Franchising your business

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1. Introduction

The flow of businesses turning to franchising as their first choice of business operation continues unabated. McDonald's is the most famous example of the franchise model but other examples include Joules, The Body Shop, and Pizza Express. In other words, franchising is big business.

Franchises differ from most other sales arrangements, such as distribution or licence agreements, in many respects. The main difference is that to the outside world, franchisor (i.e. brand owner) and franchisee (i.e. store operator) are the same. The franchisee uses the franchisor's business name or trade mark for the franchised business. In addition, the franchisor regulates closely the way in which the franchisee's business is carried on. As a result a "Big Mac" is the same the world over.

The purpose of this guide is to give a brief introduction to the potential opportunities and drawbacks as well as the issues which need to be addressed in a franchise agreement.

2. Advantages and Disadvantages

The main advantage to a franchisor is the ability to quickly scale a business by, for example, moving into new territories, whilst maintaining a large degree of control over the brand image of its product or services through the control it exercises over the franchisee.

For example, the franchisor can determine the way in which goods are displayed in the franchised shop, the uniforms which the franchisee's employees are required to wear, or even the way they are expected to greet customers.

Other advantages for the franchisor are that:

1. The franchisee's capital input reduces the cost and risks involved in expansion.

2. Increased numbers of outlets enable economies of scale.

3. Franchisee contribution towards central training and advertising costs.

4. Because the franchisee has a financial stake in the business, it is motivated to make the new outlet a success.

The franchisee benefits as follows:

1. They are self-employed.

2. If the franchisor already has a well-known name, it is (relatively) easy to quickly develop the business and less working capital will be required.

3. The franchisor may provide a high level of support relating to the management of the business.

4. The purchasing power of the franchisor may reduce the costs of the franchisee and there may be other scale related benefits.

5. If the franchisee knows that the name already sells, the risks are far lower.

6. It is often easier to obtain financing.

The main disadvantage for the franchisor is that there will be a loss of control. This is so despite the numerous restrictions on the franchisee. For this reason the franchisor must be able to terminate the franchise quickly if the franchisee is damaging the reputation of the business. A

successful franchisee may resist changes which the franchisor wishes to make, or demand changes of their own. In addition, an element of the franchisor's profit will be taken up by supporting another element in the supply chain, the franchisee. The franchisee will also gain a high level of knowledge about the franchisor's business. There is, therefore, the risk that they may later use this information to compete with the franchisor. Restrictions on the use of such information must be carefully drafted to ensure they are as legally effective as possible.

The franchisor should also be aware that running a franchised business may be quite different from running its own business. New skills will be required.

In addition, the franchisor needs to recognise the disadvantages the franchisee may see. The franchisee will be far more restricted in the way they run the business than if they were to run it independently. There may also be restrictions on the franchisee's ability to sell or pass on the business. The franchisee will be obliged to make regular payments out of their profits to the franchisor. In addition the franchisor may run into financial or other difficulties. However successful the franchisee's operation, such difficulties will impact upon their business.

3. Elements of a Franchise Agreement

The main elements of a franchise are as follows:

3.1. Exclusive rights to sell the products and use the trade marks

The franchisor grants the franchisee the right to use the franchisor's name, or a name associated with the franchisor. The name will normally be protected as a registered trade mark. The franchisor will agree not to supply the products to other parties in a given territory. Exclusivity can also be limited to particular lines of products.

3.2. Franchisor's control

The franchisor retains a certain degree of control over how the business is operated. Certain provisions will be in the agreement itself, others will be contained in a manual. The franchisor will have the right to update the manual from time to time, so retaining flexibility. Typical provisions include:

1. Control over choice of location, decoration and display of goods, appearance and behaviour of staff and opening hours.

2. Franchisor's approval required for advertising initiated by the franchisee.

3. Minimum stock levels and purchase requirements.

3.3. Assistance by the franchisor

The franchisor provides certain assistance to the franchisee. This will necessarily include guidance in the matters over which it has control. The franchisor often also supplies equipment, training, publicity and stock for the franchisee prior to the commencement of the franchise business and, where applicable, on a continuing basis.

