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Cover Story

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Legal Technology transforming the Industry in Europe, Africa and Middle East

ESSENTIAL ELEMENTS IN A FRANCHISE AGREEMENT

One of the most important business decisions that entrepreneurs often grapple with is whether or not to start their own independent business or start a franchise.

Why is a franchise well suited to the needs of an entrepreneur?

In franchising, the owner of a well-established business (“the franchisor”) grants another party (“the franchisee”) the right to use their business know-how and associated trademarks in consideration for a franchise fee.

The benefits of a franchise are manifold both for the franchisor and the franchisee.

The franchisor has access to capital and is able to expand without taking on debt. The franchisor makes money in the form of franchise fees while the franchisee takes on responsibility for running the operations of the franchise business. A business owner or entrepreneur spends considerable time hiring, firing and monitoring employees but in a franchise model, the onus is on the franchisee to take calls regarding personnel management. As a result, the franchisor can focus on long-term growth prospects and expansion. A franchisor leverages their existing goodwill and reputation to improve brand awareness and visibility by entering into franchise agreements. This model is in line with the needs and interests of the franchisor who seeks to expand efficiently.

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The franchise model is lucrative for the franchisee as well. The franchisee immediately gets access to the technical know-how and business support from a well-established player. Depending on the terms of the agreement, the franchisee may receive equipment, supplies and the fixtures for the business unit from the franchisor. Furthermore, the chances of the business failing are lower due to the customer base of the franchise and the vast network of suppliers, vendors, experts and other stakeholders associated with the franchisor. The brand recognition results in higher profits for the franchisee.

A franchising agreement is usually a bundled agreement because apart from the franchise agreement, there is also a lease agreement. The franchisor usually enters into a lease agreement with the owner of the building where the franchisee is to start operations. Thereafter, the franchisor sub-leases to the franchisee and this establishes a landlord-tenant relationship as well.

Lease Agreement: The lease agreement between the franchisor and franchisee is essential to ensure the business unit and its operations can proceed with minimal disruptions. If the franchisor is not the lessor, then the franchisee may face difficulties with respect to the premises or the rental agreement and the landlord may not be in a position to assist the franchisee/lessee as opposed to the franchisor whose interests are aligned with the franchisee. Without adequate support from the franchisor/lessor, the business unit may not be able to function effectively. Similarly, a franchisor may have problems with their franchisee and they should structure their lease agreement to ensure that if one franchisee/lessee exits, another franchisee/lessee can be brought in with respect to the same leased premises. This is because customers develop ties to the location of the popular brand and moreover, the location is also associated with the brand. This association can be leveraged by the franchisor to improve brand recognition and recall.

A few examples of successful franchises that have enabled the franchisor to expand exponentially are Food – McDonalds and Subway, Clothes and Shoes – Levi's, Adidas and Raymond and Beauty and Wellness – Juice, Jawed Habib and Enrich.

However, there is a need to protect the interests of both parties by means of a watertight contract that is fair and equitable. Let us discuss some of the important clauses in a franchise agreement.

In India, in the absence of any specific legislation on franchising, statutes such as the Indian Contract Act, 1872 and various IP related laws like the Trademarks Act, 1999 and the Patents Act, 1970 etc. apply.

Most standard franchise agreements will have certain stipulations that specify i) the minimum investment to be made by the franchisee; ii) the total area that will be required for the franchisee to operate the franchise unit; and iii) marketing and advertising support that will be given by the franchisor. Additionally, the franchisee must operate in a uniform manner to ensure the brand and offering is consistent across franchises.

Although franchising is a great alternative while considering expansion of one's business, there are certain pitfalls that every franchisor and franchisee needs to avoid in a franchise agreement. To that end, we have highlighted the important clauses in a franchise agreement that can be the cornerstone of the franchise's success.

