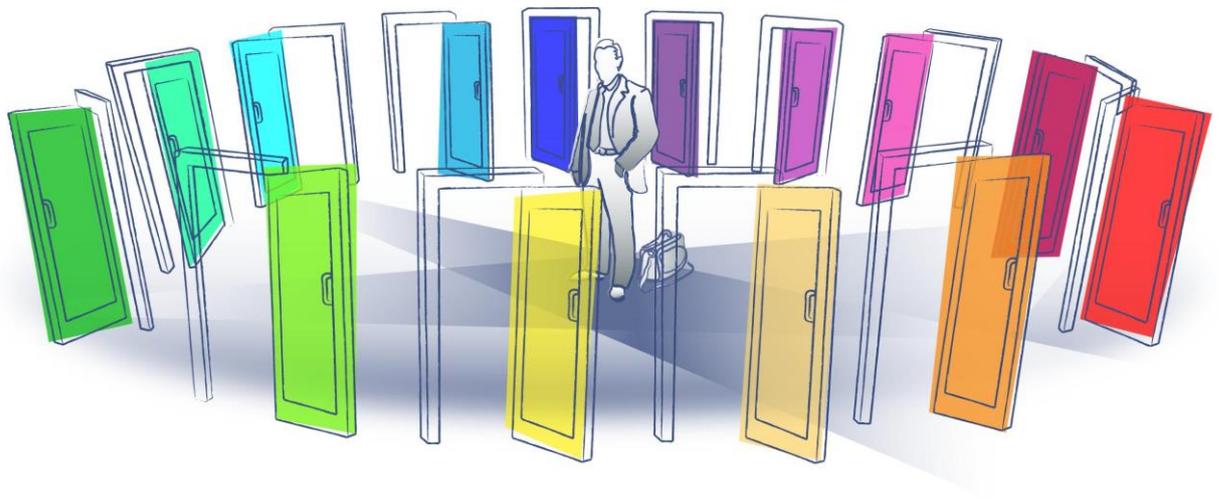


Franchising:

The Legal Considerations



Wright, Johnston & Mackenzie LLP -

The Place for Practical Advice





FRANCHISING

THE LEGAL CONSIDERATIONS

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1. Introduction

Franchising is becoming ever more popular in the UK both for those who have never run their own business and are looking for a change from their current employment and even for those experienced business people who are used to working for themselves running a completely independent business.

The reason for this popularity is that franchising has many attractions - so what are the benefits for a potential franchisee?

- Franchisees join an existing business with an established name and reputation.
- Franchisees benefit from the franchisor's experience in how to start-up the business and from their existing management and administrative infrastructure to help run the business.
- Franchisees will often find it easier to raise funding to take on an established franchise as opposed to a completely new business and, accordingly, the franchisee might have to invest less of his own money.
- In some cases, the franchisee will be given an exclusive territory which can confer a significant competitive advantage.

Naturally, where there are advantages, disadvantages also exist, and a prospective franchisee should consider these carefully when deciding whether a franchise is right for them. Some perceived disadvantages to the franchisee are:

- Franchisees purchase the support of a good franchise network at the cost of submitting to substantial control by the franchisor, exercised through the franchise agreement and the manual.

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- Franchisees will run the business under a licence and while it is natural for the franchisee to become proprietorial about his or her business, it must never be forgotten that termination or expiry of this licence can bring the business to an end.
 - Franchisees must make a financial return to the franchisor company on its investment. This can be in a number of ways, e.g. an initial fee, continuing royalties, advertising contribution, a tie-in in respect of the supply of certain goods and services, a fee for initial training and additional payments for refresher courses, and so forth.
 - Franchisees are subject to restrictions in the franchise agreement on the sale of the business and on passing it to the next generation which, to the uninformed franchisee, can appear to be unfair.

This brief guidance note for franchisees will address a number of the legal issues in franchising. It will not cover every matter in respect of which legal advice will be needed when starting up in business. The WJM franchise team can advise on all legal matters a franchisee may come across.

Other things a franchisee will need to consider which are not dealt with in this note include:

- choice of business medium (sole trader, limited company or partnership);
- preparation of a business plan;
- the whole issue of funding; and
- employment law, health and safety requirements and the other legal incidents with which every business has to cope.

