

MODULE

13

IP issues in Franchising

MODULE 13. IP Issues in Franchising

OUTLINE

LEARNING POINT 1: Franchising

1. What is franchising?
2. Types of franchising arrangements

LEARNING POINT 2: Preparing to franchise

1. Due diligence
2. Initiating the relationship
3. Franchise agreement

LEARNING POINT 3: Managing a franchise relationship

1. The operations manual
2. Improvements and training
3. Quality control

LEARNING POINT 4: Termination

1. Contract duration and renewal
2. Default and termination
3. Dispute settlement
4. Post termination issues

INTRODUCTION

A business that is bringing in profits and that has captured the interest of a market will naturally seek to expand. Franchising is one of the fastest growing and popular strategies for business expansion. It is where a person (franchisor) who has developed a certain way of doing a business gives another (franchisee) the right to use that business model in exchange for a fee.

Along with the right to use the business model the franchisor will license to the franchisee the intellectual property rights and know-how associated with that business as well as provide training and support to the franchisee. In essence, a successful business is being replicated and run by entrepreneurs who are called franchisees under the supervision, control and assisted by the owner of the business model, the franchisor.

LEARNING OBJECTIVES

1. You understand franchising as a means for business expansion.
2. You understand the role of intellectual property in franchising.
3. You understand the importance of managing these intellectual property rights.
4. You understand the cost of not managing these rights effectively.

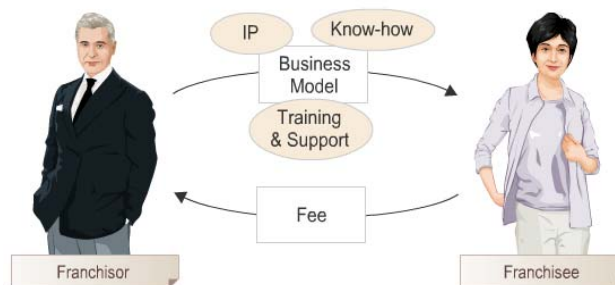
LEARNING POINT 1: Franchising

1. What is a franchise?

a. Main Concept

Franchising is where a person (**franchisor**) who has developed a certain way of doing a business gives another (**franchisee**) the right to use that business model in exchange for a fee. The business has built a certain reputation and has brand recognition.

In essence, a successful business is being **replicated** and run by entrepreneurs who are called franchisees **under the supervision, control and assisted by** the owner of the business model, **the franchisor**.



IP issues in franchising

- Along with the right to use the business model the franchisor will license to the franchisee the intellectual property rights and know-how associated with that business as well as provide initial and ongoing training and support.
- The intellectual property rights that are licensed in a franchising arrangement almost always include trademarks, copyright and often include trade secrets, industrial designs and patents - depending on the nature of the business.

One could say that franchising is a special type of licensing arrangement in that it involves the right to use a business model which necessarily includes the right to use the intellectual property rights integral to that business along with support, training and mentoring.

Learn more: Non-franchisable business

Not all businesses are “franchisable”. In order for a business to be capable of being franchised **it has to be capable of being replicated.**

The following kinds of businesses are not considered “replicable” and do not lend themselves to the franchise model:

- **Creative business** : Creative businesses require particular skills whether of an artistic or creative nature which cannot be easily taught so they are not replicable.
- **Technical business** : Technical businesses are unlikely to be franchised because in the great majority of franchises a relatively short period of induction training is provided by the franchisor.

Also low margin businesses as well as businesses that cannot sustain themselves for at least five years do not lend themselves to franchising.

More Reference 1 Case studies

Example 1

Toast sandwiches have long been a staple in Korea’s road food culture. Over the past decade, Sukbong Toast has led the toast sandwich industry, transforming the traditional toast sandwich market from road food culture to in-store franchise business.



Sukbong Toast has been ranked as a “Mukyodong Top5 Specialty” and is recognized as one of the most outstanding products sold in downtown Seoul.

Sukbong Toast is a registered trademark, and the method of making this unique product is a trade secret. The brand emphasizes the freshness and cleanliness of its ingredients and strives to provide the modern, health-conscious customer with the best quality sandwiches. There are more than 250 Sukbong Toast stores throughout South Korea.

Example 2

Jawed Habib is one of the leading hair & beauty salon chains in India. It operates around 225 salons and training institutes in 21 states and 67 cities across India, mostly through the franchising business format.



The format specifies the location, design, the number of staff, incentives,

advertisement, facilities, royalties, etc. It gives potential franchisees the option of three possible variations of the business represented by three variants of its registered trademark.



Example 3

Ya Kun has made over fifteen national trademark applications with the Intellectual Property Office of Singapore (IPOS) for its “Ya Kun” name, the “Ya Kun Kaya Toast Coffee Stall Since 1944” slogan; various posters representing the company’s history; and the names of popular products such as “Toastwich.” It has also made an international application under the Madrid system for its name and slogan.



A key to Ya Kun’s intellectual property is its know-how represented in its trade secrets. The company’s coveted kaya jam recipe is a closely guarded family trade secret, and it is manufactured in a separate, family-owned facility by staff made of family members only. Mr. Loi, and his family work hard to ensure that this recipe is not disclosed. Another important trade secret is Ya Kun coffee; which uses a special mix of various types of coffee beans which gives it a special aroma and flavor.



Ya Kun Kaya Toast
Coffee stall since 1944

Nostalgia is an important element in Ya Kun locations, so all outlets display the same posters depicting images of bygone days and the history of Ya Kun. While these posters are protected nationally through trademark applications, they, along with all of Ya Kun’s manuals and other materials

used in its franchise system, are also protected through copyright. Text relating to the history and profile of Ya Kun is also displayed in the

company's outlets in Singapore, and thus enjoys copyright protection. The Ya Kun franchise package gives franchisees the right to operate the Ya Kun Kaya Toast concept, use of Ya Kun's distinctive identity and trademark, initial and ongoing support, free exchange of new ideas, research and development (R&D) and marketing and public relations, in addition to being provided with a steady supply of official Ya Kun products. A valuable intellectual property portfolio comprising trademarks, copyright and trade secrets coupled with an effective franchising system has propelled Ya Kun to international success. Ya Kun's intellectual property combines perfectly with its brand recognition to associate Ya Kun products with quality, nostalgia and a home-grown company that has wide appeal.

