

# ECONOMIC AND LEGAL ASPECTS OF THE FRANCHISE AGREEMENT IN THE UNITED KINGDOM

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**Abstract.** *The purpose* of the article is to study the economic and legal nature of the franchise agreement in the United Kingdom (UK). Since franchising in this country is well-established as a successful and highly-regarded growth model, it is advisable to identify the key economic and legal features of the franchise agreement, in which the parties specify their rights and obligations, the franchise price, the duration of the franchise relations, the procedure for performing calculations, etc. *The subject* of the study is a franchise agreement in the UK. *Research methodology.* The research is based on the use of general scientific and special-scientific methods and techniques of scientific knowledge. The dialectical method allowed us to investigate the definition of a franchise agreement in the UK and its key terms. The comparative legal method was used to compare doctrinal approaches to this issue. The statistical method was used to establish data that reflects the effectiveness of franchising activities. The method of system analysis helped to find out in which areas of economic activity franchising is most demanded. Interpretation of the content of the UK legal acts governing issues related to the conclusion of a franchise agreement in this country was realized with the help of the normative-dogmatic method. The system-structural method was used to study the franchise agreement in the UK as a single entity (system) with the coordinated functioning of all its elements. The methods of grouping and classifying formed the basis for separation the list of conditions which are necessary for concluding a franchise agreement in the UK, as well as the provisions that should be included in the content of this agreement. Methods of analysis and synthesis helped to study some parts of this agreement to formulate further conclusions. *Practical application.* The positive experience of the UK in regulating issues related to the conclusion of a franchise agreement can be used for making appropriate changes to the Ukrainian legislation. *Correlation/originality.* This scientific work is the first research in Ukraine devoted not only to general issues of regulation of franchising activity in Europe but specifically to the franchise agreement in a separate country (in the UK) and its legal and economic peculiarities.

**Key words:** franchising, franchise contract, franchisor, franchisee, disclose, contract terms, termination, renewal.

**JEL Classification:** K12, M21

## 1. Introduction

Franchising is a business organization that allows one party – the company owner (franchisor) – to transfer the right to sell goods/products/services of the company to the other party (franchisee) for a fee.

For the franchisor, it is a great opportunity to expand its business, and for the struggling entrepreneur, it is a possibility to become a business owner, to gain experience while not creating anything new.

One of the most important features of franchising is the reduction of business risks. According to statistics, 85% of all newly created enterprises cease to operate during the first five years but only 14% of all newly created firms established within the framework of franchising.

Considering the positive role that franchising may perform in the global economy, it is important to

understand in what manner is this institution regulated in different countries of the world. Since the franchising in the UK is extremely diverse and covers many types of business and consumer markets, and has proven to be a successful and highly estimated growth model, in this article, we will turn to the experience of this particular State, and analyse the features, which are inherent in the franchising agreement, as well as legislative acts that regulate this issue.

## 2. Analysis of recent research and publications

The study of franchising as a type of international business was undertaken by N. V. Bezrukova, L. V. Voroniak, T. M. Hryhorenko, N. M. Hrushchynska, O. M. Kolodiziev, O. Ye. Kuzmin, A. M. Mahomedova, V. Ye. Sakharov, V. S. Tatarinov, T. M. Tsyhankova, A. V. Tsyrat, I. M. Shkola and others. However, this

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would be the first study in Ukraine devoted to franchising in the UK, and in particular, the economic and legal characteristics of the franchise agreement in this country. The goals of this article is to explore the history of the emergence of franchising in the UK; regulation of franchise activity in this country; contractual issues relating to franchise agreements (including pre-contract disclosure requirements, formalities, parties' rights and obligations, fees and payments, term of agreement and renewal, termination of the agreement).

### 3. Presentation of the main material

In its earliest form, franchising first appeared in the UK with the advent of the tied pub system, but at that time, it didn't become popular. In the 50s, the interest in franchising had been growing significantly, its concept was taken up by an increasing number of enterprises in various sectors of the economy. There was a rapid growth in the development of international franchising; the first international standard franchises appeared in the UK.