2. What is a Franchise?

It may be surprising to find that there is no internationally accepted definition of a franchise. For our purpose a franchise is essentially a licence of a way of doing business where the franchisee offers goods and or services to customers under the franchisor's trade marks or trade name. It is a continuing relationship controlled by the franchise agreement and the franchisor's manual. The franchisor exercises control over the franchisee and provides assistance to them. In consideration for this assistance the franchisee has to make regular payments to the franchisor.

It is important to emphasise that a franchisee is an independent party and does not have any authority to create binding contracts between the franchisee's customers and the franchisor.

3. Investigating the Franchise

Every franchisee should investigate the franchise they are interested in thoroughly. Franchisees should look at the track record of the franchisor and obtaining as much information on them and reports and searches against them as they can.

Franchisees should also to contact existing franchisees to obtain an impression of how the franchise works "on the ground". It must be remembered that existing franchisees might be guarded about providing any information which could be interpreted as critical of their franchisor but generally speaking a good franchise operation should have happy franchisees who are willing to share their experiences. Sometimes there will be an official franchisee association through which information on the franchise can be obtained.

The following are just some of the questions which could be asked of an existing franchisee (or franchisee association):

- What was the total outlay/investment at the end of the day for you, including the additional and, perhaps, less visible costs?
- Were the franchisor's projections for your business performance accurate?
- Did the franchisor really provide all the help and assistance which was promised in launching and starting the business?
- Was the initial training of significant use and did the manual provide practical and easy to follow advice?
- Is there a substantial demand for the franchise's goods or services?
- Is the franchisor prompt and efficient in dealing with problems which arise in running the franchise business?
- How much "interference" is there from the franchisor?
- Is the franchise business providing a satisfactory return to the franchisee?
 - With the benefit of hindsight, would the franchisee do it again?

4. The WJM Franchise Advice Service

Wright, Johnston & Mackenzie LLP have developed a Franchisee Advice Meeting which we provide to potential franchisees. The intention is to give you a sound grasp of the legal concept of franchising in general and, in particular, a clear account of what you are undertaking by signing up to the particular franchise contract you are interested in. A face-to-face meeting also gives you a chance to ask questions, and for us to have a thorough discussion of all the legal and commercial issues surrounding the franchise.

WJM was one of the first legal firms in Scotland to become affiliated to the British Franchise Association and has long-standing expertise in advising both franchisors and franchisees.

Recognised by Chambers' Guide to the Legal Profession as "*commercially aware and dynamic*" and staffed by "*good practical people*", WJM's multi-disciplinary franchise team has many years of experience in franchising.

Our lawyers are straightforward, straight-talking advisors. We operate a "no surprises" approach to fees, and pride ourselves in giving excellent service to our clients.

WJM is one of Scotland's leading full-service commercial law firms, and our franchising team has access to a wealth of expertise in all areas of law. Whether you have a question about employment law, inheritance tax or a customer who isn't paying, we have experts who can help. We also provide a personalised private client service for business owners.

5. The Franchise Agreement

(a) Introduction

When you have decided on a franchise that suits you and the franchisor has decided to take you on, an agreement will be produced by the franchisor. There may be preliminary agreements, for example a confidentiality agreement, which have to be signed before the franchisor will release any information relating to the franchise business but the main agreement is the franchise agreement.

The first thing you will notice is that the agreement is long. This reflects the fact that the franchise agreement must cover many different areas of commercial and legal importance. A very short franchise agreement running only to a few pages is unlikely to do this.

An experienced franchise lawyer will not normally expect to alter or revise a franchise agreement. The well run franchise will not permit its documentation to be altered in any way. The reason for this is that it is very difficult for a franchisor to run a successful network of franchises over a wide geographical area if there are a number of different franchise agreements. The franchisor will insist that there must only be one standard agreement; otherwise the success of the entire network could be endangered.

(b) The Parties

Franchise agreements often involve three parties; a franchisor company, a franchisee company and an individual. This is because where the franchisee is a limited company (often, a newly incorporated one) the company is a separate legal entity. The franchisor understandably wants the individual(s) behind the company, on whom he is relying, to guarantee performance by the franchisee.