Example 4










Pollo Campero®, a Guatemalan company, first opened its doors to consumers in 1971 in Guatemala City. As well as operating in more than 130 locations in Guatemala, Pollo Campero has a presence in 13 countries in the Americas, Europe and Asia. Its restaurants serve more than 80 million customers annually.



The distinguishing characteristics of the Pollo Campero franchise system include proprietary and registered trademarks; distinctive restaurant exterior and interior design, décor, color, identification schemes and furnishings; special menu items; the unique flavor of its fried or roasted chicken, which is marinated and breaded with a secret formula; standards, specifications, requirements and operations procedures; manufacturing, distribution and delivery; quality and safety of products and services offered; management systems/programs; training and assistance; marketing, advertising and

promotional programs.

The Pollo Campero trademark has evolved over time, from the original:

“” to “” and then on to its current, modern format. Campero operates under the Pollo Campero trademark and various other trademarks, such as “Campero” “Camperitos”, “”, “”, “”, “”, “”, “”, “”, “Club Campero”.

Franchisees are authorized to use the proprietary information in Pollo Campero's Confidential Operations Manuals for the operation of the franchise. Franchisees may not, at any time, communicate or divulge any confidential information, trade secrets, knowledge, or know-how concerning the methods of operation of the franchise which Campero provides to them, including product information, sales information, customer information and merchandising systems. Franchisees may communicate this confidential information only to employees who need access to the information in order to operate the franchise. Any information, knowledge or know-how (including drawings, materials, equipment, specifications, techniques and other data which Campero marks as confidential) together with any information, knowledge or know-how that is derived from an analysis of this data is confidential, except information that is already in the public domain.

Example 5



Jollibee and several variants of the mark are registered trademarks in the Philippines and many other Asian countries, and also in the United Kingdom of Great Britain and Northern Ireland, the United States of America and Europe.

Today, Jollibee Foods Corporation uses six different brands (including “Jollibee” for its core fast food business; “Greenwich” for its pizza and pasta chain, and “Chowking” for its oriental food outlets). It owns many trademarks including “Bee Happy”, “Yumburger”, “Chickenjoy” and “Amazing Aloha” and has registered all of its logos, some of them in several countries.

Jollibee Foods Corporation relies on a franchising model for the operation of about half of its outlets in the Philippines. In order to protect the company's high quality and service standards, potential franchisees must conform to a

specific profile (self-driven entrepreneurs with good management skills, good community standing and excellent interpersonal skills).

Successful franchising applicants undergo a three-month, full-time Operations Training Program (BOTP) at a designated training restaurant; this program is supplemented with other programs, which are designed to enrich the franchisee's management and analytical skills, and are necessary in order for the franchisee to run a successful restaurant operation.

Support for franchisees does not end there however: Jollibee also provides advice and assistance with restaurant layout and design, equipment specifications, furniture and fixtures, and construction management. Jollibee field personnel provide consulting services once the outlets are operational. Additional support to franchisees is provided in the form of creative advertising and marketing programs, product development, and manufacturing and logistics facilities.

The Jollibee Word, Logo and Mascot are registered trademarks of Jollibee Foods Corporation. All rights reserved

Example 6

The need to replicate all aspects of a business is well illustrated in the case of the franchising of the Bakers Delight fresh bread business in Australia.



The business was established in a suburb of Melbourne in 1980 by Roger and Lesley Gillespie.

The early days were typified by Roger regularly having to leave dinner parties to fill in for a baker who was ill. This was a necessary

consequence of the business needing to be able to have fresh bread available on a daily basis. By 1988, the Gillespies owned 15 bakeries, all of which operated on their formula for a successful and attractive bakery. Being satisfied with the formula, they began to franchise the business; by 1993 they had expanded to 200 bakeries. Today, there are over 700 bakeries, across three countries, including Canada, where the business operates under the COBSB read brand.

The opening of a new store is now a turn-key operation. Achieving the consistency of quality in all aspects of the business, which is necessary for a successful franchise business, arises from comprehensive training of franchisees, detailed and documented procedures, ongoing operational assistance, and strong brand recognition.

So successful is the Bakers Delight model, 40 percent of its bakeries are

owned by franchisees with more than one site.

The importance of strong branding is vital to any successful franchise. In the case of Bakers Delight, the Gillespie's were looking for a simple brand, which conveyed to the customer a fundamental message about the business. That is, that the product sold in the Bakers Delight outlets was made by an individual baker, is made from real ingredients (hence the ear of wheat) and that the baker is proud and delighted with the product they bake.

In order to protect the brand, Bakers Delight has registered several trade marks as well as phrases in Australia and has either registered or is seeking registration of relevant marks outside Australia. Furthermore, Bakers Delight treats as confidential its recipes for its baked products as well as the processes and procedures which franchisees follow when operating a Bakers Delight outlet. These proven systems cover all aspects of running an outlet and include marketing, training, finance, purchasing and point of sale reporting systems. The franchisor also manages leases on behalf its franchisees.



In the case of Canada, the company trades under the name, COBSB read, although the signature ear of wheat and style of the mark is copied from the Australian registered mark currently in use. In all other respects, the distinctive livery used for outlets in Australia is reproduced in Canada and other countries outside Australia. The livery takes the form of maroon on a white background (or the reverse) and extends to aprons and other items of clothing worn by staff.

In the words of Roger Gillespie:

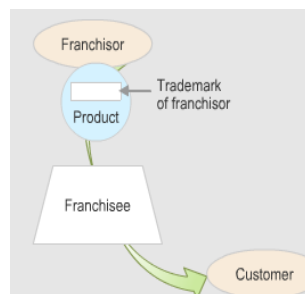
"The value of our business is intimately connected to our distinctive brand and image, our product and our people. Our failure in any one of those elements impacts adversely on the others and on our value proposition overall."

