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# Franchising

## Background

Franchising is the grant of specified rights by one party to another in return for a fee, and exists in various forms. This note will cover only business method franchising, under which a franchisor (A) grants a franchisee (B) a licence to distribute A's products or services, using A's business method and technology and under A's trade marks. A supervises that use, and provides training and other assistance (eg publicity) to B to help B in running the franchise. A franchise is thus a licence to use a business method for a period, subject to a royalty.

Many businesses use franchising. It is common in the fast food sector (eg McDonald's), hotels (Holiday Inn), utility services (Dyno-Rod) and retail products (Body Shop). Not all businesses, however, are suitable for franchising.

## Nature of franchising

The franchisee is an independent contractor, and not an agent, of the franchisor. In this respect he is similar to a distributor, although subject to much greater control than the latter. He may be a:

1. *unit franchisee*, running a single franchised outlet

2. *multiple franchisee*, running several outlets

3. *master franchisee*, having the right to run franchised outlets in a country or region, and to grant sub-franchises to unit franchisees there, or

4. *developer*, an alternative to master franchising where the developer has the right to open a number of franchised outlets itself

Royalties paid to the franchisor are normally:

1. an initial fee, and

2. ongoing service fees, usually based on a percentage of turnover or mark-ups on supplies

## Characteristics of franchising for the parties

From a franchisor's viewpoint, franchising:

1. allows rapid growth with lower capital expenditure than other means (eg direct sales operations)

2. requires close control and supervision of franchisees, and

3. requires the franchisor to own the trade name/marks and business method

From the franchisee's viewpoint:

1. as the concept is proven, the risk of failure is lower, and the initial investment less, than with a stand-alone business

2. the franchisor provides training, advertising and other support

3. the franchisee meets operational expenditure and (usually) has product risk

4. however, he does not own goodwill in the business, and the franchisor is not usually obliged to renew the agreement on expiry – so sunk cost must be covered, and

5. initial and ongoing fees are payable, and the franchisor exercises close operational control

## Main issues in franchising—the franchise agreement

The principal issues to be covered are:

1. what **rights** are granted

2. is the franchise to be **exclusive** or not? Commercially this may be unobjectionable; however, exclusivity can only be granted in certain jurisdiction after taking into consideration the competition laws prevalent in those jurisdiction.

3. the **territory**. Additional considerations (relating mainly to business practice and dispute resolution) apply where the franchise is in a different country to the franchisor

4. the **term**. Five to ten years is typical, often longer in overseas arrangements. Renewal must be considered

5. what sales **targets** and franchise development schedule are appropriate

6. what trade marks and other **IPRs** are to be licensed, and

7. the parties' **obligations**, notably:

    1. the franchisor—provision of training and other support, regular monitoring and assistance to the franchisee, updating the manual, availability of key supplies, and

    2. the franchisee—hiring suitable personnel, effort devoted to the franchise, compliance with the manual, keeping records and making payments

The franchisee often has very limited scope to negotiate the terms of the agreement, particularly with well-known franchises. Overseas, the franchisor may be more dependent on the franchisee and the latter's negotiating power greater.

## The manual

The franchise (or operations) manual contains the know-how needed to run the franchise, and sets out relevant performance standards. It is usually incorporated into the franchise agreement. There is no set format; matters normally covered include:

1. staff qualification and presentation and employment matters
2. customer service standards, complaints procedures, etc
3. pricing
4. premises layout, opening hours, requirements etc
5. stock and technical requirements
6. advertising and marketing, and
7. accounting

The manual will (and should) change frequently as the business method develops. For overseas franchises it should be translated as required.

## Confidentiality and non-competition

The business method licensed, the know-how underlying it, and much other information are confidential to the franchisor. The latter must therefore obtain enforceable confidentiality undertakings from franchisees and their employees, and disclosure of the manual and other confidential information should be restricted. The franchisor must also put in place restrictions on competing with the franchise, both during and after the term of the agreement. The latter are not enforceable in certain countries for example UK unless limited in time and area as reasonably necessary to protect the franchisor's trade secrets or business, and may be difficult to enforce abroad.

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## Competition law

As with any arrangement which may affect trade within the European Economic Area, franchise agreements may be subject to Article 101 of the Treaty on the Functioning of the European Union. However, they may benefit from the Vertical Agreements Block Exemption (a revised version of which took effect from 1 June 2010), which exempts agreements under certain circumstances where each party's share of its own market does not exceed 30%. Additional conditions apply in certain circumstances.