

# UNDERSTANDING THE CODE OF ETHICS

The British Franchise Association's Guide to Best Practice in Ethical Franchising based on the European Code of Ethics for Franchising.



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# FORWARD

This is a book on best practice in franchising. It's also about making franchising ethical, which is really just another way of saying same thing. This book is also the bfa's interpretation and clarification of The European Code of Ethics for Franchising which for the sake of convenience we'll shorten and just refer to as "the Code". There are two things you should know about the Code:

1. It encompasses best practice, based on a set of fair and ethical standards
2. The rules of membership of the British Franchise Association ("bfa") are drawn from and based on the Code. It follows therefore that any company seeking to join the bfa needs to understand the Code as a basis for meeting the requirements for bfa membership. Bfa members are obliged to adhere to the Code.

In the following section we set out for you the actual Code, developed by the European Franchising Federation. The Code is then supplemented by the bfa's Extension and Interpretation, on page 12.

We have created the bfa's guide ("the Guide") to understanding the Code. The Guide is written in plain, straightforward, everyday English. The Guide and the bfa's Extension and Interpretation will help you understand the Code and how you should apply it. Be aware that the bfa's views and interpretation in the Guide should not be taken as the definitive meaning of the Code with legal standing.

In some areas the Guide goes well beyond the formal Code, discussing details of best practice that are not contained anywhere in the Code. For example, it also includes material from the bfa's Technical Bulletins, which also form part of best practice even though not specifically in the Code. The purpose is to explain and illustrate how the bfa interprets the Code and defines best practice and sets its standards in the real world of franchising.

Bfa members are expected to comply with the Code, the Extension and Interpretation and this Guide, as well as the bfa's rules of membership and the bfa's Technical Bulletins.

The Guide is not a manual on how to go about franchising your business. There are plenty of bfa affiliated advisers who can help you with this. The bfa's own website is also overflowing with helpful information.

# PART 1

## THE EUROPEAN CODE OF ETHICS FOR FRANCHISING AND THE BFA'S EXTENSION AND INTERPRETATION

### Introduction

The European Code of Ethics for Franchising ("the Code") has been developed by the European Franchise Federation ("the EFF"). In adopting the Code, the EFF recognised that national requirements may necessitate certain other clauses or provisions and delegated responsibility for the presentation and implementation of the Code in their own country to individual member National Franchise Associations.

The Extension and Interpretation which follows the Code has been adopted by the British Franchise Association, and agreed by the EFF, for the application of the Code for the bfa and its members within the United Kingdom.

### Preamble

1. This preamble sets out the purpose of the European Code of Ethics for Franchising and the principles under which Member Associations of the EFF will apply the Code in their countries.
2. The Code is a practical ensemble of essential provisions for the governance of the relations between a franchisor and each of its franchisees, operating together in the framework of the franchise network. The overarching principles of ethics that underline this set of provisions are good faith & fair dealings, which translate as franchisor-franchisee relations based on fairness, transparency and loyalty each of which contribute to founding confidence in the relationship.
3. The principles of the Code are applicable at all stages of the franchise relationship; pre-contractual, contractual and post-contractual stages.
4. The Code constitutes the franchising industry's self-regulatory code and is there for all stakeholders in the franchise industry in Europe to look to for guidance on franchising generally.
5. The Code's clear and unambiguous principles are not in contradiction with national laws and fundamental rights in the EU with the continuing objective of setting up a more efficient framework for franchising.

# THE EUROPEAN CODE OF ETHICS FOR FRANCHISING

6. In particular, the Code is the foundation stone of the action of the EFF's National Franchise Association members. Their respective membership rules, accreditation as well as disciplinary schemes must comply with the standards set in the Code. The Code, in its entirety, is binding for all EFF members as well as their respective memberships. The Code is endorsed by all EFF member franchise associations each of which is committed to its promotion, interpretation and implementation in their own country. Each association is responsible for ensuring that the Code is publicly available, in particular to all those entering the franchise industry.
7. National franchise associations which are members of the EFF have the opportunity to add to the Code a National Extension and/or Interpretation provided that it does not derogate from or misinterpret the Code.
8. The EFF represents the franchise industry as a whole which, in a multi-stakeholder approach, means the interests of the franchise networks, inclusive of franchisors and franchisees towards public authorities, civil society, and consumers.
9. The Code was originally written in 1972 by major industry actors in Europe, members of the EFF's founding associations. It directly reflects the experience of good behaviour of franchisors and franchisees in Europe. It was reviewed in 1992 to reflect the evolution of franchising on the market as well as to meet the development of the EU's regulatory frame.
10. The Code has been updated in 2016 in order to further integrate provisions which reflect the continued franchisor-franchisee experience on the market in the countries of its Member associations, as well as to meet the recommendations of the European Commission on matters of Self-Regulation. The Code is a living plan of action. Its updates are ongoing and iterative so as to remain relevant to an ever- evolving industry.
11. The EFF believes, and this is attested by its 40-year experience as the single voice for franchising in Europe, that robust Self-Regulation is the best adapted and most flexible mode of regulation for the European franchise industry. It is on this foundation that Franchising has contributed significantly to the promotion of independent entrepreneurship, in particular the development of SME's and modernised commerce, as well as related employment on the European markets.
12. The EFF is a not-for-profit international association constituted in 1972. It is registered in Brussels, Belgium where it has a permanent Secretariat. The Federation's members are the single accredited national franchise associations from countries that fall under the geo/institutional conditions expressed in the EFF's Statutes.
13. The most important of the EFF's roles is to promote the adoption of the Code so as to secure the development in the EU of proper and ethical franchising.

## 1. Definition of Franchising

Franchising is a system of marketing goods and/or services and/or technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the Franchisor and its individual Franchisees, whereby the Franchisor grants its individual Franchisee the right, and imposes the obligation, to conduct a business in accordance with the Franchisor's concept.

The right entitles and compels the individual Franchisee, in exchange for a direct or indirect financial consideration, to use the Franchisor's trade name, and/or trade mark and /or service mark, know-how, business and technical methods, procedural system, and other industrial and / or intellectual property rights, supported by continuing provision of commercial and technical assistance, within the framework and for the term of a written franchise agreement, concluded between parties for this purpose.

**”know-how”** means a package of non-patented practical information, resulting from experience and testing by the Franchisor, which is secret, substantial and identified.

**”secret”** means that the know-how is not generally known or easily accessible; it is not limited in the narrow sense that each individual component of the know-how should be totally unknown or unobtainable outside the Franchisor's business;

**”substantial”** means that the know-how is significant and useful to the buyer for the use, sale or resale of the contract goods or services;

**”identified”** means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality;

## 2. Guiding Principles

- 2.1 The Franchisor is the initiator and long-term guardian, in a market, of a franchise network, composed of the Franchisor and its individual Franchisees.

### 2.2 The commitments of the Franchisor:

The Franchisor

- i. shall have operated a business concept with success in the relevant market, for at least one year and in at least one pilot unit before starting its franchise network in that market;
- ii. shall be the owner, or have the legal rights to the use of its network's trade name, trade mark or other distinguishing identification;

- iii. shall recognize their franchisees as independent entrepreneurs and shall not directly or indirectly subordinate them as employees;
- iv. shall provide the Individual Franchisee with initial training and continuing commercial and /or technical assistance during the entire life of the agreement;
- v. shall grant the right to use the know-how transferred and/or made available to the Franchisee, which know-how it is the franchisor's responsibility to maintain and develop;
- vi. shall transfer and/or make available the know-how to the Franchisee through adequate means of information and training and shall monitor and control the proper use of that know-how;
- vii. shall encourage feedback of information from Franchisees in order to maintain and develop the know-how transferred and/or made available to them;
- viii. shall, in the pre-contractual, contractual and post-contractual phases of their relationship with Franchisees, seek to prevent any wrongful usage of or, in particular, the transmission of know-how to, competing networks so as to avoid prejudice to the interests of the network;
- ix. shall invest as appropriate the means, financial and human, to promote his brand and to engage in the research and innovation that will ensure the long-term development and continuity of his concept;
- x. shall inform prospective and individual franchisees of his internet commercial and/or sales policy;
- xi. shall seek to safeguard the interests of the network in the development of its (the Franchisor's) on-line commercial and/or sales policy;
- iv. shall act loyally with regard to each of the other Franchisees of the network as well as with regard to the network itself;
- v. shall supply the Franchisor with verifiable operating data to facilitate the determination of performance and the financial statements necessary for effective management guidance;
- vi. shall allow the Franchisor to ensure that the quality and image of the concept is properly maintained in the products and services provided by the Franchisee to the customer/consumer;
- vii. shall recognize his responsibilities as a fully independent entrepreneur with regard to the customer/consumer;
- viii. shall not disclose to third parties the know-how and other information material to the operation of the franchise provided by the Franchisor, neither during nor after termination of the franchise agreement.