All words, logos and mascots above are registered trademarks of its company. All rights reserved.

b. Categories of franchise

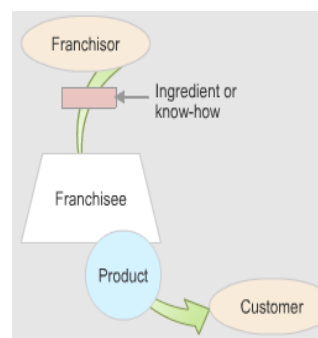
1. Product or Distribution Franchise -

A product manufactured by the franchisor (or on his behalf by another) is sold to a franchisee who in turn sells it to the consumer under the trademark of the franchisor. Such a franchise is usually restricted to a particular geographical area and the franchisee pays fees referred to as royalties to the franchisor for the right to do business under his trademark

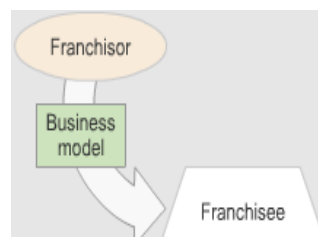


2. Manufacturing, Production or Processing Franchise

- The franchisor sells to the franchisee an essential ingredient or provides some specific know-how, which along with ongoing quality controls by the franchisor, enabling the franchisee to manufacture/product/process the final product and sell to the consumer. Coca cola operates in many markets in this manner supplying franchisees with the essential ingredient of Coca cola protected by a trade secret enabling them to produce the final product.



3. Business format franchising – The owner of a business(franchisor) licenses to another(franchisee) the right to use the particular business model including the intellectual property associated with it, particularly the trademark. Business format franchising is the most widely used form of franchising.



Four essential elements of business format franchising.

- The franchisor allows the franchisee to use under license its proprietary IP, principally its trademarks but also its designs, patents, copyright and its confidential business information.

The most important is usually the trademark on which the brand has been built and it is that brand recognition that makes the franchised business attractive

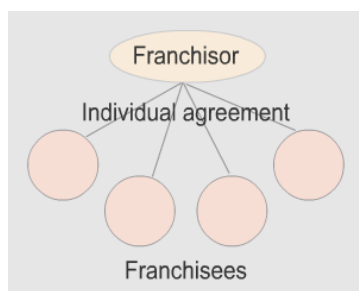
- The franchisor controls the way the business is run and managed by the franchisee.
- The franchisor provides training, mentoring and assistance to the franchisee.
- The franchisee makes both initial and periodic payments to the franchisor.

c. Advantages and disadvantages of franchising

	Advantages	Disadvantages
To the Franchisor	<ul style="list-style-type: none"> ·Business Expansion ·Infusion of new capital through franchise fee ·Additional revenue stream through royalties ·Franchisees perform better than employees ·Reduced operating costs ·Spreading of risks ·Smaller central organization 	<ul style="list-style-type: none"> ·Cost of launching a franchise ·A bad choice of franchisee could be disastrous for the whole franchise ·Cost of maintaining the franchise network ·Confidential business information has to be shared and thus become vulnerable
To the Franchisee	<ul style="list-style-type: none"> ·Rely on recognition of a established brand ·Smooth entry into a proven business model ·Availability of training, support and financing ·Established customer base ·Low risk ·Personal ownership 	<ul style="list-style-type: none"> ·Control by the Franchisor, little flexibility ·High start up costs, obligation to pay royalties ·Obligations to report ·Lose identity, customer does not know who owns the outlet ·Vulnerable to the network. Bad reputation of one outlet affects the whole network

2. Types of franchising arrangements

(a) Direct Franchise Agreement – A franchisor may enter into individual franchise agreements with each territory or outlet. Here the franchisor has direct control of his franchisees and a revenue flow that does not need to be shared with others.



However, direct franchising **may not be that suitable when the outlets are in another country.** Problems may include the issues of repatriating revenue, tax implications as well as the difficulties of dealing with the uniqueness of different countries, including language, culture, laws, regulations and business practices.

(b) Master Franchise Agreement - A franchisor may enter into a master franchise agreement whereby another entity is given the right to sub-franchise the franchisor's business concept within a given territory with a development timetable. These rights are usually secured by an initial development fee charged by the franchisor.

(c) Development Agreement - A development agreement obliges a developer to open multiple outlets in accordance with a development timetable. Vis-à-vis the developer and the outlets; rather it involves franchising between the franchisor and the developer.

Learn more: International franchising

There are essentially five ways in which a franchise system can be expanded overseas:

- the franchisor grants **franchises to franchisees** in the target country;
- the franchisor establishes **a subsidiary or a branch operation** in the target country and that subsidiary/branch acts as the franchisor;
- **a joint venture** is established between the franchisor and a third party with knowledge of the target country. The joint venture will act as the franchisor in the target country;
- the grant of a **master franchise agreement**;
- the grant of a **development agreement**.

In the context of going international it is important to keep in mind that **intellectual property rights are territorial in nature**. There where planning to go overseas with a franchise operation **it is important to ensure that the intellectual property rights are protected in that territory**.

LEARNING POINT 2: Preparing to franchise

1. Due diligence

It is essential that prospective franchisees undertake a thorough check of the franchisor and the franchise proposition. Undoubtedly, franchisees must obtain full information on the number of franchisee failures which have occurred and must be able to speak to all and not just the best performing franchisees. In the case of a new franchisor, if it has not undertaken adequate pilot testing this should be a major concern to a prospective franchisee.

a. Selling a franchise

Feasibility Study and Pilot Testing

- When considering franchising a business it is important to **carry out a feasibility study with the assistance of franchising experts**. It is also important to **undertake pilot testing whether by recruiting a pilot franchisee or by using the company's own staff**.
- The pilot franchise will not only provide **an assessment of the financial viability of the franchise** but will enable the franchisor to ensure that it is able to **transfer its know how, refine the franchise offering and develop its operations manual**.

How do you market your franchise?

Franchisees are recruited in a number of ways. The difficulty in recruiting franchisees should not be underestimated. It is important, as a starting point, to understand **how franchisees research and select a franchise**.

- **Over three quarters look at a franchisor's web site**. Going forward this figure

is likely to increase and, therefore, franchisors need to ensure that their web site is easy to find, easy to navigate and encourages franchisees.

