

## **FRANCHISING: what is it?**

Note: The use of the masculine gender (he/his) in the texts of the EFF's website does not denote gender bias, but simply facility of language.

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### 1. Franchising: definition & descriptions

- The European Franchise Federation promotes and defends the following definition of (business) Franchising because it details the essential elements of a franchise agreement. In particular it highlights the cornerstone of any franchise system which is the KNOW-HOW it has developed for that particular system. It is in a franchise's know-how that lays the **value** of the business proposition and which makes a franchise business **duplicable and transferable** to independent entrepreneurs/operators working "at arm's length" from the franchiser.

- European Code of Ethics for Franchising. The Code states:

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

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

KNOW-HOW - the description below is adapted for franchising from the definition in:

COMMISSION REGULATION (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices\*

\*replaced in 2010 by the COMMISSION REGULATION (EU) No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices which is accompanied by its Guidelines <http://ec.europa.eu/competition/antitrust/legislation/vertical.html>

**Note:** EC Regulations 330/2010 and 2790/1999 describe **intellectual property rights' (IPRs)** as including industrial property rights, KNOW HOW, copyright and neighboring rights.

"**Know-how**" means a body of non-patented practical information, resulting from experience and testing by the Franchisor, which is secret, substantial and identified;

-"**secret**" means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily accessible;

*EFF interpretation: 'secret' must not be understood in a narrow sense whereby each individual component of the know-how should be totally unknown or unobtainable outside the Franchisor's business;*

-"**substantial**" means that the know-how includes information which is indispensable to the franchisee for the use, sale or resale of the contract goods or services;

*EFF interpretation: in particular for the presentation of goods for sale, the processing of goods in connection with the provision of services, methods of dealing with customers, and administration and financial management; the*

know-how is indispensable for the Franchisee because it constitutes the transfer of a tested and proven business system, devised to improve the competitive position of the Franchisee, in particular by improving the Franchisee's performance or helping it to enter a new market .

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

*EFF interpretation:* the description of the know-how can be set out either in the franchise agreement, in a separate document or recorded in any other appropriate form.

- In a lot of franchise literature, particular in English, the business system described above is known as "business-format franchising". Other languages use the terms "formula" or "system" in reference to format.

Source of the following description: Martin Mendelsohn, "Franchising Law", Kluwer, 2004

"Business format franchising" is a type of commercial relationship based on a contractual agreement between two independent business parties, the franchisor (the seller of the business proposition) and the franchisee (the buyer of the business proposition), in which the franchisor grants the franchisee, for the term of the contract, the right to buy and operate the franchisor's branded and formatted business system for a fee and according to the prescribed rules and procedures developed for the system by the franchisor.

The franchisor's "business format franchise" necessarily comprises the following 5 essential elements:

1. A brand name (registered as a brand name and/or a trademark, etc.) which serves as the umbrella sign for the network, and a rallying sign for the consumer and public,
  2. a licence to the use the brand, granted to the franchisee by the franchisor,
  3. a business system – a business concept formatted into a duplicable value "package" founded on the franchisor's tested Know How and his continued assistance during the term of the agreement,
  4. payment by the franchisee of a financial consideration, either in a direct form, such as an entrance fee and/or a continuing fee ("royalty"), and/or an indirect form such as a mark-up on supplied goods,
  5. the investment in, and ownership of, the assets of the franchised business by the franchisee.
- The French Franchise Federation characterises "business-format franchising" as the "reiteration/duplication of a successful formula".
    - reiteration/duplication implies that the formula has first been tested through a pilot outlet/setup by the franchisor or with his support, on a relevant market before being sold as a business proposition; that it has proven itself to be transferable and successfully operable an independent business entrepreneur/operator including "first-time" entrepreneurs;
    - successful implies that the formula/system has been tested with success and affords tangible opportunities of success to its franchisees;
    - the reality of the "network" and its dynamics, which does not translate into contractual terms, is nevertheless at the heart of any business-format franchise. The franchiser-franchisee relationship is bilateral on a contractual level, but on the operational level, the rights and obligations of each are embedded in the operations of a close-knit network of franchisees operating in complementarity and for the good of the whole network.

## 2. Mutual duties and services of the franchiser & each franchisee

Brief overview of the franchisers and franchisee's mutual duties, services, rights and obligations. These duties are specific to each party but complementary. They must be executed in a spirit of cooperation, dialogue and transparency. This list is illustrative and non-exhaustive.	
Franchisee	Franchisor
Optimise his sales on his allocated territory or customer group	steering the business's overall development strategy
Doing so in full respect of business format as contractually defined, including respecting the common identity and reputation of the franchise network, as well as the confidentiality of the business know-how transferred	Protecting its concepts and IPRs, including the franchiser's know-how. The EC Block Exemption Regulation 330/2010 (see below) defines IPRs as such: "intellectual property rights' includes industrial property rights, KNOW HOW, copyright and neighbouring rights".

