

The Legalities of Franchising in the UK: What International Franchisors Need to Know



Introduction

For any successful international business, expansion into the United Kingdom ("UK") offers exciting new business opportunities and growth potential.

Since the 1960s when the very first franchise networks, such as Dyno-Rod, were launched in the UK, franchising has taken root and flourished as an effective technique for expanding businesses. According to the NatWest BFA Franchise Survey 2013, there are now approximately 930 franchisor brands operating in the UK across a variety of sectors, 39,000 franchised outlets, 561,000 people are employed in franchising and the "franchise industry" has annual turnover of £13.7 billion.

For international businesses based outside of the European Union ("EU"), the UK is often chosen as a base from which to establish a "beach head" before further expansion across the EU and, indeed, further afield. There are a number of factors which contribute to the UK's popularity as a key market for international businesses, including the UK's reputation as a lightly regulated place in which to do business, the emergence of English as a truly global language, London's status as one of the leading capital cities in the world, access to London's capital markets and the perceived efficiency and fairness of the English court system in resolving international commercial disputes.

This article considers some of the key legal issues which international franchisors should bear in mind when expanding into the UK.

The UK and its relationship with the EU

A common misunderstanding about the UK is that it has a single legal system. The UK was created by the political union of previously independent countries and there are three distinct legal systems; English law, which applies in England and Wales, Northern Irish law, which applies in Northern Ireland, and Scots law, which applies in Scotland. While England and Wales, Northern Ireland, and Scotland diverge in the more detailed rules of common law and equity, and while there are certain fields of legislative competence devolved in Northern Ireland, Scotland, Wales and London, there are substantive fields of law which apply across the UK. This article will consider legal issues from the perspective of English law.

Another common misunderstanding is that the EU is a genuine single market with a fully harmonised legal system. The EU is a union of 28 different member countries (called "Member States"), that share common political, economic and social objectives. The EU promotes the free movement of goods, services and workers and operates a 'harmonized' legal regime designed to ensure consistency between Member States' laws. However, significant differences remain between the national legal, regulatory and cultural regimes of individual Member States that prove challenging to businesses entering the EU market. In addition,

some countries often considered "European" (like Switzerland and Russia) actually sit outside the EU and are subject to wholly independent national regimes.

Therefore, whilst a legally compliant English law franchise agreement will, by its very nature, incorporate a number of EU legal principles (see below for more information on Competition Law), if it is to be used in other Member States, it should still be reviewed for its compliance with the mandatory local laws of the relevant Member State.

The Regulation of Franchising in the UK and the EU

The disparity between the legal systems of Member States applies to franchising. Various Member States have franchise specific regulations requiring, for example, franchisors to register with the authorities and/or issue a pre-contractual disclosure document to prospective franchisees.

The courts in some Member States do not always recognise the difference between a commercial agent and a franchisee. By applying commercial agency laws by analogy, franchisees in certain Member States have been able to successfully claim compensation at the expiry of a franchise agreement.

Some Member States are civil law jurisdictions, such as Germany, and have a codified duty of good faith, which applies to all elements of the franchise relationship. This can impact on a franchisor's contractual discretion and its ability to take unilateral decisions on behalf of the network.

There is no analogous legislation in the UK requiring registration of franchise agreements or pre-contractual disclosure, nor do the English courts confuse franchisees for agents. There is no general duty of good faith under English law which applies to franchising, although some recent court judgments indicate that English law may be starting to move in the same direction as some of its European cousins. Nevertheless, English law remains an attractive choice of law for international franchisors wishing to do business in the UK and the wider EU.

The British Franchise Association ("BFA") is a trade association which promotes ethical franchising in the UK. The BFA's "Code of Ethics", which is not legally binding but which its members must abide by, provides a benchmark for good industry practice in relation to issues such as advertising, recruitment, the exercise of fairness throughout the franchise relationship and dispute resolution.

Claims for misrepresentation are one of the principal sources of franchise litigation in the UK. Whilst it is not a legal requirement, the Code of Ethics requires its franchisor members to issue a "full and accurate written disclosure of all information material to the franchise relationship" prior to signing the franchise agreement - a disclosure document can be a useful tool in clarifying the key terms of the relationship and defending any future claim.

Structuring the Franchise Business

At a very early stage, the franchisor will need to decide which entity or structure will best fit its needs and expansion plans. This will depend on factors such as the revenue model, tax profile, ease of raising debt and equity finance, and the commercial strategy at both a Member State and a European level. In particular, businesses launching into the UK may intend to operate corporately owned outlets as well as franchised outlets and/or provide "on the ground" support to its franchise network, in which case a launch may or may not be best achieved through the creation of a new vehicle, acquisition of an already established local business or purely on an arm's length basis.

Foreign ownership and investment in the UK is subject to very few regulations. The UK Trade and Investment government agency exists to assist foreign businesses to invest in and move to the UK. There are no general restrictions on foreign ownership of UK assets or companies. All new companies must register with Companies House, the registrar for companies in the UK, and will be subject to official requirements, such as the filing of annual accounts.

UK employment contracts are subject to a number of statutory protections for employees. Many derive from EU-wide laws affecting the employment relationship which are designed to harmonize employment rights across the EU. Critical employee considerations include impact of local tax regimes on employee stock options, Works' Council establishment, talent availability, and transferring employment rights for employees acquired in a business sale context (TUPE).

Choice of Law

An important consideration for an international franchisor is which law should govern its franchise agreement for the UK, and in which venue it will choose to resolve disputes.

