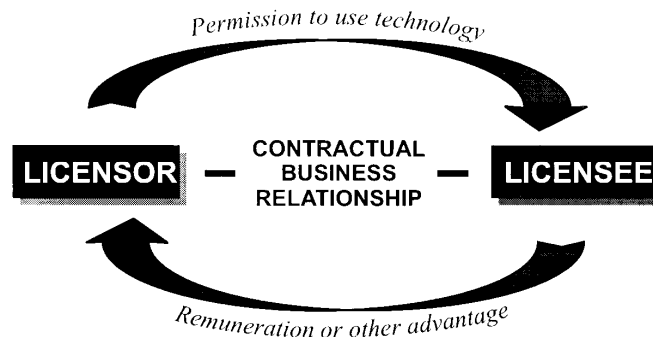


## UNDERSTANDING THE ESSENTIALS OF A FRANCHISE AGREEMENT

By Eugene Honey

A Franchise Agreement is a sophisticated form of Licence Agreement. It is therefore necessary to first look briefly at what a license is and what can be licensed. The graph below sets out the essentials of a License Agreement. You will note that at the core, it is a contractual business relationship between a licensor and licensee. The licensor is either the proprietor or a holder of certain intellectual property rights or technology which he allows the licensee to use in return for some sort of remuneration or other advantage.



Intellectual property rights which can be licensed include statutory or non-statutory intellectual property rights. Statutory intellectual property rights include patents, designs, trade marks and copyright whereas non-statutory intellectual property rights include know-how, trade secrets, customer lists, formulas, business methods, personnel training and manuals.

The object of a license is almost invariably to commercially exploit technology or intellectual property. To ensure the long term success of a License Agreement ie. to achieve a win/win situation, it is recommended that the license must be structured in such a way that it is to the mutual benefit of both parties.

### TYPES OF FRANCHISE

Although it is often said that there are two main types of franchising, namely (i) product and trade mark or trade name franchises and (ii) business format franchising, this is not an accurate explanation. A more correct approach is to view a product or trade mark franchise, as franchising in a simpler form in that the franchisee is only entitled to use the franchisor's name or trade mark and product. This type of franchising is prevalent amongst motor vehicle dealers, soft drink bottlers and certain fuel service stations. Thus in a product or trade mark franchise only a single or a limited number of intellectual property rights are used.

The opposite end of the scale is a full business format franchise in terms of which the franchisee uses the franchisor's entire business concept, which includes the name, trade marks, copyright, goodwill, know-how, trade secrets, trade dress and similar intellectual property. It is clear that in a full business format franchise numerous intellectual property rights are licensed to the franchisee to use. The two customary "types" of franchises are therefore at opposite ends of a continuum. It is of course for the franchisor or proprietor of the intellectual property to decide precisely what makes commercial sense and what he is going to allow the franchisee to use.

### DEFINITION OF FRANCHISING

The International Franchise Association defines a full business format franchise as follows:

"Franchise operation is a contractual relationship between the franchisor and the franchisee in which the franchisor offers or is obliged to maintain continuing interest in the business of the franchisee in such areas as know-how and training, wherein the franchisee operates under a common trade mark, format or procedure owned or controlled by the franchisor, under which the franchisee has or will make a substantial capital investment in his business from his own resources."

It is apparent that the key elements of the definition include:

- (1) a contractual relationship,

- (2) the franchisor offers or is obliged to maintain a continuing interest in relation to the know-how and training,
- (3) the franchisee operates under a common trade mark, format or procedure,
- (4) owned or controlled by the franchisor, and
- (5) the franchisee has or will make a substantial capital investment from his own resources.

The licensing of intellectual property to the franchisee is a central theme of the Franchise Agreement. The three most important areas of intellectual property in most franchise systems are trade marks, copyright and know-how.

## TRADE MARKS

In terms of the Trade Marks Act, a trade mark includes any sign capable of being represented graphically including:

- A device, logo or representation.
- A name or signature.
- A word, words, phrase or slogan.
- A letter or series of letters.
- A numeral or series of numerals.
- The shape and configuration of a product or part thereof.
- The pattern and ornamentation appearing on a product, packaging or advertising material.
- A colour or combination of colours.
- A container for goods, or any combination of the aforementioned.

