May 2011 - Franchising Issues

1. Definition of franchising. A system of distributing goods and services in which one organisation (the franchisor) grants the right to another (the franchisee) to produce, sell or use its developed product, service or brand for profit.

2. A franchisee is a person who licensed - franchised - to sell or use the franchisor's products mark or services. McDonald's Family Restaurant and KFC (Kentucky Fried Chicken) chains are examples of franchisors who let various outlets sell their products.

Choice of law and jurisdiction and legislation

3. Franchising Issues from a Romanian legal perspective. The law allows both parties to negotiate and agree many aspects of the contract and therefore it is important that the parties know and understand their rights and obligations.

   a. Romanian law to apply if parties agree.

   b. Absence of choosing then Romanian law as law of domicile of franchisee.

4. Most international franchise agreements are under English law, Swiss law or American law. We generally recommend the choice of English law because England is an EU member state and has implemented all the relevant directives and regulations. English law is also the most liberal law from the point of view of the franchisor in that is allows almost total freedom of contract.

5. Jurisdiction or dispute resolution venue. We would normally suggested arbitration or the exclusive jurisdiction of the English courts in order to ensure that a judge or arbitrator who is familiar with English law resolves disputes under the agreement.

Exclusivity

6. Most franchise agreements are exclusive. However, they often contain exemptions from exclusivity such as in relation to internet sales, mail order or the ability of the franchisor to pursue a competing concept under a different trade mark or name.

7. If a franchise agreement is non-exclusive the franchisor is free to open a competing business in the immediate vicinity of the franchisee's facilities. It is not illegal in Romania.

Pre-contractual disclosure

8. What has to be disclosed, by whom and when?

9. The initial franchise fees and possible refund obligations.

a. Initial franchise fees can be very substantial. They vary from between €10,000 for a small mobile franchise to more than €100,000 for a restaurant franchise.

b. If the franchise agreement is terminated at an early stage for example because the franchisee has not been able to successfully complete the franchisor's training, is there an obligation to refund some or all of the initial fee paid?

c. If terminate during the period of franchise is part of the initial fee refundable.

d. On-going franchise fee. How and when payable.

Location

10. Liability of franchisor for location advice.

a. Many franchisors insist that they approve the location chosen by the franchisee for the franchisee's facility or shop. If the location turns out to be unsuitable would the franchisor be liable?

Purchasing

11. Purchase ties and bulk purchasing

a. Many franchisors purchase products which they supply to franchisees with one nominated supplier. Often that supplier will give volume discounts. Usually the franchisor benefits from this arrangement either by way of mark up on the price of the products or because the franchisor received an incentive payment from the supplier.

b. Also to be considered is the price at which the goods or services are to be sold to the consumer.

Franchisee's obligations

12. Franchisee's obligations

a. Most franchise agreements contain a long list of franchisee's obligations. This is important to ensure uniform quality throughout the system. The Franchise system can only be successful where all franchisees work to the same level of quality

13. More specifically the Franchisor may want to have

a. Location

b. Method of Business

c. Presentation

d. The right to approve new employees before they can work in franchisee' facility.

e. Stipulating compulsory opening hours for franchisee's facility.

f. The franchisor's right to settle customer complaints in the name and on behalf of franchisee.

g. franchisor's right to approve terms of business used by franchisee

14. Franchisor's discretionary rights.

a. Many franchise agreements provide that the franchisor has considerable discretion when performing its contractual obligations. The franchisor will usually undertake to provide advice and assistance to franchisees. However, many agreements will stipulate that such advice is only provided "where the franchisor in its sole discretion considers that an additional support is necessary". The same applies to many other franchisor obligations.

Restrictions

15. Restrictions on competition and local enforcement

a. Franchise agreement will contain restrictive provisions during life of the franchise agreement.

b. Many franchisors will have the benefit of the Vertical Restraints Block Exemption Regulation.

16. Restrictions covering third party participants.

a. Many franchise agreements impose obligations on third party participants mainly on the franchisee's side. These include the franchisee's shareholders where the franchisee is a company, certain senior management staff and the franchisee's directors. Sometimes it is even attempted to restrict the wife and children of the franchisee from competing.

b. Confidentiality and non-competition agreements for staff.

c. Confidentiality and non-competition agreements for directors.

d. Confidentiality and non-competition agreements for shareholders.

e. Personal guarantees given by the owners of the franchisee's business.