- **Over half will have investigated other brands** and, therefore, franchisors must ensure that their franchise offering, in terms of the initial fee, continuing fees, turnover and profitability are not less attractive than those of their main competitors.
- In addition, prospective franchisees will have undertaken research through general franchise websites, often **starting with the national franchisor associations**. They may well **also have attended seminars on franchising**.

b. Buying a Franchise

What sort of people become franchisees?

There is no single type of franchisee but franchisees must have:

- the support of their family;
- be determined and hardworking;
- have the ability to “sell”;
- have sufficient financial resources; and
- be prepared to comply with the franchise system.

Learn more: Role of national franchise associations

Most countries have franchise associations. Usually they were set up to provide the advantages of franchising and generally to increase public and governmental awareness of franchising. They are often networking clubs for franchisors but the most sophisticated franchise associations do much more.

Role of national franchise associations :

- promote franchising through their websites;
- provide educational courses;
- list franchise experts;
- liaise with government bodies;
- set out and enforce a code for ethical franchising; and
- discipline members.

2. Initiating the relationship

The following are the checks that a franchisee should make on a franchisor:

- Confirm the validity of the franchisor's intellectual property that is to be licensed to the franchisee.
- Ask existing franchisees
 - if their business remains profitable and, if so, what are the critical factors that make it successful.
 - how long it took them to become profitable. How much funding they required in order to set up the business and reach the break-even point.
 - their opinion of the franchisor, in terms of the quality of information provided in the operations manual.
 - if they had to do it all over again, would they buy this franchise, and why.
- Contact as many franchisees as possible who have relinquished this particular system, and ascertain their reasons for doing so.
- Ascertain whether the franchisor operated a pilot scheme before launching the franchise, and if so, how long the scheme was in operation.
- Determine what lawsuits, if any, the franchisor has been a party to; what types of cases and the final outcome in each case.
- Seek the advice of an experienced franchised consultant/lawyer on both the franchise disclosure document and the franchise agreement. Seek the advice of an accountant on any financial information provided by the franchisor.
- Determine how many franchise associations, if any, are in existence in the relevant territory, and whether the franchisor is a member.

3. Franchise agreement

a. Laws that apply to franchising

(1) Franchise disclosure laws

Many countries have disclosure laws which require **information to be provided to prospective franchisees before they commit to the franchise**. Sometimes, as is the case in the United States of America, the disclosure requirements are quite detailed.

Full and accurate disclosure would generally include the following information:

- A description of the business format, details of the pilot operation, how long the franchisor has been in business, the people involved in the franchisor's company, details of other franchisees, the franchisor's likely competition, and any special laws that might apply to the franchised business, such as special license or permit requirements.
- Problems facing the franchisor, including any of involving in convicted crimes, fraud or violations, law suits, bankruptcy filings of the franchisor or its officers.
- The costs involved in starting and operating a franchise and other costs which the franchisor may not have to disclose (depending on the national laws) such as ongoing royalty fees, supply costs, and insurance.
- What restrictions if any would apply such as which suppliers to use, what goods can be sold, and the area in which the franchisee could operate ("territory").
- The intellectual property owned by the franchisor which the franchisee will be allowed to use in the franchise, in addition to any relevant intellectual property disputes.
- Financial statements, which should indicate the franchisor's current financial condition.
- Membership of trade and/or franchise associations.
- Grant-back provisions.

- How disputes under the agreement would be settled, and what liability would accrue for the costs of such dispute settlement.
- A copy of the current form of the franchise agreement.

(2) Registration requirements

A number of countries **require franchisors or their agreements to be registered with a governmental agency**. In addition, civil law countries impose a general duty of good faith on all commercial transactions including the grant of franchises.

Some countries have adopted **laws that require the registration of the disclosure statements as well as the franchise agreement with a government authority** in order for the franchise relationship to be valid. **This provides protection to the franchisee** including the right to bring action against the franchisor for violation of disclosure requirements.

Some are however of the view that disclosure requirements are sufficient protection for prospective franchisees and that registration requirements add an unnecessary administrative requirement which adds cost and burden on the franchisor.

(3) Franchise relationship laws

Once the parties have entered into a franchise agreement the franchise relationship laws regulate various aspects of the franchise relationship such as the franchisor's right to terminate, the right of renewal and the right of transfer.

(4) Anti competition laws

In many countries, **laws for controlling the anti competitive behaviour of franchisors exist**.

Anti-competitive practices that limit, distort or prevent competition are often prohibited by national laws (e.g. antitrust laws in the United States or in other countries competition law or policy, or Fair Trading or Anti monopoly law). **The**

superior bargaining power of the franchisor may be abused in many ways that may cause harm to the franchisee and ultimately to consumers. Franchise agreements are subject to the purview of various competition laws.

b. Main provision

(1) Parties

Identify the parties to the contract.

The party granting the right is referred to as the **franchisor** and the party receiving the rights is called the **franchisee**.

(2) Definitions

The terms used in the agreement will be defined so that each time they are used they are understood in a specific way.

(3) Rights Granted

This section will set out what exactly is being granted to the franchisee.

It will indicate;

- whether the Franchisee is an **exclusive, sole or non-exclusive** franchisee,
- **the territory** in which he is competent to operate,
- **the intellectual property rights** which he has the right to use.

(4) Fees

There are generally three kinds of fees that are payable.

- **An initial fee** : an up front lump sum fee which is also referred to as a franchise fee
- **On going fees** : which are royalties paid based on a percentage of the turn over
- **Various one off fees** : renewal fees, advertising fees, administration fees etc.

(5) Term

The term of the agreement would be for a limited period of time, **usually an initial period of 5 years with the right to renew.**

(6) Non-agency

A clause stipulating that **the franchisee is not an agent of the franchisor**, but is, rather, an independent contractor, and that the parties are not partners or associates, is intended by the franchisor to make it clear to the franchisee that it is not an agent and that, as such, it is responsible for its own liabilities.