It is often said that the corner stone of the Trade Marks Act is distinctiveness. To be registrable and so as to function as a trade mark, the mark must distinguish the goods and services in relation to which it is used from the goods or services of others.

## COPYRIGHT

The next important area of intellectual property is copyright. Generally speaking, copyright is the right given to the creator, author or other person who may own the copyright of certain types of works, not to have that work copied or reproduced without authorisation. Copyright exists in various types of works including literary works such as manuals, documents, articles, promotional materials, disclosure documents, novels and publications. Artistic works include logos, labels, menus, advertisements and diagrams. Computer programmes also enjoy copyright.

A critical point to remember is that generally the author of copyright work is also the owner thereof, unless the work was made by an employee during the course of his employment. In this instance the employee will be the author, but the employer will be the owner. It is therefore essential that copyright in all works including logos, promotional materials, company documentation and other works which are prepared externally or outsourced, even if they have been paid for, are competently transferred to the franchisor in writing. If this is not attended to, although the franchisor (and the franchisees) will be able to use any such materials, the franchisor will not be the owner thereof.

## KNOW-HOW

The term know-how usually refers to a wealth of technical knowledge, commercial information and experience developed and acquired by a fairly specialised production organisation. It is often reduced to the form of a operating

manual or reflected in similar documentation. Many of the success features of franchises reside in the know-how, trade secrets and confidential information. It is important to note that if know-how or trade secrets are "leaked" or become public knowledge, it will no longer be possible to protect it and it may become valueless. Competent confidentiality provisions should therefore be included in the Franchise Agreement or in the employment contracts.

## FRANCHISE AGREEMENT PROVISIONS

Next we turn to the Franchise Agreement itself. Due to the nature and complexity of a Franchise Agreement, it is the intention in this article to only highlight a number of important clauses or provisions which need to be considered when preparing or considering a Franchise Agreement.

## DEFINITIONS

As in any other agreement, the parties must be properly identified and described. It is essential in a Franchise Agreement that the intellectual property being licensed is also properly identified and described in the Agreement. Definitions should therefore include the trade marks, copyright, trade dress, know-how, trade secrets and other intellectual property. The definitions should also include a description of the franchised business. Further, bearing in mind that the proprietor or holder of the intellectual property is allowing the franchisee to use the intellectual property, definitions should also be included as to precisely what intellectual property will be used in which territory and for what period. Provisions should therefore be included for inter alia the territory, commencement date, the termination date and renewal.

## GRANT

One of the most important terms in a Franchise Agreement is the grant clause. When considering this clause it should be borne in mind that there are various types of License Agreements. The first is an exclusive License or Franchise Agreement where certain intellectual property rights are given exclusively to a franchisee to use for example in a certain area. This franchisee will therefore be able to exclude all others including other franchisees and the franchisor from operating in that area. It should be borne in mind that where exclusive licenses are given, minimum performance standards or other safe guards should be put in place in the best interests of the franchise system.

The second type of License Agreement is that of a sole Franchise or License Agreement. Using the same example, in this instance the franchisee is given the sole right to operate a franchise or outlet in the specific area. This however, does not exclude the franchisor, who will be able to open one or more outlets and compete directly with the franchisee in that area.

Finally, there is an ordinary license or franchise in terms of which a franchisee is given the right to use the intellectual property, but enjoys no exclusive or sole rights whatsoever. For example if he is given an area within which to operate, the franchisor and other franchisees will also be entitled to operate in the same area.

## PAYMENT

The clauses relating to payment usually include at least three types of payment. These are the upfront lump sum, which is usually described as a franchise fee and which is paid to obtain the license or franchise. The breakdown of this amount usually includes the costs of setting up the outlet, costs of training, legal costs and an amount for goodwill. In newer franchises the amount attributed to goodwill is usually smaller, whereas in the more established franchises larger sums are requested for the established goodwill.

Royalty payments are also made by the franchisee to the franchisor. These could be fixed monthly, quarterly or annually. Alternatively, amounts based on a percentage of turnover are paid. These royalties are payable in lieu of the ongoing use of the intellectual property. The royalty figures have also been described as a management service payment, possibly to justify or to enhance the franchisee's perception that he is also receiving management services from the franchisor.

