

The Franchise Agreement

- *What should it contain?*

The Law

For those of you who are considering franchising your business you should be aware that there is no specific legislation for franchising in the United Kingdom. For the franchisor, this is both good news and bad news. It is good news because it means that the franchisor is at liberty to offer whatever terms he wishes to his franchisees. The bad news is that because there is no specific legislation for franchising, the common law and the plethora of existing legislation governing commercial relationships have the potential to affect every franchise transaction. To this has to be added the Competition Rules of the European Union which also apply to the United Kingdom. The penalties for failing to comply with any applicable laws range from rendering a contract unenforceable to a criminal conviction of the directors of the franchisor company involved.

Some legislation was drafted at a time when franchising was not very well known in the United Kingdom, and the manner of drafting is such that franchise agreements can nevertheless be caught by such legislation. It is therefore very important to ensure that the person who is charged with the task of drafting a franchise agreement is not only aware of the various rules, regulations and legislation concerned, but also thoroughly familiar with them; otherwise a franchise agreement may appear to be legally sound on the face of it, but will actually be defective by reason of the fact that it has been inadvertently caught by a particular piece of legislation of which the draftsman was unaware.

“..some legislation was drafted at a time when franchising was not very well known in the United Kingdom..”

Franchisees play no part in drafting the franchise agreement nor is it negotiable. Franchise agreements are in a standard form and apply equally to all franchisees. A franchisee is invited by the franchisor, to ‘take or leave it’. It is important therefore that franchise agreements are properly drafted.

The Ethics

Even though a franchise agreement is perfectly legal it may not be ethical. A franchise agreement will tend to be more readily accepted in the market place if it satisfies, amongst others, the criteria laid down by the British Franchise Association and the banks.

The Franchise Agreement

A franchise agreement should achieve three fundamental objectives:-

FIRST Given the absence of specific franchise legislation, it should contractually bind the franchisor and the franchisee and accurately reflect the terms agreed upon.

SECOND It should seek to protect for the benefit both of the franchisor and the franchisee the franchisor's intellectual property.

THIRD It should clearly set out the rules by which the game is to be played.

1. The Terms

In the absence of specific legislation or regulation of franchising with the United Kingdom, the franchise agreement becomes all important in determining the rights and obligations of the franchisor and the franchisee and the relationship between them. In this respect the franchise agreement can be said to form the "engine room" of the whole transaction. If difficulties should arise between the franchisor and the franchisee they will need to turn to the contract to see what, if any, rights and obligations have been provided in the franchise agreement.

What, then, should one look for in a franchise agreement?

A franchisee will look for promises:-

1. to train the franchisee and his staff;
2. to supply goods and/or services;
3. to be responsible for advertising, marketing and promotions;
4. to assist the franchisee to locate and acquire property and have it fitted out and converted into a franchised outlet. (Similar considerations apply with regard to the acquisition of vehicles, fitting them out, equipping the franchisee etc.);
5. to assist the franchisee to set up in business;
6. to improve, enhance and develop the business system; and
7. to provide certain management and, possibly, accounting services.

Franchisors will be anxious to ensure that the franchise agreement clearly sets out the obligations of the franchisee.

A franchisor will also wish to:-

1. monitor the performance of the franchisee;
2. protect himself from unfair competition;
3. protect his intellectual property; and
4. impose obligations and restrictions on the franchisee with regard to the exercise of the rights granted by him to the franchisee.

2. The Intellectual Property

These are in the nature of:-

Trade Name;
Goodwill;
Methods of production and/or processing;
Confidential Information and know-how;
Copyright;
Trade Marks and Service Marks.

Unless the franchise agreement contains sufficient safeguards to protect the franchisor's intellectual property rights, the franchisor may find that he is unable to prevent infringement of his rights by a third party or an ex-franchisee.

“...also contain mechanisms necessary for protecting the franchisor's intellectual rights from infringement....”