Another reason for involving the individual(s) is to ensure that any post-termination restrictive covenant (a clause restricting the franchisee from competing with the franchisor's business when the agreement comes to an end) will be enforceable against the individual(s) as well as against the company itself. A covenant only against the company (as already mentioned, a separate legal entity) might prove worthless to the franchisor as it would not prevent the individual(s) setting up in competition with the franchisor.

(c) Duration and Renewal

There is no standard duration for a franchise agreement. In setting the term a franchisor will normally consider the profitability of the franchise and allow sufficient time for franchisee's start-up costs to be absorbed, a break even position to be attained and thereafter a period in which the franchisee can enjoy the profits from the franchise. In assessing whether or not the duration of the agreement is acceptable to the franchisee, a well prepared business plan is invaluable.

Most franchises provide for an initial term which is followed by option of renewal of the agreement by the franchisee. This gives both parties an opportunity to assess the success, or otherwise, of the franchise.

For example, the duration might be expressed as an initial term of, say, five years with the right of the franchisee to renew the agreement for a further five years. The right of renewal will almost inevitably be one which the franchisee is entitled to exercise and it is not something the franchisor can impose on a reluctant franchisee.

However, renewal of the agreement by the franchisee is not automatic or a foregone conclusion. The franchisor will usually require to be satisfied that the franchisee's

performance has been satisfactory and that the franchisee has not breached the agreement at any time during the initial term.

The successful franchisee is unlikely to founder on these requirements. However, the agreement might contain an often more problematic provision which requires substantial additional investment by the franchisee in order to secure renewal of the agreement.

The successful franchise business will almost inevitably have undergone some changes during the initial period and, in fact, the terms and conditions on which new franchises can then be granted may have changed. Therefore at renewal there may be some negotiation with the franchisor involving the level of continuing fees to be paid by the franchisee. In addition, the franchisee might be required to refurbish or revamp the franchise premises.

Franchisees should consider carefully the terms of a "revamp" clause. In particular, if the "revamp" comes close to opening a completely new operation it is arguable that the franchisor should be able to show that the revamped franchise has been sufficiently tested (even pilot tested) to prove that it is more successful than the franchisee's existing business format. In this situation the franchisee or their lawyer should ask the franchisor for this information. Otherwise the franchisee is unable to make an informed decision as to whether or not to make the investment necessary to revamp the existing business.

Another request which may be made of the franchisee when renewing the contract is to relinquish and waive all claims against the franchisor. Such clauses might be open to attack as being an unfair exclusion of liability by the franchisor but the franchisor will usually insist on the clause being included. The franchisee should carefully consider whether or not there are any outstanding issues which should be aired and hopefully resolved rather than renewal

of the agreement which may deny the franchisee the opportunity to pursue these claims at a later date.

(d) Fees & costs

Any good discussion about a franchise must identify the different fees and expenses the franchisee will have to incur. There will in most cases be a clause in the franchise agreement helpfully headed "Fees" but this is very rarely the end of the matter and the remainder of the agreement has to be examined to identify where other costs arise.

The franchisee will often be asked to pay an initial fee. This should cover the initial costs to the franchisor of setting up the franchise, for example, franchisee selection, perhaps initial training and professional fees and expenses in completing the franchise agreement. It should not contain a profit element for the franchisor or, at the very worst, a very small element of profit.

The franchisee will then be expected to pay a royalty, sometimes described as a service fee. There will always be two components; a percentage and a basis of calculation. It is very important to understand clearly the way in which the royalty or service fee will be calculated since, for example, 5% of net profit could well turn out to be significantly less than 1% of gross turnover.

Before looking at further costs it is worth mentioning here that the franchisee will usually be required to maintain accurate books of accounts and records, to give regular reports to the franchisor on business activity and to permit the franchisor or its agents access to these books and records in order to check the information. If the franchisee is a limited company it might be required to send a copy of the audited annual accounts of the company to the franchisor within a certain period after the financial year end. In this regard the franchisor

may require the franchisee to have a certain date as the year end so that the franchisor receives at a certain time in the year the annual accounts of all its franchisees which can then be examined and, if necessary, further investigated. Compliance with these requirements will represent another cost for the franchisee.

