

## Franchise Agreement and Mutual Obligations Between the Franchisor and the Franchisee

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**ABSTRACT:** As a defined business industry franchising is still quite new. As such, there are varying theories how to address even the most common situations. Franchise agreement is the most important and represents the only way of legal protection for the franchisor and the franchisee to secure themselves, since they are investing time, money and in case of franchisor, intellectual property as well. Prior to signing agreement, it is necessary for both sides to thoroughly investigate the market and gather enough information about this mutual venture.

**Key words:** Agreement • Franchise • Legal • Obligations • Franchisor • Franchisee • Intellectual Property

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### INTRODUCTION

#### Who Are Franchisor and Franchisee and What Their Legal Relationship in Franchise Business Is?:

Franchising, in modern business language, is a method of marketing through which successful franchisors (business owners) expand the retail distribution of their goods or services by contracting with franchisees (independent third parties). Franchisees agree to operate the retail sales or service outlets featuring the franchisor's original trademarked goods or services and agree to implement the franchisor's marketing methods at the franchisee's capital costs. In exchange for this opportunity, the franchisee agrees to pay an initial fee and ongoing royalties to the franchisor [1].

In franchising there are two parties, franchisor and franchisee. Franchisor is entrepreneur who has following characteristics:

- Appears as a legal owner who owns a brand, that is, a marketable brand, as well as can be a design or a brand of visual identity
- Provides bids for his products, services and technology through distribution channels

- Appear as intellectual owner of the capital of knowledge and sells a developed method of work that has already yielded a business result.
- His business method is intellectual capital and that is Know-how.

On the other side, we have a franchisee, as an entrepreneur who is securing his business strategy through franchising. Entrepreneur is an independent individual and he is conducting business on his own behalf and for his account and doesn't represent an agent of franchisor.

The Franchisees Are:

- Owners of business entities that carry out both entrepreneurial activity and through the franchise are determined to achieve the growth of the organization.
- Entrepreneurs who are starting an independent business through a franchise to reduce risk of failure
- Persons who have no job and are unemployed so their franchise is an opportunity for a new job.
- Persons who are employed but want to expand their cycle of interest by investing in franchising.

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The franchises observed this way, from the point of the franchisor and the franchisee, represent the possibility of new development and business success of the organization and ensure the sustainable growth at the same time. The quality of franchising and preserving the business reputation of the franchise is responsibility of the franchisor, who must monitor organization and operations of the franchisee in question, continuously controlling quality of the franchisee products and services in order to help franchisee to achieve the expected business results.

The franchisor action does not end with the introduction of the franchisee to the business. On the contrary, he is still interested in promoting the franchise in question and in monitoring and controlling the franchisee's conduct and what is done to preserve reputation of its business and intellectual property. Also, franchisor is doing all that to influence successful implementation of the franchise and to ensure satisfaction of franchisee's product and services sold to end consumers. Therefore, it is necessary to establish co-operation on the principle of reciprocity and good business between the franchisor and the franchisee and at the same time to pay special attention to training the franchisee to learn all that is necessary for the required business success of the franchise.

The franchise agreement has, over time, become typical with uniform contractual criteria translated into provisions that apply as principles of international obligation and trade law and also in line with international conventions in the field of intellectual property. This has both, legal and practical implications for the settlement in case of any disputes, applying agreed uniform legal rules and other international rules.

If we look at the cycle of behavior of the franchisor and the franchisee, their "life cycle", the following stages can be observed:

- Franchisor and franchisee establish a collaborative relationship and both are satisfied with the results achieved
- Disharmony begins to arise in the mutual relations of participants in the franchise agreement even though franchisee still retains an appropriate business relationship with the franchisor
- Problems with relationship begin when the franchisee considers that his contribution to the success of franchising and marketing of products and services is the main one and that everything is based on his commitment and work

- Franchisee begins to oppose and challenge franchisor.
- The reconciliation usually happens as the franchisee understands that working together is better for franchise success.

The business relationship between the franchisor and the franchisee is a steady business movement where business relationship can develop or sometimes stagnate. Mainly, the success and sustainable growth of an organization is based on the quality of this business relationship, so relationship development and promotion are accelerated by a proper understanding of the business relationship nature and interests of the franchisor and the franchisee. "Relationship develops, there is a clear understanding that building equality is a significant aspect of a franchise decision to buy. This means that the productive relationship between the franchisor and the franchisee is a long-term strategic relationship that brings value to both parties. When the franchisee does not earn more than his salary, the relationship is terminated [2].