It is common practice in full business format franchises, that each franchisee contributes a fixed amount or a fixed percentage of turnover on a regular basis towards the promotion and advertisement of the franchise operation. These monies are preferably paid into an independently managed fund. This fund is usually managed by the franchisor in consultation with the franchisees.

In certain franchises administration is attended to on behalf of the franchisees by the franchisor in return for which the franchisee may pay to the franchisor a fixed monthly sum or a small percentage of turnover.

## FRANCHISOR OBLIGATIONS

The next essential part of the Agreement are the obligations of the franchisor. The franchisor's obligations are divided into initial and ongoing obligations. Initially the franchisor will assist with the setting up of the premises or outlet,

furnish the franchisee with the operations and procedures manual, disclose the entire franchise system to the franchisee and train the franchisee.

Ongoing obligations of the franchisor includes additional necessary training from time to time and also to assist with problems, management and to provide guidance, in addition to the ongoing management and development of the franchise system. It is essential in the long term best interests of the franchise system that the Agreement include positive obligations and duties on the franchisor to render these services.

## FRANCHISEE OBLIGATIONS

The obligations of the franchisee are usually fairly extensive. These should include provisions to the effect that the franchisee should operate the franchise strictly in accordance with the franchise system, usually as set out in the operations and procedures manual. In addition to fairly standard terms such as for example an obligation to pay all sums due timeously and to engage and properly train suitable staff, provisions should be inserted to the effect that the franchisee should enhance and promote the intellectual property, goodwill and reputation of the franchise at all times. In addition, the franchisee should also advertise and promote the franchise in accordance with the directions, requirements and specifications of the franchisor from time to time.

These provisions are essential so as to ensure a common brand, identity, consistency and quality. The franchisee should also in this regard allow regular inspections so as to ensure quality control.

Where monies are paid on a percentage of turnover, it is essential that the franchisee be obliged to give full access and assistance in respect of accounting records to the franchisor.

Ideally a franchise system should have a comprehensive operating and procedures manual. This should be a dynamic annexure to the Franchise Agreement and the agreement should provide that the franchisee shall act in accordance with the manual, as amended from time to time. This will enable the franchisor, where it makes prudent commercial sense to develop the business, to do so without having to continually sign updated Franchise Agreements.

## ASSIGNMENT/CESSION/ALIENATION OF RIGHTS

The Agreement should contain a provision preventing the franchisee from ceding, assigning or in any way alienating any of his rights or sub-franchising without the written consent of the franchisor. This is an added protection to the franchisor and greater franchise system in that it will prevent franchisees from selling or alienating their rights, thereby possibly introducing unskilled and inappropriate franchisee persons into the business.

## TERMINATION

The termination clause should be comprehensive in the best interests of the entire franchise system and/or other franchisees. In addition to standard provisions such as timeous payment, the clause should include provisions entitling the franchisor to cancel the Agreement if the franchisee fails to act in accordance with the operations and procedures manual, performs inadequately or maintains poor quality standards. Further, if there is any challenge on the proprietorship of the franchised intellectual property, this should also be a ground for possible termination of the Agreement.

## AFTER TERMINATION

The Agreement should also provide for an after termination clause in terms of which the franchisor will be entitled to after the termination of the contract to retrieve all materials, documents, programmes and products bearing, reflecting or embodying the intellectual property of the franchisor or which is associated with the franchisor.

## RESTRAINT OF TRADE

So as to protect the franchise system, it is certainly advisable to insert restraint of trade provisions. These should be reasonable with regard to territory, nature of activity and period. Of concern here is that although it is often in the best interests of a franchise system to have all franchisees sign the same Franchise Agreement, this may not be appropriate in this instance. For example, if a franchise system sells three sizes of franchisee outlets, it would be inappropriate to have the identical restraint of trade provisions in each instance. A restraint of trade provision could be quite reasonable in the instance of a multi-million rand franchisee outlet rendering services to clients from a large area, whereas the same provisions could be quite unreasonable when considered in the light of a far smaller franchisee outlet. If a court finds a restraint of trade provision "unreasonable" it will be unenforceable. It is therefore prudent to rather include narrower or more reasonable restraints than broader restraints which may be unreasonable and therefore entirely unenforceable.