Revenue Sharing Clause: Revenue Sharing takes many different forms. The franchisor may charge a fee only for use of its trademark and brand name. There may also be an agreement to sell between the franchisor and the franchisee to the exclusion of any third party etc. The revenue sharing models also differ with relation to the industry and the nature of the business. For example, in the IPL, the teams generate revenue through brand sponsorships. The franchises which partner with brands endorse the brand logos on their shirts and kits. Similarly, merchandise of the teams that are sold like t-shirts, caps, watches and kits also form a part of their revenue. With respect to companies, operating profits are shared between the partners and shareholders. A revenue sharing model is mutually beneficial as any profits or losses are shared between the franchisor and the franchisee.

From revenue sharing, it becomes important for the parties to the franchisee to secure their interests and to ensure that no profits or goodwill accrue to any third party.

Exclusivity Clause: All franchise agreements should have an exclusivity clause that gives the franchisee a competitive edge. This clause usually is a part of a larger contract and ensures that the company or individual works exclusively with the issuer of the contract. The exclusivity clause provides protection to all the parties in a contract. It prevents one party from selling or promoting a third party's goods and services and thus is well suited to franchise agreements. In the event of inclusion of an exclusivity clause, the parties should ensure that it is mutually beneficial to both the franchisor and the franchisee. There should be scope for increased competition in the event of limitation of future work opportunities. It should ideally help one party become the exclusive provider of goods and services to a business and/or receive goods and services exclusively from another party. In the event the business unit is unable to turn a profit, business support can be extended to the franchisee and if that fails then the franchisor should assist the franchisee in shutting shop by buying back the goods and minimizing their losses as the brand and reputation of the franchisor is at stake.

Non- Compete Clause: Let's also touch upon the non-compete clause in a franchise agreement. The non-compete clause is primarily to protect the franchisor's know-how and Intellectual Property (IP) that is built over time and differentiates his business from competitors. The non-compete clause is subject to the rules of Section 27 of the Indian Contract Act, 1872. The said section holds that agreements in restraint of trade are void.
However, the courts of law in India have carved out certain exceptions to Section 27 and they are as follows.

- Section27 talks about restraint imposed on the freedom of trade and business. However, restraint of trade has been recognised as valid under certain circumstances. The statutory exception to Section 27 says that if the goodwill of a business is sold to another then the seller can agree with the buyer not to carry on a similar business within a defined territorial limit subject to reasonable restrictions as the parties may agree upon.

● The second important exception has been carved out by the courts in the famous case Niranjan Golikari v. Century Spinning & Mfg. Co. It states that when there are restraints on trade during the operation of an employment when the employee is contractually bound, it will not be hit by Section 27 and is not regarded as restraint of trade.

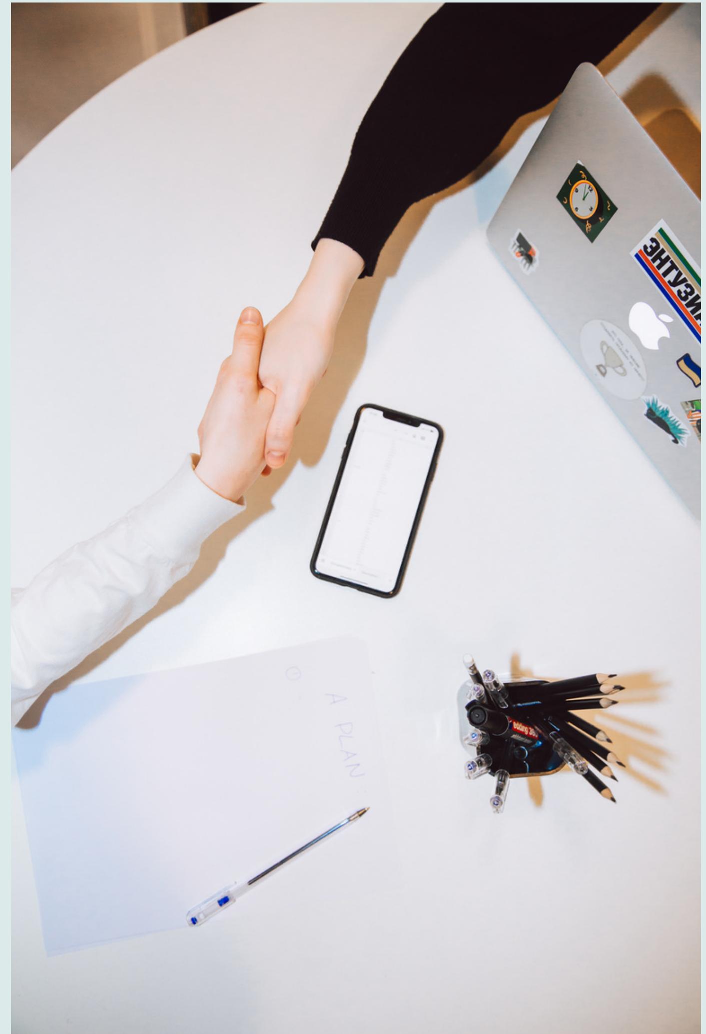
● Similarly, the third important exception is related to the franchisee's right to deal with competing products during the subsistence of the franchise agreement. In M/s Gujarat Bottling Co. v. The Coca Cola Co., the court held that the terms of commercial contracts have passed into the accepted currency of contractual and conveyancing relations and since they aim at promoting trade and business, they will not be in contravention to Section 27.

