

GERMANY – PRE-CONTRACTUAL DISCLOSURE REQUIREMENTS AND RELEVANT CASE LAW

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As there is no statutory regulation of pre-contractual disclosure requirements in Germany, the obligations of franchisors are based on principles set out by the courts. This article considers the standards and guidelines applied by German courts in cases where one party, usually the franchisee, challenges the validity of the franchise agreement for reason of violation of the franchisor's pre-contractual obligation to inform the franchisee. The author considers the principle of "good faith", the scope and limits of the franchisor's obligation and recent trends in case law. Whereas there is no (general) obligation on a franchisor to advise a prospective franchisee with respect to general risks of self-employment or to provide a detailed calculation of profitability to him, recent developments show that a high level of duty of care is expected.

1. The principle of "good faith"

Unlike in the US or in certain European civil law countries such as France, Spain, and Italy, there is no specific franchise law in Germany and therefore, pre-contractual disclosure is not regulated by special statutes or monitored by a specific agency. Instead, general principles of law and statutory provisions of the German Civil Code ("*Bürgerliches Gesetzbuch – BGB*") pertaining to the law of obligations in general and to other types of contracts need to be observed by a franchisor who intends to sell a franchise concept to a prospective franchisee. Here, sections 241 and 311 BGB determine the general statutory framework:

Section 241

Duties arising from an obligation

- (1) By virtue of an obligation an obligee is entitled to claim performance from the obligor. The performance may also consist in forbearance.
- (2) An obligation may also, depending on its contents, oblige each party to take account of the rights, legal interests and other interests of the other party.

Section 311

Obligations created by legal transaction and obligations similar to legal transactions

- (1) In order to create an obligation by legal transaction and to alter the contents of an obligation, a contract between the parties is necessary, unless otherwise provided by statute.
- (2) An obligation with duties under section 241 (2) also comes into existence by
 1. the commencement of contract negotiations ...

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The pre-contractual obligation as defined in section 311 BGB is strongly influenced by the general principle of good faith laid down in section 242 BGB:

**Section 242
Performance in good faith**

An obligor has a duty to perform according to the requirements of good faith, taking customary practice into consideration.¹

A franchisor’s general obligation to inform is derived from the principle of good faith and whether or not said obligation was fulfilled is subject to an individual analysis on a case by case basis.

Also the (non-statutory) general principle of freedom to contract and the resulting right of each contractual party to negotiate freely the content of the contract it wishes to conclude is limited by the requirement to act in good faith: the party having superior knowledge (in most cases the franchisor) may not use the same to the detriment or the disadvantage of the other party (prospective franchisee). As a result the disclosure of certain information is deemed essential in order to avoid an imbalance which prevents the “weaker” party from observing and protecting its own rights in an appropriate manner.

¹ English translations quoted from: http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p0723

2. Scope of duty to inform

Due to the lack of statutory provisions defining to what extent a franchisor is required to disclose certain information to a prospective franchisee the currently applicable standards and guidelines were mainly developed by courts and by groups of interest such as the German Franchise Association.

2.1 Code of Ethics of the German Franchise Association

In paragraph 3 of the Code of Ethics of the German Franchise Association (*Deutscher Franchise-Verband e.V.*) which corresponds to para. 3 of the Code of Ethics of the European Franchise Federation the franchisor’s obligations in the pre-contractual negotiation phase are summarized as follows:

3. Advertising for the recruitment and acquisition of partners and disclosure

- 3.1 Advertising for the acquisition of franchisees should be carried out without ambiguity and without the use of misleading information.
- 3.2 All PR matters and advertisements which are used for the purpose of winning franchisees and which mention results, numbers and possible profits made by the franchisee have to be non-misleading and factually correct.
- 3.3 In order to enable future franchisees to decide on binding agreements with full knowledge of all facts, he will receive prior to the signature of a binding agreement a copy of the valid code of conduct as well as the complete and accurate written disclosure of all information and documents relevant for the franchise relationship.²

The Code of Ethics of the German Franchise Association has a binding effect on its members only. It can therefore only serve as a general guideline for franchise systems.