(7) Franchisor's Obligations

The Franchisor will help the franchisee get on his feet by providing him the following **initial assistance**:

- **Advice on finding premises.**
- **Advice on equipment, fixtures and fittings in the Premises.**
- **General advice on how to set up the franchise.**
- **Undertake a PR launch.**
- **Provide a copy of the Operations Manual.**
- **Provide initial training.**
- **Facilitate trademark registration, if it has not be registered.**
- **Identify or otherwise support the franchisee in defending any third party claims of intellectual property infringement by franchisee.**

The Franchisor will also provide the following **continuing assistance**:

- **Provide advice and guidance relating to the business.**
- **Supply products to the Franchisee.**
- **Train the Franchisee's personnel.**
- **Assistance in maintaining quality control.**

(8) Franchisee's Obligations

Similarly the franchisee is obliged to do *inter alia* the following:

- Lease or own premises as approved by the franchisor.
- Operate the business in accordance with the Operations Manual.
- Refurbish and equip the premises as required by the franchisor.
- Only use stationery, invoices, and products which are supplied by the franchisor.
- Use only signs and packaging in connection with the business as have been approved by the franchisor.
- Maintain the premises to the highest standards and not carry out any alterations without the franchisor's consent.
- Use his best endeavors to promote and extend the business.
- Operate the business during hours specified by the franchisor.
- Ensure that the staff are well dressed, clean and polite.
- Not employ as a manager any person who has not completed the franchisor's training course and been approved by the Franchisor.
- At the request of the Franchisor provide potential franchisees with information as reasonably requested.
- Protect the franchisors trade secrets, inform of him any potential infringements of its IP and claims of infringement.
- Make timely payment of fees.

(9) Accounting Records

The Franchisee will be required to keep records and make regular reports to the franchisor. The franchisee may even be required follow a certain a record keeping system which allows the franchisor to see how different franchisees are performing. The franchisee will also be required to allow the franchisor access to and audit these records.

(10) Advertising

Most franchise agreements require franchisees to make a regular contribution to a fund held separately which the franchisor will use for advertising the system as a whole. If any specific advertising has to be done in relation, for example, to a specific outlet then it would be subject to the approval of an advertising agency approved by the franchisor.

(11) Insurance

Franchisors are usually concerned to ensure that their franchisees are adequately insured because of the possibility of claims being made against the franchisor for the acts of the franchisee. The franchisee will be under obligation to take out insurance for the business and furnish to the Franchisor copies of policies and evidence of payment of premiums.

(12) Sales of Business

Usually the franchisee has no right to transfer the franchise without the Franchisor's consent and the Franchisor has the first right of refusal. That is, the franchisee must offer its business to the franchisor before it looks for another purchaser. The Franchisor will have the right to approve or reject any purchaser presented by the franchisee.

However, if the Franchisor does not want to buy it then it must consent to the transfer if certain conditions are met including that the purchaser meets the Franchisor's minimum standards, the costs of investigation and training are made and the Agreement has not been breached by the present franchisee.

(13) Non-Competition

To protect the franchise system, the franchisee is restrained from conducting similar business during the term of the franchise and after. These provisions

are looked at with some suspicion by the courts and it is important that they be “reasonable” particularly the restraints after the termination of the franchise. If the restraints are limited in time and territory they are more likely to be considered reasonable.

(14) Intellectual Property

The grant clause will specify that **the franchisee will be granted the right to use the intellectual property pertaining to the franchise.**

A further clause will identify the relevant intellectual properties such as trademarks, designs, copyright, trade secrets and patents relevant to the franchise and establish that they are owned by the franchisor and put in place safeguards to protect them from being infringed.

After termination of the agreement the franchisee cannot use the trademark of the franchisor and will be bound to not reveal the trade secrets that he acquired during the course of the franchise. There will also be mechanisms in place as to what to do if there is infringement, in that who would be responsible for taking action etc.

(15) Termination

The Franchisor may terminate this Agreement if the Franchisee:

- **Fails to commence business** within three months of execution of the Agreement.
- **Is in breach of specific terms of the Agreement** which should be listed.
- **Persistently defaults in payment of any amounts** due to the Franchisor.
- **Is found to have supplied materially false or misleading information** in or supporting the franchise application.
- Goes into liquidation/bankruptcy or is insolvent

Following termination of the Franchise Agreement the Franchisee:

- Must cease to **use the Franchisor's trade marks and other intellectual property** and must not thereafter hold itself out as being a franchisee of the Franchisor

- Must **pay to the Franchisor** all sums payable to the Franchisor whether or not then due.
- Shall return to the Franchisor all manuals, literature, promotional material, letter heads, invoices or anything else which indicates any association with the Franchisor.
- Shall **provide the Franchisor with a list of all customers** and potential customers of which it is aware.
- Shall **not make use of or disclose any confidential information** relating to the system or the franchised business.
- Shall **not compete with the Franchisor**.

More Reference 2 Protecting a franchise's trade secrets

No. 1: Define the franchisor's trade secrets broadly in the franchise agreement, for example -- "As used herein, the term Trade Secrets mean, any information, including, but not limited to, any manuals, contracts, customer data, supplier data, financial data, price lists, know-how, methods, techniques, processes, compilations, formulas, programs or patterns relating to the operation of the franchise and the products or services thereof."

No. 2: Specifically state in the franchise agreement that any items embodying the franchisor's trade secrets are being licensed to the franchisee as opposed to being sold.

No. 3: Specifically state in the franchise agreement that the franchisee is prohibited from "reverse engineering," decompiling or disassembling any items embodying the licensed trade secrets.

No. 4: Require the franchisee to acknowledge that he or she is not violating any restrictions of former employees or other previously-owned franchises and that he or she will not disclose or use any trade secrets of any former employers or other previously-owned franchises in the operation of the present franchise.

No. 5: Stress the importance of maintaining secrecy of the system's trade secrets and specifically include a statement in the franchise agreement wherein the franchisee acknowledges that he or she may have access to the franchisor's trade secrets and that these trade secrets have substantial value that provide the franchisee with a competitive advantage.

No. 6: Include specific provisions in the franchise agreement that restrict unauthorized use and disclosure of the system's trade secrets and prohibit the franchisee from delivering any papers, or publishing any articles pertaining to the franchise or its activities until they are first reviewed and approved for publication by the franchisor.

No. 7: Include specific provisions in the franchise agreement in the event of the franchisee's severance, including: requiring the immediate return of any of the franchisor's trade secret information and any items embodying those trade secrets; requiring acknowledgment that he or she has no ownership interest in the trade secrets or any items embodying the trade secrets.