3.4. Duration

Most franchise agreements are granted for five years, with a right to renew for at least one further period; a fee may or may not be payable on renewal. It is important that the initial franchise period is sufficiently long to give the franchisee some prospect of recouping its costs and making profits before expiry. Renewal should be conditional on the franchisee achieving certain performance levels.

3.5. Payment

The franchisee normally makes three types of payment to the franchisor during the course of the

agreement:

The initial fee – The purpose of this fee is for the franchisor to cover its expenses in promoting the franchise. The initial fee is normally kept reasonably low with perhaps 10-15%of the fee being attributed to the grant of the trade mark licence.

Continuing fees – This is the royalty element and is usually charged as a percentage of the franchisee's sales. This fee reimburses the franchisor for the costs of supporting the franchisee on a continuing basis and also represents its profit. Alternatively the franchisor may not require royalties but simply supply goods to the franchisee at a price which covers its costs and contains a profit element. The franchise agreement will normally include minimum sales (in the case of a royalty arrangement) or minimum purchase (in the case of a supply arrangement) provisions in order to protect the franchisor's profits.

Advertising charge – This charge is made in respect of national advertising undertaken by the franchisor, often based on the turnover of the franchisee. The franchisee can check that their payment is used for these purposes as it is usual for the franchisor to place such payments in a special bank account.

In addition, there may be a fee payable on renewal of the agreement.

The franchise agreement will generally provide for interest to be charged in cases of late payment.

3.6. Accounts

The franchisor will want to inspect the franchisee's accounts and sales records and regulate the way in which they are produced. As well as satisfying the franchisor's interest in the financial health of the franchisee, this is also essential for the proper calculation of royalties and advertising charges.

3.7. Insurance

The agreement will normally require the franchisee to take out insurance, in respect of the assets of the business and liabilities to the public. There is also a risk that, because of the degree of control exercised by the franchisor over the franchisee, and the fact in the public's mind there is no distinction between the two, the franchisor could be held liable for the franchisee's negligence. Accordingly the franchisor will usually wish to obtain insurance to cover itself against such a risk.

3.8. Assignment

The franchisor will not normally allow the franchisee to dispose of the business without its consent. The franchisor will want to ensure that the prospective purchaser of the business is suitable and financially sound. The franchisor commonly retains the option of equaling any offer made for the business and purchasing it itself.

If the franchisor is also the landlord of the franchisee, it will be concerned that the franchisee does not acquire security of tenure of the premises from which

the franchise is undertaken. If the franchisee were to have security of tenure, they could demand the renewal of their lease on its expiry, even where the franchise agreement had terminated. Security of tenure can be avoided through a straightforward court application by both the parties for approval of the arrangement.

3.9. Termination

Most agreements provide the franchisor with wide and absolute powers to terminate the agreement quickly and easily if the franchisee is not performing satisfactorily. In case of poor performance, as a step falling short of termination, the franchisor might retain the right to appoint an "acting manager" to try and remedy the situation.

3.10. Bank guarantees and guarantors

The franchisee will often be a company with limited liability. In the event of the franchisee becoming insolvent the franchisor will rank as a normal creditor in the liquidation. Accordingly the franchisor should take steps to ensure payment of the monies owed to it. It is normal to request a bank guarantee in an appropriate sum. A personal guarantor of the franchisee's obligations, who will normally be the person running the franchise, should also be considered.

4. The Regulation of Franchising

There is no specific UK legislation relating to franchise agreements. Franchisors and franchisees may apply to join the British Franchise Association, although membership is not compulsory in law. Members of this body undertake to adopt a code of ethics. In addition the association provides a forum for the interchange of information and franchising expertise.

Despite the lack of legislation specifically relating to franchising other legislation, both EU and UK, will impact on franchise agreements.