² http://www.franchiseverband.com/fileadmin/dfv-files/Dateien_Dokumente/Code_of_ethics.pdf

“... a prospective franchisee may be considered worthy of a higher degree of protection than other entrepreneurs.”

2.2 Landmark decisions of the Higher Regional Court of Munich

In contrast, however, the development of more specific disclosure requirements is owed to a large number of court rulings that over the years have identified many standards and principles applicable to the pre-contractual phase of negotiation of a franchise agreement. And even though the general observation has to be made that in its entirety the judgments rendered by numerous courts of the first and the second instance are rather inconsistent and to a high degree very case-specific (a ground-breaking decision by the German Federal Court of Justice is still outstanding) it is also true that the ideas and concepts behind those standards have been well elaborated and structured by the courts.

Here, it is primarily the Higher Regional Court of Munich (*Oberlandesgericht München*) that has established over the years a whole legal framework as to what quality of information a prospective franchisee can expect to receive from a franchisor prior to signing the franchise agreement and in what circumstances the validity of a franchise agreement can be successfully challenged for reason of lack of proper pre-contractual information.

(i) *Burden of proof lies with the franchisor*

Already in 1987 the Higher Regional Court of Munich held that it is the franchisor who bears the burden of proof that the information he had provided to the prospective franchisee was accurate.³

³ OLG München, 13.11.1987 - 8 U 2207/87

(ii) *Franchisor must provide full and accurate information regarding profitability*

In 1993 the Higher Regional Court of Munich once again had to decide whether or not a franchisor had violated the pre-contractual obligation to inform.⁴ Here, the court was more specific as to what kind of information is to be provided and defined the following guiding principles heading the decision:

1. The franchisor must provide to the franchisee correct and full information regarding the profitability of the system.
2. The franchisor who is liable for damages as a result of a violation of the pre-contractual obligation to inform may not attribute contributory negligence to the franchisee who rather carelessly believed the franchisor's advertisement.

It is apparent from this decision that the Higher Regional Court of Munich took the view that a prospective franchisee may be considered worthy of a higher degree of protection than other entrepreneurs. This view was confirmed in many other cases reviewed by courts where the prospective franchisee typically became self-employed for the first time and started his existence as an entrepreneur (*“Existenzgründer”*) with a franchise concept.

(iii) *Superior knowledge results in responsibility*

In 2001, in the *Aufina* case, the Higher Regional Court of Munich defined exceptions to the general rule that each party is responsible to gather all sorts of information it deems necessary in order to evaluate the pros and cons, risks and benefits related to entering into a contractual relationship with the other party by stipulating the following: provided that in a particular situation certain circumstances exist that are known to only one of the negotiating parties and provided further that the party having such superior knowledge is aware (or should be aware) of the fact that those circumstances are of importance to the other party in making a decision, then the party with superior knowledge assumes responsibility towards the other party.⁵ It goes

⁴ OLG München, 16.09.1993 - 6 U 5495/92

⁵ OLG München, 24.04.2001 - 5 U 2180/00 (*“Aufina”*)

without saying that it was the franchisor who was considered to have superior knowledge which he was supposed to share with the prospective franchisee prior to closing.

In the *Aufina* case the court also emphasized once again that any information provided by a franchisor (even if given without having been asked for by the prospective franchisee) has to be accurate: in that particular case the franchisor had claimed the quota of franchisees' failure to be less than 3% and the system's earning possibilities to be guaranteed in the long term and above average while there was actually a significant number of dissatisfied franchise partners.

In that context it has to be noted that a franchisor is not under all circumstances required to disclose information as to how many business operations of franchisees failed in the past. However, an obligation to inform exists if it can be stated that as a result of such failures the franchise system in its entirety is in a precarious situation. Further, if the prospective franchisee specifically requests information regarding the failure rate of franchisees in the system the franchisor is required to answer that question accurately.⁶

“... the extent of the franchisor's obligation to inform mainly depends on the individual prospective franchisee's need to know and the possibilities of the prospective franchisee to get access to relevant information.”