No. 8: Include specific guidelines in the operating manuals for protecting the secrecy of the franchisor's trade secrets, including: limiting access to the trade secrets to only those franchise employees that have a need-to-know for the performance of their duties; requiring locking of all offices, file cabinets or storage rooms in which confidential information may be found; providing appropriate legending and treatment of all trade secrets; limiting access to copying and scanning equipment and computers; and password-protecting all computers and encrypting all electronic communications containing references to the trade secrets.

No. 9: Require the franchisee to have every employee who may have access to the franchisor's trade secrets execute an employment agreement having non-disclosure provisions, restrictive covenants, and notice requirements of subsequent employment.

No. 10: Require the franchisee to conduct periodic meetings with the franchise employees to instruct them as to their responsibilities to maintain secrecy of the franchisor's trade secrets. The franchisee should also conduct severance interviews with any terminating employees in which they acknowledge in writing their post employment obligations to the franchise.

LEARNING POINT 3: Managing a franchise relationship

1. The operations manual

The **operations manual** is at the very **heart of the franchise system** and is critical for its success. **It guides the franchisee through every step of the business** and is **a handy reference** whenever questions arise and ultimately **ensures consistency by the different franchise locations and the maintenance of quality standards.**

The operations manual would generally include:

(1) Introduction

- brief summary of the franchise business
- what the franchisee will have to do
- what the franchisor will provide
- details of the existing franchise network
- the franchisor's business philosophy
- trademark(s) and other intellectual property to be used

(2) system : A detailed description of the system and each of its elements

(3) operating methods

A list of what is required in order to operate the business should be set out, and could include (depending on the business):

- equipment
- how the equipment is to be operated
- equipment problems
- stock requirements
- IT requirements (hardware and software)
- vehicle requirements

(4) Operation instructions

All matters relating to the operation of the business should be set out in detail and should include:

- standard forms and procedures
- financial records and reporting
- payment of franchise fees
- general accounting, tax matters; information on how to complete necessary forms
- cash control and banking procedures
- how to deal with cheques, debit cards and credit cards
- staff requirements
- staff uniforms
- procedure for disciplining staff
- summary of employment legislation
- breakdown of job description for staff
- opening times
- trading patterns
- purchasing requirements and stock levels
- pricing policies
- insurance

(5) Advertising and marketing recommendations

- Local news papers
- public relations companies
- launch procedures
- marketing material
- point-of-sale advertising
- local advertising policy
- recommendations in relation to public relations and advertising

(6) Outlet

Suggested location of store

- store layout
- display and merchandising techniques
- cleanliness
- complaints procedures

(7) Standard forms

All standard documentation and forms required to be used in the business should be set out.

- business names act notices
- accounting and financial forms
- order forms
- stationery
- data protection act forms
- contracts of employment

(8) Legal issues

In countries which have detailed disclosure requirements, these requirements must be complied with. In countries which do not have such requirements, a summary of relevant legislation, licenses and permits should be provided.

(9) Franchisor's directory

- A list of the franchisor's employees with their job descriptions and reporting structure
- useful telephone numbers and contact details

2. Improvements and training

a. Improvements

Inevitably during the course of the franchise both the franchisor and the franchisee will develop improvements. The Franchise Agreement will require the franchisor's improvements to be implemented by the franchisees and will also require the franchisees to pass on and license the improvements they develop to the franchisor. It is essential that there is a free interchange of ideas.

b. Training

Not only must initial training be provided because usually franchisees will have no knowledge of the franchised business but the Franchisor must provide updating training.

The initial training is usually provided "free of charge" in the sense that its cost is included in the initial fee and continuing training should be provided at cost and not at a profit for the Franchisor because its purpose is to have a well trained franchise network.

3. Quality control

It is important to maintain quality control.

Quality control is key to **maintaining the appeal of the franchise and the value of the brand**. In addition a trademark owner is under legal obligation to maintain quality control in the use of the mark when he licenses his trademark which is the case in franchising. If quality falls in one franchise outlet it will **affect the whole franchise**.

More Reference 3 Quality control

The core of a franchise agreement is the licensing of a trademark which (together with other intellectual property rights such as trade secrets, copyrights, design rights and patents) underpins a brand. The brand is the

lifeblood of the franchise. Protecting it and strengthening it is of crucial importance to both the franchisor and the franchisee; in the case of both parties, their success depends on the brand maintaining and, hopefully, strengthening its appeal.

In order to maintain its appeal, the brand must deliver on the quality and consistency of experience expected of it. A franchisor, having granted another party (the franchisee) the right to use the brand, must not and cannot divest itself of the responsibility of controlling the quality of the goods and services that are offered under the brand; it must also ensure that the entire visual and emotional experience of interacting with the brand remains consistent for the consumer. As a result, irrespective of which franchised outlet the consumer engages with, their experience of the product must be the same. The franchisor cannot divest itself of this responsibility because quality control is vital for maintaining the appeal of the franchise and the value of the goodwill associated with the brand. If quality standards fall in one franchise outlet, it will affect the whole franchise. Another reason why the franchisor cannot divest itself of this responsibility is because, as a trademark owner, it has a legal obligation to ensure that quality control is maintained by a trademark licensee (which in this case is the franchisee). If a franchisor does not continuously discharge this responsibility, then he may be deemed to have abandoned his trademark and may lose his trademark rights. Licensed trademarks which do not have proper quality control are called "naked licenses".

As illustrated above, the franchisor exercises considerable control over the way the franchisee operates the franchise so as to ensure that the entire franchise system adheres to certain predefined quality standards. Controlling quality begins at the point of franchisee selection, and continues throughout the lifetime of the operation of the franchise. The operations manual is the basis for the franchise operation and thus provides an objective basis for the quality standard against which the performance of the franchisee is measured. To ensure quality control, compliance with the requirements and standards set out in the operations manual must be guaranteed. Initial and on-going training, followed by regular scheduled and random visits to the franchisee's business, are important ways of ensuring that the franchise system is being followed in every respect and that the reputation of the brand remains intact.

The operating manual is the starting point.

It is the basis for the franchise operation and thus the standard against which the performance of the franchisee has to be measured. **To ensure quality control, compliance with the standards set out in the operations manual must be ensured and enforced.**

It is ensured through initial and on going training followed up by field visits. Today more and more of this is done through the internet where learning materials are made available, training videos and pod casts are accessible to all.