The UK is a signatory to the New York convention on the enforceability of foreign arbitration awards and the UK has a number of bi-lateral treaties with other countries which recognise judgments passed by foreign courts.

Understandably, international franchisors prefer to elect the law of their home country in their franchise agreements. This approach is likely to work in the UK, but it is important to check and in any event take advice on the impact of mandatory English law on the franchise agreement.

For international franchisors which are using the UK as a "beach head" for further expansion into the EU and further afield, and/or which use multi-tier structures such as master franchising, electing English law to govern the franchise agreement (or at least the sub-franchise agreement, in the case of master franchising) is a sensible decision. For international franchisors which are based in common law jurisdictions, English law will feel very familiar. In addition, a franchise will be much more attractive to a prospective

UK and/or European franchisee if it is subject to English law and the venue for resolving disputes is in the UK (as opposed to a non-European choice of law and venue for disputes).

Protecting the Brand

Each Member State has its own IP regime, as well as being subject to EU law and international treaties.

Trade marks and design rights can be registered through the UK Intellectual Property Office (IPO) or alternatively an application for a Community Trade Mark ("CTM") or design right could be filed with the Office for Harmonisation in the Internal Market ("OHIM") to provide protection in all 28 Member States. If the franchisor already has marks registered in other jurisdictions which are party to the Madrid Protocol, it may be possible to add the UK to the international registration by application to the World Intellectual Property Organization ("WIPO").

Other key IP issues include the protection of copyright (which is not a registrable right in the UK) in materials such as the franchise manual and the acquisition of employee, franchisee and consultant-generated IP (which is typically secured by contract) and strategies to guard against counterfeiting.

Competition Law

Franchise agreements can affect competition between either Member States (in which case the European Commission ("EC") may take enforcement action against an offending party) or at a national level (and in the case of the UK, the Competition and Markets Authority may take action), particularly if they contain location restrictions and pricing obligations. Not all franchise agreements fall within remit of the controls imposed by Competition Law if they are not of sufficient size and scale to be deemed relevant. In addition, some franchise agreements are exempt from Competition Law restrictions if they meet certain criteria. This is a complex area of law, and penalties for breaches can be severe (including unenforceability of agreements and/or fines expressed as a percentage of global turnover), which is why specialist franchise lawyers should be consulted.

Some of the key issues include:

- **Pricing controls** – it is not possible to require franchisees to sell products and/or services at set or minimum prices. However, there is some scope for short term price promotions and restrictions on excessive prices.
- **Exclusivity** – it is possible to grant exclusivity to a franchisee to operate a franchise in a Member State or within a defined territory within a Member State. However, the exclusivity must not prevent the franchisee from accepting "passive sales" which may originate from outside of its exclusive territory.

- **The Internet** – the EC treats almost all business-related online activity as "passive selling" and therefore it is not possible to prevent a franchisee from promoting and/or selling its products/services online, but it is possible to impose certain quality controls and restrictions.
- **Exclusive supply and other non-compete obligations** – restrictions on a franchisee's ability to operate a competing business and/or sell competing products and/or source products from third party suppliers must be drafted carefully and the restriction in question should go no further than is necessary to protect the franchisor's legitimate business interests and know how.

Other laws affecting franchising in the UK

Trading Schemes

The Fair Trading Act 1973 and the Trading Schemes Act 1996, regulate 'pyramid selling' schemes in the UK, and can apply to poorly drafted franchise arrangements, in particular those which involve sub-franchising, independent sub-contractors, or other multi-tier structures. It is important to ensure that the franchise comes within one of the exemption criteria; otherwise a franchisor may find that its agreements are unenforceable or worse, its directors and officers could face criminal liability.

Anti-Bribery

The Bribery Act 2010 has created one of the strictest anti-corruption regimes in the world (even in comparison to the US Foreign and Corrupt Practices Act), including a corporate offence of failure to prevent bribery. It is a strict liability offence for which companies face an unlimited fine if found guilty. Individuals found guilty of involvement in bribery face a maximum penalty of 10 years imprisonment. An offence would be committed by a commercial organisation when a person performing services on its behalf bribes another person and intends to obtain or retain business for it.

The Act has not yet been tested in relation to its applicability to the franchisor/franchisee relationship, although analogous legislation in other jurisdictions has been applied to the franchise relationship. Whether it does apply will turn on the degree of control that the franchisor has over the franchisee, and the degree of benefit that the franchisee's activities confer on the franchisor. It is important, therefore, that international franchisors protect themselves to the greatest extent possible and ensure that they have "adequate measures" in place to prevent bribery in their franchise networks.

Data Protection

The EU has the strictest data protection regime in the world. Complex rules govern every aspect of the data lifecycle, impacting when and how businesses can send marketing, use website cookies and collect, store and transfer personal data. This is particularly relevant for consumer facing franchise businesses, where a franchisee is often collecting customer data and

processing it on behalf of its franchisor, who ultimately controls and owns that data. Setting up or operating in the wrong way can degrade the value of this vital business asset, cause serious damage to the brand and run the risk of incurring substantial fines from the regulators, both in the UK at an EU level.

Conclusion

It is extremely important that franchisors looking to do business in the UK invest properly in taking legal advice from a lawyer specialising in franchising to ensure that their business operations and franchisee agreements are legally compliant. Understanding the risks and issues and managing those risks through effective structuring and enforceable legal contracts will enable international franchisors to reap the rewards of doing business in one of Europe's largest and most dynamic markets.

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