⁶ OLG Frankfurt a.M., 12.05.2011 - 22 U 181/08

The *Aufina* decision is in line with other court decisions stating that the prospective franchisee is entitled to obtain from the franchisor without asking all information the franchisor is aware of and which is recognizably of importance and relevance to the prospective franchisee as to whether or not to sign the franchise agreement. In this decision it was also specifically stated that the extent of the franchisor's obligation to inform mainly depends on the individual prospective franchisee's need to know and the possibilities of the prospective franchisee to get access to relevant information.

(iv) Information provided must be accurate

It was only one year later, in 2002, when the Higher Regional Court of Munich in the *Personal Total* case once again confirmed that any sort of information, not only profitability calculations, must be accurate if provided by the franchisor. The franchisor had claimed the average number of average personnel placements to be higher than it actually was.⁷ The average turnover per personnel officer based on this figure was subsequently clearly higher than the actual average turnover of the previous years. The court ruled that the franchisee was deliberately misled by the franchisor and the franchisee was awarded damages.

3. A relationship of trust

It is quite obvious that any sort of information that is provided by the franchisor must be accurate and not misleading. Further, if asked by a prospective franchisee for specific information, e.g. how many franchisees went bankrupt in the recent past, a franchisor is bound to answer accurately and to provide correct information.⁸ However, the question remains as to what degree a franchisor is required to inform a prospective franchisee.

The franchisor's legitimate interest to protect his know-how and to not share his entire knowledge or even business secrets related to the franchise concept collides with the prospective franchisee's

⁷ OLG München, 01.08.2002 - 8 U 5085/01

⁸ OLG Frankfurt, 12.05.2011 - 22 U 181/08

“... the relationship between a franchisor and a prospective franchisee in the phase of negotiation is considered as a relationship of trust by which a certain degree of responsibility is imposed on the franchisor.”

(equally legitimate) interest to have a solid basis for making a reasonable business decision.

As already indicated above, the relationship between a franchisor and a prospective franchisee in the phase of negotiation is considered as a relationship of trust by which a certain degree of responsibility is imposed on the franchisor. If and to what extent this responsibility requires particular information to be disclosed or not depends on the individual situation, taking into account the principle of good faith.

Apart from applying the aforementioned general principles, the prospective franchisee's actual need to know in the particular circumstances of the case, the opportunity to obtain such information from the franchisor only or from other sources as well as the franchisee's personal background, business experience, and knowledge of the franchise system are to be taken into account.

The Regional Court of Krefeld in this context denied a franchisee's claim for damages on the grounds that the franchisor in the negotiation phase had offered that the prospective franchisee may get in contact with other franchisees of the concept in order for him to gain more business insight (e.g. information regarding annual turnover) and which the (then prospective) franchisee had declined.⁹

⁹ LG Krefeld, 04.10.2004 - 3 O 243/06

There is broad agreement and consistent case law stating that providing full and truthful information regarding the following aspects are indispensable for proper pre-contractual information by the franchisor:

- information regarding the franchise system and how it works, including the potential for successful business operation,
- relevant know-how as identified in an operations manual,
- major obligations of the franchisor,
- lack of protection of essential IP-rights,
- sufficient evidence of a successful pilot operation,¹⁰
- business figures of comparable operations,
- information on fees, investment, capital,¹¹ and franchisee's necessary commitment to work.

4. Limits of the franchisor's obligation to inform

In the same way as courts have defined what information is so essential that it has to be provided to a prospective franchisee, they also stipulated what sort or degree of information may not be expected to be (fully) disclosed in the pre-contractual negotiation phase.

In a number of cases courts have stated that in general, a franchisor does not have to supply profitability calculations or a location analysis, as both are considered to be the franchisee's responsibility,¹² but that a franchisor is (only) required to supply such data and information enabling the prospective franchisee to assess the profitability himself.¹³ If, however, the franchisor does provide profitability calculations those calculations have to be accurate.