LEARNING POINT 4: Termination

1. Contract duration and renewal

a. Contract duration

The most common length for franchise contracts is five to ten years. A very small percentage of franchise agreements are for less than five years.

The advantage of having a five year term

- It enables a franchisor to submit an updated franchise agreement to a franchisee on renewal and also enables the franchisor to withhold renewal if the franchisee's performance has been poor.
- Franchisors such as MacDonald's Burger King and KFC grant franchises for twenty years which mirror the lease of the premises which franchisees take and, of course, reflect the high start up costs involved.

b. Contract renewal

There is an expectation that in relation to a five year franchise agreement it would see two renewals and in respect of a ten year franchise agreement one

renewal would be offered so that franchisees are guaranteed at least fifteen or twenty years assuming the conditions in the renewal clause have been complied with. On a resale the incoming franchisee should have a “guaranteed” period of time in which to operate the franchise. It should be equivalent to the time period that would be offered to a new franchisee rather than the remaining operating time of the original franchisee.

2. Default and termination

A right to terminate is extremely important in franchising **because to the outside world franchisees are the franchisor**. As a result, if a franchisee is doing something wrong, then it would be normal for franchisors to want to be able to take rapid action to avoid damage to the brand. Such action may include termination of the franchise agreement.



A termination clause should:

- It should be **clear** and **unambiguous** about which situations entitle the franchisor to terminate.

Courts generally dislike one party (especially if that party is economically more powerful than the other) having the right to terminate a long term contract for relatively minor breaches;

- It should **ensure that there is a termination procedure**.

Whilst some breaches are so serious that immediate termination is essential – these include a franchisee being involved in a competing business, passing on confidential information, encouraging other franchisees to breach their franchise agreement and deliberate under declaration of turnover, in other situations the franchisor needs to consider adopting a procedure of offering assistance first before threatening termination;

3. Dispute settlement

Disputes are bound to arise and preventing them, managing them and resolving them are crucial for the long term health of the franchise.



The most common and the more appreciated of dispute settlement mechanisms are **mediation and/or arbitration** which are widely regarded as both less expensive and less time consuming compared to litigation.

The agreement should normally provide for the possibility of resorting to mediation and/or arbitration.

Mediation and arbitration

- **Arbitration** as compared to mediation is **closer to litigation** in that a formal decision is delivered by the arbitrator and which is normally enforceable.
- **Mediation** on the other hand is less formal. The parties select by consensus a mediator whose job is to facilitate the settlement of the dispute by enabling the parties to come to a mutually acceptable agreement. The mediator thus has no authority to decide a case as such but to enable the parties to reach a solution that is acceptable to both parties. During the mediation process the parties have the opportunity to present their respective positions to the mediator in the presence of each other and in private to the mediator. All such private discussions would of course be confidential.

More Reference 4-1 Common Areas of Conflict

The two guiding principles governing the resolution of franchise disputes are: first, if at all possible, franchisors should avoid adopting a heavy-handed legalistic approach; second, franchisors should not give the franchise network the impression that they are a “soft touch” and that franchisees may choose which provisions of the franchise agreement and operations manual they wish to comply with. It is not easy to reconcile these two principles.

Franchisors should not adopt a heavy-handed and legalistic approach to franchise disputes, except in the case of very serious breaches of the franchise agreement. Examples of such breaches would include where a franchisee is encouraging other franchisees to breach their franchise agreements; is disclosing confidential information; is misusing the trademarks or other intellectual property of the franchise; is intending to set up a competing business; is refusing to pay fees. In these scenarios, the franchisor's primary obligation is to take rapid and effective action, so that the franchisee does not "get away with it" and also so that the right message is communicated to the other members of the franchise network. In cases of "non life-threatening" disputes, franchisors should try to engage in a dialogue with their franchisees and find a resolution. Ideally, this process would involve negotiation, and if that fails, mediation and, finally, arbitration. Litigation should be the last resort. The resolution of disputes would be facilitated if parties involved in franchise agreements, when executing a contract, were to include a dispute resolution clause providing for WIPO Mediation followed, in the absence of a settlement, by Expedited Arbitration.

Some Common Areas of Conflict

1. Failure to make payments

One of the main reasons that disputes arise in franchise relationships (often called "royalty resentment") is the failure to make royalty payments by a franchisee whose business has reached a mature stage, and who resents paying the franchisor for what is perceived to be little in return.

2. Site selection and encroachment

Usually, the franchisee is responsible for site selection, and the franchisor is obliged to assist in this process but, ultimately, has the right to reject the site chosen by the franchisee. The rejection of sites chosen by the franchisee has given rise to a number of disputes. Similarly, the perceived encroachment by the franchisor on the territory granted to the franchisee by opening competing franchises near the franchisee's allocated territory has given rise to disputes. Additional practices which may be disputed by the franchisee include where the franchisor is competing with the franchisee's business by using other means such as Internet sales or distribution of its products through other outlets in the franchisee's territory.

3. Accounting practices and procedure

The franchise agreement imposes on the franchisee the responsibility to report to the franchisor a range of information from which the franchisor can judge performance, verify royalty payments, and ensure that obligations are being met. Failure to supply such information is a common ground for disputes.

4. Misuse of advertising funds

A common advertising fund, to which all franchisees contribute, is usually maintained in order to fund the advertising of the franchise in general. The use of this fund as a ready source of capital for other purposes by the franchisor is considered misuse, and has given rise to litigation.

5. Supervision and support

One of the attractive aspects of franchising as a way of doing business is the ongoing support provided by the franchisor to the franchisee throughout the duration of the franchise agreement. Conversely, failure to provide the agreed training and support often leads to litigation.

6. Approved suppliers

In order to maintain quality control it is standard practice for franchisors to require franchisees to purchase certain items from approved suppliers, including, in some cases, the franchisor itself. Franchisees who discover that they can buy the same things elsewhere for less may not source from alternative suppliers without the consent of the franchisor.

