

## **Alert** | Franchise & Distribution



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### **Dutch Franchise Code Triggers Legislation, but Will That Solve the Issues That Triggered the Code?**

The Dutch franchise code was drafted with the goal of becoming an industry-wide accepted code of conduct. Based on the well-known governance principle of “comply or explain,” the code offered both franchisors and franchisees an opportunity to carefully consider the inclusion of any contract clause that deviates from its standards. Although this system has worked for many years in the Dutch corporate governance model, which regulates the position of various stakeholders in listed entities, franchisors have been reluctant to apply this principle to contracts with their franchise partners.

From franchisors’ point of view, the default setting in the comply or explain model interfered with the freedom to contract and was counterproductive to innovation. That discussion has been influenced by debate between franchisors and franchisees in the retail industry on the impact of increasing online business. Many existing franchise contracts did not foresee online business at all, and almost none of them dealt with the impact of online business on offline business. As a result, when franchisors developed profitable online businesses, turf wars ensued. Franchisees, who were granted some territorial protection to recoup their investments in the franchise outlet, wanted a “fair” share of the online business to compensate the offline business lost to that channel. Further, franchisees were unable to duplicate online business at the local franchise level (and often were precluded from doing so under the existing franchise contracts). The fight over this issue has resulted in litigation with respect to some well-known Dutch franchise formulas.

Business conflicts between the various distribution channels are unlikely to be resolved with legislation affording mandatory protection to franchisees, unless the legislator can fix the geography of the channel conflict for existing situations. Even still, new franchise contracts would have to distinguish between online and offline markets as to the grant of exclusivity.

To be in line with current EU and national competition law, offline franchisees should, as distributors, be able to have their own online business. The question is which restrictions could be brought under the *Pronuptia*<sup>1</sup> criteria (i.e., restrictions objectively justified by the need to protect (i) the knowhow of the franchise, or (ii) the identity and reputation of the franchise formula) and thus be permitted *per se* for franchise as ancillary restraints being exempt from the application of competition law. That could make franchise distinctly more special and allow for more restrictions on franchisees than the regular selective distribution model, where an absolute ban on online sales is not permitted and only third-party platforms may be excluded.

Apart from some other protection for the franchisee against unbalanced contracts, legislation could potentially provide incumbent franchisees with approval power (or compensation) if an existing offline formula would add online business that would impact the offline exclusivity of such franchisees. This legislation would only require consultation; it could never give a solution in a specific case. The result of aborting discussions would likely be either litigation as to compensation or termination of the contract, which would include some form of an indemnity to compensate the value created by a franchisee. In German distribution law, the goodwill indemnity developed with respect to commercial agency is also applicable to franchisees.

But for the disputes that have cast shadows over the creation and implementation of the franchise code, the supplementary and/or the restricting effect of the Dutch law notion of good faith will have to resolve the existing disputes in equity.

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<sup>1</sup> The EU landmark case on franchise and competition law, CJEU 28 January 1986, Case 161/84; *Pronuptia de Paris GmbH v. Pronuptia de Paris Irmgard Schillgalis*

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