Franchise agreements

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1. Introduction

Many businesses grow by offering franchise opportunities and many people are able to start in business by taking on a franchise. Franchising a business involves granting a licence to trade using its brand name and business model to another business (the franchisee). The franchisee pays an initial licence fee and a recurrent royalty or service fee and is responsible for financing and managing the franchised outlet. The franchisor plays a continuing role in supporting the franchisee but, in the right situation, can benefit from cost-effective expansion. Several of the world's biggest brands have built their business using a franchise model, including 7-Eleven, Subway, McDonalds and Burger King. Franchises in India include InXpress, RollaCosta, Gelato Vinto and Gayatri Electric Vehicle. Vietnam is a hotspot for franchising with local franchises including Wrap and Roll, Trung Nguyen and Maxx. Cambodia has a successful franchise, Brown Coffee.

A franchise agreement is just like any other contract – it sets out the rights and obligations of each party and provides appropriate remedies if either party fails in their obligations.

2. Business format franchising

The most common form of franchising is business-format franchising in which there is a legal agreement between a franchisor and a franchisee that allows the franchisee to trade using the franchisor's brand name and business model. Typically, this enables the franchisee to open their own outlet from which to sell the franchisor's products or services. When franchises are offered for sale, they are typically restricted to specific geographical areas to avoid competition between franchisees.

The franchisor, that is, the owner of the original business, provides the franchisee with the information and resources such as operating manuals, training programmes, proprietary software, specialist equipment, point-of-sale items, livery and stock they need to set up and operate their franchise outlet. They usually give the franchisee continuing support.

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The franchisee is an independent operator. They pay an initial franchise fee and recurrent royalty or service fees to the franchisor in return for the resources and support they need to run the outlet. They are responsible for financing and managing the outlet. However, they must run the outlet in accordance with the business model specified by the franchisor, who will make requirements relating to such matters as quality control, pricing and customer service. The franchisor may supply the franchisee with some of or all the raw materials and indeed may require that franchisee uses only their materials.

Other agreements, sometimes described as franchising, but strictly are not, include:

- Licensing agreements**,** where a business allows another party to manufacture and sell their products but does not dictate the business model;
- Distribution agreements, where a business allows another party to purchase and re-sell their products.
- Agent agreements, where a business allows another party to sell their products on their behalf , with the agent receiving a commission on whatever is sold.

3. Business suitability

The franchise model does not suit every business. To build a successful franchise, a business primarily needs to be successful, replicable and have a unique selling proposition. The business needs to be attractive to potential franchisees and will need to be able to generate a worthwhile profit. The franchise model depends on franchisees running successful individual businesses so both they and the franchisor make a profit. A business that is suitable for franchising is likely to have:

- A product or service that is expected to have long-term demand.
- A healthy profit margin.
- A clearly defined business model, which can be easily communicated and replicated.
- Proven sales and marketing techniques that can be applied to franchise outlets.
- A distinct selling point - for example, a brand name, a unique product or service or a strong reputation.
- The resources, financial and otherwise, to deal with the demands of managing the franchise model and supporting franchisees.

In contrast, a business is unlikely to be suitable for franchising if:

- It requires specific skills that are difficult to transfer or learn.
- It is subject to regulation that makes the setting up of franchise outlets difficult.
- It is tied to a particular location and cannot be operated from other places.
- It can easily be replicated without the need for training or resources from the originator.

4. The franchise agreement

The franchise agreement is a written document that sets out the terms of the arrangement between the franchisee and franchisor. It covers in detail the rights and obligations of each party. It is important that the agreement is fair to both parties, ensuring that franchisees are properly supported, and that the franchisor can act in the best interests of the business as a whole and protect their intellectual property. Key terms a franchise agreement should cover include:

- The identity of the franchisor and the franchisee
- The rights of the franchisee, including use of brand names and trademarks and the right to sell the specified goods or services.
- The rights of the franchisor, such as the right to dictate how the franchisee operates their outlet, for example in terms of quality or customer service.
- Territory restrictions, detailing the geographic area in which the franchisee is entitled to operate and any exclusivity that exists in this arrangement.
- The initial resources and information that the franchisee will receive, such as the operating manual and training.
- The support services that the franchisor will provide to the franchisee, such as administrative and marketing support.
- The initial and recurrent fees the franchisee will pay the franchisor, the means by which recurrent fees are calculated and the payment schedule.
- The rights of the franchisor in approving, or not, a new franchisee if the existing franchisee decides to sell their business.
- The duration of the agreement and arrangements for renewal, or otherwise, once the agreement ends.
- A termination clause specifying the grounds on which either party can terminate the agreement, and the consequences of such a termination.
- Franchisee obligations and restrictions after termination

The franchise agreement can be a lengthy and complex document and it is important that it is clearly drafted to protect the interests of both the franchisor and the franchisee. Indeed, it is in the interests of both franchisor and franchisee to seek independent legal advice on the agreement before they sign. However, for the sake of fairness and consistency, franchisees should, as far as possible, all be on the same terms.

5. Fees and payments

Most business originators that operate a franchise model charge franchisees an initial fee plus recurrent fees such as service charges and royalties. There may be some extra charges for services that fall outside of the agreed fees. For example, some franchisors may require franchisees to purchase goods or supplies from them at prices higher than the wholesale cost to the franchisor. The main fees are:

- Franchise fee: This is the initial fee paid at the start of the franchise agreement. It may be paid upfront or in instalments during the franchise set up. The fee amount can vary greatly depending on the type of business and customer awareness of the brand.
- Recurrent fees. Most franchisors charge a monthly service fee to cover the support services provided to the franchisee. This can be a set monthly amount, a royalty based on the franchisee's turnover, or, more typically, both. Recurrent fees represent the main income stream for franchisors. Fees that are based on turnover can benefit both parties because the franchisor has a clear incentive to ensure that the franchisee is successful (though there needs to be agreement on how sales will be reported and on the franchisor’s right to audit the figures).

6. Further information

Sample franchise agreements are easily available online. See, for example, www.pandadoc.com/franchise-agreement-template

Seid, M (2020) Negotiating a franchise agreement, available at www.thebalancesmb.com/negotiating-a-franchise-agreement-1350094 website

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