#### **2.4 The ongoing commitments of both parties:**

##### The parties

- i. shall seek to safeguard the image and reputation of the network in the running of their respective businesses;
- ii. shall exercise good faith and fairness in their dealings with each other. The parties shall give written notice of any contractual breach and, unless inappropriate, grant reasonable time to the other party to remedy default;
- iii. shall respect the confidentiality of information material to the franchise concept provided by the one to the other;
- iv. shall resolve complaints, grievances and disputes with good faith and goodwill through fair and reasonable direct communication and negotiation;
- v. shall where appropriate and where parties have failed to resolve a dispute through direct negotiation, seek in good faith mediation before litigation and/or arbitration organized or approved by an EFF National Association Member;

### **2.3 The commitments of each Franchisee:**

#### The Franchisee

- i. shall accept the obligation to collaborate loyally with the Franchisor in ensuring the success of the network which the franchisee has joined as an informed and fully independent entrepreneur;
- ii. shall devote its best endeavours to the growth of the franchise business and to the maintenance of the common identity and reputation of the franchise network;
- iii. shall be responsible for the human and financial means that it engages in its franchise business and is responsible as an independent entrepreneur, with regard to third parties, for his acts within the framework of the franchise;

### 3. Recruitment, Advertising and Disclosure

- 3.1 Advertising for the recruitment of Individual Franchisees shall be free- of ambiguity and misleading statements.
- 3.2 Any recruitment, advertising and publicity material, containing direct or indirect references to future possible results, figures or earnings to be expected by Individual Franchisees, shall be objective and shall not be misleading.
- 3.3 In order to allow prospective Individual Franchisees to enter into any binding document with full knowledge, they shall be given a copy of the present Code of Ethics, or a public access to it, as well as full and accurate written disclosure of all information material to the franchise relationship, within a reasonable time prior to the execution of these binding documents.
- 3.4 The prospective Franchisee is responsible for carefully analysing the information material to the franchise relationship, including choosing to take appropriate professional advice, before signing the franchise agreement.
- 3.5 The prospective Franchisee must be truthful and transparent in the information about his experience, his financial capacities, his training, background and any other information material to the franchise relationship he provides for the purpose of his selection by the Franchisor.
- 3.6 **If a Franchisor imposes a pre-contract on a candidate individual Franchisee, the following principles should be respected:**
  - i. prior to the signing of any pre-contract, the candidate Individual Franchisee should be given written information on its purpose and on any consideration he may be required to pay to the Franchisor to cover the latter's actual expenses, incurred during and with respect to the pre-contract phase; if the franchise agreement is executed, the said consideration should be reimbursed by the Franchisor or set off against a possible entry fee to be paid by the Individual Franchisee;
  - ii. the pre-contract shall define its term and include a termination clause;
  - iii. the Franchisor can impose non-competition and/or confidentiality clauses to protect its know-how and identity.

### 4. Selection of Individual Franchisees

A Franchisor should select and accept as Individual Franchisees only those who, upon reasonable investigation, appear to possess the basic skills, education, personal qualities and financial resources sufficient to carry on the franchised business.

### 5. The Franchise Agreement

- 5.1 The Franchise agreement shall comply with the National law, European community law and this Code of Ethics and any National Extensions thereto.

- 5.2 The agreement shall protect the Franchisor's industrial and intellectual property rights so as to secure the common identity, reputation and interests of the franchise network.
- 5.3 Franchisors shall offer to franchisees all agreements and all contractual arrangements in connection with the franchise relationship, in writing, in the official language of the country the Individual Franchisee is established in or in a language in which the franchisee formally declares itself competent. Signed agreements shall be given immediately to the Individual Franchisee.
- 5.4 The Franchise agreement shall set forth without ambiguity, the respective rights and obligations of the parties and all other material terms of the relationship.
- 5.5 The essential minimum terms of the agreement shall include at least the following:
  - i. the rights granted to the Franchisor
  - ii. the rights granted to the Individual Franchisee
  - iii. the Franchisor's intellectual property rights on the brands, signs, etc. which should be established for a term at least as long as the term of the franchise agreement
  - iv. the goods and/or services to be provided to the Individual Franchisee
  - v. the obligations of the Franchisor
  - vi. the obligations of the Individual Franchisee
  - vii. the terms of payment by the Individual Franchisee
  - viii. the duration of the agreement which should be long enough to allow Individual Franchisees to amortize their initial and subsequent investments specific to the franchise
  - ix. the basis, including the notice which both parties must give, for any renewal of the agreement
  - x. the terms upon which the Individual Franchisee has the right to sell or transfer the franchised business as a going concern and the Franchisor's possible pre-emption rights in this respect
  - xi. provisions relevant to the use by the Individual Franchisee of the Franchisor's distinctive signs, trade name, trademark, service mark, store sign, logo or other distinguishing identification
  - xii. the Franchisor's right to adapt the franchise system to new or changed methods
  - xiii. provisions for termination of the agreement
  - xiv. provisions for surrendering promptly upon termination of the franchise agreement any tangible and intangible property belonging to the Franchisor or other owner thereof.

### 6. The Code of Ethics and Master-Franchise Systems

This Code of Ethics shall apply to the relationship between the Franchisor and its Individual Franchisees and equally between the Master Franchisee and its Individual Franchisees. It shall not apply to the relationship between the Franchisor and its Master-Franchisees.

*End of the European Code of Ethics for Franchising. Latest revision: final 6 Dec. 2016*

# THE BRITISH FRANCHISE ASSOCIATION EXTENSION AND INTERPRETATION OF THE CODE

This Extension and Interpretation forms an integral part of the Code adopted by the bfa and to which its members adhere.

The term "Article" as used in this Extension and Interpretation, and the Guide that follows, refers to the relevant article of the Code.

## 1. Application

The Code, the Extension and Interpretation and the Guide, as well as the bfa's Rules of Membership and the bfa's Technical Bulletins, form part of the membership agreement between the bfa and its members. It does not form part of the contractual agreement between franchisor and franchisee, unless the franchisor specifically states otherwise.

## 2. Independance

The Code states in Article 2.2(iii) that the franchisor must ensure that it recognises its franchisees as independent entrepreneurs and not as employees. This is important. Whilst franchisees must operate their businesses in line with the system as developed by their franchisor, franchisors must treat franchisees as independent business operators, running their businesses at their own discretion and their own risk. Whereas the relationship between an employer and an employee or worker is governed by employment law, the franchise relationship is not. The franchise relationship is governed by the franchise agreement, and franchisees are independent contractors.

## 3. Disclosure

The objectivity of recruitment literature (Article 3.2) refers to all recruitment, advertising and publicity material. But note that the requirement to be objective and not misleading applies to all franchisor communications with their franchisees.

## 4. Confidentiality

For the generality of the Code, 'know-how' is taken as being as defined under European law. However, for the purposes of Article 3.6 it is accepted that franchisors may impose non-competition and secrecy clauses to protect other information and systems where they may be reasonably regarded as material to the operation of the franchise.

## 5. Contract Term

Article 5.5 of the Code provides that the minimum term for a franchise contract should be long enough for a franchisee to amortize their investment over the length of the term. However, it is recognised:

- a. that for a minority of the largest franchise opportunities amortizing initial investments may not be a primary objective for the franchisee. In such cases the objective should be to adopt a contract period which reasonably balances the interests of the parties to the contract.
- b. that this section could be subject to national laws concerning the restraint of trade.

