

FRANCHISING IN THE UK

The franchising of know-how, business systems and a business name is a well-established and widely used method of business expansion. Franchising in the UK is relatively unregulated compared to other countries and is self-regulated by the British Franchise Association which promotes the practice of ethical franchising in accordance with its code of ethics, which is based on the European Code of Ethics. Membership of the BFA however is voluntary.

This note contains an overview of some of the key issues which a franchisor or franchisee should consider when entering into franchise arrangements.

1 **Trademark/Trade Name and Know How:** In order for a business to be franchiseable it must contain:

- substantial know how which is secret and confidential; and
- a trade mark which can be licensed to others. Ideally the Trade Mark should be registered at the Intellectual Property Office

The franchisor must have taken all appropriate steps to protect its intellectual property and prevent infringement actions being brought against it and its franchisees by third parties.

2 **Pilot Operation:** The business must be capable of being replicated successfully and profitably on an arm's length basis. This is usually demonstrated by the franchisor operating a pilot operation either through a company owned operation or through a pilot franchisee. This establishes credibility, substantiates financial projections and allows for refinements to the business model to be made.

3 **Confidentiality:** In order to ensure that the franchisor's trade secrets are protected a confidentiality agreement should be entered into with prospective franchisees at the outset and the franchise agreement must contain appropriate confidentiality provisions.

- 4 **Franchise Information Memorandum:** where a disclosure document or prospectus about the franchise is provided to the franchisee this must be based on fact. If financial projections are included then an appropriate disclaimer should be included to limit liability for misrepresentations and the projections must be able to be substantiated. The BFA has issued a recommended disclaimer for use in these situations.
- 5 **Operations Manual:** The Operations Manual is critical to the business. It supplements the franchise agreement and should consist of all the technical and practical issues of operating the business. This forms part of the franchise agreement and has contractual force. It can usually be amended by the franchisor on an on-going basis to reflect changes in the business systems.
- 6 **Franchise Agreement**
A comprehensive franchise agreement should be prepared which sets out the respective rights and obligations of the parties and contains all of the key protections for the franchisor. The franchise agreement I usually prepared in line with the BFA's Code of Ethics.
- 7 **Parties:**
- **Franchisor:** Tax advice needs to be sought at the outset to establish whether the core business should be the franchisor or whether a new company should be established thereby ring fencing liability and protecting the intellectual property which remains with the core business.
 - **Franchisee:** Where the franchisee a limited company then a personal guarantee should ideally be obtained from the key directors and shareholders of the company's obligations under the franchise agreement plus specific non-compete and confidentiality undertakings similar to those undertaken by the franchisee.
- 8 **Exclusivity:** Consider whether a franchisee will be granted an exclusive territory or a prime marketing area and whether the franchisor is also entitled to operate within the territory. If exclusivity is granted consider minimum performance targets with a specific right to terminate/or loss of exclusivity if these are not achieved.

- 9 **Payment:**
- **Initial fees:** It is usual for the franchisee to pay an initial fee upon signature of the agreement followed by an on-going management services fee. According to the BFA's Code of Ethics the initial fee should cover the cost of establishing the franchisee in business with a small element of profit to the franchisor. A franchisor should not be seen to be achieving its main income from the sale of franchisees alone, instead this should be achieved from the on-going management fee. This ensures that the Franchisor's success is linked to that of the franchisee.
 - **Ongoing fees:** The on-going fee usually termed as a management fee, can be structured in a number of ways e.g. a fixed fee or a percentage of the franchisee's total turnover after vat or a combination of both. In addition a marketing contribution may be charged which again is usually a percentage of the franchisee's turnover. This money is held centrally and applied to general promotion of the brand and business. Where a percentage of turnover is charged the definition of 'Turnover' or any other similar definition will need to be considered carefully and it is usual to include audit rights and provisions in respect of accounting and records. It is usual for the on-going fees to be paid monthly so as to be able to keep a close eye on the sums (or weekly if appropriate).
- 5 **Trade Mark Licence:** Where the trade marks are registered it is usual for the franchisor to enter into a trade mark licence with the franchisee and include in the franchise agreement appropriate protections for the franchisor in respect of trade mark/intellectual property rights. If the trade marks are not yet registered appropriate provisions will still need to be included. Consider whether the franchisor has the right to re-brand and is prepared to warrant the use of the trade marks.
- 6 **Term:** Franchise agreements tend to be for long initial periods e.g. 5 or 10 years. The term should be long enough for a franchisee to be able to recover his initial investment and make a profit. If there is an exclusive purchase obligation then the term should not be longer than 5 years to avoid a potential breach of relevant competition law.
- 7 **Renewal:** Renewal is a convenient break point at which a franchisee can be required to sign up to the then current franchise agreement and helps to ensure that as far as

possible there is uniformity of contractual terms across the franchised network and all franchisees are treated fairly.

When considering rights of renewal the franchisee may not expect to pay a renewal fee other than payment of legal costs. A right of renewal is usually conditional upon certain events e.g. no material breach of the agreement by the franchisee, the franchisee being prepared to enter into the then current form of franchise agreement, completion of refresher training by the franchisee and it's employees, the franchisee giving up any claims against the franchisor.