In Gujarat Bottling Co. Ltd. & Ors. v. Coca Cola Co. & Ors. the Supreme Court held that agreements in restraint of trade are not automatically void and may subsist during the course of the contract. It made reference to the contract between GBC and Coca Cola and held that franchise agreements that incorporate a provision to ensure that the franchisee shall not deal with competitors cannot be regarded as a restraint of trade.

However, the courts in India have also held that post-termination restraint on competition may be allowed to a certain extent depending on the reasonableness of the clause and its language.

Another important clause is the termination clause which is particularly important in the event of a breach of contract by either party and will ensure neither party suffers further losses.

Termination Clause: A well drafted termination clause can serve the franchisor's interests. If they are not satisfied with the business model used by the franchisee and it is not very profitable, then he can exit the agreement without a penalty. This provision must allow the franchisor to send a termination notice in the event of a default and if the default isn't remedied within a stipulated time frame, then the agreement can be terminated. The franchise agreement should be drafted to foresee any eventuality that could be detrimental to either party's interests. In 2012, a leading luxury fashion brand (franchisor) found that their Indian partner (franchisee) were not paying the rent and their outlets in a popular mall in Delhi were operating without electricity. Further, the goods were not being cleared by franchisee and they were lying with the Customs Department. The franchisor was able to exit the franchise agreement due to their termination clause and since the Indian partner was not fulfilling their obligations, it enabled the former to exit without suffering huge losses. The franchisor continues to have a presence in the Indian market. Similarly, an ex-cricketer (franchisee) had a tie-up with a luxury manufacturing company (franchisor) based in Germany which owns a luxury pen brand. The former introduced the latter's products in India.



Thereafter, the franchisor cut ties with the franchisee without adequate notice and decided to tie-up with another company. This resulted in the franchisee filing a civil suit against the franchisor and subsequently the matter went into arbitration. This underscores the importance of an effective termination clause as matters can take a turn for the worse at any point. As such, there should be scope for an exit for both parties without any serious legal problems.

While the termination clause is essential to ensure that a franchise agreement can be terminated with minimal losses, it is also important to ensure that the parties fulfil their obligations as agreed under the franchise agreement.

Conclusion

A well drafted contract will play a central role in the success of the franchise. It will help avoid expensive and contentious litigation, improve business relations and can help avoid breach of contract. Litigation may force a business owner to shut down operations and create several problems for proprietors and business owners. While the above clauses are fundamental to any franchise agreement, it is by no means exhaustive and it would be advisable to consult a legal professional before entering into a franchise agreement to protect each party's interest.