Meet the franchise format's standards and procedures	developing and improving the franchise concept and KNOW-HOW to ensure its continued competitiveness, reputation and customer satisfaction
provide the requested information as well as allow personally developed improvements to be integrated into the company's know-how for the benefit of the network	Developing and improving its start-up and continued assistance to the franchisee in the course of the agreement (training, general management assistance). It provides the marketing operations instructions (Manual or "bible") to enable the franchisee to carry out the business
cooperate with new promotion programs as well as upgrades of the format/system	Developing responsible recruitment strategies of franchisees
guaranteeing the end-customer the best possible service	Ensuring the promotion of the brand on the market through appropriate advertising campaigns
Pay the fees* according to the contractual schedule	Develop efficient record-keeping systems for purposes of control, adjustment, advice, benchmarking
	Set up regular platforms for franchisor-franchisees communication, including working commissions
	Foresee conflict management procedures
	Update all binding documentation: contracts, operations manuals, pre-contractual disclosure obligations, as the case may be (see Regulation)

\* Fees and costs: a franchisee buying a franchise "value package" including IPRs and access to the franchisor's know-how will pay a combination of different types of fees. Each franchise format defines its own types of fees and fee schedule.

Fees may include:

- Entrance or start-up fee which usually included a licence fee
- On-going royalties as service fees for the on-going support services of the franchiser
- Advertising fees

Franchisees will also, in the course of time, be asked to invest in the upgrading costs of the format/system. Upgrades are necessary to keep up with market trends and to maintain the competitiveness of the brand.

"understanding franchisee fees" see: <http://www.thebfa.org/join-a-franchise/understanding-franchise-fees>

### 3. Motivations of each party for choosing franchising

Some motivations for opting to develop or join a franchise business.	
Franchisor	Franchisee
To develop and roll out a business format/system which will be sold for a regular fee to independent operators	To be able to start a business without having to start from scratch alone while being an independent entrepreneur; being in the business "for yourself but not by yourself"
To develop the business with the added input of franchisee capital which increases the possibilities for the franchiser of rapid expansion of the system	To buy into a system which, in principle, has been tested; proven successful in the given circumstances;
To develop the business in locations beyond the franchiser's natural boundaries of business (new and international markets)	To gain immediate access to a market via the right to use the franchiser's brand or trademark and to benefit from customers attracted to the brand
To develop a business in which the franchiser has his specific duties and obligations and the franchisees their own	To benefit from the transfer of know-how and assistance during the term of the contract

	Buying into an existing and branded business can enhance the survivability of a new franchised business in the first crucial years after start-up.
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#### 4. Franchising and vertical clauses of restraint to protect IPRs including Know-How

##### Reference:

COMMISSION REGULATION (EU) No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices and its GUIDELINES on Vertical Restraints (Text with EEA relevance) (2010/C 130/01) <http://ec.europa.eu/competition/antitrust/legislation/vertical.html>

Often, franchise agreements include various clauses of restriction with the view of protecting its IPRs. IPRs are described as including industrial property rights, KNOW HOW, copyright and neighboring rights.

Such clauses are governed by Competition law which determines the conditions under which such clauses are licit and in what circumstances. Indeed, for Competition law, in an open and free economy, contractual arrangements must not constitute a barrier to free trade. Competition law & authorities control this. **However, the protection for example of brands and IPRs, know-how, territorial or customer groups may be protected by clauses of restriction in due respect of particular conditions.**

For the purposes of Competition law, a franchise agreement is viewed as principally a distribution agreement (which includes IPRs, but in which IPRs are accessory to the distribution component which constitutes the principal object of the agreement) as well as a vertical agreement.

The Regulation 330/2010 defines:

- A 'vertical agreement' as an agreement or concerted practice entered into between two or more undertakings each of which operates, for the purposes of the agreement or the concerted practice, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services;

- A 'vertical restraint' as a restriction of competition in a vertical agreement falling within the scope of Article 101(1) of the Treaty. Examples of vertical restraints are (i) non-compete clauses, (ii) exclusive distribution.

The Guidelines in its section on Franchising, state (p. 39, #190, (a)), **"The more important the transfer of know-how, the more likely it is that the restraints create efficiencies and/or are indispensable to protect the know-how and that the vertical restraints fulfil the conditions of Article 101(3)"**

#### 5. History & other meanings of the term "franchise" and subsequently of "franchising"

The term "franchise" is a term that dates back to the 13<sup>th</sup> & 14<sup>th</sup> centuries in Europe. To be granted a franchise was to be granted a liberty, a privilege to do something. In Medieval Europe, towns developed as agglomerations in which traders and shopkeepers were granted rights/privileges/"franchises" to operate with relative independence from obligations usually due to the feudal authorities. Likewise, some of the first territories colonised in northern America – in the name of the English or French kings - were developed on the basis of franchises granted to the first colonisers to open and develop new territories.

