15 Essentials of Franchise Agreement: What Do You Need to Know?

Embarking on a new franchise investment can be exhilarating, but you should not let your excitement get you off the legal hook. While investing in a franchise, two crucial documents demand attention: the Franchise Disclosure Document (FDD) and the Franchise Agreement. The franchise Disclosure Document is the initial checkpoint offering insights into franchise operation, due diligence, and nondisclosure obligation. Meanwhile, a Franchise Agreement is an agreement between a franchisor and a franchisee whereby the parties arrange a licensing scheme for using intellectual property, brand, and trade secrets upon payment of a certain fee or royalty by the franchisee to the franchisor. Therefore, it is a contractual agreement underlying the relation, rights, obligations, terms and conditions.

For prospective franchising, a franchising agreement is essential. Not just the agreement, but the agreement must highlight crucial elements such as royalty fee, initial cost, training, support, period, etc. Let's explore the essentials of a franchising agreement and the governing laws in Nepal.

Relevant Laws for a Franchise Agreement in Nepal

There is no consolidated franchisee law or franchise agreement laws in Nepal. The laws are scattered in many legal instruments. National Civil Codes provides the foundation for the formation of the Franchise Agreement. Other relevant laws are as follows.

- National Civil Code,2017
- Competition Promotion and Market Protection Act, 2007
- Patent, Design and Trademark Act, 1965 (PDTA)

Foreign Franchise

For a foreign franchise, four additional legislations are attracted.

- The Foreign Investment and Technology Transfer Act 2019 (FITTA)
- Foreign Investment and Technology Transfer Regulations, 2020 (FITTR)
- Foreign Exchange (Regulation) Act 1962 (FERA)
- Foreign Exchange circulars and Notices issued by Nepal Rastra Bank (NRB)

Essential Dimensions of Franchise Agreement

To draft a comprehensive franchise agreement, you should analyze the document from legal, commercial, and technical aspects. The agreement must give a comprehensive idea about the subject or the matter of the franchise agreement, the legal compliance, and the financial or commercial aspects.

Technical Dimension - This approach covers the subject or the matter of the agreement, such as the type of franchise, the modality adopted, etc. It is about the business itself, the technical aspect, or the company's nature. A well-drafted franchise agreement should highlight the nature and the technicalities involved within the industry.

Commercial Dimension - This approach governs the financial or commercial part of the agreement, such as the fees, initial operation cost, royalty, license, tax, payment, etc.

Legal Dimension - This approach analyzes clauses that require legal interpretation, making the document clear and concise. It also ensures that the agreement is legally valid and enforceable, that the dispute resolution clause is fair and effective, and that there is a well-defined exit clause. A well-formatted agreement should be precise, leaving no room for subjective interpretation; the laws should be clear and accurate. Also, it involves the permissibility, associated conditions, and process of franchising or the franchising agreement.

Essentials of Franchise Agreement

Rights and Obligations

A well-formatted franchise agreement should incorporate the franchisor's and franchisee's rights and obligations. The franchisor's obligation can be divided into initial responsibility and ongoing obligation. Initial duties include setting up an outlet, furnishing it, providing and operating a procedural manual, disclosing the entire franchise system, training, etc. Meanwhile, ongoing obligation includes other support and guidance required after the franchise operates. Similarly, the franchise agreement should specify the franchisee's responsibility, providing strict coherence to the franchisor's branding, marketing, goodwill recognition, and others. You can draft a comprehensive operating and procedural Manual highlighting the obligation of the franchise and attach it to the Annex of the Franchise Agreement.

Fees and Payment

This section includes the total fees and payments that are to be made by the franchisee to the franchisor. Generally, the fees or charges in the franchise module are of three types: Upfront lumpsum, ongoing lumpsum, and Promotion and Advertising Cost.

Upfront- Lumpsum- It is the initial franchise fee paid to obtain a license from the franchisor. It covers set-up costs, legal costs, training costs and the amount of goodwill.

On-going Lumpsum- This is generally referred to as the royalty the franchisee pays to the franchisor monthly, quarterly, or annually as per the agreement. This amount is paid for using intellectual property, management services, etc.