Consideration should also be given, wherever possible to the protection of intellectual property rights, such as customer lists, know-how, trade secrets and confidential information, in this clause.

## DISCLOSURE

It is necessary for the franchisor to furnish the franchisee with a competent disclosure document more than seven days prior to signature of the Agreement. It is therefore advisable to have a provision in the Agreement confirming that the franchisee was furnished with the disclosure document more than seven days before the date of signature and that he is happy that he has been furnished with sufficient reasonable information so as to place him in a position where he was able to properly assess whether to buy the franchise or not.

## CONFIDENTIALITY

It is advisable that confidentiality agreements be signed by relevant staff in franchisee outlets so as to protect the know-how, trade secrets and confidential information of the franchise system. These clauses could also be inserted into employment contracts.

## SURETYSHIP

Where appropriate, members, shareholders of close corporations, companies or other corporate entities should be requested to sign suretyship agreements so as to make them personally liable and accountable to the franchisor.

## PROVISIONAL PERIOD

In certain instances, it is advisable to consider the inclusion into the Agreement of a provisional period of for example six months during which the franchisor will be able to terminate the agreement relatively easily if the franchisee does not achieve and maintain certain objectives and standards. This is an additional clause to fall back on, as it is often difficult to assess from the initial interview and a few contacts with the franchisee whether he will at a later date be a competent and successful franchisee.

## COMPETITION COMMISSION CONCERNS

Before concluding it is appropriate to deal with the Competition Act and the concerns of the Competition Commission. Although the Government originally assured FASA that the Competition Act was never intended to apply to franchising, there are no provisions excluding their applicability to the franchising sector and the position has in any event subsequently changed, which has led to considerable uncertainty. The concerns of the Competition Commission have included horizontal relationship collusion, vertical relationship collusion, retail price maintenance, exclusive territories, exclusive dealing, tying of products and intellectual property rights.

Retail price maintenance appears to be a primary concern of the Competition Commission in that a franchisor cannot dictate minimum prices or minimum discounts to its franchisees. Further, prices should also be recommended, rather than fixed and there should be no sanction or penalty if the recommended prices are not adhered to.

Very broadly speaking, with regard to exclusive territories, exclusive dealing and the tying of products, despite the fact that such provisions may at first blush reduce competition, when looking at all the facts and at the franchise system in detail, justifications or defences of efficiency, technology or other pro competitive benefits, may be raised. The difficulties with intellectual property rights appear to revolve around refusals to grant licenses to third parties and where there are excessive charges for the use thereof. Here defences or justifications would be possible if the IP for example enhances efficiency in the franchise system and that exclusivity and protection of owners investment, as well as the importance and value of the intellectual property being used can be justified in the circumstances.

Unfortunately many of the aforementioned provisions in franchise agreements and in franchise systems are essential to and very often the reasons for the success of the franchises. The current state of uncertainty is unfortunate, particularly as, the Government has recognised that franchising is a viable route to increase its development of small to medium type businesses in South Africa.

In addition, we understand that a new Franchising Act has been drafted, the purpose of which, we understand is to introduce some regulation to the franchising industry to further its interests in developing this sector. On request FASA has made substantial recommendations which are in fact not very different from what FASA's approach and practices have been for many years, being ethical franchising and protecting the interest of both parties with a view to an ongoing win/win situation, coupled with the development of franchising in general.

The recommendations have also largely been fairly consistent with the international Unidroit model of franchising, which encourages fuller disclosure by especially the franchisor. We understand that it is the Government's intention to not unduly restrict franchise systems, as this has not been successful in many countries, but rather to look towards regulating in such a way so as to ensure the success and ongoing development of franchising.

## CONCLUSION

In conclusion, it needs to be reiterated that it is essential that the Agreement properly identifies all aspects of the franchisor's intellectual property and other proprietary rights and that these are properly protected and licensed to the franchisee. The contract should also focus on and accommodate the specific needs and requirements of the franchise operation and control the relationship between the parties in a positive and constructive manner.

Finally, a competent written Franchise Agreement is a key factor to promote and enhance a win/win situation and to protect the respective rights of the parties and the entire franchise operation. It is therefore certainly advisable, particularly as franchise agreements are extremely complex, that legal assistance from an expert skilled in intellectual property and franchising be obtained.