Inevitably the franchisee will be required to undergo initial training and perhaps to attend refresher courses throughout the duration of the agreement. Often attendance will be at the expense of the franchisee, so there must be taken into account the direct expense of having personnel attend the training courses and the "soft or indirect" costs of having these people unavailable to participate in the business. It is important to find out where the training courses will be held.

The franchisee will often be expected to make a contribution to the costs of advertising the franchise network. Again care must be taken to understand properly the amount of this commitment. Also it is important to try to ensure that the national advertising will cover the area in which the franchisee is operating. For example, television advertising in the south east will be of no benefit to a Scottish franchisee but he or she may well be contributing to the expense of the advertising campaign.

The franchisee might be required under the agreement to obtain certain goods or services from specified suppliers. This is a "tie-in" and is often necessary to ensure that the quality of the goods or services being supplied under the franchise is uniform and as the customer expects. However, this could well limit the scope for the franchisee to make cost savings by sourcing such materials elsewhere.

On certain occasions the franchisor may be entitled or may be requested to provide management assistance in running the franchise, for example, if the franchisee becomes unwell or even wants to take a holiday. Inevitably there will be a charge for this service.

If the business is to be sold the franchisor might introduce a prospective purchaser who is acceptable to the franchisor. Beware that the franchisor will often expect to receive a commission or introduction fee for providing this service.

These are the main areas regarding costs which need to be examined. They can represent significant costs for the franchise business and it is essential that they are taken into account when preparing the business plan.

(e) Exclusivity

It is not the case that every franchise will confer an exclusive territory on the franchisee. However, where exclusivity is to be granted it is very important that the word "exclusive" is used in preference to the word "sole". This is not purely a matter of legal terminology; the words simply mean different things.

If a party is appointed the "sole" franchisee in an area, it would be interpreted to mean that while the franchisor would not appoint any other franchisees in that area, the franchisor is not prevented from opening company owned outlets.

On the other hand, "exclusive" means that the franchisee will be protected from competition both from the franchisor itself and from other franchisees appointed by the franchisor. In other words, the franchisor is completely locked-out of the area.

Sometimes an exclusive right will be conditional on the franchisee generating a certain level of return for the franchisor. If this cannot be achieved, the franchisor may reserve the right to appoint other parties in the same area to open company owned outlets.

(f) Transfer of the Business

It is very important that a franchisee understands the restrictions that will apply in regard to the transfer of the franchise business whether by voluntary sale or through succession.

A franchise will never be freely transferable as the success of a network depends significantly on the franchisor's selection of franchisees. The British Franchise Association's Code of Ethics states:-

"The agreement should give the franchisor the same freedom to deal with the purchaser as if it was a direct applicant to the franchisor".

Therefore the clauses in the agreement governing transfer will usually provide that the franchisor has to be satisfied with the capability and suitability of the proposed purchaser and that he or she will have satisfactorily completed initial training. Naturally, the franchisor will only consider any proposal if the franchisee has not breached the agreement and all payments are up-to-date. Some agreements will in fact provide that the purchase price has to be deposited with the franchisor who then has a right to deduct from it any sums due by the franchisee (including any administrative charges levied by the franchisor for dealing with the purchase) before the balance goes to the franchisee.

Sometimes a franchisor will have a pre-emptive right or option to acquire the business of the franchisee on the terms being offered by the purchaser. This usually requires a copy of the offer to purchase the business to be sent to the franchisor for consideration.

Most franchise agreements also cater for the situation where the franchisee wants to sell but has not identified a purchaser. Franchisors might retain a list of suitable purchasers and, for the payment of a suitable commission, the franchisor will effect an introduction.

Transfer of the franchise can of course also happen in the event of the death or incapacity of the franchisee which, in the case of a franchisee which is a limited company will be the death or incapacity of the individual(s) behind the franchisee company.