Financial obligations

17. Financial obligations and rights of audit.

a. The agreement will stipulate that this is paid to advertise the system.

b. As regards financial reporting most franchisors require monthly turnover reports. To verify the accuracy of those reports franchisors require copies of audited annual accounts or similar documents.

c. May this obligation lead to excessive costs for the franchisee, and therefore be too expensive?

Sale of business

18. Sale of franchised business.

a. Most franchise agreements seek to restrict the ability of the franchisee to sell its business. Often the franchisor is also given a right of first refusal in respect of any proposed purchase offer.

b. What provisions need to be put in place for the franchisor to take over the lease of the franchisee's premises?

c. How can the franchisor prevent the sale of the franchisee's business to a non-desirable purchaser?

19. **Termination rights**.

a. Most franchise agreements do not give the franchisee a right to terminate before expiry of the term.

b. Franchisors right to terminate the agreement.

20. **Post termination provisions**

a. Most franchise agreements contain restrictions which apply once the franchise agreement has been terminated.

b. These include a post term

i. restriction on competition,

ii. a post term confidentiality obligation (which is usually open ended), and

iii. An obligation to cease using the franchisor's trade secrets, know-how and trade marks.

Romanian Franchise law

21. The franchisor is

a. a person owns the rights over a registered trademark; the rights must be exercised for a period at least equivalent to the term of the term of the franchise agreement;

b. grants the right to exploit or to develop a business, a product, a technology or a service;

c. provides the beneficiary with initial training for the exploitation of the registered trademark;

d. Disclosure. Romanian franchise law does require disclosure before making the agreement but no cooling off period.

i. The franchisor has to disclose the acquired and transferable experience.

ii. Details of the proposed financial arrangement such as royalty network access fee periodical royalties' services and technologies and details of any purchase arrangements.

iii. Details allowing the franchisee to draft his financial plan.

iv. Details concerning exclusivity.

v. Other terms of the proposed agreement.

1. The object of the agreement.
2. Rights and obligations of the parties.
3. Financial terms.
4. Details of the length of the agreement.

e. The franchise agreement must comply with the following principles:

i. the term shall be set so as to allow the beneficiary to depreciate the investments related to the franchise;

ii. the franchisor shall inform the beneficiary by prior notice sent in due time with respect to its intention to continue the agreement on the expiry date or not to execute a new agreement;

iii. within the clauses related to cancellation, there will be clear stipulations concerning the circumstances that may lead to cancellation without prior notice;

iv. the terms for operating the assignment of the rights under the agreement shall be clearly stipulated, especially the terms for the designation of a new successor;

v. the right of first refusal shall be provided, in case the interest in preserving or developing the franchise network requires the acknowledgement of this right;

vi. the non-competition clauses shall be included in the agreement for the protection of the know-how;

vii. The financial obligations of the beneficiary shall be clearly stipulated and shall be determined so as to facilitate the fulfilment of common objectives.

f. Based on the franchise agreement, the franchisor controls the compliance with the trademark.

g. The beneficiary undertakes to pay a royalty and is authorised to use the trademark associated to the products and/or services and/or technologies.

h. Upon the termination of contractual relations, the post-contractual relations shall be based on the rules of loyal competition.

i. The franchisor may impose firm obligations to the former beneficiary, thus protecting the confidentiality of the business and especially preventing know-how from being used by a competing network.

i. In case the franchisor proposes the execution of an exclusivity agreement, then must be included:

i. in the event that a fee is collected for becoming part of the franchise network, upon the execution of the franchise agreement, the amount related to exclusivity right is proportional to the entry fee;

ii. in case there is no entry fee, the methods for the reimbursement of the exclusivity fee are stipulated in the event of the cancellation of the franchise agreement;

iii. the exclusivity fee may cover part of the expenses necessary for the implementation of the franchise and/or for limiting the area and/or for the transmitted know-how;

iv. the exclusivity agreement must include a cancellation clause, convenient for both parties;

v. The term is determined according to the specific characteristics of every franchise.

vi. The franchisor may require a non-competition and confidentiality clause, in order to prevent the alienation of the know-how transmitted during the term of the exclusivity agreement.

22. **Advertising and selection**

a. The advertising for the selection of beneficiaries must not be ambiguous and must not include any erroneous information.

b. The advertising documents presenting the foreseen financial outcome of a certain beneficiary must be objective and checkable.

c. The franchisor selects the beneficiary proving the required competences, namely: the necessary managerial competences and financial capacity for exploiting the business.

d. The franchisor, acting as the initiator and warrantor of the franchise network, must strive to preserve the identity and reputation of the franchise network.

Conclusion

23. Method going forward to encourage business and economy.

24. Known brand which may not fit the market.