## 6. Master Franchisees

Article 5.5 (iii) of the Code states that the Franchisor's ownership of intellectual property rights in their brand and system should be for a term at least as long as the term of the franchise agreement. With regard to Master franchisees, in interpreting this Article, the bfa takes into account the Master franchisee's renewal rights, thus ensuring that a Master Franchisee has a potentially long enough term left on its master franchise agreement to grant unit franchises. However in the spirit of the Code the bfa also makes the assumption that if the master franchisee's contract were to cease, in order to ensure that the grant of the intellectual property rights under the franchise agreement are not prejudiced, the responsibility for the continuing trading of the unit franchisees should be preserved by transfer to the Franchisor or its nominee.

## 7. Contract Renewal

The basis for contract renewal should take into account the length of the original term, the extent to which the contract empowers the franchisor to require investments from the franchisee for refurbishment or renovation, and the extent to which the franchisor may vary the terms of a contract on renewal. The overriding objective is to ensure that the franchisee has the opportunity to recover their franchise investment.

## 8. Adoption

This Extension and Interpretation and the Guide were adopted by the bfa, replacing the previous version, on .....

# PART 2

## DEFINITION OF FRANCHISING, EXPANDED

Let's now take a further look at the Code, with guidance in best practice from the bfa.

### WHAT IS 'THE CODE'?

The European Franchise Federation (EFF) believes that robust self-regulation is the best adapted and most flexible mode for regulating franchising.

The Code provides that the conduct and relationship between franchisor and franchisees should always be fair, transparent and in good faith, and describes what is meant by this. This philosophy applies throughout the entire franchise relationship, starting before contracts are signed and lasting even after the contracts have ended.

The Code exists for the benefit and protection of all parties involved in franchising. Its standards of conduct and ethical principles apply to how franchisor and franchisees conduct themselves and deal with outside parties, such as consumers, public authorities, and society in general. Its ethical principles do not clash with national laws or fundamental rights.

The Code applies to the relationship between a franchisor and its individual franchisees, and equally between a master franchisee and its individual franchisees. It is not intended to form part of any franchise agreement or other contract between franchisor and franchisee unless this has been specifically agreed. The Code does not apply to the relationship between a franchisor and any master franchisees it may have.

The Code, in its entirety, is binding on all national franchise associations who are members of the EFF. All members have agreed it, and all members must comply with it, promote it and implement it.

National franchise associations are permitted to add sections of their own to the end of the Code, once these have been approved by the EFF. These are 'national' extensions that apply only to that country, including the bfa's Extension and Interpretation which appears in the *British Franchise Association Extentions and Interpretation of the Code* section.

This definition of business format franchising immediately below, which appears in the Code, is as good a definition as you will ever find:

*Franchising is a system of marketing goods and/or services and/or technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the franchisor and its franchisees, whereby the franchisor grants its franchisees the right, and imposes the obligation, to conduct a business in accordance with the system developed by the franchisor.*

*In exchange for fees or other financial consideration, the franchisor grants a franchisee the right to use the franchisor's trade name, know-how, technology and systems and other intellectual property rights, supported by continuing provision of commercial and technical assistance, within the framework of a written franchise agreement.*

#### How does a franchise work?

A franchise has the following key features:

- The franchisor and franchisee are at all times distinctly separate legal entities. Franchisees are not employees of the franchisor.
- The franchisor grants certain rights to the franchisee, and these rights carry certain obligations.
- The rights granted to the franchisee are usually (but not necessarily) restricted to a territory given to the franchisee. This may be defined in the franchise agreement by reference to a county, or a list of postcodes, or as shown on a map
- The franchisee is licensed to use the franchisor's intellectual property and methods.
- The franchisee is obliged to conduct his/her business in the way that the franchisor determines.
- The franchisor is obliged to provide certain things. Depending on the business concerned, it could be the supply of products, or sales leads, or technical support, or ongoing training or R&D or central services (such as bookkeeping or telephone answering) or whatever is written into the franchise agreement.
- The franchise agreement will specify what payments (and in what form, and how frequently) the franchisee will make to the franchisor. The terms will be clearly defined, as will the basis of calculation for these payments.
- The bfa considers that a further fundamental element of any franchise is that the business model itself is workable and consequently that the franchisor must ensure that it continues to be workable for the duration of the franchise agreement.
- Business format franchising is a business system and not to be confused with a simple licensing or sales agency arrangement or distribution network.

The word 'know-how' appears in the EFF's definition. The know-how of each franchise brand is ordinarily contained in an Operations Manual, which might be hard copy, or online, or both.

# THE ELEMENTS OF AN ETHICAL BUSINESS FORMAT FRANCHISE

A franchise network consists of a franchisor and franchisees:

- The franchisor who develops a methodology for the operation of their system. They own the intellectual property in the business concept (including their brand name and know-how).
- Franchisees who buy into that system. They commit to running their own business in accordance with the franchisor's instructions, which are set out in the franchisor's operations manual.
- Importantly, whilst the franchisees must follow the instructions of the franchisor as to how the business is structured, each franchisee owns their own business and are legally responsible for it. The franchisees are independent contractors. Their own efforts determine whether or not their business is a success.

There are some absolute minimum requirements that need to be present for a franchise to be considered to be operating to good ethical standards. These elements should be present not only when a new network is first being set up but also throughout the duration of the existence of the network. These elements are that the franchise business must be:

- **Franchisable**
- **Viable**
- **Ethical**
- **Disclosed**

What does this mean in practice? Let's look at these four critical elements in more detail.

## Franchisable

Franchisable means that the business model can be replicated in other locations, with other people operating it, and still succeed. The nature of the business concept needs to be such that someone other than the franchisor can successfully exploit it.

You cannot franchise an idea (a misconception often held by people when they first think about setting up a franchise). For a business system or business model to be able to be franchised, first there must be something tangible and worthwhile to franchise. Otherwise, what is the franchisee actually buying? Business format franchising is not about testing your theories with somebody else's money. The would-be franchisor must be able to demonstrate that they have been successfully operating that business themselves in the form that they propose to franchise, and further that the business model is transferable to other places, under different ownerships.

Granting a franchise means licensing a franchisee to run a replica version of your business. Often, but not always, in a different geographical location to yours. It therefore has to be possible for a franchisee (with suitable training) to copy your business model successfully. Many business concepts are replicable, but not all are. You will potentially find it difficult if your business:

- depends on a specific customer base that few franchisees would have access to
- depends on a limited region or location
- is heavily reliant on one person's personality or attributes, or is dependent on a very rare or specific skill set, such that it is difficult to train other people, or where the pool of potential suitable franchisees is extremely narrow or specialised.

The business that the franchisee will run needs to be saleable. In other words, the franchisee must be able to develop some value in their customer base that they can sell on to another franchisee. When a franchisee invests in a franchise, they are not buying a job. They are investing in the development of their own client loyalty.

## The “pilot”

In order to proof-check the concept, franchisors will have run some form of “pilot” operation before embarking on a full-scale franchise recruitment campaign. This can take various forms:

- The franchisor may already have been running the business themselves in the form that they plan to franchise. They need to have been doing this for a sufficiently long period of time to demonstrate that the concept will have long-term success. In many cases, the bfa will consider that running the business for two years before considering franchising is sufficient, but this depends on a number of factors.
- The franchisor may set up (or have already set up) their own company-owned branch(es), operated at “arm's length”. This provides an opportunity to test various locations.
- The franchisor may have a third party (perhaps a business associate or former employee) running a stand-alone operation, to demonstrate that the franchise operation can be successful.

Whichever route is followed, the pilot must provide objective evidence that the franchised outlet can run independently on an “arm's length” basis, without the franchisor's day to day involvement. The pilot should replicate as far as possible the business that a franchisee will run. It needs to have its own separate management accounts, which exclude the franchisor's development costs (eg the creation of the operations manual and the franchise agreement) but include a realistic picture of the costs that an independent franchisee will incur, whether in the context of systems licences, cost of equipment, staff costs and overheads, or otherwise.

The success of the pilot must be demonstrated for a reasonable time: one year is considered the absolute minimum period for such a business to have operated before a business owner can consider developing a franchise model for it, but a franchise is more likely to succeed if the concept has been operated profitably for a couple of years at least.

One pilot operation is a minimum: two or more is better. One benefit of multiple pilots is that you can test the business in different environments, which could be coastal towns, tourist resorts, inner cities, high streets, out-of-town locations, or university towns - all depending on the product or service involved and the model that needs to be tested. It may work in London, but what about the Lake District? Or vice versa? Applying this example would indicate the types of markets where the business may or may not thrive. What is needed is such number of pilot units in locations typical of those in which franchisees will operate.