The most important principles and elements of the franchise agreement are based on:

- The franchisor appears as the official owner of the intellectual capital of knowledge, defined in a certain form of intellectual property and related rights like Know-how, with defined patent law, trademark, license, containing an idea, product, service, distribution procedure, special equipment, etc.
- Transfer of usage rights for a certain period of time
- Obligation to use the transferred rights in a given period of time, provided that the instructions given are strictly adhered to.
- The franchisee is obliged to enable the franchisor to conduct control to verify the manner in which the franchisee operates and exercises given franchise rights.
- The franchisee is obliged to duly execute the agreed fees to the franchisor
- The 'Initial fee' and 'Royalty fee', respectively, are the entry franchise fee and the basic franchise fee, with the first being paid when concluding the franchise agreement as a ticket to the franchise and the basic fee is paid after beginning of the activity and this continuously in the foreseen payment periods and amounts approximately from 0.3% to 4% depending on realization of the business, with the increase of turnover, the percentage of payments is reduced.

In the context of the said above, it should be noted that franchising ensures that the franchisee "is not completely independent and therefore not always in a position to independently determine the rules in his organization" [3]. Therefore, a franchise deficiency is observed when the franchisee is exposed to too much control by the franchisor, which can lead to unexpected risk in the business result. On the other hand, franchising can contribute to various modalities in the transfer of technology and Know-how models, which completes the range of products and services offered in a particular market and as stated by Justus and Gastrogiovanni, enables franchising", expanding beyond national borders and this becoming the fastest-growing form of business in the global economic system" [4].

There are various models of international franchise agreements depending on the contractual type of franchise relationship, such as:

- Franchisor and franchisee sign a separate franchise agreement (for each franchise unit separately).
- Franchise Development Agreement.
- Master franchise.

In most the franchise contracts there is a requirement for the presence of the franchisor in the country of the franchisee, where it is specifically added obligation of the franchisee for performing business activity and of course stated need of the franchisor to perform control of the same. All of this is done in order to have better implementation of franchise. Therefore, the franchisee can be organized further, for the success of franchise to form:

- Registration of a branch without legal subjective as an office or similar
- Establishment of sub-company, or companies by the franchisor with legal subjectivity;
- Eventual conclusion of the contract on the joint venture with the status or only the obligatory effect.

It is also possible that the franchisor on the given market forms a pilot operation, before selling franchise to the franchisee, that will be a recommendation for further franchisees.

The franchise agreement, usually is followed by other contracts, such as:

- Confidentiality agreement
- Agreement for the Prohibition of Competition Agreement,

- Indemnation and actual legal provision of the agreement on transfer of franchise
- Agreement for termination
- Agreement for sale of software license
- Joint-venture contracts

The most likely causes of dispute:

- A mismatch of expectations
- Inappropriate choice of franchise partner
- Failure to reach minimum performance requirement
- Lack of franchisor support
- Failure to maintain brand standard [5]

#### **Rights and Obligations of the Parties to the Franchise Agreement:**

Starting from the fact that there are rare countries that have a *lex specialis*, which would have arranged principles of the franchise agreement, based on the conformity of laws with norms of international regulations in this area, that the franchise has applicable legislation of the host country, which is related to obligations of law and regulation of rights, obligations and protection of the same derived from intellectual property rights and in relation to related rights.

Obligation is built on the principle of equality of the contracting parties and represent a legal relationship between them. Legal relationship between the franchisor and the franchisee is done by signing Franchise agreement which will regulate mutual relationship, their rights and obligations. The content of the contract and regulation of mutual relations is based more on generally accepted legal principles in international trade rather than on some special national regulation of the country from which parties of the contract have incorporated their businesses in. Reason for this is the uniformity of applicability and better solution, especially when parties in the contract are coming from different countries. The unified harmonization of the principles and structure of the franchise contract, from the aspect of internationally binding mutual relations in the transfer of franchise rights, is of great importance.

Most importantly, legal protection that is provided this way is bringing equal obligation for the franchisor and the franchisee and possible different definition for this matter at the national level of the contracting parties. In most national legislations there are no specific laws on franchises that would regulate this subject matters with specific regulations and usually this agreement is based on existing sources of law rights.

When an organization in its development program manage to design and develop a new business model, protect the Know-How, patent and license a product or service and market the rights to operate that model and the way of doing business, then we say that the organization was able to devise a new franchise, which it then markets to another franchisee. "It might be assumed that if an intellectual property right can easily be created, the protection conferred on its owner must be relatively limited. The contrary is the case. On the one hand, copyright is not a true monopoly right in the same sense as a patent, trade mark or a registered design, so proof of independent creation is always a defense to an infringement action - indeed, it is the corollary of the requirement of originality" [6]. The organization that designed the franchise and transferred it to the new user appears as the franchisor, however, the franchisee organization gets the right to the franchise model and performs the franchise activity in a certain way, for a fixed period of time and in a certain determined market, or a certain geographical area. In this way, franchising represents an appropriate business privilege, obtained through a legal transaction between the franchisor and the franchisee, since it is given to the recipient that is, allowed to perform certain business activity. That is why franchising means the right of the franchisee to afford in this way the acquisition of a business model that will expand his commercial activity and at the same time to distribute his products and services under a licensed trade name.

