

Nicola Broadhurst, head of franchising at Munday's looks at the contents of the franchise contract by reviewing how it should deal with the obligations of the two parties.

## THE OBLIGATIONS OF THE TWO PARTIES

### CONTRACTUAL OBLIGATIONS:

#### Franchisor's initial obligations

Although it is important to protect the brand from being brought into disrepute by the actions of an incompetent or destructive franchisee this does not mean that the franchisor is at liberty to impose numerous obligations on the franchisee whilst accepting few, if any, obligations itself.

Certainly in ethical franchising the franchisee should have a clear idea of exactly what obligations the franchisor is undertaking in return for the fees it is receiving from the franchisee. These obligations should be set out in clear and unambiguous terms in the franchise agreement.

Too often a franchisor cross refers to fees in the operations manual, rather than the agreement. Yet the manual is rarely seen at the outset by the franchisee

The franchisor's initial responsibilities towards the franchisee before the latter is ready to open for business should be 'unambiguously set out, and followed by those services and benefits which it will provide periodically during the term of the agreement in return for the continuing fee.

Typical initial responsibilities include the requirement to provide the initial equipment, stock and stationery that may be required by the franchisee in setting up; advice and assistance in locating and securing premises from which the business is to be conducted; advice and assistance in fitting out the premises in the typical format of the franchise business; initial training in the system; assistance in the initial marketing launch for the business; and the provision of the operations manual.

The franchisee must ensure that all set up obligations promised in the franchise marketing literature are included in the agreement and fulfilled by his franchisor.

#### Operations Manual

The operations manual is one of the most essential parts of the franchise concept. Generally, all business-format franchises are heavily dependent upon the use of operation manuals which contain the day-to-day details of the franchised business. It is franchisor's obligation to provide the operations manual to its franchisees at the outset and it should be contractually obliged to send regular updates to its franchisees.

The operations manual forms part of the franchise contract, but as it is continually updated it is the dynamic part of the contract and regard must be paid to it by all franchisees. It is usually an obligation for franchisees to comply strictly with the provisions in the manual.

Clearly, this ability to unilaterally amend the manual, and thereby effectively the contract, can be open to abuse by unscrupulous franchisors. However, it is important that the franchise agreement provides that it will prevail in the event of a conflict.

It is important, however, that if a franchise business is to develop and adapt over the course of the agreement that there is an ability for the franchisor to impose modifications on the franchisee in order to maintain uniformity amongst the network and to be able to adapt to market conditions quickly and effectively. These modifications, however, should not materially change the rights granted in the agreement.

#### Franchisor's ongoing obligations

The continuing obligations of the franchisor should extend to ongoing advice, support, training and assistance to be provided to the franchisee during the course of the agreement, and in the case of product-

based franchises the supply or sourcing of the products concerned. It is preferable to set out exactly what this advice and assistance consists of whether in the operations manual, or in the agreement. The more detail that the franchisor is prepared to give, the better for the franchisee. The franchisee must also be clear as to whether there will be additional charges.

## **Franchisee's obligations**

The franchisor will seek to impose numerous obligations on the franchisee in order to protect its intellectual property and trade secrets and to tie the franchisee into its way of doing things. If the franchisee has other business interests these will need to be adequately dealt with either by way of an exception or a complete prohibition.

The confidentiality provisions in the agreement are obviously essential and the franchisee is also normally required to obtain a confidentiality agreement from its key employees to protect the disclosure of any trade secrets during the course of the business. A template undertaking should be provided by the franchisor.

The main obligations include observing certain minimum operating hours, paying the franchise fee, following the accounting system laid down by the franchisor, maintaining the requisite insurance coverage, allowing the franchisor's staff to inspect the premises and speak to customers to establish that the standards are being maintained, and to purchase goods or products from the franchisor or its designated suppliers.

## **Payment provisions**

Usually there is a separate section in the contract which deals with the fees that the franchisee is required to pay. The manner and the timing of such payments should be clearly set out to avoid confusion.