## Viable

Viable means not only that there is a replicable business, but also that both the franchisor and the franchisees can run it profitably. It must be shown that, if operated properly, the franchise provides a satisfactory financial return to both parties.

For the franchisee this means a reasonable return on the investment and for the work involved and for a reasonable period, in addition to being able to pay the franchisor any fees due under the franchise agreement.

For the franchisor it means earning sufficient from the fees to be able to operate profitably in the medium to long term. It is normal and to be expected that a franchisor will be unable to trade profitably in the short term as the income stream from his franchisee(s) will not be sufficient to fund the outgoings required to support and develop the franchise network. Until there is a sufficient number of franchisees to provide an adequate income stream, the franchisor will be probably be funding the operation out of working capital or reserves.

Success does not necessarily mean that the business has to be profitable in its first year. The business plan might show losses for a period before it breaks even and then moves into profit. The important thing is that this is known, predicted, planned and budgeted for, and that the pilot operation performs in accordance with that plan.

The operation of a pilot operation, as described above, is a critical evidence point.

## Ethical

The Code states that “the conduct and relationship between franchisor and franchisees should always be fair, transparent and in good faith” as stated in the Code. Essentially this means that both parties will adhere to both the letter and the spirit of the contents of the Code and to the principles of fair play and honesty.

The Code, the Extension and Interpretation and this Guide all aimed at providing a clear framework for ethical franchising, and the standards and behaviours that are expected. The bfa devotes much time and energy into exploring, explaining and clarifying how this standard of conduct, of fairness and honesty and transparency, works in the real world in different situations. The bfa guides the franchising community according to these standards.

All franchisors should make their prospective franchisees aware, prior to any commitment, of the Code, and either give them hard copy or direct them to where it can be found online.

## Disclosed

Disclosed means giving prospective franchisees all the information they require to be able to make a properly informed decision as to whether to invest in the franchise. Generally, the disclosure should be in written form (hard copy or online). Depending on the specifics of the particular franchise, disclosure by the franchisor should include such things as:

### The business

- The financial status of the franchisor's company, including a set of its latest accounts not less than 18 months old, accompanied by the statement: “that there has been no decline in its financial position since the date of the accounts which would result in the franchisor not having adequate resources to finance its present business requirements”;
- Confirmation as to whether it had had any action taken against it in consequence of debt save for any genuine disputes to which it was professionally advised that it at least had an arguable case. If the franchisor cannot provide such certificate or confirmation they must provide a full explanation of the position.
- How long it has been operating and how long it has been franchising;
- If it a recently-formed franchise, information about and results of the pilot operation(s).

### The people

- Information (name, qualifications, responsibilities, business experience) on the directors and other key people with authority to make decisions directly and substantially affecting franchisees;
- Confirmation that none of the senior people has had a criminal conviction, or been declared bankrupt or insolvent, or the subject of an order disqualifying them from acting as a director.

### The opportunity

- A description of the franchise business model and the initial and continuing services which will be made available to the franchisee;
- Proper verifiable financial forecasts in respect of the franchise model, presented in a transparent and honest way, including stating clearly on what experience, circumstances or realities these projections have been based;
- Information about the performance of the network;
- How many franchisees they have, how long they've been trading and where they trade from;
- How many (if any) franchisees have sold their business in the previous two years and the proportion which were at a price that exceeded the initial franchise fee;
- If site approval is a feature of the franchise the franchisor should explain the basis of approval and whether they intend the franchisee to rely on their own choice, and if so to what extent;
- Again, where the franchise requires premises, will the franchisor be taking a headlease or will the franchisee be negotiating a deal directly with the relevant landlord;
- Where products are supplied by the franchisor, the franchisor should indicate what will happen if the source of supply fails;
- Transparency on any ‘purchasing incentives’ or commissions that the franchisor receives on purchases made by the franchisee.

Further detail about the requirements for disclosure are provided in the *Franchise Recruitment* section.

## The agreement

- The main commercial terms of the franchise agreement: length of term, fees payable, whether or not the franchisee will have an exclusive territory, whether or not a deposit agreement will be entered into before the franchise agreement;
- Whether the franchisor is a bfa member, and if so, what category of membership they hold.

## The history

- Whether the franchisor has terminated the agreements of any franchisees within the past year, and on what grounds;
- Whether any franchisees have terminated their agreements within the previous year, and why;
- Whether there have been any franchisee business failures or closures.
- Information about any current or recent legal disputes, especially details of any litigation or arbitration;
- Access to all current franchisees so that the prospect can contact them to ask his/her own questions;
- Whether the franchisor or any franchisee have previously traded in that territory and if so, the trading history of that territory for the past five years;
- Specific trading history (if any) of the brand (whether franchisor, franchisee or company owned) in the particular territory under consideration.

Note that where personal data is to be provided, the provisions of the General Data Protection Regulation 2018 should be followed. The bfa will require potential new members to sign a Data Sharing Agreement.

# OBLIGATIONS OF A FRANCHISOR

In addition to the overarching obligations and standards already referred to such as proving that the system works, taking responsibility for the brand and the network, full disclosure to prospective franchisees, and behaving in a fair, honest and open way, there are some specific responsibilities that should be noted.

## **Brand**

Every franchise will have an identifying brand or trade name, which must be protected by a trademark. A prospective franchisee (or their lawyer acting for them) should always check to see whether that is in fact the case. The franchisor has the obligation to protect its brand in the interests of all parties. The franchisor will then license their franchisees to use the brand in their own businesses, with proper safeguards. If the brand is owned by someone other than the franchisor (e.g. a director personally or the master franchisor), the franchisor using the brand must have the right to use it and licence it to its franchisees.

For their part, franchisees are obliged to use the brand in the manner set down by the franchisor. The franchisee must help preserve and protect the integrity and reputation of the brand.

## **Know-how and other intellectual property**

“Know-how” is explained in the *Elements of an Ethical Business Format Franchise* section. This, together with other intellectual property rights (which might include, for example, copyright and database rights) are made available to franchisees through the Operations Manual, which sets out what is to be done and how, and through the provision of training. The franchisor is responsible for the proper use and control of the know-how.

The franchisor’s intellectual property rights should run for a term at least as long as the term of the franchise agreement. Where the franchisor entity is not itself the owner of the relevant intellectual property – for example where this is held by an associated entity – there must be a suitable intra-group licence agreement.

Franchisees will, as they gain experience in the business often have valuable feedback to give to the franchisor in respect of the know-how and the operating systems of the business generally. The franchisor should encourage such feedback and where appropriate consider incorporating any worthwhile improvements or innovations into the system. This then improves and develops the body of know-how for the benefit of all the franchisees. But note that the ownership of the know-how, and all other intellectual property rights used in the franchisor’s system, always remain with the franchisor. As guardian of the brand and the know-how the franchisor will at every stage do their level best to prevent any wrongful usage of these. In particular the franchisor will be most vigilant in guarding against the transmission of intellectual property rights to anyone outside the network.

## **Training**

Every new franchisee needs to be properly trained by the franchisor in all aspects of the business. As well as covering those elements that are particular to that franchise network, training will often also include elements that are common to most if not all businesses (basic bookkeeping or selling skills, for example).

Training before the franchisee opens their own business is known as 'initial training'. Typically, initial training tends to last for two or three weeks, but this varies from one system to another. Thereafter there should be some form of periodic ongoing training. This will vary from network to network, but in any good franchise network there will be some provision for the franchisor to upgrade or update or enhance or just refresh the skills and abilities of their franchisees. This provision of ongoing training is one of the factors that helps establish that this is in fact a business format franchise, and not just a licensing arrangement.

### **Ongoing support**

Ongoing training, mentioned above, is one form of ongoing support for franchisees. Another thing is continuing support and advice. Continuing support does not mean running the franchisee's business for them, but it does mean providing certain services or support, for which the franchisee will pay the franchisor, normally as part of a regular and continuing management services fee.