Franchising means the use of the franchise in the business activity of the organization with new franchise production or services whereby it is assumed that such a sought-after brand, patent, license, know-how as a business model is organized in the business entity of the franchisee and means working in addition to methods in terms of business management in all business aspects, including reducing business risk and ensuring the development of the organization and sustainable growth, leading to economic progress.

First franchise was Singer Sewing Center (Dougan, 1998.) which was prepared and developed by Isaac Singer 1885. Sir, in the 19<sup>th</sup> century. He developed a sales network by concluding individual deals with the seller's goods, giving them the right to sell products that operated on local markets [7]. Franchise contract should adhere to all the principles of the obligations of the law and the general principles of contracting, as well as from the generally accepted franchise code. The contract in the provincial sense manifests free will and the interests

of the contracting parties to comply with their rights and obligations. This applies especially to the part of contractual provisions concerning the protection of intellectual property rights, as protection of identity and reputation of both contractual parties with an emphasis on keeping business secrets.

The basic provisions that should contain the franchise agreement are:

- Rights of a franchisor
- Rights of franchisee
- Products and services that the franchisor will deliver to the franchisees
- Obligations of a franchisor
- Obligations of franchisee
- Payment terms for the franchisees
- The duration of the franchise contract
- Conditions under which a contract will be made to extend the franchise
- Conditions under which the recipient of the franchise may use the trading name, character, logo, franchise network or any other label of visual or other identity
- Conditions under which the franchise agreement may be terminated
- Conditions under which the transfer of property (material and non-material) is subject to franchise after the termination of the contract.

The franchise contract is most commonly:

- Transfer of exclusive rights to the sale of goods and performing services on contracted territory
- The transfer of the right to exploit the commodity or service trademark,
- Sample model and the company to assign the right to exploit the business
- Know-how to perform services depending on the contractual division of the tasks
- The quality control of sales and services.

The fact is that the franchise agreement represents a legal relationship between the parties, the franchisor and the the franchisee as entities of legal affairs, enter into a binding legal relationship that links them together through the realization of the franchise project. Each of them performs in their own name and for their own account, but it is very interested in the business relation and franchise operations in accordance with the business franchise planning of the concerned franchise. Although the risk of business is not common, each organization carries its part

of the business risk on successful performance of franchising activities, certainly that both participants in the franchise business make mutual efforts for the realization of the project.

Starting from the need to take franchised activities everywhere in the world with norms of international regulations, the European Franchise Federation, which also adopted the code in 1972, was established for EU countries. This was accepted by a large number of countries and the code in the whole way defines the relationship between the parties of the franchise contract, but also the rights and obligations of the franchisor and of the franchisees. In this way, the harmonization of national regulations in this area with the defined legal effects of contracting parties included in the code is accomplished.

#### **Rights and Obligations of Franchisor and Franchisee Based on Signed Agreement and Franchise Activity:**

The franchise agreement is a two-sided contract with strictly foreseen rights and obligations of the participants in this business venture. What arises as the obligations of the contracting parties, at the same time, is the right which makes the case and the goal of the contract and manifested the will of the contracting parties.

Rights and obligations of the franchisor and the franchisees can be defined in the following manner as contracted mutual relationship:

- First of all, the franchisor must be certified by the holder of property rights of franchises and all accompanying intellectual property rights and their related rights such as Know how. Also, with this connection, it must be the owner of the trade name, the commercial sign of the franchise network
- Also, prior to the transfer of franchises and all franchising rights, it must be performed to check the functionality and eligibility of the same for placing it in the particular market
- The franchisor has to make a public call before putting his franchise as a product on the market as well as transparently show all conditions for franchise rights transfer which franchisee has to comply with. Special attention has to be put on code of ethics.
- It is possible to have the option and conclusion of the preface with the selected franchisees, in which it must meet the franchisees for concluding the preface and introduce them with the consequences of disrespecting the agreement.

