Legally binding

John Pratt, senior partner at franchise firm Hamilton Pratt, explains what you should expect to find in a franchise agreement

Business format franchising contains four essential elements:

- The franchisor allows the franchisee to use the name associated with the franchisor.
- The franchisor exercises continuing control over the franchisee.
- The franchisor provides assistance to the franchisee.
- The franchisee has periodically to make payments to the franchisor.

The franchise agreement is fundamental to the success of a proposed franchise. It should reflect the way the franchisor intends to operate its business, as well as seeking to protect the franchisor from franchisee claims. As a result, a franchisee must thoroughly investigate a franchisor, its system and network before he enters into the franchise agreement.

Guiding principles

Although franchise agreements are tough commercial agreements prepared by franchisors, they should nevertheless strike a balance by following some guiding principles:

- Balanced. Although franchise agreements are drafted by the franchisor's legal team and favour the franchisor, there are limits - which experienced franchise lawyers will understand - on how one sided they should be.
- Selling document. The franchise agreement should not, because of the way it is drafted or presented, have the effect of deterring prospective franchisees.
- No legal terminology. Franchise agreements are complex commercial documents, but a prospective franchisee should be able to understand it. Plain English should be used with no legal terminology.
- Well presented. A well presented franchise agreement discourages franchisees from amending it and shows the franchisor attaches importance to the quality of the agreement.

No two franchise agreements are the same - they range from 20 page tiddlers to 120 page monsters, but are all likely to contain the following important clauses:

Rights granted

The rights granted by the franchisor to its franchisee will either be exclusive or non exclusive. About 70 per cent of franchise agreements grant some sort of exclusivity. Generally, in franchises that are operated from retail premises no exclusivity is given. If you are granted exclusivity, you need to establish precisely to what does the exclusivity relate - customers or premises - and even with an exclusive territory you cannot prevent another franchisee from responding to an unsolicited enquiry in your exclusive territory.

Franchise fee, term and renewal

The franchisee pays an initial fee. That fee should not contain a profit for the franchisor, because otherwise a franchisor's business could simply be the sale of franchises. Its purpose is to reimburse the franchisor the cost of granting a franchise.

The duration of the franchise agreement is typically five years. There should be a right for the franchisee to renew the franchise agreement for at least two further terms, subject to the franchisee having not materially breached the franchise agreement. Occasionally franchise agreements are granted for 10 years with one renewal term or, for high start-up cost franchises such as McDonald's or Burger King, for the duration of the lease of the franchise premises - 25 years.

Franchisor's obligations

You would expect a franchisor to provide the following:

- Advice on finding premises/vehicles.
- Advice on alterations to and fixtures and fittings in the premises/vehicles.
- General advice on how to set up the franchise.
- Such equipment, stock, fixtures and fittings as are listed in the schedule to the agreement.
- A PR launch.
- The provision of the operations manual.
- An initial training programme.

The franchisor should, during the term of the agreement, be obliged to:

- Provide the franchisee with know-how, advice and guidance relating to the business.
- Supply products to the franchisee.
- Train the franchisee's personnel.
- Organise meetings for franchisees.

Franchisee's obligations

Extensive restrictions and obligations are imposed on the franchisee, because the franchisor has to be able to ensure the standards of the franchise system are maintained. Franchisees usually have to:

- Refurbish and equip the premises or vehicle as required by the franchisor.
- Only use products, equipment and stationery specified by the franchisor.
- Operate the business according to the franchise operations manual.
- Maintain the premises or vehicle to high standards.
- Use his best endeavours to promote the business.
- Operate the business during hours specified by the franchisor and not be involved in another business.

It is important to recognise that these obligations are imposed for the benefit and protection of franchisees generally, because a non compliant franchisee may have a detrimental effect on the franchise network.

Continuing fees

The franchisee will generally pay a continuing fee (based on a percentage - usually eight - of gross turnover) and will be obliged to maintain accounting records and supply the franchisor with VAT returns and other financial reports required by the franchisor.

Often the franchisee is obliged to contribute to national advertising - usually about two per cent of turnover - and to take out such insurance cover relating to the business as the franchisor requires. In addition, the franchisor can instigate audits and checks on a franchisee.

Sale of business

Probably the only disadvantage of taking a franchise is that a franchisee cannot sell his franchise to whoever he wants - a purchaser has to be someone the franchisor would want as a franchisee. As a result, you would expect clauses that provide as follows:

- That the franchisee shall not transfer the franchise without the franchisor's consent.
- The franchisor will consent to a transfer provided the purchaser meets the franchisor's minimum standards, payments of the investigation costs are made and there are no breaches of the agreement.
- The franchisor has the option to match any offer for the business that is made to the franchisee.

Death/incapacity

On the death or incapacity of the franchisee, the franchisor often provides a manager until the franchised business is sold. If a sale is not agreed within a reasonable period of time, the franchisor can terminate.

Termination

The franchisor requires the right to terminate the agreement if a franchisee commits a serious breach of the franchise agreement, does not remedy a breach or consistently breaches the franchise agreement, even if those breaches are minor. Often a franchisor will be able to terminate if a franchisee:

- Fails to commence business.
- Breaches important terms of the agreement.
- Persistently defaults in payment due to the franchisor.
- Supplied false or misleading information in the franchise application.
- Is insolvent.

But there will be many other situations where a franchisor can terminate.

The duration of the franchise agreement is typically five years

Consequences of termination

Generally, following termination the franchisee must:

- Cease use of the franchisor's brands.
- Pay all sums due to the franchisor.
- Return to the franchisor all manuals, literature and anything that bears the franchisor's trade name.
- Provide the franchisor with a list of its customers and potential customers.
- Not use or disclose any confidential information relating to the system of the franchised business.
- Not compete with the franchisor.

The non compete clause has to be drafted with great care to ensure it is enforceable. It will be subject to a test of reasonableness, but unlike non compete clauses in employment contracts it is likely to be enforceable.

Guarantee

If you operate your franchised business through a limited company, the individuals who have set up the limited company will be required to guarantee to the franchisor the obligations of the limited company.

Operations manual

The operations manual has been mentioned a number of times in this article. It is a crucial document. It deals with the day to day operational issues in running a franchise and can be - and indeed should be - changed and updated by the franchisor on a regular basis. A breach of the requirements of the operations manual is almost always also treated as a breach of the franchise agreement. **WF**