In 1959 ServiceMaster, the largest international franchise company began its operations in the UK. By the mid-1960s, some of the largest fast-food brands had become well-established international franchises, led by McDonald's and KFC.

However, in the 1970s, franchising in the UK was suspended. This was partly due to economic fluctuations but more because of the damage caused to its reputation by pyramid schemes, which falsely represented their activities as franchising. However, by the end of the 1970s, the UK's eight largest domestic brands – ServiceMaster, Dyno-Rod, Holiday Inns UK, Kentucky Fried Chicken, Wimpy International, Ziebart GB, Prontaprint and Budget Rent a Car appeared. They tried to rebuild the reputation of franchising and to differentiate their activities from the illegal practice of financial pyramid schemes. In order to achieve this goal, the British franchising association (BFA) was established in 1977.

During the last decade, franchising in the UK has been developing at a fast pace. About 1000 domestic and foreign franchise networks operate in the territory of this country in the most diverse sectors of the economy.

The authoritative annual research into the state of the industry BFA/NatWest Franchise Industry Survey has found that both short- and long-term growth trends in the franchise sector are extremely powerful, including since the economic recession in 2008. Indeed, there is a significant annual increase in terms of numbers of brands franchising, numbers of franchisees, numbers employed in franchise businesses, and the overall turnover of the franchise sector. The same study has shown that about 90% of franchisees report the profitability of their business and less than 4% of franchise companies fail for commercial reasons each year (The British Franchise Association).

The total contribution to the UK economy from franchising is estimated at GB£15.1 billion, which generate about 44,200 franchise companies. The total number of employees in the franchise sector has reached 621,000 people. 38% of British franchisers work internationally: 30% of them in Europe, 8% in the United States of America (Chris Wormald).

All typical franchise models have found their place in the UK market. The choice of model depends on a variety of commercial factors, such as the nature of the business, the required level of investment, and the position of the franchisee. For example, for local franchising franchisors choose: direct franchising for individual companies franchisee; area development agreements or "cluster franchises", where franchisees are granted the right/obligation to open a number of outlets in a defined geographic territory; development agreements (without sub-franchising) for the whole of the UK or very large regions (such as Scotland); master franchising, where the master franchisee selects, teaches and supports his sub-franchisees; franchising of a joint venture, where the franchisor and franchisee work towards a common goal (Chris Wormald).

The law does not impose any restrictions on the organizational and legal form of the franchisor but the most common form in the UK is a limited liability company. Other common forms of franchise companies are a joint-stock company, a private company or a partnership.

When entering foreign markets, the franchisor can open a branch, establish a local subsidiary or enter into a joint venture with a local company to create an infrastructure in a new territory. In this case, of course, it is necessary to consider taxation and transfer pricing issues.

Since the UK has no special laws regulating franchise activity, in 1977 a specific regulatory body, the British Association of Franchising (BFA), was established, the main task of which is to accredit a company's suitability for membership based on strict criteria related to operational practices, business procedures, franchise agreement terms – and the support offered to franchisees. Membership in the BFA is not mandatory but many franchisors are joining this organization since it accredits franchise companies, and acts as a Trade Association. Membership in the BFA imposes certain obligations on franchisors; in particular, they must adhere to: 1) disciplinary procedure; 2) complaints procedures; 3) appeals procedure; 3) the Advertising Standards Agency's Code of Advertising Practice; 4) The BFA Code (British Franchise Association), which was adopted by this organization in accordance with the European Code of Ethics for Franchising (hereinafter referred to as the Code of Ethics). The BFA Code includes some of the provisions of the Code of Ethics, as well as the special provisions inherent in the franchising of the UK, which specify the norms of the Code of Ethics; 5) reporting requirements.