- 8 **Franchisor's Initial Obligations:** In return for the initial fee the agrees to undertake to provide certain advice/training e.g. general advice on how to set up the franchise, possibly a PR launch, a copy on loan of the franchise manual, an initial training programme and possibly certain equipment.
- 11 **Franchisor's Continuing Obligations:** The agreement should list the franchisor's continuing obligations e.g. to provide know how, advice and guidance, to supply any relevant products to the franchisee (e.g. parts to be installed, stationery) and to provide training. On-going support by a franchisor in franchising should not be an option but a commitment.
- 12 **Franchisee's Obligations:** These are usually extensive and cover all main aspects of trading. It is worth noting that under relevant completion law a franchisor cannot oblige its franchisees to sell any product/service at a particular price although it is able to recommend a retail price to the franchisee and set a maximum price. Minimum prices may not be set. Consideration needs to be given as to whether the franchisee should be obliged to purchase all ongoing consumables exclusively from the franchisor or should be able to obtain them from a third party (subject, for example, to appropriate quality criterion).
- 13 **Training:** Details of training obligations should be included e.g. who will train, at what cost, and how often the franchisee's employees need to be trained.
- 14 **Advertising:** Consider whether there is any minimum spend by each party per year and whether the franchisee will also be required to pay towards a central advertising fund via a marketing contribution. Usually a franchisor will want to approve all marketing material used by its franchisees.

- 15 **Insurance:** The franchisor usually obliges the franchisee to take out certain insurance cover with a right for the franchisor to receive prior notice of cancellation together with evidence of payments made. Consideration should be given to the risks to be covered by the franchisee and in particular key man insurance.
- 16 **Telephones:** If telephones are an important part of the franchised business then consideration should be given to the franchisee being required to subscribe to a particular telephone number. Alternatively the franchisee can be obliged to transfer the franchisee's telephone numbers to the franchisor upon termination of the agreement.
- 17 **Premises:** If the franchisee is required to take out premises then depending on whether location is key the franchisor may wish to take the lease in the first instance and sub-let the premises to the franchisee. Alternatively where the franchisee is acquiring the lease directly oblige the franchisee to enter into an option deed giving first right of refusal to the franchisor on termination of the agreement.
- 18 **Sale of the Business:** The franchisor should consider restricting the franchisee's right to transfer or sell the franchise/agreement The franchisor may wish to include a right of first refusal enabling it to match the purchaser's offer. If the franchisee is a limited liability company then consideration needs to be given to include provisions preventing the franchise from being transferred simply by transferring some or all of the shares.
- 19 **Non-Competition:** Usually a franchisee will be restricted during the term of the agreement from carrying on a competing business. Consideration also needs to be given as to whether or not the franchisee can carry on any other business. Such restrictions need to be considered carefully so as to be as enforceable as possible in the circumstances.
20. **Death and incapacity:** It is considered good practice to ensure that provisions are in place to allow a manager to be appointed to assist in running the franchisee's business for specified periods of time in the event of the franchisee's death or incapacity. Typically the Franchisee or his personal representatives would be allowed a period of time to nominate a beneficiary to take over the business or a longer period to try to sell the business before the franchisor's right to terminate applies. The franchisor is entitled to make a charge for the provision of the manager.

- 21 **Termination:** It is not usual to allow the franchisee a right to terminate the agreement as the franchisor will wish to ensure that the franchisee is committed to the franchise for a decent period of time. Therefore the rights of termination tend to be one sided in favour of the Franchisor and it is usual to include a detailed list of those breaches which would entitle the franchisor to terminate on notice. Examples could include failure to make payments, persistent complaints about the quality of service, and if the franchisee has a detrimental effect on the brand.
- 21 **Consequences of Termination:** It is usual to include very comprehensive conditions following the termination to ensure that the franchisee hands over key material and information and is effectively disassociated from the brand.
- 22 **Post Termination Non-Compete Covenants:** It is usual to include non-compete restrictions which will apply to the franchisee and the individuals where the franchisee is a company following termination or expiry of the franchise agreement. These typically prevent the franchisee from competing from the premises or within the franchised territory or soliciting customers for a period of up to 12 months post termination. In order to be enforceable these restrictions need to be limited in both time and territory in order to be reasonable and must be drafted with care.
- 23 **Liability and Indemnity:** It is usual for the franchisor to seek extensive indemnities from the franchisee in respect of possible liability of the franchisor for the actions of the franchisee. However, the indemnity given will only be as useful to the extent that the franchisee itself is solvent. A franchisor should be particularly careful about the representations made to the franchisee prior to entering into the agreements. The BFA's guidance is that franchisors should not seek to limit their own liability unreasonably.
24. **Representations:** it is important that all representations that the franchisee is relying on in entering into the agreement are acknowledged or attached in writing to the agreement and all other liability in this regard is excluded in so far as is possible. Claims for misrepresentation by franchisees remains a common cause for litigation.
25. **Boiler Plate:** The usual boiler plate provisions will need to be included in the Agreement e.g. confidentiality, waiver, cumulative rights, entire Agreement clause, governing law etc.

25 **ADDITIONAL CONSIDERATIONS**

- ***Terms and conditions of business:*** In addition to the franchise agreement the general terms and conditions of business that a franchisee is to use in his business need to be reviewed and adapted to ensure that they are suitable for use and limit both the franchisee and the franchisor's liability
- ***Services provided by Franchisor:*** Where the franchisor is providing back office support or other customer enquiry handling services the relationship between the two parties must be clearly set out to avoid the franchisor being liable to the franchisees' customers.
- ***Competition law:*** Care must be taken to ensure that the franchise arrangements do not breach relevant competition law which is particularly relevant where there are exclusive purchase obligations, exclusive territories and non-compete restrictions.
- ***Trading Schemes Act:*** care must be taken to ensure that the arrangement falls within one of the exemptions to pyramid selling schemes detailed in the Trading Schemes Act.

International Franchising: The above does not deal with the international elements of franchising – please see our briefing note on International Franchising for further information.

For further information please contact **Nicola Broadhurst, Beverley Flynn** or **Beverley Whittaker** on 01483 302264.

This information is necessarily brief and is not intended to be an exhaustive statement of the law. It is essential that professional advice is sought before any decision is taken.

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