Promotion and Advertisement Cost- This is typically attracted in a full business format franchise, which includes contributing a fixed amount or a fixed percentage of the turnover toward the promotion and advertisement of the franchise operation.

While drafting a franchise agreement, you must specify the payment types, the frequency, and the amount to be paid.

Foreign Franchise in Nepal

First, a foreign franchising company must be approved by the DOI to operate. Following is the process for franchising a foreign Brand/Entity

- Trademark Registration in DOI
- Signing a Franchise Agreement between the foreign company and a registered Nepali entity
- Approval of Franchise Agreement and other related documents from DOI

For payment of the royalty fee, The Foreign Technology Transfer Rules, 2077, in Annex I have mentioned the limitation on the royalty that can be paid to foreign franchisors. According to rule 5(1)(2), the following are the limitations on the royalty fee for a foreign franchise company.

Royalty	**Local Sales**	**Exports Sales**
If determined based on gross sales or the fixed rate	up to 5 % of total sales excluding tax	up to 10% of total sales excluding tax

If the royalty is Determined based on net profit	up to 15 % of net profits	up to 20% of net profits

Similarly, for the reparation of the royalty or the licensing fee, approval for the same should be taken from the Nepal Rastra Bank [Foreign Technology Regulation Act (FERA) 10(5)]. The Foreign Exchange Management Department within the NRB regulates and facilitates foreign exchange-related aspects.

Thus, you must consider these ceilings while drafting a franchise agreement. If the amount exceeds the ceiling, the Nepali law deems such an agreement invalid. Also, you must follow Nepal Rastra Bank circulars and directives for the change in teh policy regarding royalty limitation, repartation, etc. We advise you ti take legal advice from a corporate attorney before signing a Franchise agreement.

Intellectual Property

This section highlights the specific type of intellectual property right granted to the franchisee. Generally, IP rights encompass two aspects.

- Use of the brand or trademark only
- Use of or access to trademark, know-how, trade secrets, etc.

The agreement should explicitly specify the type of intellectual right granted to the franchise and associated limitations.

For the fees and payment related to the use of the trademark of a foreign brand, FITTR has mentioned a ceiling.

Local Sales	**Exports Sales**
up to 2% of total sales excluding tax for alcohol and tobacco industry	up to 5% of total sales excluding tax for alcohol and tobacco industry

up to 3 % of total sales excluding tax for other industries	up to 6 % of total sales excluding tax for other industries

Training and Support

The Franchise agreement should mention the type of training and support the franchisor will provide both during the initial phase and while in operation. This includes skill-related training, marketing support, branding or advertisement support, etc.

Period of Franchise and Terms of Renewal

Generally, the registration of the trademark of the foreign franchise is for a term of 5 years with the potential for renewal. There are no specific laws regarding the licensing of the trademark, but the DOI approves licensing of a trademark for 5 years. Similarly, the time for the franchise agreement is 5 years according to the Nepalese law, with possible renewal or extension of the contract. Thus, while drafting a Franchise Agreement with jurisdiction over Nepal, consider the agreement's time frame per the prevailing law. Also, add a clause relating to the agreement period and the terms for renewal.

Territory Right

In extending franchise rights, ensuring compliance with Nepal's competition laws is crucial. Specific locations for each franchise must be outlined to avoid competition conflicts, ensuring that no two franchises operate in the same area to prevent customer division or anti-competitive practices. Besides, you must also review the Competition Promotion and Market Protection Act, 2007, to ensure that the franchising agreement does not lead to anti-competitive provisions as stated in clauses 3,7 and 8.

Confidentiality Clause

This clause is a savior for the franchisor as it protects intellectual property and other essential rights disclosed to the franchisee. This clause provides that the information obtained during a franchisee agreement should be confidential even after the termination of the contract. It also highlights the people who are granted access to confidential information and the associated

obligations. This ensures that a non-compete obligation is imposed on the contracting party, and the franchise shall not use the knowledge gained through franchising for purposes other than those permitted by the contract.