The provisions of the BFA Code must be unquestioningly fulfilled by the members of the Association; the sanction for non-compliance is the exclusion from the organization. Among the main requirements enshrined in this Code, one can distinguish the following: 1) a potential franchisor must run at least one pilot project before creating its own franchise network; 2) the franchisor must return the previous deposits; 3) advertising should not contain ambiguous and false statements; 4) the parties must act in good faith with respect to each other, including in resolution of disputes.

As it was already noted, British legislation does not have clearly defined norms that regulate the implementation of franchise activity. This also applies to franchise agreements, which are mostly concluded in accordance with the provisions of the contract law. Despite the lack of a special law, this issue is fully regulated. Thus, the rules governing the implementation of franchise activities are contained, *inter alia*, in: 1) the Competition Act 1998, which regulates the conclusion of contracts, including franchise agreements. The Competition Act prohibits agreements that have an effect on trade and restrict competition in the UK. An agreement that violates the requirements stipulated by this Act may be declared null and void, and the parties may be liable for the fine of up to 10 percent of their income. Third parties affected by such agreements may claim damages; 2) Block Exemption Regulation (BER)), adopted in accordance with section 101, paragraph 3 of the Treaty on the Functioning of the European Union (Commission Regulation). Thus, if the franchise agreement contains restrictive provisions, it may be exempted from the prohibition of the conclusion of antitrust agreements if the total market share of competitors in the relevant market does not exceed 5 per cent, or the market share of each non-competing entity in the relevant market does not exceed 10 per cent. This provision is called the *de minimis* principle, but it does not generally apply to franchise agreements, as they usually include provisions aimed at market sharing between the parties. If the *de minimis* principle cannot be applied, the franchise agreement may be exempted from the prohibition in accordance with the BER, which apply only to contracts that do not contain certain types of severe restrictions of competition, and the market share of the franchisor and franchisee in the relevant market does not exceed 30 percent (clause 8 of the BER); 3) The Trading Schemes Act 1996, which was adopted to regulate pyramid schemes. Since franchise agreement falls under the definition of trading schemes, the provisions of the Act 1996 apply to it. The Act provides for criminal and civil sanctions for violation of its norms; 4) Data Protection Act 1998 (as amended on May 25, 2018), which regulates the processing of personal data. The activity of any enterprise in the territory of the UK, which is carried out using data on an individual, is

subject to this Law. Violation of the provisions of the Data Protection Act may result in criminal and/or civil liability; 5) Unfair Contract Terms Act 1977 (UCTA). Franchise agreements in the UK usually contain provisions on exemptions that seek to restrict or exclude the franchisor's liability to a franchisee. The legality of such provisions is determined with reference to this Act, which states that these provisions are enforceable only if they are fair and reasonable; 6) The Bribery Act 2010, which prohibits the offering or receiving of bribes in the UK and provides for severe penalties for companies and societies that are not in a position to prevent bribery in their organizations. That is, theoretically, franchisors can be held liable if their franchisees accept or give bribes. Therefore, franchisors are required to take adequate measures to prevent bribery (Hamilton Pratt).

There is no generally accepted definition of franchising in the UK, so BFA uses the definition given in paragraph 1 of the Code of Ethics adopted by the European Franchise Federation (Code of Ethics of the European Franchise Federation). In accordance with this definition, 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.

At the same time, BFA emphasizes that the franchise agreement should be fair and comprehensive. There is no such thing as a "standard document" that meets the needs of all businesses without exception in franchise relationships. Each contract is unique and is adapted to the requirements of franchise activity.

A good franchise agreement will ensure that the obligations and rights of both parties – i.e. franchisor and franchisee – are set out as required and the final contract is likely to run to 40 or more pages. However, it does not mean that the franchise agreement is a balance of rights and obligations between equitable business partners. Since franchisor is responsible for the entire network, it may sometimes act contrary to the interests of the individual franchisee for the benefit of the network (British Franchise Association).

