

DOI: <https://doi.org/10.24297/jssr.v20i.9566>

Franchising Contracts and its Legal Issues: A Sight on the UK and US Laws

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Abstract

Franchising, being a widely adopted business strategy on a worldwide scale, is dependent on complex legal structures that regulate the interactions between franchisors and franchisees. This article presents an informative overview of franchising contracts and the associated legal issues, focusing on a comparative analysis between the United Kingdom (UK) and the United States of America (US). This paper aims to provide insight into the structure, regulation, and enforcement of franchising contracts in two different jurisdictions. Through careful examination, the specific characteristics of both jurisdictions will be highlighted. This article examines franchising contracts and their legal intricacies in two notable legal systems.

Keywords: franchising contracts, regulation, enforcement, United Kingdom, United States.

Introduction

A business that is generating financial gains and has successfully attracted the attention of a target market will inherently pursue growth and expansion. Franchising has emerged as a rapidly expanding and widely used approach for facilitating business growth. The harmonious partnership between two legally independent organizations, known as a joint venture, is a commonly employed arrangement across various sectors and scales. It is distinct from other forms of corporate collaboration such as trademark licensing, distribution, and commercial agency (Sotiroski, 2016). Typically, a franchising arrangement is established through a contractual agreement wherein the franchisor grants the franchisee the privilege to utilize their established business format, operational procedures, and intellectual property, including signs, trademarks, logos, or trade names, for the purpose of distributing a specific product or service. In return, the franchisee is obligated to pay fees and royalties (Gandhi, 2014). In addition to granting the franchisee the privilege of utilizing the business model, the franchisor will also grant intellectual property rights and expertise pertaining to the business while offering support and training to the franchisee (WIPO). In essence, the replication and operation of a prosperous business is undertaken by entrepreneurs known as franchisees, who are overseen, controlled, and supported by the business model's proprietor, referred to as the franchisor. Despite its appealing qualities, participating in a franchise enterprise involves negotiating a range of legal considerations. Nevertheless, it is imperative for potential franchisees to have a comprehensive understanding of the legal matters associated with investing in a franchise prior to entering into any contractual arrangements.

Franchising Landscape

Franchising is a concept that involves:

The process by which a franchisor gives a franchisee the right to sell or utilize a system, product, or service that has been established by the franchisor.

- The application of a trade, quality mark, or trademark owned by the franchisor by a franchisee.
- A payment made by the franchisee to the franchisor in exchange for consideration (often an "up front" payment or a "royalty on sale" or the combination of the two) (Pengilley, 1985).

The term "franchising" refers to a business relationship in which a business owner, known as the "franchisor," distributes or markets their goods, services, or techniques through connected dealers, known as the "franchisees," in accordance with a licensing agreement (Kariyawasam, Samarkovski, & Lisa, 2012). It is a contract that is legally enforceable and describes the rights and duties of both the franchisor and the franchisee that are involved in the franchise relationship (Ana, 2023).

Typically, a franchise agreement is created when a set of particular features are apparent in an arrangement:

- In the context of business operations, a franchisor is an entity that confers onto a franchisee the privilege to engage in commercial activities by providing goods or services within a predetermined framework or marketing strategy. The operations of the firm are significantly influenced, overseen, or influenced by the franchisor or its affiliated entities.
- The enterprise is affiliated with a certain trademark, advertising, or commercial symbol that is owned, utilized, licensed, or designated by the franchisor or its affiliate.



- The franchisee is obligated to provide or consent to providing specific forms of remuneration to the franchisor or its affiliated entity prior to commencing or sustaining the business operations (ACCC, 2023).

Legal Issues Associated with Franchising Contracts

1- Trademark Infringement

Trademark infringement is a prevalent legal concern that can potentially emerge within the context of a franchise agreement. A trademark refers to a distinctive identifier, such as a word, phrase, logo, or symbol, that serves the purpose of differentiating a particular brand or product from those offered by other entities in the market (WIPO). Typically, the franchisor possesses ownership of the trademarks affiliated with their brand and grants the franchisee a license to utilize them within their business operations.

Nevertheless, in the event if the franchisee employs the franchisor's trademarks in a manner that isn't authorized by the franchise contract, or uses comparable or similar trademarks that are likely to confuse clients or generate confusion with the franchisor's brand, it may lead to a violation of trademark rights. The improper utilization of franchisor trademarks may result in legal repercussions, such as the initiation of legal proceedings by the franchisor seeking damages or an injunction to prevent unauthorized usage (Kilcommons, 2023).

In order to reduce any trademark infringement concerns, it is essential that the franchise contract explicitly outline the rights and responsibilities of the franchisee pertaining to the utilization of the franchisor's trademarks. The agreement must define the exact trademarks that the franchisee is permitted to utilize, the method in which they may be employed, and any limitations imposed on their usage. It is essential that the franchisee adhere to the franchisor's requirements for the utilization of trademarks and obtain explicit consent prior to employing any newly developed or altered trademarks.