Franchisors should be aware that it is not only the interests of the franchisor that these rights be protected. Franchisees are equally concerned to ensure that the franchisor had done everything that is reasonably possible for him to protect the intellectual property rights in question. Many franchisees purchase a particular franchise because of the high profile a particular franchise enjoys in the market place. In many cases, a franchisee has the choice of which franchise to purchase in the same market sector and one of the reasons why a franchisee will have chosen a particular franchise is because of its strong brand image.

It follows therefore that the franchisee will be anxious to ensure that in the event of infringement, the franchisor has taken sufficient steps to safeguard his ownership in his intellectual property rights so that he can stop infringement and thereby protect the reputation of that brand name both for himself and for his franchise network. If the contract is weak on this point, franchisees will not consider that particular franchise to be a sound investment proposition because the franchisor will be limited in what he can do to prevent a “copy-cat” operation from being set up in direct unfair competition with a franchisee.

Brand names and trade marks are becoming increasingly important to business; they can increase the asset value of a company and therefore need to be adequately protected. The franchise agreement should therefore not only grant relevant rights to the franchisee and reserve rights for the franchisor, but should also contain mechanisms necessary for protecting the franchisor’s intellectual rights from infringement.

3. The Rules

All franchisees should be treated as a family and, as such, there should be no room for favourites. As stated above, it is for this reason that franchise agreements are in a standard form with all prospective franchisees being offered the same terms with no special deals being done. If a franchise agreement is to be non-negotiable then it is important, from the franchisee’s point of view, that it is not only sound from a legal point of view but also well balanced in terms of rights and obligations of the parties and takes into consideration the franchisee’s concerns also. Again, in the absence of legislation or regulation, which tells the franchisor and the franchisee what to do and how to behave, and given that franchisors and franchisees perceive the franchise relationship to be a long term one, it is important that the contract spells out very clearly what is expected by and of each party to the contract.

The franchise agreement should therefore clearly:

1. specify in detail the duties and obligations both of the franchisor and of the franchisee;
2. state the grounds upon which the franchisor will seek to terminate the franchise agreement;
3. deal with the payment of franchise fees and the timing of those payments; and
4. set out the consequences of such termination.
5. some thought has to be given to the franchisees and their objectives and provision is therefore usually made in the franchise agreement to deal with what is to happen should the franchisee die or become permanently incapacitated.

It is also advisable to deal with the question of what is to happen if a franchisee wishes to sell his business during the term of his franchise agreement. Here, as in other matters, a balance has to be struck between the need of the franchisee to realise his investment as and when he wants to and the requirement of the franchisor to approve those coming into the franchise network and to prevent those leaving the network (for whatever reason) from continuing to use the franchisor's trade secrets and competing unfairly.

“...for the franchisor, the franchise agreement is an income producing asset...”

The franchise transaction is complex and the franchise agreement must respect that complexity. To the franchisee, the franchise contract represents an investment. His business depends upon it to the extent that his business may disappear should it terminate. For the franchisor, the franchise agreement is an income producing asset which will ultimately have a place on his balance sheet. If for any reason the franchise contract turns out to be defective, the cost to the franchisor can be the loss of his whole network (given that the franchise agreement is in a standard form). Although it may be tempting for both franchisor and franchisee to rely on goodwill, ultimately it is only the contract that matters.

Whatever the size or reputation of the franchisor, prospective franchisees will always look to the quality of the franchise agreement because they know that there may be a change of policy within the franchisor company or that the people running the franchise operation may change. They know that at the end of the day, all they can rely upon will be whatever rights are written into that contract.

Once a franchise agreement has been signed, both parties will be bound by it. It can be a double edged sword and if the franchisor has got it wrong he will have to pay the price. A final word of caution - remember that generally speaking, there is still no law against making a bad bargain!

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Manzoor Ishani is a Senior Consultant Solicitor with Sherrards (Solicitors), a commercial practice advising franchisors and franchisees in the UK and internationally (Tel: +44 (0)1727 832830; e-mail mgi@sherrards.com; www.sherrards.com). He has specialised in franchising for more than 30 years and is a former member of the Legal Committee of the British Franchise Association and is co-author of “Franchising in the UK”, “Franchising in Europe” and “Franchising in Canada”, and has helped UK companies franchise into more than 27 countries.