A variation of the meaning today refers to being granted or benefitting from an exemption or immunity from an obligation. For example, in health systems that are subsidised by a public authority, the patient and State share the costs of the medical acts, with the patient usually paying for a "base" portion of the total costs. The subsidising authority exempts itself from that "base" portion, the franchise, and subsidises the remaining portion. Similarly, it is common in most vehicle insurance contracts that the person insured will be responsible for paying a portion of (franchise) of whatever costs are engaged (ie. repair costs following an accident). The "franchise" is designed to the benefit the insurance company.

**Note: Industrial franchising** (wholesale or retail)

Manufacturers may licence their product(s), recipes or processing methods to wholesalers who will produce or process the products and sell them on a particular market. Contractual procedures and standards will often be included with the licence. In turn, the products may be sold to other intermediaries, wholesalers or retailers.

This scheme is closer to an industrial licence agreement than to “business-format franchising” unless a separate franchise agreement is adjoined to the industrial licence agreement.

An example is the production/bottling/ Coca-Cola licence agreement. An industrial licence may be combined with a distinct distribution agreement that may be a franchise agreement.

## 5. What franchising is not

**Caution:** The frontiers between franchising and other forms of businesses with independent operators is a delicate issue. Professional advice is recommended when considering signing any such business contract.

The modernisation, expansion and globalisation of commerce and markets has led to a multitude of types commercial relationships involving an association of independent business operators banded together to draw greater benefits from the pooling together of resources. Each type has its specificities.

The following business schemes may share elements with “business-format franchising” but should not be assimilated to business-format franchising, nor called “franchising”.

Corporate chain store: a chain of outlets are commonly owned and controlled by a single company and its branches or subsidiaries; employ central buying and merchandising and sell similar lines of merchandise.

Voluntary chain: a network of independent retailers or service companies (i.e. hotel chains) engaged in centralised bulk buying, and eventually some common merchandising, common standards of service but leaving a fair margin for individuality in outlet name, design and operations. The chain entity is structured as an enterprise\*. The relationship between this structure and the chain members may be contractual or corporate (corporate relationships being either cooperative or capitalistic)

Cooperative: a network of independent businesses each part-owner of a central entity which acts as a buying platform; may conduct joint promotion efforts; many cooperatives today also develop a separate “business-format franchise” entity to accelerate the growth of the network in which the “distributor” may or may not also be a part-owner of the cooperative.

### Licence agreements

A licence right may relate to any of the following Intellectual ((intangible) Property Rights-IPRs: trademark, name/brand, patent, copy right, legally protected design, trade secret, manufacturing process or any item of value.

The licensor sells the right to USE the licence (not the ownership of the licence) under the terms of the agreement to an independent licensee who in return pays a fee or royalty.

All franchises necessarily have a licence component to their franchise contract, and this is an essential element of any franchise contract, but business-format franchising offers, in addition, a business format which sells as a packaged business proposition.

Note: Under EU Competition Law, franchise agreements benefit, under prescribed conditions, from the terms of the Block Exemption Regulation on Vertical restraints as applied to distribution agreements (distribution of products or services) because the Commission considers the primary object of franchise agreement to be the distribution process and not the license even if the licence component is a necessary and essential element of any franchise agreement.

Agency agreements: the **agent** acts for and in the name of the **principal** for a fee; usually; unless otherwise specified by contract, an agent does not assume the risk or venture of the deals; an agent is not an independent entrepreneur as a franchisee is understood to be the purposes of a franchise agreement.

### Broker agreements:

i.e. Independent brokers or agents who sell financial services supplied by financial institutions.

Closer to agency agreements than to franchise agreements. For example, if one of the following essential elements is absent, they cannot be qualified as a franchise agreement: initial & ongoing know-how, does the “franchisee” have the right to sell the business?, who owns the customer base, etc.?

### Selective distribution-SD:

The BER 330/2010 states that a ‘selective distribution system’ means a distribution system where the supplier undertakes to sell the contract goods or services, either directly or indirectly, only to distributors selected on

**the basis of specified criteria** and where these distributors undertake not to sell such goods or services to unauthorised distributors within the territory reserved by the supplier to operate that system giving the right to a selection of intermediary dealers to sell a company's products or services;  
The difference with franchise agreements (which may include an element of 'exclusive distribution') is the selection criteria for each distributor: in SD, the specified selection criteria must be standardised. In franchising, franchisors have full liberty in the recruitment criteria & procedures of their future franchisees. One of the advantages of franchising for a franchisee is that the business-format offers the opportunity to candidates with no or limited independent business experience to own and run a business.

\* source: Distribution Law in Europe, E&Y, 2001

*For clarification on the subtleties of the differences or overlap between the networks described above and franchise agreements, the EFF highly recommends consultation with experienced distribution/franchise lawyers/attorneys.*