The accounting and reporting procedures should also be stipulated and the franchisee should be required to produce regular profit and loss accounts and audited or certified accounts at the end of each financial year. This is an essential protection for any franchisor to ensure its franchisees are trustworthy. This regular accounting by the franchisee also ensures that action is taken as soon as any financial problems in the business become apparent.

## **Advertising**

The franchisee is usually restricted in the way in which it can advertise its business. This helps to protect the brand of the franchisor, which is one of its most valuable assets. Inappropriate advertising can easily damage the reputation of the business.

Some franchises are more heavily dependent on advertising than others and in some contracts there is an obligation on the franchisees to commit a minimum spend on advertising, or to contribute regularly to an advertising fund which is maintained by the franchisor to promote the network. It is useful, even where the franchisor does not intend to use such a fund immediately, to provide for this in the contract as trying to impose an advertising fee at a later date on a franchisee, where this right has not been reserved, is extremely difficult.

The advertising fee should be paid into a central fund which is audited on an annual basis, and a certificate showing the expenditure and income of the fund should be sent to the franchisees. This gives some accountability of the franchisor's actions to the franchisees which promotes trust in the franchisor's actions.

## **Terminating the relationship**

The ways in which a franchisee may be allowed to exit the franchise should be clearly dealt with in the franchise agreement. There is usually a restriction on the franchisee selling or assigning the business without the consent of the franchisor. It is obviously important that any incoming franchisee meets with the

franchisor's approval and is subject to the same rigorous selection procedure that the other franchisees have had to satisfy.

In many franchise agreements, the franchisor will reserve the right to buy back the business, i.e. a right of first refusal which is exercisable within a specified time period after the franchisee has served notice that it wishes to sell its business. Where there is a prospective purchaser the right to buy back the business should be on the same terms as those offered by such purchaser. This avoids a franchisor undercutting a genuine market price.

The way in which the sale is dealt with will vary from franchise to franchise and most franchisors seek to impose a transfer fee to recoup their administrative costs in investigating the prospective purchaser, plus a commission payment where it has introduced the purchaser. The levels of these fees vary, but in order to be reasonable they should not present an obstacle to the sale.

On the death of a franchisee, the franchisor may stipulate that the business should be assigned or sold in order to avoid the goodwill diminishing and the business being run into the ground. There is usually a time period within which the personal representatives of a franchisee can elect to assign the business or to sell, in each case with the franchisor's approval.

Again in the event of incapacity, particularly where the franchise is service based and dependent upon the franchisee being able to run it, the franchisor may wish to reserve the right to appoint a manager, but will still want to have the option to force the franchisee to sell the business should the incapacity go on for too long. The length of period varies. In some cases it can be three days and in others 180 days or more.

One of the key parts of the franchise agreement from the franchisor's point of view will be its ability to terminate the contract where a franchisee is in breach of its obligations. Invariably a franchise agreement will have a comprehensive list of those events which will constitute a sufficiently serious breach by the franchisee that the franchisor will have the right to terminate.

Unless it is a fundamental breach, however, the franchisor should be careful to allow the franchisee a reasonable period of time to try and remedy the breach. The courts increasingly take the attitude that parties should be seen to be attempting to resolve their differences before resorting to any form of litigation and should act reasonably at all times. Therefore, a franchisor, who arbitrarily terminates the agreement without allowing the franchisee the chance to rectify a breach (unless of course it is a substantial) will be open to challenge by a franchisee.

The usual events that give rise to termination include failure to pay fees on time, failure to provide the accounting information required, insolvency and breach. Usually, the franchisee is not given an express right to terminate the agreement itself and must rely on common law principles, which provide that the franchisor must be in fundamental breach of its obligations before a franchisee can terminate.