In the event of death or incapacity the options would be to transfer the business to a beneficiary or perhaps a relative of the franchisee or permit a sale of the business along the lines of the provisions already mentioned for a voluntary sale. Therefore the franchisor may have an option exercisable in these circumstances to purchase the business or may assist the representatives of the franchisee by finding a suitable purchaser.

The important point in relation to these matters is that they can take time. Accordingly, franchise agreements often contain a provision enabling the franchisor to step in and keep the business of the franchisee running until it has been decided what will happen. This right of the franchisor to appoint a manager to run the business may also arise where the franchisor feels it is prudent or expedient to provide such assistance on the grounds that it is necessary to protect the wider interests of the franchise network.

The main point regarding transfer of a franchise business is that a great degree of control is exerted by the franchisor. Successful franchisees will expend a great deal of time, effort and money in building up the business and it can be a cruel shock to find that realising the worth of this investment is subject to these close controls.

6. The Manual

Along with the franchise agreement the manual regulates the terms on which the franchisee must operate the franchise business. It should set out quite clearly the day-to-day operational instructions to the franchisee.

No two manuals will be the same but they should cover the following.

- A summary of the background to the franchise business and what it is envisaged that the combination of the franchisor and the franchisee should be able to achieve.
- A detailed description of the system which represents the secrets of the success of the franchise.
- A list of operating methods including for example instructions on operating and servicing equipment, stocking levels and any requirements for vehicles.
- Standard forms and documentation to be used in the franchise business.
- Information on cash controls and banking procedures and instructions on the maintenance of financial records and financial reporting.
- Outline advice on the application of employment law and information on staffing levels, training, discipline, disciplinary procedures and so forth.
- Opening times.
- Details of technical support which the franchisor will provide and information of manufacturer's guarantees which the franchisee is entitled to invoke.

Unlike the franchise agreement the manual can be (and almost inevitably will be) changed during the course of the franchise agreement. As already mentioned franchises evolve and develop and the manual should be updated to reflect these improvements and changes. It is important that the franchisee always obtains details of these changes but in case there is a lack of co-ordination in updating individual manuals, it is usually recommended that a definitive copy of the manual be kept at a specified location.

This power to amend the manual does at least theoretically give the franchisor the power to make significant changes to the franchise. The point should be raised at the outset and it should be made clear that if there is at any time any dispute between the agreement and the manual, generally the agreement should prevail.

7. Premises

A major commercial task for franchisees and franchisors is to find suitable premises for the business, particularly where a "high street" location is necessary.

Legally, the most important issue is the terms and conditions on which the franchisee will occupy the premises. In the vast majority of cases this will be on the basis of a lease from the franchisor if it owns the premises or a sub-lease if the franchisor itself has leased the premises. The terms and conditions of any lease or sub-lease must be carefully reviewed as part of the Franchisee Advice Meeting. In particular, it is important to ensure that the franchisee's obligations under the lease or sub-lease will terminate at the same time as the franchise agreement. This is usually not a problem as the franchisor quite naturally wants to ensure that on termination of the franchise agreement the franchisee has to vacate the franchise premises.

It is important to mention that the law of property in Scotland is fundamentally different from the law in England. Franchise agreements prepared under English law will contain provisions designed to avoid certain rights enjoyed by tenants in England, including franchisees. These are irrelevant in Scotland and any franchise agreement prepared in England must be amended to ensure that it can operate under Scots law.

The franchisee might be expected to pay for the initial fitting out of the premises and will inevitably have continuing financial obligations under the lease or sub-lease including payment of rent and service charges and the cost of any necessary repairs. These must be taken into account when assessing the cost of a franchise. We produce a separate briefing note on the property aspects of franchising: contact us for a free copy.

8. Conclusion

The approach in this paper has not been to look at all aspects of a franchise agreement but rather to consider some of the issues which can arise which are of particular concern to a franchisee. Some points have not even been mentioned; for example, provisions allowing termination of the agreement.

In addition, as mentioned at the outset, there are major issues which will affect franchising like any other business including employment law, insurance, health and safety and so forth.

However, the areas which have been covered (and those which have been omitted) at least indicate that franchise agreements are complex legal documents. It is necessary to cover many different aspects of a continuing relationship so, inevitably, the agreements are lengthy.

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