¹⁰ OLG München, 11.07.1996 - 24 U 63/95: obligation to inform if no such pilot operation exists

¹¹ OLG Köln, 16.05.1994 - 2 W 14/94

¹² OLG Brandenburg, 28.09.2005 - 4 U 37/05; OLG Düsseldorf, 30.06.2004 - VI U (Kart) 40/02; OLG Düsseldorf, 28.02.2007 - VI U (Kart) 27/06

¹³ OLG Düsseldorf, 30.06.2004 - VI U (Kart) 40/02

In this context, it was stipulated by the Higher Regional Court of Düsseldorf that the data provided to the prospective franchisee must not be outdated as this would be considered as being misleading. The court ruled that providing old data (which in that case were more positive than the latest available data) constituted a violation of the pre-contractual obligation to inform because such outdated information was not representative and therefore of no substantive use for the franchisee.¹⁴

For a prospective franchisee it is certainly of interest to know whether the franchisor is involved in litigation as a plaintiff or defendant. Here, courts have ruled that a franchisor is only required to provide detailed information on pending law suits if and to the extent that the outcome of such pending law suits is relevant for the potential of success of the prospective franchisee, in which case it would be considered as information which needs to be disclosed prior to entering into the contract.

In certain cases a franchisee may even be expected to actively request additional information and failure to do so would be interpreted as a lack of prudence on the franchisee's side. In a case decided by the Higher Regional Court of Celle a franchisor had provided statistical projections to the prospective franchisee. A dispute arose as to whether the franchisee was sufficiently informed prior to entering into the franchise agreement. The Higher Regional Court of Celle ruled that in case a prospective franchisee needs further clarification with regard to statistical projections made by the franchisor, but misses the opportunity to obtain such clarification this would not constitute misleading information and thus a violation of the pre-contractual disclosure obligation by the franchisor.¹⁵

Similarly, the opportunity to visit other franchisees' businesses is taken into account at the franchisee's expense when assessing the extent of the franchisor's pre-contractual disclosure obligation as

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ruled by the Regional Court of Krefeld.¹⁶ In that case a franchisee had been offered to visit other franchisees' businesses in order to get more business-related information specific to the system. The franchise agreement provided that the franchisor would not be liable for the profitability and the profits or losses of the franchise operation in question. The court ruled that the franchisee had been given – in addition to all kinds of data and materials prepared by the franchisor – the opportunity to do his own research and a potential failure to do so could not be held against the franchisor.

5. Recent trends

A franchisee who can provide evidence that he would not have contracted if he had been informed properly, e.g. by showing that he was provided with misleading information or that essential information was withheld from him, is entitled to claim damages and to terminate the contract.

While several court decisions in the years 2004 – 2009 had emphasized the entrepreneurial responsibility of a prospective franchisee and consequently required a certain degree of self-assessment from a prospective franchisee, there seems to be a tendency in recent case law to emphasize the need for protection of a prospective franchisee instead and to consider him as the “weaker” party.¹⁷

¹⁴ OLG Düsseldorf, 28.02.2007 – VI U (Kart) 27/06

¹⁵ OLG Celle, 29.01.2008 – 13 U 127/07

¹⁶ LG Krefeld, 04.10.2007 – 3 O 243/06

¹⁷ Eckhard Flohr, Die vorvertragliche Aufklärung beim Abschluss von Vertriebsverträgen, *ZVertriebsR* 2013, p. 71 – 79, p. 75

In various cases decided by The Higher Regional Court of Schleswig,¹⁸ the Higher Regional Court of Hamburg,¹⁹ the Higher Regional Court of Brandenburg²⁰ and others it was stipulated that in franchise relationships as well as in other contractual relationships each party bears its own risk. With respect to the application of the principle of good faith it was specifically ruled that it would be exaggerated to demand from the franchisor that it provides the prospective franchisee with a detailed profitability analysis prepared at the franchisor's expense and to hold the franchisor liable for its accuracy.²¹ Instead the franchisee would be required to make the analysis himself or entrust a third party expert with it. Courts further pointed out that each party is responsible for gathering information as to the risks and chances of a business relationship and to make its own conclusions with respect to the market opportunities.