2- Franchise Disclosure Documents (FDD)

The Franchise Disclosure Document (FDD) is a document that is required by the Federal Trade Commission (FTC) that must be provided to a prospective franchisee before finalizing a franchise transaction (What are Some Common Legal Issues Associated With Franchises, 2023). The Franchise Disclosure Document (FDD) covers significant details pertaining to the franchisor, the franchised company, the franchise contract, as well as the rights and obligations of both the franchisor and franchisee. Thoroughly examining the Franchise Disclosure Document (FDD) before entering into contractual agreements or initiating financial transactions with the franchisor holds significant importance.

According to legal regulations, it is important for a franchisor to furnish a Disclosure Document to a potential franchisee prior to the sale of a franchise. The Franchise Disclosure Document (FDD) does not possess the features of a contract per se. However, it is important to note that a franchisor may be subject to legal liability for the contents of the FDD in the event of a misrepresentation dispute. The contents of the Franchise Disclosure Document (FDD) are determined by federal and state rules, which impose various restrictions on the incorporation of certain elements by franchisors. These constraints relate to elements such as financial claims and disclaimers (IFA, n.d.).

Comparison Between the UK and US laws

The UK happens to be one of the few nations that doesn't have laws that specifically affect franchises. This makes it a very appealing place for many, especially foreign brands that want to grow. In contrast to the USA, there are no registration requirements and franchisors have no obligation to give potential franchisees information in a certain format (Shvarts, 2023).

There are no laws in the UK that directly regulate franchising (Canfield, 2011). Franchising is governed by English laws that cover contracts, intellectual property, real estate, and competition (Bowler & Sanghera, 2023). The franchising business also engages in self-regulation through the British Franchise Association (BFA) and its Code (Pratt & Barrett). The Code facilitates appropriate interactions between a franchisor and its franchisees during the course of their franchise relationship (Bowler & Sanghera, 2023). While the Code lacks legal enforceability, BFA members voluntarily commit to adhering to its provisions. Moreover, the English courts have historically acknowledged the significance of the Code, underscoring its relevance and impact. Consequently, ignoring its importance would be imprudent.

In the UK, pyramid selling regulation (The Trading Schemes Act 1996) applies specifically to franchising. This law applies to some multi-tiered franchises in which the franchisee is permitted to choose sub-franchisees to advertise and sell goods and services. A violation of the pyramid-selling laws can result in a criminal charge (Bowler & Sanghera, 2023). In the UK, the franchise industry exhibits much less stringent regulation as compared to its counterpart in the United States. (TSB, n.d.).

In the United States, franchise laws are regulated by the Federal Trade Commission (FTC) (Bazrafshan, 2023). The regulatory body known as the U.S. Federal Trade Commission (FTC) established 16 C.F.R. Part 436, commonly



referred to as the FTC Franchise Rule. This rule was implemented with the purpose of overseeing and controlling the process of offering and selling franchises within the United States. According to the FTC Franchise Rule, a business arrangement or relationship can be classified as a "franchise" if the contractual conditions, regardless of whether they are expressed orally or in writing, meet the following three criteria:

- The franchisee shall be granted the privilege to engage in the operation of a business that is recognized or affiliated with the trademark of the franchisor or to provide, market, or sell goods, services, or products that are recognized or affiliated with the trademark of the franchisor.
- The franchisor possesses or exercises a substantial level of control over the franchisee's operational procedures or offers substantial support in the franchisee's operational procedures.
- As a condition for obtaining or initiating the operation of the franchise, the franchisee will be obligated to either make a mandatory payment or pledge to make a mandatory payment to the franchisor or its affiliated entity. According to the Compliance Guide issued by the Federal Trade Commission (FTC), it is stipulated that the obligatory payment must amount to a minimum of \$500 during the initial six months of commencing operations (Rosen, Salis, & Carol, 2023).

In the UK, there are no requirements for registering a franchise. However, it is good practice to give potential franchisees complete and clear details about the franchise opportunity (Bowler & Sanghera, Franchise Laws and Regulations England & Wales 2024, 2023). In the US, however, the FTC Franchise Rule does not force franchisors to file their FDDs with a federal government or administrative agency. It only requires franchisors to provide information before the sale. Any breach of the FTC Franchise Rule's disclosure rule is a breach of the U.S. Federal Trade Commission Act. This gives the FTC the power to sue franchisors in federal court and seek remedies (Losen, Leonard, & Carol, 2023).

U.S. franchisors can grow their businesses across the United States mostly through business format franchising. To grow their businesses internationally, they usually use a different method called "master franchising." This model entails a collaboration between a franchisor and either a Master Franchisee or a Sub-Franchisor, with the aim of establishing and managing units within a designated international region under the franchisor's brand. The Master Franchisee, regarded as a franchisee in terms of disclosure and registration regulations, undertakes numerous responsibilities typically assigned to the franchisor (Rosen, Salis, & Carol, 2023). In the UK, there is no legal definition for "franchise" or "franchisee," so the classification doesn't affect the rules. This means that the deal can be looked at from a business rather than a legal point of view (Bowler & Sanghera, Franchise Laws and Regulations England & Wales 2024, 2023).