In the UK, unlike most European countries, there is no legally binding obligation to disclose information before concluding a franchise agreement. There is



also no legal requirement for its parties regarding the voluntary provision of information since the burden of responsibility for data verification lies solely with the purchaser in accordance with the principle of "Caveat Emptor" (the buyer beware). It means that it is up to the potential franchisee to demand, request, and investigate certain information from relevant sources and to evaluate it from the point of view of equivalence, as well as to conduct a review of the franchisor's activities.

However, a franchisor is obliged to answer fairly and honestly on direct questions. The franchisee has the right to file a lawsuit in case of providing him with misleading information that led to the conclusion of the contract on terms contrary to those charged by the franchisee or to the causing damages (Iain Bowler).

Article 3.3 of the BFA Code requires BFA member franchisors to provide a copy of the Code to prospective franchisees, along with a "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." The Guide to the Code contains further guidance on the extent of "full and accurate written disclosure".

Besides, this issue is also regulated by the Unfair Contract Terms Act (UCTA) (Unfair Contract Terms Act 1977). According to this Act, any provision in the standard form agreement, which has not been negotiated by its parties, is subject to a fairness test. If the provision could damage the franchisee, the franchisor is required to justify the necessity for it to be included in the content of the contract. In addition, according to the UCTA, a franchisee is afforded the same protection as a consumer.

Concerning the payments for franchise activity so it is usual for the franchisee to pay an initial fee upon signature of the agreement followed by an on-going management services fee. According to the BFA's Code of Ethics, the initial fee should cover the cost of establishing the franchisee in business with a small element of profit to the franchisor. A franchisor should not be seen to be achieving its main income from the sale of franchisees alone; instead, this should be achieved from the on-going management fee. This ensures that the franchisor's success is linked to that of the franchisee.

The on-going fee usually termed as a management fee can be structured in a number of ways e.g. a fixed fee or a percentage of the franchisee's total turnover after vat or a combination of both. In addition, a marketing contribution may be charged which again is usually a percentage of the franchisee's turnover. This money is held centrally and applied to the general promotion of the brand and business. It is usual for the on-going fees to be paid monthly so as to be able to keep a close eye on the sums (or weekly if appropriate).

British law does not provide for essential terms of the franchise agreement. Nevertheless, paragraph 5.4 of the Code of Ethics contains a list of conditions that is advisable to include in the content of a franchise

agreement. They are as follows: 1) rights and obligations of the franchisor and franchisee; 2) goods and services provided by the franchisor, as well as the transfer of know-how; 3) franchisees payment obligations; 4) provisions on the use of intellectual property; 5) duration of the contract: it should be long enough for the franchisee to amortize the initial investment (usually a franchise contract is concluded for 10 years); 6) the conditions under which the contract may be terminated or renewed; 7) the conditions under which a franchisee can sell the franchise business; 8) the franchisor's right to develop a franchise network; 9) the provision for the immediate return of the franchisor's property in case of termination of the contract and, if applicable, compensation of the franchisee; 10) control right: guidelines on the degree the franchisee is bound to the business concept should be handed to him; 11) contract penalties.

The rights and obligations of the parties to the franchising agreement are provided in the BFA Code. In accordance with its provisions, the franchisor must: 1) guarantee 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. In accordance with the definition given in the same Code, know-how is a body of non-patented practical information, resulting from experience and testing by the Franchisor, which is secret, substantial and identifiable; 2) in the pre-contractual, contractual, and post-contractual phases of its relationship with franchisees, use all reasonable means 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; 3) offer to its franchisees an unqualified right to sell or transfer their business as a going concern; 4) inform prospective and individual franchisees of its internet communication and/or sales policy.

The franchisee, in its turn, is obliged: 1) 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. This provision underlines the fact that any potential franchisee is independent of the franchisor but, at the same time, must assume responsibility for the success of the joint activity; 2) to be responsible for the human and financial means that it engages in its franchise business; 3) to act loyally towards each of the other franchisees of the network.