7. Raw material pricing

Where the franchisor receives rebates from manufacturers, and does not pass these on to the franchisees, this creates disaffection. Franchisees expect economies of scale as a result of being part of a franchised system; as such, they expect to purchase raw materials at a lower price than would be the case if they purchased them on their own. This leads to conflict when franchisees believe their competitors have lower input costs.

8. Unequal treatment

If benefits are offered to one franchisee they should, in general, be offered to all other franchisees in the system, unless it can be established that special circumstances warrant the benefits being offered to one particular franchisee only.

9. Transfers by franchisees

If, for whatever reason, a franchisee wishes to sell the franchise, the franchisor should facilitate that process by identifying potential purchasers. Any potential purchasers suggested by the franchisee should only be rejected by the franchisor on "reasonable" grounds.

10. Misrepresentations by franchisor's management team and sales team

Litigation has followed from misrepresentations made by a franchisor's employees to prospective franchisees in an effort to secure a franchisee. Typically, this involves inflated earnings claims or projections, or inaccurate initial investment requirements. It is therefore important that the franchisor's management team and sales team are properly apprised of the dangers of overzealous efforts to secure a franchisee, and are trained accordingly. Equally, in countries which have detailed disclosure requirements, care must be taken to comply with such requirements, as the failure to do so by the franchisor could result in action being taken by both the franchisee and the regulatory authorities.

11. Business system changes, re-branding

The franchisor should, as far as possible, involve franchisees in their efforts to modify the franchise business system, or to re-brand. Such activities normally involve considerable costs; therefore, franchisees should be fully involved and in agreement with the proposed changes. If re-branding also involves changing the trademark or creating a variant of it, it would have legal consequences in terms of ownership and the right to use that mark; this issue would need to be dealt with and clarified appropriately.

12. Intellectual property disputes

In general, disputes in relation to intellectual property will revolve around the failure by the franchisee to use the intellectual property granted by the franchisor in the prescribed manner; infringement of the intellectual property by third parties and issues as to whose obligation (and cost) it is to sue; the franchisee being sued by third parties for infringement of their intellectual property rights and the responsibility of the franchisor to join in the defense and/or indemnify the franchisee. Issues that may arise after termination of the franchise agreement include where the franchisee continues to use the intellectual property of the franchise, or discloses confidential information acquired during the franchise relationship. In a case where the franchisor attempts to prevent the franchisee from using the trademark after the termination of the franchise agreement, one of the common defenses used is that the franchisor failed to ensure that the franchisee adhere to specific quality control standards during the franchise relationship, and therefore, the franchisor has abandoned his rights in the trademark through a "naked license". Another example of an issue that may lead to an intellectual property dispute is where, at the time the franchise was launched, the franchisor had not obtained registered rights and the franchisee registers the mark in his own name. This type of scenario is normally dealt with by a clause in the agreement requiring the franchisee to transfer the trademark to the franchisor. A variation of the above scenario is where a franchisor operates under a specific brand but allows its franchisees to add a geographical description, such as "London" or "South West" or "UK". In such situations, franchisees sometimes claim to have rights to the trademark and their geographical description. For this reason, giving the franchisee the option of adding descriptors to the trademark should be avoided.

The incidence of disputes and misunderstandings may be minimized if proper records are maintained. In addition, a comprehensive effort on the part of the franchisor during the process of franchisee selection may help to either prevent or minimize future problems. Appropriate franchisee selection is crucial for the success of a franchise. While there are no guarantees, the fact that the franchisor has invested the requisite amount of time and energy into the process of carrying out a thorough evaluation of the franchisees' suitability and qualifications (experience, financial background, motivation and commitment) may help the franchisor to avoid future conflicts with their franchisees. Similarly, it is important that franchisees also carry out due diligence by seeking expert assistance and by carefully studying their potential financial obligations, so as to ensure that they can fulfill such obligations and ensure that the franchise business is financially profitable for them.

4. Post termination issues; non-competition clause

Franchise agreements contain both “in term” and “post term” non compete covenants. The in term covenants prevent franchisees being involved in a competing business for so long as they are a franchisee. The prohibition should extend to the individuals who are a party to the agreement if the franchise is granted to a limited company. Similarly, post term covenants impose obligations after the termination of the agreement.

Non-compete covenants, preventing the ex-franchisee from being involved in a competing business, are considered restraints of trade and are enforceable only if they are "reasonable". In determining whether they are reasonable, the following three factors are considered:

- **The duration (time) of the restraint**

In general, one year is a recommended maximum.

- **The scope of restricted activity**

Certain jurisdictions have laws that contain specific norms regulating this matter; therefore, it is important to review local legislation. The restriction should be confined to the scope of the franchised activity. For example, if the franchisee operated a burger restaurant, a non-compete which applied to "any food operation" is likely to be held invalid as overbroad.

- **The geographical area where the restraint applies**

Limit the non-compete area to the territory specified in the franchise agreement or, if no specific territory is noted, to the "customer area" of the franchisee's business. Therefore if 80% of the franchisee's customers live within 5 kilometers of the franchised premises, it would be unwise to extend the covenant any further.

QUIZ

Q1. Identify the incorrect statement

- 1) All businesses are franchisable
- 2) The IP rights licensed in a franchised business almost always include trademarks
- 3) Franchising is a popular means of business expansion
- 4) The franchisee runs a legally separate business that is a replication of the franchisor's business

Answer : 1)

All businesses are not franchisable. For a business to be franchisable, it must be replicable. Creative businesses and very technical business are not easily replicable.

Q2. Identify the incorrect statement

- 1) The franchisee can benefit from an established brand.
- 2) The franchisee can enjoy the fact that the consumers know that he is the owner of the outlet.
- 3) The franchisor earns money through royalties and other franchise fees.
- 4) The franchisee can rely on training and mentoring.

Answer : 2)

As far as the consumer is concerned the outlet is that of the franchisor. The identity of the franchisor is not visible to the consumer.

Q3. Identify the incorrect statement

- 1) Some countries demand by law that the franchisor discloses certain information to the franchisee.
- 2) A franchise agreement must be registered at a government registry.
- 3) The operation manual is a detailed reference on running the franchise.
- 4) The franchisor exercises considerable control over the way the franchisee operates the franchise.

Answer : 2)

As to whether a franchise agreement must be registered at a government registry depends on the law of the country.