What services are provided, and what the franchisee pays for them, vary widely from network to network. In some franchises, the franchisor might just provide technical advice and back-up as required. On the other hand, some franchisors undertake invoicing and credit control on behalf of their franchisees. Most franchisors will provide some ongoing assistance with sales and marketing. In some networks the franchisor will provide the sales leads. There will be telephone contact, there may be regional meetings, there may be webinars, there will almost certainly be periodic conferences. The level of services and support a franchisee can expect (and will be entitled to) will have been disclosed before the franchisee joined the network.

### **Sales and marketing**

Although franchises almost invariably require the franchisees to be responsible for finding their own customers, in most cases the franchisor provides at least some level of support in sales and marketing. In particular, franchisors will in many cases want to establish their own system for online selling, that works for the benefit of the network as a whole.

### **Development**

It is the responsibility of franchisors to invest in the development of the franchise in the most appropriate ways in order to promote the brand and to engage in R&D and innovation that will ensure the long-term development and continuity of the concept. Businesses do not stand still, nor do trends or competitors or fashions or technology. A franchise cannot, once set up, expect then to continue on and on unchanged. The franchisor should be leading the way in developing and evolving the business model and the network as the market requires.

### **Operations manual**

The operations manual sets out the details of how the franchisor's system is to be operated. It should be provided to the franchisee at the point at which they complete their initial training. The agreement sets out the essential principles of how the franchise should be run, whereas the operations manual sets out the detail. Whilst the franchise agreement cannot be changed mid-way through a franchise term, the operations manual can and should be. It should be an evolving document that develops along with the business, and it should therefore be reviewed and updated regularly. Technical details, therefore, such as account details, contact details, customer service procedures, are best contained in the manual rather than in the agreement.

# **OBLIGATIONS AND COMMITMENTS OF A FRANCHISEE**

Franchisees are obliged to run their business according to the system laid out by the franchisor. They have bought the opportunity to run their own business, but it is under the brand and system controlled by their franchise.

### **Brand and System**

Franchisees commit to using the brand and the know-how, and following the system (as per the operations manual and the training). It is essential that all franchisees operate their business in a consistent way. Whilst the franchisee must use their initiative, they must not change or divert from the system that the franchisor has established.

### **Operate and Develop the Business**

Franchisees are not employees and are responsible for the development and success of their own franchise business. They must rely on their own efforts and commit to doing everything reasonable to operate and grow the business successfully.

### **Maintain Standards**

Franchisees must maintain the standards, help protect the brand, the reputation, the image, the quality, and cooperate with the franchisor and with the other franchisees in all these things.

### **Confidentiality**

Franchisees undertake to keep the know-how and all other proprietary information about the franchise confidential. This applies not only whilst they are a franchisee but also for a period after the franchise agreement has ended.

### **Information for monitoring performance**

Franchisees must provide accurate information to the franchisor about their business. This enables the franchisor to provide guidance to the franchisee in respect of such data, to establish how well a franchisee is performing and to ensure the proper level of continuing fees is being paid (especially when based on a percentage of the franchisee's turnover). This is an important feature of franchising. The transparency of franchisee information is not simply a way of checking up on a franchisee – it enables the franchisor to provide guidance and support.

### **Access to premises and records**

The franchisor should be entitled to enter franchisees' premises when the franchisee operates from commercial, industrial or retail outlets. It is not thought acceptable for a franchisor to have the power to enter into a franchisee's home if they operate from residential premises.

# FEE STRUCTURES

Fees payable by franchisees fall broadly into five categories:

1. **The Initial Fee** – as the name suggests, this is a lump sum payable when a franchise agreement is signed. It covers the cost incurred by the franchisor in selecting and setting the franchisee up, including the cost of initial equipment and training. The bfa does not expect that a franchisor makes a significant margin on this payment. The financial benefits that the franchisor gets should come through the ongoing operation of the franchised business.

2. **Ongoing royalties or management fees** – often referred to as “Management Service Fees”. Ordinarily this is based on a percentage of the franchisee’s turnover, meaning that the franchisor has a vested interest in supporting franchisees to increase income. However, the ongoing fee may take different forms. The bfa will support fixed monthly fees only where they are fair and reasonable and where they are commercially justified. The same applies where franchisors have percentage fees, but also impose a minimum base fee.

3. **Advertising contributions** – it is quite common for franchisors to collect a small levy from franchisees which is put into a marketing and advertising fund used by the franchisor for the benefit of the network as a whole. (Something in the region of 1 or 2% would be typical.) This is sometimes referred to as an “Advertising Levy”, and sometimes as a “National Marketing Fee”. The sums paid are put into a separate bank account controlled by the franchisor and used solely for the purposes of marketing the brand and the system within the UK. The fund should therefore benefit of the network as a whole.

It should be clear in the franchise agreement what sorts of items will be charged to the advertising fund. The franchisor should provide at least annual verification from the franchisor’s accountant of how much has been collected and how it has been spent.

Note that if a franchise agreement does not allow for the payment of advertising contributions, the franchisor cannot introduce them later (except, in certain circumstances, on renewal). It is therefore sensible for a new franchisor to allow for an advertising contribution, even though the agreement provides that it will not be introduced unless the franchisor introduces it on specified notice.

4. **Product costs or costs of services** – it is not unusual for franchisors, particularly in the retail/food sector, to make most of their money out of the supply of product to franchisees. This means that some franchises have “product ties”. In other words, the franchisee is bound to purchase product from the franchisor or from another mandated source. The same can happen where franchisors mandate the use of a certain supplier of funding or services.

As a general rule no franchisor should have secret sources of income from the operation of the system by franchisee, e.g. hidden commission, introduction fees or purchasing incentives (eg “kick-backs” or “back-handers”). These are in essence payments by franchisees, since the benefits are retained by the franchisor and not passed on to the franchisees.

It is permitted for franchisors to make a mark-up (or to obtain a commissions, fees or incentives) on products or services supplied to franchisees, provided that:

- The existence of mark-ups (or commissions, fees or incentives) is made clear to franchisees (even if the exact amount of it is variable and not disclosed);
- The franchisor nevertheless ensures that the supply to franchisees is on terms which are competitive. A franchise that is dependent on franchisees paying uncompetitive prices for product or service will never be viable in the long term; and
- The benefit of the mark-ups, commissions, fees or incentives to the franchisor do not compromise the objectivity and good faith of the advice they give to franchisees as regards the operation of the system. In other words, the franchisor must act in the best interests of franchisees when recommending or requiring the use of a supplier. They must not require franchisees to use a supplier who provides a lesser service, or at a higher price, purely because the franchisor obtains a direct or indirect benefit.

5. **Additional fees** – depending on the structure of the franchise, the franchisor may well charge for additional items, such as software licences, additional training.

The bfa expects, in relation to all fees:

- That they allow for a viable and profitable business for both franchisor and franchisee
- That they are transparent.

# FRANCHISE RECRUITMENT

This section deals with the process of attracting franchisees to join the network.

## Suitability

A franchisor should select and accept as individual franchisees only those who, upon reasonable investigation, appear to possess the basic skills, education, personal qualities and financial resources sufficient to carry on the franchised business. For their part, prospective franchisees must be truthful and transparent in providing information about their experience, their financial capacities, their training, background and any other information material to the franchise relationship that they provide to the franchisor, so that the franchisor has a clear and honest picture of the prospects.

If the franchisor uses a broker in the process of marketing and selling franchises they must ensure that they comply with the Code. The franchisor cannot rely on the judgement of others (however experienced they may be) in franchisee recruitment, as only the franchisor will know the qualities they are looking for in a franchisee. The franchisor will have a large pool of possible candidates and a rigorous assessment process for selecting franchisees. The ultimate selection should be made by the franchisor (not delegated to third parties). Franchisors should also be aware that they may be liable for any statements made by a third party (e.g. to point too rosy a picture of the franchise in order to encourage candidates).

Ultimately, the success of the network will depend on the quality of the franchisees in the system.

## Disclosure

Further details about the types of information that should be disclosed to franchisees are can be found in the *Elements of an Ethical Business Format Franchise* section. The franchisor must ensure that any advertising or marketing aimed at recruiting franchisees contains no misleading statements, and nothing that could be considered ambiguous.