The validity of the franchising agreement is not legally defined, but at the same time, there is a certain duration of the provision concerning the purchase of goods and equipment from the franchisor.

Thus, it is often agreed in a franchise agreement that the franchisee is obliged to acquire goods from the franchisor and not from other sources, including other franchisees. Such an obligation is legitimate only if it does not violate the rules of competition law and is necessary to maintain the identity and reputation of the franchise network. If such an obligation is not necessary

to maintain the identity and reputation of the franchise network, then the Block Exemption Regulation (BER) is applied. According to article 5 of this Regulation, purchase obligation is not subject to its regulation, if the duration of this obligation does not exceed five years. If the duration of the obligation exceeds five years or is tacitly renewable then the provisions prescribed in the BER are applied to it.

The franchise agreement in the UK is a long-term contract, which is concluded for a term of five to ten years. The main condition is that this term should be sufficient enough for the franchisee to be able to return its initial investments and to benefit.

As a rule, a franchise agreement is terminated due to the expiration of its validity. It is not usual to allow the franchisee a right to terminate the agreement as the franchisor will wish to ensure that the franchisee is committed to the franchise for a decent period of time. Therefore the rights of termination tend to be one-sided in favour of the franchisor and in the presence of an exclusive list of breaches on the part of the franchisee. The examples of such breaches are: regular non-payment, constant customer complaints about the quality of service, and the behaviour of the franchisee, which negatively affects brand reputation.

Usually, a franchise agreement includes a provision on restricting competition that applies to the franchisee after the termination or expiration of the franchise agreement. This provision prohibits the franchisee to compete from the premises or within the franchised territory or soliciting customers for a period of up to 12 months post-termination. In order to be legally valid, this provision should be limited in both time and territory.

The franchise agreement may be renewed by the mutual consent of the parties, which must be registered in the relevant clause of the agreement. In the case of franchisor's refusal to continue cooperation, a franchisee does not obtain the right to demand compensation unless such right is enshrined in the contract. In accordance with the BFA Code, all legal grounds for the renewal of franchise agreement should be clearly stated in the contract itself.

#### 4. Conclusion

From its feudal roots to becoming one of the fastest-growing sectors of the UK economy, franchising has come a long way. Every year one can observe an increase

of all indicators of franchise activities that testifies to its remarkable success and popularity.

However, franchising in the UK is relatively unregulated compared to other European countries. Since the UK does not have a single franchise law, this kind of economic activity is regulated by the Code of Ethics (BFA Code), adopted by the British Franchise Association in accordance with the provisions of the European Code of Ethics for Franchising, adopted by the European Franchise Federation. BFA is an organization that accredits franchisors and requires its members to comply with its standards, which are enshrined in the BFA Code and other technical bulletins.

Although British law does not have clear rules governing franchise activities and conclusion of franchise agreements, these issues are fully regulated by a number of UK and European legal acts.

In the UK, unlike most European countries, there is no legally binding obligation to disclose information before concluding a franchise agreement, as well as no legal requirement for its parties regarding the voluntary provision of information. However, the BFA Code obliges its member franchisors to provide prospective franchisees with a full and accurate written disclosure of all information necessary to establish franchise relations with potential franchisees.

The UK legislation does not also provide for essential conditions for a franchise contract, so the parties have the right to determine them at their own discretion in accordance with the recommendations provided in the BFA Code.

The validity of the franchise agreement is not legally defined but should be sufficient enough for the franchisee to be able to return its initial investments and to benefit. The maximum allowed duration of the contract will depend on whether it contains any provisions restricting competition.

The right of termination tends to be one-sided in favour of the franchisor; there is no practice of termination of the agreement at the request of the franchisee. It is recommended to include provisions on terms of termination of the franchise agreement into its content.

The franchise agreement may be renewed by the mutual consent of the parties. In the case of franchisor's refusal to continue cooperation, a franchisee does not obtain the right to demand compensation. It is recommended to state all legal grounds for the renewal of franchise agreement in the contract itself.

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