchisees benchmark performance and find improvements. Field support and audit departments contact each franchisee weekly and field delegates visit stores on a regular basis.

Type of information exchanged within a network

Operational:

- Operational reports
- Marketing campaign: Advertising and promotional communication
- Legal protocols
- Customer satisfaction scores



Financial:

- Daily turnover
- Average sales receipts
- Turnover per product category

The data generated from the franchise network is closely monitored to identify challenges, capitalize on opportunities and make timely decisions that could affect the success of the network. In addition to the data directly connected to the network, this company runs qualitative and quantitative research, focused on consumers as well as franchisees. Research guides strategic goals and decisions regarding the management and development of products, services and the network as a whole. The business is heavily reliant on data and data analysis to manage the entire franchise system.

Managing information exchange

Franchisees are obliged to provide data on the financial success of their business to the franchisor but may choose to if this can help improve the running of their operations. All financial and operational data received are used with the sole purpose of providing guidance and support, in order to optimize their operations and maximize their profits.

Example 7: Food and beverage business (Greece, with activities in seven other European markets, small formats)

Reporting systems

Financial reports relating to sales in store and through e-shops is shared daily, and franchisees communicate data entry through CRM and ticketing platforms. Field support and audit departments visit stores and meet franchisee partners on a regular basis.

Type of information exchanged within a network

Operational:

- Operational reports, store management updates, legal and sanitary protocols
- Preventive breakdown maintenance, facility cleaning, sanitary measures
- Customer experience data

Financial:

- Daily turnover
- Average sales receipts
- Turnover per product category

The data generated from the franchise network is closely monitored to identify challenges, capitalize on opportunities and make timely decisions that could affect the success of the network. More specifically, among many other strategic targets, the franchisor closely monitors:



- Sell-out data, with the purpose of understanding trends and product demand
- Price changes on materials and products, to negotiate in time and achieve better deals and prices;
- Data deriving from the FMCG retail market, to identify potential opportunities and capitalize accordingly.

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