- If the franchisor fails to comply with the concluded pre-acceptance, it is obliged to return to the franchisee all paid funds to the name of granting the franchise or must compensate them with the amount of franchised fees
- The pre-term contains a deadline when the contract must be signed, with the need to define the reasons that may affect the movement of the conclusion of the same
- In the pre-agreement franchisor protects its business secrets regarding the identity of the organization, ownership of franchise rights, intellectual property rights, Know-how and other

The obligations of the franchisor are determined depending on the type of franchise and the contract is specified as obligations to the franchisees, such as:

- Transfer of the rights of an exclusive sale of goods and services
- Transfer the right of use of a trademark
- Transfer of the right to use business name and other business signs
- The concession to Know-how (technical technological methods of production, use of recipes, formulas, specifications, methods of production and business knowledge in acquisition of consumers, knowledge in the organization of placements and turnover and knowledge in the basis of financial and economic and commercial calculations and similar
- Obligation of control and supervision in the protection of the trademark, standards of quality and other standards, systems, methods and assortment of products and services.
- The franchisor is obliged to provide the franchisee with certain supplementary activities to assist in facilitating and start the franchise work, then the services of education and training of personnel, assistance in organization management and assistance in marketing activities, campaigns and other similar activities.

On the other hand, the franchisee has obligations as well, which are mainly related to:

- When performing franchise activities, the franchisee shall strictly comply with all contractual standards and business instructions, as well as technical and technological procedures.

- Obligation of obtaining certain goods and materials from the franchisor or from the person he determines
- Obligation of investing in accordance with the agreement investment activities
- To secure and protect business secrets and Know-how

Payment of franchised fees and deadlines in everything with contractual provisions. Performing franchising activity on a concrete franchise contract means a whole set of the franchise activities that prior to concluding the franchise agreement should obtain as many as possible information for proper business decision making in franchising. Franchised activity is a complex business venture which includes a significant investment by the franchisees. Therefore, franchisee must obtain the following information:

- Obtaining adequate verified information about the franchisor and his franchise
- How franchise perform on a specific market
- What is the business success of the franchise?
- What business results were achieved by the current franchisees on the subject franchise?
- How many franchised tickets and franchise fees fit into their financial plan of performing franchised activity?
- Calculation of business success and profitability of franchise and achieved business result
- Financial liabilities for the procurement of goods and materials
- Calculation of all other costs, rents, labour energy, taxes and contributions, payment of credit payments and so on.

The ongoing commitments of both parties:

- The Parties shall seek to safeguard the image and reputation of the network in the running of their respective businesses
- The Parties shall exercise good faith and fairness in their dealings with each other.
- The Parties shall give written notice of any contractual breach and, unless inappropriate, grant reasonable time to the other party to remedy default;
- The Parties shall respect the confidentiality of information material to the franchise concept provided by the one to the other

- The Parties shall resolve complaints, grievances and disputes with good faith and goodwill through fair and reasonable direct communication and negotiation
- The Parties shall where appropriate and where parties have failed to resolve a dispute through direct negotiation, seek in good faith mediation before litigation and/or arbitration organized or approved by an EFF National Association Member [8].

It is of particular importance for the franchisees to arrange the control by the franchisor and to what extent it is performed. Then, the time limit performed franchising, under what conditions and how the business relation ceases to exist and especially what are the regulations for the case of unilateral termination of the contractual obligation.

This form of contracting belongs to unnamed contracts because the law does not recognize it as an explicitly prescribed contract of obligation and business so it is important that there are mutual consent of the parties and that it is not contrary to compulsory regulations.

Freedom to contract franchise transactions, implies that the contract contains all the provisions and principles of the law on obligations, starting with the rules of agreement, compliance with agreement relationship and obligations, termination of the agreement and other. The franchise agreement also has the character of a mixed contract, since it also contains elements of some other contracts, for example sales contracts, leases, etc.

Authorization acquired through the acquisition and licensing of a franchise rights is granted to the franchisee:

- To use a protected invention in production
- To market products and services obtained from a protected franchise
- To benefit from the acquired franchise.

## CONCLUSION

Results of the research led to the following findings:

- Legal protection of intellectual creativity of an individual is necessary in order to be valued, compensated and recognized, becoming this way intellectual capital which enables fair trade on the market through intellectual property rights.

- With registration of a patent, trademark or copyright to a franchise product or service, an organization obtains a license and becomes owner of certain process, information or technology, which further can be used as a method of growth in terms of economy by assigning the same to franchises for financial gain through legal agreement.
- In order to accelerate growth in franchising, it is necessary to market through e-commerce as it leads to internationalization and recognition of the brand, increasing competitiveness and most importantly this could be a way to have rapid response to customer demands. Distribution model between franchisor and recipient is most acceptable because it allows the franchisee to have his domain on the website, electronic billing system and ability to independently distribute products and lead customer service.
- Intellectual property legal protection needs to be ensured, nationally and internationally because intellectual property and trade in intellectual property rights are an important factor in accelerating technology, innovation and therefore market development. A large number of international agreements and organizations are engaged in successfully regulating intellectual property rights.

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