Indemnification

The Franchise Disclosure Document and the Franchise Agreement contain confidential information, obligations, liabilities, infringements, negligence, etc. Sometimes, the franchisee's fault may cause damage to the franchisor in terms of financial or branding or other factors. If any such mishaps occur, who shall be responsible for the indemnification? This should be highlighted in the franchising agreement. While drafting a franchising agreement, the franchisor and the franchisee's limited liability and the separate personality must also be considered. The indemnification would be summoned from the franchisee (the company), and the other party(shareholder and directors) shall be protected unless the corporate veil is lifted.

Minimum Performance Requirement

A franchise has a certain brand name, customer base, and high reputation. The negligence of the franchisee may affect the brand value of the franchisor. Thus, it is always advisable that the franchisor gives a manual of minimum performance standards which should be followed to retain the franchise. The manual could be attached to the Annex of the Franchise agreement.

Insurance Requirement

Under this clause, the franchisee promises to maintain and procure specific insurance policies such as comprehensive general liability insurance, automobile insurance, unemployment and worker’s compensation insurance, etc. This depends on whether the franchisor asks the franchisee to purchase such insurance.

Contingencies in the Event of Death or Incapacity

This clause highlights the status of the agreement in death or the incapacity of the person signing the contract. Most franchising agreement leaves no room for this clause. Still, it is a critical clause that states the franchise's rights, liabilities, status, and performance after the death or incapacity of the person taking the franchisee.

Termination/ Exit Requirement

The contract must specify conditions under which the Agreement would be terminated. It could include breach of contract, non-performance, force majure clause, non-payment, and other standard contract provisions. It should delineate whether termination can be initiated unilaterally or necessitates mutual consent from both parties. Furthermore, the agreement should contain a clause granting the franchisor the prerogative to terminate if the franchisee deviates from the stipulated operational procedures documented in the operation and procedures manual or fails to maintain the prescribed standards.

Also, there might be a need to exit voluntarily because of poor performance, relocation, financial difficulties, etc. Thus, the exit and termination clause should specify all the conditions that might arise in the future, causing termination or exit. If you pay attention to all these aspects, it is very unlikely that you will encounter any legal consequences in the future..

Dispute Resolution and Governing Law

A dispute resolution clause is considered a midnight clause because drafters often focus on other terms and conditions and overlook the dispute resolution clause, or they are formed at last when everything is completed. This causes problems in a dispute settlement due to a need for more specific measures and clarity.

While framing any franchise agreement, you should mention which forum is to be approached in case of a dispute. Nepalese law does not give recognition and enforceability to matters decided in foreign domestic courts. So, the appropriate forum should either be the domestic court of Nepal or arbitration (remember, it should be arbitrable under Nepalese law).

Also, you must ensure that the agreement specifies applicable laws and the procedural law (lex arbitri) for the dispute resolution. Designating applicable and procedural laws and avoiding pathological clauses is always advised. Furthermore, the place or jurisdiction of recognition and enforcement of the awards guaranteed should also be considered while framing governing laws for dispute settlement.

Post-Termination Clause

Another necessary clause in the franchise agreement is the post-termination clause. This clause outlines the obligations and rights of both parties after the deal concludes. It specifies aspects such as transition assistance, non-compete agreements, and the handling of intellectual property and confidential information post-termination.

Boilerplate Clause

You should include other boilerplate or standard format clauses, such as Waiver, Severability, Notices, Attorney fees, Relationships, Assignments, Force majeure etc.

Other standard format clauses include a definition of franchisor, franchisee, intellectual property, royalty, etc. Also, the agreement must precisely state the effective date of the agreement.

Conclusion

Understanding the intricacies of a franchise agreement is paramount for any prospective franchisee. From comprehending the essential dimensions—technical, commercial, and legal—to recognizing the significance of rights, fees, intellectual property, and dispute resolution, a thorough grasp of the franchise agreement ensures a successful and legally sound franchising venture. Additionally, abiding by relevant laws, considering foreign franchising regulations, and acknowledging post-termination and boilerplate clauses further strengthen the foundation of a fruitful franchise partnership. Legal counsel and a meticulous approach to drafting and reviewing the franchise agreement are indispensable for a thriving franchise endeavor.