An ethical franchisor will however, usually provide that where a franchisee does not pass the initial training the agreement will terminate with a partial refund of the initial fee. This is obviously a useful protection for both the franchisor and franchisee as it allows the franchisor to quickly show the door to an unsuitable candidate with little harm done, and it softens the blow for the franchisee.

On termination, it is vital that the franchisor can ensure that the franchisee is disassociated from the franchise network as quickly as possible. This will include the right to enter the franchisee's place of business and take down any relevant signs or advertising material, obtain lists of relevant customers, and usually some form of restriction on the way in which the franchisee can trade in the immediate aftermath.

The likely restrictions to be imposed on the franchisee on termination are similar to those to be found in employment contracts and sale contracts, such as the non-poaching of customers of the business and restricting the franchisee from setting up a competing business within the immediate vicinity.

The duration of these restrictions and their geographical scope varies, depending on the nature of the business and the level of competition in similar markets. These restrictions need to be carefully drafted in order to ensure that they are enforceable and expert advice should be sought in this regard.

## **Minimum performance targets**

Increasingly, franchisors are seeking to monitor the performance of their franchisees more carefully, particularly where exclusive territories are granted, and weed out those who do not achieve a realistic level of sales. This is done by setting performance targets, usually related to the level of sales to be achieved, and can be monitored either monthly, quarterly or yearly. Where a franchisee fails to meet these targets, the franchisor can reserve the right either to remove exclusivity if the franchisee operates in an exclusive area, reduce the territory if a territory has been given, or even terminate the franchise agreement.

## **Standard clauses**

Some clauses are standard and can be found in almost every commercial agreement. They include the following.

### **Waiver:**

Most franchise agreements will allow the franchisor to take action on a breach by a franchisee, even where it may have failed to take action on a previous breach. Without these provisions, common law would make it difficult for a franchisor to act.

### **Warranties:**

Franchisees are generally prevented from giving any guarantees or warranties about the services or goods to be provided other than those contained in the operations manual. This prevents a franchisee from bringing the network into disrepute by saying something false, particularly where the franchisor may incur liability as a result.

### **Dispute/arbitration:**

Most contracts contain provisions dealing with how disputes may be resolved. Generally, franchisors either provide for arbitration or mediation, or a combination of the two procedures. Care needs to be taken to ensure that such dispute resolution procedures are optional as a contractual obligation to follow a course of action can invalidate some legal insurance.

## **Financial projections**

Franchisors generally give financial projections to prospective franchisees. These should be based on hard facts and figures that have been gained from trading experience by the franchisor and not simply "plucked from the air".

There is usually a clause in the agreement to exclude liability on the part of the franchisor for any representations, warranties or statements which may have been given to the franchisee prior to signing the franchise contract. This is usually qualified by a proviso that any representations which the franchisee is relying on must be annexed to the agreement.

Franchisees should be well aware of the impact of this clause before they sign the agreement. It may well be that the franchisee is relying on something which is not stated in the contract and has not ensured that it is annexed to the agreement. This may prevent the franchisee from relying upon it at a later date.

From a franchisor's point of view such a clause is essential to protect it from over enthusiastic claims and introduces a degree of certainty into the relationship.

## **Conclusion**

As can be seen, the franchise agreement has to encompass numerous aspects of the franchise business and it is no wonder that it is often a lengthy document. It is not sufficient for a franchisee to rely solely on the reputation of a franchisor without ensuring that the franchisor is tied down to specific contractual obligations in a properly drafted franchise agreement.

New management may take over, or the concept change dramatically during the term of the agreement, and a wise franchisee ensures that there are safeguards in place to protect him in these eventualities.

Invariably once a franchise agreement has been signed it will not be looked at again until renewal. However there are cases where disputes occur and when what is written in the franchise agreement will determine the outcome. If the issue is not addressed clearly and concisely in the agreement then this will merely confuse issues further, incurring more costs and aggravation.

Whilst there are common provisions in all franchise agreements, each agreement must be tailored to be specific to each franchise concept and it must cater specifically for the needs of its franchisor.

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