Honesty and transparency are called for at all times. Franchisors need to be especially careful in respect of any advertising, promotional or publicity material, including handouts and brochures, that contains any references (direct or indirect) to or examples of possible results, figures, or earnings that might be expected by individual franchisees. Dishonesty or ambiguity at this stage will usually result in a dispute at a later stage. Any illustrations of or references to earnings, profitability or indeed anything financial must be clear and objective, and never misleading.

A prospective franchisee must have a full knowledge and understanding of the franchise they are considering, before they enter into any binding agreement. The franchisor must give prospective franchisees full and accurate written disclosure of all information relevant to the franchise relationship. This needs to be done within a reasonable time prior to the execution of any binding documents, so that the prospective franchisee has sufficient time to take advice and to consider the whole situation carefully. They should also be told about the Code, and either given a copy of it or directed to where they can find it online.

The prospective franchisee is responsible for carefully analysing all the information material to the franchise relationship. They should be advised and encouraged to take appropriate professional advice (legal advice certainly, and perhaps financial advice as well) before signing the franchise agreement.

## Financial illustrations

Often called projections or forecasts, financial illustrations and models can easily be misleading for a candidate franchisee. Unethical franchisors will often exploit this. A feeling of having been shown unrealistic or misleading projections is one of the most common causes of complaint or disputes from franchisees against their franchisors. This is also a significant risk area for franchisors. There are an increasing number of court decisions in which courts have held in favour of franchisees who have been substantially misled by misleading or inaccurate forecasts. Tempting though it is for franchisors to promise substantial profits for their franchisees, it is extremely unwise for franchisors to provide any forecasts unless these are backed up with hard data based on previous operating experience.

There are many ways in which franchisors present their financial illustrations or projections, but whatever format they use they must state clearly and unambiguously the basis upon which they have been cast, in particular the actual real-life experience on which they are based.

Specific statements about the source of data, such as the examples: "The above figures represent actual performance achieved by the pilot operation", or "represent the average turnover achieved by all franchisees who had been trading for longer than 12 months" are likely to be acceptable. They must appear boldly and clearly where the candidate franchisee cannot miss it, and ideally on every page on which projections appear.

Franchisors should:

- show illustrations of what they or a franchisee have actually achieved in practice. (Remembering that no franchisee whose figures have been used should be identified without their consent);
- explain to what extent any recent economic or trading conditions may have impacted on performance within the system since the date of such illustrations;
- show what sort of gross profit and net profit might be achieved if certain turnover levels are reached. The gross margin and revenue expenses shown in any such calculation should be the same as or no better than those actually achieved in practice by the franchisor or on average by its franchisees;
- in presenting the illustrative figures, clearly state whether or not depreciation, any salary or wages for the franchisee and the cost of servicing loans are included.

Franchisors should not:

- cherry-pick, by showing prospective franchisees the results of only their most successful franchisees;
- assume that results achieved by the franchisor's own outlets will be achieved by franchisees with no prior experience of the business;
- state figures which are aspirational, rather than actual;
- be unrealistic or incomplete in estimates of likely operating costs.

A “disclaimer” added to any projections along the lines of “There is no guarantee that you will achieve these figures, nor should you rely on them as a warranty or guarantee” can and should be used. Critically, however, it must be remembered that a generalised disclaimer is not a “get out of jail free” card. Misleading financial forecasts will always leave a franchisor exposed to a claim for pre-contractual misrepresentation. No lawyer can draft a way out of that.

In all cases, franchisees should be warned that no franchisor can warrant the accuracy of any financial performance in any particular case. As prospective franchisee should take proper accountancy advice when considering the franchise proposition, and their own involvement and skills level will have a marked effect on the results the business achieves. This is also a point which should appear boldly and clearly where projections appear.

#### **Guaranteed turnover promises**

References to “guaranteed” turnover should be avoided, save in the case of a very few franchises that are able to supply a guaranteed level of contracts to their franchisees. In the contract cleaning industry, some franchisors provide franchisees with a guaranteed volume of contracted work. In some cases different levels of guaranteed turnover can be bought with different levels of initial fee. However, the margins at which such work can be delivered are not guaranteed as this will depend on the efficiency of the franchisee as well as the nature of the work. Such schemes can be manipulated by unscrupulous franchisors who choose to get contracts for franchisees by under-pricing them and still being able to claim that they have provided the guaranteed turnover to the franchisee.

The bfa expects franchisors offering such guarantees to display on all adverts and material containing such to state (in an easily readable format and in close proximity to the guarantee) “Guaranteed turnover is not a guarantee of profitability”. The franchisor must still then provide full information about financial performance and levels of profitability within the system, as described above.

#### **Profit, money back or buy back guarantees**

Guarantees or statements of this nature can be misleading to prospective franchisees. Where they are used, they must be clear, free from ambiguity, and must not involve any misleading statements or half-truths. The bfa’s view is that marketing literature should properly describe the type of guarantee, and should state, in an easily readable format, in close proximity to the guarantee: if it is a profit guarantee, whether this relates to gross or net profit; the circumstances under which the franchisee may claim under the guarantee (e.g. any time restrictions); which parts of the franchisee’s total investment do not form part of the guarantee (e.g. initial fee, working capital, operating costs, cost of sales); the circumstances under which the franchisee would lose the right to claim under the guarantee (e.g. failure to comply with the franchise agreement and whether these are material breaches/minor breaches/breaches of the operations manual) and any other conditions.

#### **Celebrity endorsement**

Having a famous person say, for example, “I recommend this” or “This is an excellent business” could easily mislead or deceive a prospective franchisee into buying a particular franchise, based not on the realities and risks but simply because a celebrity has been paid to say something nice about it.

Franchisors should not use endorsement by a celebrity to promote the franchise opportunity or the benefits of being a franchisee. The exception is where the celebrity is a current (or very recent) active franchisee of the franchisor, and/or had a material financial stake in the franchisee operation. In other words, the celebrity knows from first-hand experience what he/she is talking about, and/or has ‘skin in the game’.

For the avoidance of doubt, the above applies to the enforcement of the franchised business opportunity, but not the endorsement of the end product of service to the consumer (unless of course such an endorsement is misleading or deceiving).

#### **Pre-contracts**

Some franchisors choose to impose a pre-contract on prospective individual franchisees. It may deal with the terms on which any deposit is paid by the franchisee before signing the franchise agreement (see below). It may also include a period of exclusivity over a proposed territory, enabling the franchisee to complete their due diligence and take professional advice before they sign. It will also impose non-competition and/or confidentiality clauses to protect their know-how and identity.

Before being asked to sign any pre-contract, the franchisor must explain the content and purpose of it, as well as the financial and other implications of it for the franchisee, including the circumstances under which any deposit may or may not be refundable to the franchisee.

#### **Deposits**

Up until the franchise agreement has been signed, either party should be able to back out and walk away. The intent of the Code is that any deposits paid by a prospective franchisee who withdraws before signing the franchise agreement should be refunded after the deduction by the franchisor of its quantifiable directly-related costs. The details of any pre-contract deposit must be given in writing to the prospective franchisee, including the details of what costs, if incurred, will be deducted from the deposit and under what circumstances.

#### **What can be deducted from the deposit?**

Costs that, if related to the particular candidate, can legitimately be deducted from any refund include but are not necessarily limited to: estate agents’ fees, surveyors, solicitors, accountants, travel costs, food and accommodation, and paid research for the particular territory.

#### **What shouldn’t be deducted from the deposit?**

Costs that cannot be legitimately deducted from any refund include but are not limited to staff costs (including the investment of staff or management time), and “opportunity costs”, i.e. the cost of a lost sale to an alternative applicant for the same territory.

When the franchise agreement is signed, the amount of deposit already paid should be set-off against the balance of the initial fee payable by the franchisee (see *Fee Structures* section for more information).

## Research and due diligence

Once:

- the franchisor has determined that the prospective franchisee meets the requirements for the system
- the franchisor has disclosed all information to the franchisee as described above
- the franchisee has completed their due diligence and is ready to proceed

the next step is signing the franchise agreement.

Franchisee candidates should be strongly recommended, before signing, to take independent legal advice from a lawyer who is knowledgeable in franchising. This is not in order for the franchisee to negotiate the franchise agreement. Franchisors will want all franchisees to be contracting on the same terms and will not permit renegotiation. Rather, it is to ensure that the franchisee fully understands what they are committing to, and the financial and legal consequences of the franchise agreement, before they sign and start their franchise business.