In the United Kingdom, there are no obligatory disclosure requirements for the selling of sub-franchises. Nevertheless, in the event that a master franchisee holds membership in the British Franchise Association (bfa), the disclosure obligations outlined in Article 3 of the Code come into effect, thereby requiring the master franchisee to collaborate with the franchisor (Bowler & Sanghera, Franchise Laws and Regulations England & Wales, 2023). Misrepresentation lawsuits by sub-franchisees can be reduced by making sure there is enough information available. Whereas in the US, the FTC Franchise Rule enforces pre-sale disclosure requirements on franchisors, whereas sub-franchisees are not subject to such responsibilities. Although the Rule does not explicitly cover the topic of master franchising, the Multi-Unit Commentary provided by NASAA offers guidance to franchisors regarding their disclosure responsibilities in relation to multi-unit arrangements, which encompasses master franchising (Losen, Leonard, & Carol, 2023).

The Federal Trade Commission's (FTC) Franchise Rule violations are deemed unfair or deceptive acts in the United States, as stated in Section 5 of the FTC Act. Failure to comply with the rule can result in legal penalties (Losen, Leonard, & Carol, 2023). Non-compliance is irrelevant in the United Kingdom because there are no statutory pre-sale disclosure rules for franchises. Furthermore, the categorization of franchisees becomes more of an economic consideration than a legal necessity (Bowler & Sanghera, Franchise Laws and Regulations England & Wales, 2023).

The Copyright, Designs, and Patents Act 1988 (CDPA) is the legislation that grants copyright protection in the UK. Copyright protection is automatically granted to a work, regardless of its recording format, as long as it is within the scope of the Copyright, Designs, and Patents Act (CDPA). Additionally, trademarks can be registered under the Trade Marks Act 1994 (TMA), as amended, at the Intellectual Property Office (IPO) (Bowler & Sanghera, Franchise Laws and Regulations England & Wales 2024, 2023). For the US, it is part of the Paris Convention and the Madrid Protocol, which are run by the World Intellectual Property Organization (WIPO). These agreements make it possible for a trademark to be filed in all member countries using the same process, which is called an "International Application." In accordance with the provisions of the Madrid Protocol, it is a prerequisite for a trademark to undergo first registration and approval within a particular participating nation, referred to as the "Office of Origin." Subsequently, the trademark is to be submitted to the World Intellectual Property Organization (WIPO) for the purpose of worldwide approval and registration within a timeframe of either 12 or 18 months. After receiving approval at the World Intellectual Property Organization (WIPO) level, the trademark can be



subsequently presented to the other member nations where the trademark proprietor intends to secure trademark protection (Losen, Leonard, & Carol, 2023).

In the UK, although there exists no formal mandate for franchise contracts to be regulated by English law, it is common for a significant number of franchise contracts to be subjected to English law. The decision to explore this option is often adopted with the objective of enhancing the market appeal of a franchise system within the UK. While it is true that there are certain cases in which franchise contracts may be governed by the laws of a certain U.S. state, it is not widely recognized as a common practice (Bowler & Sanghera, Franchise Laws and Regulations England & Wales 2024, 2023). In the United States, franchises are not obligated to abide by local law unless there are non-waivable state regulations or particular statutes that mandate the supremacy of local law over the option of law provision (Losen, Leonard, & Carol, 2023). Franchisors in the U.S. have flexibility in choosing the governing law for their franchise agreements.

Both the UK and the US provide a degree of choice when it comes to selecting the applicable governing legislation for franchise agreements. In the United Kingdom, it is typical for English law to be selected as the governing law. However, in the United States, franchisors are permitted to choose the governing law according to their own preferences, albeit subject to some restrictions imposed by state statutory regulations.

Conclusion

Franchising is a powerful company expansion strategy that fosters a mutually beneficial relationship between franchisors and franchisees. Legal considerations become crucial when businesses strive to reproduce successful models, with trademark infringement and franchise disclosure forms (FDD) playing critical roles. The UK doesn't have laws that specifically cover franchises, so businesses regulate themselves through industry codes and generalized legal systems. There aren't any mandatory disclosure requirements in the UK, and regulations aren't as strict there, which makes it a good place for foreign brands to franchise. The United States, on the other hand, has stricter rules that are ruled by the Federal Trade Commission (FTC) and the FTC Franchise Rule. By breaking this rule, you are breaking Section 5 of the FTC Act, which says that information must be disclosed before being marketed. In the United States, business format franchising is the most common type. However, master franchising is often used for foreign growth. Both the UK and the US let franchisors choose which law applies to franchise deals. In the UK, English law is usually chosen, but franchisors in the US can choose any law they want, as long as they don't break any rules. To put it simply, the UK and US legal systems have different methods of franchising that are based on the specifics of each market.

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