Recently, however, there seems to be a slight shift in current jurisprudence with respect to the franchisor's obligation to inform on the profitability of the system as a decision in 2011 of the Higher Regional Court of Hamm²² shows:

The franchisor (a school concept) had filed a payment action against the franchisee for outstanding royalties amounting to more than EUR 160,000. The franchisee defended the case by arguing that the franchisor had breached the obligation of pre-contractual disclosure giving him the right to withdraw from the franchise agreement and to claim damages from the franchisor. The court denied the franchisor's claim for payment and stated that the franchisee had rightfully cancelled the franchise agreement for reason of violation of the pre-contractual information obligation. It was held that the franchisor had not accurately informed him about the franchise system's profitability. The profitability forecast and indicated sales figures had been estimated by the franchisor without taking the

features of the planned location into account. According to the court's ruling the franchisor would have been required to make a comparison between the business' planned location and other location factors. The court saw it as an obligation on the franchisor to indicate that the profitability forecast was based on estimations only because the franchisee was not in the position to realize that the indicated figures were given with no factual background without having them reviewed by an expert which he was not required to do. The franchisor's claim for outstanding royalties was denied and instead the franchisee was granted the right to withdraw from the franchise agreement. The court further confirmed that as a result of the rightful withdrawal from the franchise agreement the franchisee would be entitled to damages.

The view taken by the Higher Regional Court of Hamm which emphasizes the idea of protection rather than the entrepreneurial responsibility of the franchisee was recently supported by the Higher Regional Court of Düsseldorf.²³ The court pointed out that a prospective franchisee regularly depends on the pre-contractual information given by the franchisor in order to get an idea of the sustainability of the franchise operation. With respect to data relating to the profitability of the system the court stated that the franchisor assumes a special degree of care when preparing such data for a prospective franchisee. Such data and information must be prepared in a way that allows the franchisee to create a realistic forecast of the business opportunities of the specific franchise operation. The court further pointed out that those franchise systems operating for many years in a market and therefore having a great degree of experience regarding the facts and figures relevant for the profitability of the business are required to share that knowledge in an overall accurate and truthful manner with a prospective franchisee.

¹⁸ OLG Schleswig, 22.01.2008 - 1 W 27/07

¹⁹ OLG Hamburg, 30.12.2002 - 5 U 220/01

²⁰ OLG Brandenburg, 28.09.2005 - 4 U 37/05

²¹ OLG Brandenburg, 28.09.2005 - 4 U 37/05

²² OLG Hamm, 22.12.2011- I-19 U 35/10

²³ OLG Düsseldorf, 25.10.2013- I-22 U 62/13

“... recent developments show that a high level of duty of care is expected from the franchisor when providing information in the negotiation phase.”

The trend described above was confirmed by the Regional Court of Hamburg in January 2014²⁴: the court awarded damages in an amount exceeding EUR 150,000 to the plaintiff, a franchisee of a fashion store concept, for reason of violation of the pre-contractual disclosure obligations of the franchisor. The court criticised the fact that the investment proposal which provided for a 5% growth rate in the yearly turnover for the initial five-year period was based on the mere hope for a positive development of the shop's business at the chosen location rather than on past experiences of the franchisor with shops in comparable locations. It was held that by failing to explicitly identify these circumstances to the franchisee - who was an experienced business man and had owned a fashion store for many years prior to joining the franchisor's concept as a franchisee - the franchisor was liable for all costs and expenses incurred by the franchisee as a result of relying on the information given and entering into the franchise agreement.

6. Conclusion

Courts have repeatedly stated that the role of a franchisor as a potential future contractual partner of a prospective franchisee in the pre-contractual phase is not the one of an advisor to a business start-up. So, there is no (general) obligation on a franchisor to advise a prospective franchisee with respect to general risks of self-employment or to provide a detailed calculation of profitability to him. However, recent developments show that a high level of duty of care is expected from the franchisor when providing information in the negotiation phase. This degree of care is unknown in other comparable situations, e.g. in the negotiation of a long-term distribution agreement or a commercial agency agreement.

There will be no special legislation in Germany in the near future providing for statutory regulation on pre-contractual disclosure in franchise relationships. So, the uncertainties described in this article will remain. Franchisors are therefore well advised to apply utmost care in the preparation of the data and information they make available to prospective franchisees.

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²⁴ Regional Court of Hamburg, January 17, 2014 - 332 O 249/12