4.1. Article 101(1) of the Treaty on the Functioning of the European Union

Article 101(1) prohibits agreements which prevent, distort or restrict competition within the European Union or aim to do so. Examples of provisions which are prohibited are those which fix selling or purchase prices or trading conditions and those which make the conclusion of contracts subject to supplementary obligations which have no real connection with the contract (for example, a requirement to stock unrelated products). The agreement must also have an effect on trade between member states of the EU. This precondition is widely interpreted. For example, an agreement under which a franchisee is restricted to a certain territory and is unable to set up business in another member state has been held to constitute an effect on trade between member states.

However, most franchise agreements will not be caught by Article 101(1). Many such arrangements relate to products or services which are traded on a local level rather than between member states and will therefore not have the required effect on trade. Other agreements will fall within the scope of a notice published by the European Commission in relation to agreements of "minor importance". For franchise agreements this means that the market share must be 10% or less.

4.2. The Competition Act 1998 (as amended)

This Act represents a fundamental updating of UK competition law. It is modelled on Articles 101 and 102 of the EU treaty (TFEU) and gives major powers to the Competition and Markets Authority.

In the case of franchise agreements, the issue is whether or not they qualify for the EU block exemption for vertical agreements (such as franchise agreements). If they do (or would have done so had they had an effect on trade), they will be exempted also from the Act.

If they do not qualify, the issue of infringement of the Chapter 1 prohibition under the Act

may arise.

5. International Possibilities

Franchising on an international scale presents a number of options.

The franchisor may enter directly into franchises with companies in the target country. The main difficulties here will be in providing adequate back up and exercising sufficient control from a foreign country. The franchisor may also lack familiarity with local business practices and have language problems.

Granting a master franchisee the right to sub-franchise in the territory may be a solution, although here profits will be shared with a third party and there will still be a need to police the master franchisee.

An alternative is to establish a branch or subsidiary in the country of operation. In this way, the franchisor can exercise greater control over the operations. There will also be no necessity to share the revenue with a third party although the franchisor may still be obliged to pay for local business advice.

Finally, the franchisor may enter into a joint venture with a partner in the target country.

6. Taxation

A major issue in international franchising is taxation. It may be to the franchisor's advantage to have the fees paid by the franchisee taxed in the UK. The franchise structure chosen should allow for this.

The franchisor will wish to ensure that payments under the franchise agreement are received in the most tax efficient manner. This, in turn, will often depend on the tax status of the franchisor. For example, if the franchisor is not resident and not ordinarily resident in the UK, a capital payment which falls outside the UK tax net would be most beneficial for him, from a UK tax viewpoint. In such circumstances, the tax consequences in the franchisor's home country would also have to be taken into account in structuring the transaction.

Royalty payments are subject to a withholding at source at basic rate under UK domestic tax legislation. This can result in a cashflow disadvantage for the franchisor. Often this is rectified by requiring the franchisee to pay an additional amount so that the franchisor receives, net of the deduction, the amount they would have received in the absence of the requirements to make such a deduction. Whether or not the franchisee should agree to such a provision will depend on the negotiating strengths of the parties. If the franchisee agrees to such a provision, a further provision requiring the franchisor to make a reverse payment to the franchisee on the franchisor receiving any tax benefit as a result of the deduction should be included.

In the case of an overseas franchisor, the deduction at source is often disapplied by the relevant double tax treaty. In such circumstances, a clearance from the Inspector of Foreign Dividends is required before the franchisee can make payments without making a deduction at source. The franchisor would require the franchisee's co-operation to obtain the clearance. Appropriate provisions should be included in the franchise agreement.

Sometimes the franchisor's country will not have a favourable double tax treaty with the UK. In such circumstances, offshore structures which minimise the withholding are considered. Restructuring the royalty payment as a capital payment or a payment for management or advertisement services or for the supply of goods also can avoid the withholding.

The re-characterization of any payment has to be considered carefully to ensure that it is effective.