## After the franchise agreement is signed

Once the franchise agreement is signed, the obligations of the parties start. The franchisor must provide the support and training, and the franchisee must start trading. (See *Franchise Agreement* section about the main terms of the franchise agreement.) There are two particular scenarios, however, in which this may not happen, and which are worthy of specific mention:

1. **Termination following training** - Rarely, it may become clear during the training course (which always takes place after the franchise agreement has been signed) that the franchisee is simply unsuitable, and that it is in everybody's best interests that the franchisor and the franchisee go their separate ways. In this situation the franchisor is entitled to terminate the franchise agreement. The franchisor should return the franchisee's deposit, less deductions for direct costs (as described in the *Franchise Recruitment* section, and in this case also including recruitment costs incurred by the franchisor).
2. **The franchisee is not able to secure a site within their territory** - The initial fee will in most cases be payable in full (less any deposit) on the signing of the franchise agreement. In some industry sectors, however, it may be some months before the franchisee is able to secure and open a suitable site in their territory. It is fair that the franchisee is obliged to use all proper efforts to find their site and agree terms with their landlord. However, the bfa expects franchisors to take a responsible approach. It would be unethical for a franchisor to sign a franchisee up to a specific territory without the franchisor having already identified for itself that there are suitable sites available in that territory and which have or are likely to obtain requisite planning approvals. The bfa will also expect, if the franchisee is unable to secure a site within a reasonable time despite using their best efforts, that the franchise agreement can be terminated and that the initial fee would be refunded (subject to suitable deductions).

## Compliance

To be considered ethical and in compliance with the Code, franchise agreements must comply with

- the Code itself
- the Extension and Interpretation
- the spirit of the Guide
- UK and EU law.

Franchisors will be expected to review and update their franchise agreements from time to time, at least every few years. This is not just to reflect any changes in the business, but also to keep track of developments in the law which impact on the agreement. When you update your template form of agreement, it will not apply to franchisees who are in the middle of their term, but it will apply for any new franchisees recruited and also for renewals. You will need to provide the bfa with a copy of your updated agreement and a bfa affiliate solicitor will be required to confirm that the agreement complies with this Code.

## Overseas brands

The requirements apply not only to franchise concepts developed in the UK, but also to franchisors from other parts of the world, looking to develop within the UK. Because the legal framework in every jurisdiction is different, it is highly unlikely that a franchise agreement prepared for a jurisdiction outside the UK will be fit for purpose in the context of UK franchise development. The agreement will at the very least require review and amendment by a UK franchise legal specialist, and may even need to be drafted again from scratch.

One particularly notable example of this relates to retail pricing. Whilst in many parts of the world it is quite normal for a franchisor to mandate minimum retail prices for its franchisees, this is contrary to UK and EU law, and as such is not acceptable in a UK franchise agreement.

## Form

The franchise agreement is a long document. Most will be in the region of 50 or 60 pages. This is because it sets out in detail what the requirements of the system are. The obligations on the franchisee are onerous, because the franchisor needs to ensure, for the benefit of everyone in their network, that franchisees operate strictly within the rules of the system and maintain the reputation of the brand.

A good franchise agreement will be created bespoke for each franchisor. Just as no two franchises are the same, neither are no two franchise agreements. Never believe anyone who advises you that you can work with a template agreement and simply fill in the blanks. This will not protect any of the parties. Similarly, if you are given a franchise agreement which is, say, 5 pages long, do not applaud its brevity. It will not be fit for purpose.

All franchise agreements must be in writing. Signed agreements must be given promptly to the franchisee. Any variations specific to a franchisee should be recorded in a side letter.

Prospective franchisees should never be encouraged to ignore what a franchise agreement says on the basis that the franchisor suggests it won't apply in practice.

Note that once a franchise agreement is signed by franchisor and franchisee, it cannot be changed, at least not until it is due for renewal, unless all parties agree. It is therefore an important document.

Below are some of the key features which appear in most franchise agreements. This is not an exhaustive list, but it highlights some typical terms, and in some cases how these are impacted by the Code and by the bfa's approach to ethical franchising.

**The parties** – The agreement will of course name the franchisor and the franchisee. Commonly, the franchisee will be a limited company entity. In that case, it is very likely that the franchisor will require the ultimate shareholders in their personal capacities to guarantee the obligations of the franchisee under the agreement, and they would then also be named as parties. This is to ensure that the franchisee always has "skin in the game". These individuals may be referred to in the agreement as "Principals", "Individuals" or "Guarantors". Similarly, the franchisor may also insist that an owner or senior manager in the franchisee's business acts as the "Key Person". In other words, they have primary responsibility for running the business on a day to day basis.

**Rights granted** – This section sets out the rights that are being granted to the franchisee and whether or not the franchisee has exclusivity within a specified territory. The rights should include the franchisee requires in order to run the franchise business, including the use of the brand and know-how. There will be specific provisions in the agreement relating to the franchisor's trade mark rights.

**Term & renewal** – This specifies how long the agreement will last for and what renewal rights are being granted.

**Fees** – This will explain what fees are payable by the franchisee (see Fee Structures section.)

**Franchisor's obligations** – This will set out the franchisor's initial and ongoing obligations, and will provide details of the training required.

**Franchisee's obligations** – This is likely to form the bulk of the agreement. It will be detailed and onerous, because the franchisee must be undertaking to run the business in exactly the way that the franchisor has created for the system.

Some obligations will appear in all franchise agreements (for example, the requirement for the franchisee to use their best efforts to develop the business, and not to do anything which could damage the reputation of the brand, the obligation to keep records, to insure their business). Other obligations will be specific to the particular industry sector (for example, compliance with regulations relating specifically to the care sector, or to the restaurant sector). If the franchise is premises based, the agreement will set out how premises are to be approved by the franchisor.

**Minimum Performance Criteria** – the agreement is likely to specify that the franchisee must achieve a minimum level of performance in order to retain their franchise. This is particularly so where the franchisee has an exclusive territory. It is reasonable for the franchisor to insist that a base level of performance is achieved in that territory, otherwise the potential to exploit the system in that territory is lost. The bfa expects such clauses to be fair and reasonable.

The minimums should be fairly easily achievable, and should not amount to stretch targets. When approving a member for bfa membership, the bfa will consider any minimum performance criteria on a case by case basis. In looking at minimum performance clauses, the bfa seeks to balance all the factors involved, including how the minimum performance level is set and upon what it is based, any account to be taken of differences between territories or markets or changes in economic conditions, the consequences of failure, the nature of any remedial plan, how such a plan is to be decided, and ultimate remedies and sanctions. The franchisor must be able to drive performance forward, but not at the expense of the fundamental principle of reasonableness.

One example of what the bfa may in some circumstances consider reasonable would be if the franchisor, reserved their right to specify minimum performance criteria as they reasonably see fit taking into account local market conditions from time to time, provided that nothing in the agreement requires the franchisee to achieve gross sales in any year after the first 2 years of the agreement which are more than 70% of the average gross sales for the same period of all network franchisees who have been operating for longer than 2 years.

**Remedial plan** – the agreement should contain a procedure enabling the franchisor to manage a franchisee's poor performance. This should include setting specific tasks and objectives, and possibly undergoing training, so that the franchisee's performance can be brought up to scratch. Unless the failure by the franchisee is fundamental and material, a franchisor should always guide the franchisee towards improvement in performance, rather than jumping straight to termination.

**Franchisor's limited liability** – general limitations or exclusions of franchisor's liability (other than in the case of representations) are unlikely to be accepted by the bfa as being reasonable. Clauses to such effect in franchise agreements should be avoided.

**Advertising, communications and online business** – The agreement should explain the franchisee's responsibility for advertising the business and seeking customers. If the franchisor is running an advertising fund (see Fee Structures section) the agreement should set out what sorts of costs will be met out of it. The agreement should also make clear the rights and obligations on each party as regards social media, and (where appropriate) whether the franchisee or the franchisor (or both) will be able to carry out online sales in the franchisee's territory and elsewhere.

**Sale of the franchisee's business** – the agreement should permit a sale by the franchisee of its business. For more on this topic, see *Sale of a Franchisee's Business* section.

**Non-competition and confidentiality** – in order to protect the franchise system as a whole, the agreement will prevent a franchisee from disclosing confidential information. It will also impose restrictions on a franchisee's involvement in any competing or similar business, not just during the term but also for a period of time after termination of the agreement.

**Death or incapacity of the franchisee** – the agreement should have a process for enabling the franchised business to be taken over by a beneficiary or sold in the event of the franchisee's death, and should allow a sale of the business in the event that the franchisee is no longer able to run it.

**Termination** – the agreement will specify the grounds on which the franchisor can terminate the agreement if the franchisee is in breach. It will also set out what actions need to be taken by the franchisee when the agreement comes to an end.

# RENEWING THE FRANCHISE AGREEMENT

The Code provides that a franchisee should be given notice of and contractual breach and, where appropriate, be allowed reasonable time to remedy the default. Circumstances in which a franchisor should be entitled to terminate a franchise agreement immediately, without an opportunity to rectify, include:

- Insolvency (including bankruptcy, liquidation, or the appointment of an administrator or receiver);
- The franchisee deliberately acting in a way that damages the brand or may have a detrimental effect on the network;
- An incurable breach of a material provision in the agreement;
- Failure by the franchisee to remedy a breach complained of, within the specified time;
- Repetitive or persistent breaches;
- Abandonment of the business by the franchisee;
- Serious criminal conviction.

The length of time it is reasonable to give a franchisee to remedy other breaches depends on the nature of the breach, how urgent it is that it is remedied and how much time is reasonably required to remedy. A short period will be reasonable for a failure to meet standards which directly and adversely affect the customers, a money default, a breach of the law (e.g. Health and Safety) or hygiene issues. It may be reasonable to allow 15 to 30 days for the remedy of a default relating to an operational procedure.

**Step-in rights** – in various circumstances, including where the franchisee is in breach, the agreement may well allow the franchisor to step in and run the franchisee's business on their behalf.

There are some specific clauses that the bfa will never deem to be acceptable in a franchise agreement. These include:

**Gagging clauses** – in other words, clauses which explicitly or implicitly restricts or prevents a franchisee from communicating freely with the bfa in relation to matters of dispute, complaint, ethical behaviour or bfa membership rules.

**Time of the essence clauses** – in other words, a clause which gives a franchisor a blanket right to terminate or cease support if the franchisee does not do something within a strictly limited timeframe.

**Dispute resolution** – the agreement should provide a mechanism for dispute resolution.

The Code requires both parties to exercise good faith and goodwill when resolving disputes, imposing an obligation on both parties to genuinely attempt to settle their differences. In a franchise relationship this can present difficulties as very few franchisors would be prepared to debate the system, its standards, whether they have been complied with or if the system should be changed. There can be many areas where differences can arise due to misunderstanding and poor communication. It is an ethical requirement that both parties try and get to the root of the problems and find a solution.

The bfa offers mediation and arbitration schemes to assist in the resolution of disputes, details of which can be found on the bfa website

The requirement for fairness in dealings between the parties is equally important when it comes to franchise agreement renewals.

## Realising value

The right to renew the agreement is fundamental to business format franchising. The bfa's view is that "franchisees who are in compliance with the terms and conditions of their agreement shall have the right to realise the value of their business on transfer." In practical terms this means that a franchisee should have the right to re-sell their business towards the end of their last term (or indeed at any other time of their choosing) and the franchisor should be prepared to grant a new five year term to the buyer, otherwise the value of the business will be dramatically diminished if, for example, the buyer can only have the balance (perhaps one year) of the outgoing franchisee's term.

## The basis for renewal

The bfa takes the view that, so long as the parties discharge their obligations, the franchise relationship should be capable of continuing on a long-term basis. The longer the period of operation, the greater the scope for a franchisee to realise their investment on an ultimate sale of their business. The bfa therefore usually expects that franchise agreements will allow at least one right of renewal for an additional term at least as long as the original term. The grant of a right of renewal should be fair and the franchisor should not impose unreasonable conditions to create barriers.

## Typical renewals

Some franchisors may offer a single twenty year term, which is fine provided the agreement is clear about any rights of renewal. Far more typical is a "5 + 5 renewal". This means that a franchisee, provided they are not in breach of the conditions for renewal (which may include having reached specific pre-agreed performance targets) can be sure of being granted a second term of five years. This "5 + 5" arrangement is ordinarily adequate time for a franchisee to have built up value in the business.

## Reasonable conditions for renewal

- that the terms applicable on renewal should be those contained in the franchisor's then current terms of the franchise agreement (and note that the bfa expects that any changes in financial terms on renewal should be fair to both franchisor and franchisee);
- that no unattractive commercial terms may be introduced as a mechanism to discourage renewal;

# SALE OF A FRANCHISEE'S BUSINESS

- an obligation on the franchisee to remedy any existing breaches and to have substantially observed the terms of the existing agreement (but note the bfa's expectation that the franchisor will have been working on a remedial plan with a franchisee who is not meeting the required standards, so that the franchisee has a fair opportunity to improve performance before their renewal date);
- a right not to accept a late application for renewal if a franchisee has failed to comply with the notice provisions in the renewal clause.

## Contentious areas and changes to the system

- A clause making renewal conditional on a complete new re-fit to a shop may or may not be fair and reasonable. This largely depends on whether a franchisee would have sufficient opportunity to recoup the cost of their re-fit over the length of the renewed term.
- bfa's view is that it is likely to be fair for the franchisor to insist that the franchisee implements new technology in the business on renewal, especially where the franchisor can demonstrate a likely cost effectiveness and increased efficiency. Any introduction should not cost significantly more than the franchisee might be expected to pay elsewhere for the provision of similar services.

## Charging a fee at renewal

The charging of a renewal fee is discouraged if used as a method of unfairly imposing a financial burden at a time when the franchisee may be in a vulnerable position. The bfa's recommendation is to charge a fee that covers the franchisor's legitimate costs of administering the renewal (e.g. legal fees, any retraining or refresher course for the franchisee and so on) but not to treat it as an additional source of profit.

The Code requires that the franchisee should be in a position to sell their business. The bfa believes it is fundamental to a franchisee's ability to recoup their investment and make a profit on their endeavours for them to be able to sell their business in due course to a third party. Indeed, it can be enormously helpful for franchisors who, when recruiting new franchisees, can demonstrate that other franchisees have made a strong return on their investment through the sale of their franchise.

It is reasonable for the franchisor to impose certain conditions that must be met before a franchisee can sell, and all such conditions should be clearly stated in the franchise agreement. It is critical that franchisors facilitate franchisee sales, and do not seek to make an unfair profit for themselves out of it.

Reasonable conditions may include:

- The payment of reasonable fees to the franchisor. Any fee charged by the franchisor at resale should be proportionate and relevant to the services provided to the outgoing franchisee in facilitating the sale. These might include assisting with a sales prospectus, finding the potential buyer, dealing with the new application, vetting, and training and support for the incoming franchisee. The franchisor may also include a reasonable set fee or percentage of the sale price where the franchisor has introduced the purchaser to the franchisee, and/or a separate provision for the payment by the outgoing franchisee of the franchisor's legal fees associated with the resale.
- The selling franchisee should be in substantial compliance with their franchise agreement, with no fees outstanding (or with outstanding fees being deducted from the sale proceeds before being paid over to the outgoing franchisee)
- The buying franchisee must have the requisite credentials to be part of the franchise network. The franchisor should apply the same criteria to potential buyers as they would a new franchisee buying a new territory
- The sale price must be such that the franchisor is confident that the buyer will have a viable business and that they can service any borrowings.
- The sale agreement between buyer and seller must be approved or provided by the franchisor. Any condition requiring a re-fit of premises and equipment should be reasonable, and the cost of the re-fit should be proportionate to the value of the business to both the outgoing and the incoming franchisee.

## Selling price

The franchisee should not be prevented from selling their business at market value, including a reflection of the value of the customer base, rather than at its net asset value.

## Pre-emption

Some franchise agreements give the franchisor an option to purchase the business from a franchisee who is looking to sell. This is a right of "pre-emption". Such an option should not enable the franchisor to buy the business for less than (a) it is worth on the market as a going concern or (b) the price offered by a bona fide arm's length prospective purchaser. The option period should not be longer than is reasonable for the franchisor to decide.



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