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A New Era in International Franchising

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**NEWS FROM AROUND THE WORLD:
UNITED KINGDOM**

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In this paper I will look at recent developments relevant to franchising that have occurred in the UK. The UK does not have a specific franchise law, so new developments tend to arise in connection with contractual disputes decided by the courts and as a result of new legislation that impacts franchising indirectly.

New Legislation

A number of new statutes that are relevant to franchising will be mentioned here.

- The General Data Privacy Regulation (GDPR) will come into force on 18 May 2018. Most franchisors hold personal data including franchisee personal data and customer personal data and accordingly franchisors will be directly impacted by this new Regulation.
- Brexit update. Unfortunately, there is no more clarity for franchisors regarding the impact of Brexit on their IP protection in the UK. It is hoped that EU registrations will be “grandfathered” over, but this has not yet been confirmed.
- The UK government is planning a more stringent withholding tax regime for Licensors based in low tax jurisdictions. This could impact foreign franchisors that have set up in low tax countries such as Luxembourg.

Important new court Decisions

There have been a number of important decisions by the UK Courts that are relevant to provisions frequently encountered in franchise agreements. These are:

- Liquidated Damages and the Rule against penalties: The rule against penalties has been “recast”¹
- Misrepresentation by negligent misstatement. When is it better to say nothing?
- The meaning of good faith and an implied duty of good faith in “relational contracts” such as franchise agreements.
- The use of exemption clauses to limit liability

1. **The Rules Against Penalties**²

As a matter of public policy, penalty clauses are not enforceable under English law. Franchise Agreements often contain liquidated damages clauses, and it is important to understand whether these will be enforceable in the UK. If they were to be classed as “penalty clauses”, they would not be enforceable.

a. Recent Decisions regarding penalty clauses

Following the decisions of the Supreme Court in *Cavendish Square Holding BV v Makdessi and Parking Eye Ltd v Beavis*³, the law in relation to the rule against penalties has been recalibrated. The rule is not confined to typical liquidated damages clauses and extends to other types of clause including: (i) “withholding payment” clauses;⁴ and (ii) “forced transfers” at undervalue.⁵ Before the rule can apply, the court must determine whether the clause in question is a secondary obligation capable of breach. The rule does not apply to primary obligations. Thus a clause, which is not drafted so as to involve any breach, may be viewed as

¹ Per Ed Peel in a recent talk at Dentons.

² Thanks go to Ed Peel for his excellent talk and subsequent notes at Dentons London

³ [2015] UKSC 67; [2015] 3 WLR 1373.

⁴ One of the clauses in *Makdessi* allowed for the withholding of the last two instalments of the price.

⁵ The other clause in *Makdessi* entitled C to purchase shares from D at a potential undervalue.

a “disguised penalty clause” and the rule will apply. Where the clause is in the nature of a secondary obligation, the court will ask if there was a “legitimate interest” to be protected. It will then ask if the means of protection were so “out of all proportion” as to amount to something which was “extravagant or unconscionable”. Where the clause is a typical liquidated damages clause, a comparison with the damages that would ordinarily be awarded will be made and the court will ask if the amount is proportionate. For other types of clause, a broader assessment is required. In a commercial contract, the extent and nature of the negotiations, the sophistication of the parties and the input of legal advice will be relevant considerations in making any broader assessment. Recent decisions have indicated that it has become even more difficult to successfully invoke the rule in a commercial contract between sophisticated parties of equal bargaining power, but not impossible. However, in franchise agreements, where the franchisee may not have been given an opportunity to negotiate the liquidated damages amount, franchisors may find it more difficult to rely on these principles.

b. Excessive Interest rate can be a penalty

In *First Personnel v Halfords* a contractual rate of interest of 2% per month on unpaid agency fees was a penalty.⁶ The principal reasoning was the lack of any justification for a rate, which was well above the “commercial norm”, or the rate payable under the Late Payment of Commercial Debts (Interest) Act 1998. Instead, he awarded interest at the rate payable under the 1998 Act: 8% (per annum) above the official Bank Rate.

By contrast, in *ZCCM* the Court held that a clause calling for accelerated payment of sums due under a settlement agreement, upon breach, did not amount to a penalty. Nor was a clause imposing a default interest rate of LIBOR plus 10% a penalty.

In *Holyoake v Candy* the rule an interest rate of 15 % per annum was upheld. Nugee J. had to deal with a provision, which charged a default interest rate of 15% p.a. compounded monthly which also involved an element of interest on interest⁷.

Franchisors can learn from this that contractual interest rates need to be kept at around 1 % per month or apply the rate under the Act up to a maximum of 15 % per annum where both parties are of equal bargaining power and advised by counsel.

2. Misrepresentation/mis-selling

English law does not require the franchisor to give a disclosure document to the franchisee. As such, disclosure type cases are addressed by the law of misrepresentation. Under the Misrepresentation Act, if the franchisee can show that they were induced to enter into the franchise agreement by a misrepresentation (eg an incorrect earning claim), they may be able to have the franchise agreement set aside and their monies returned to them. English law recognizes innocent, negligent and fraudulent misrepresentation. In each case it needs to be shown that a representation was made which was not true and that the franchisee relied on it when entering into the agreement.

In *Holyoake v Candy* D was found to have made a number of fraudulent representations to C ahead of C’s decision to enter into certain agreements with D and others. But as C did not believe any of D’s “deliberate lies” and was “not in any sense deceived by them”, they were unable to raise any claim in deceit. This decision provides a possible defense to

⁶ See also *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch), noted in an earlier session.

⁷ At [486]

misrepresentation claims by franchisees but only if it can be shown that the franchisee was not deceived by the statements and did not believe what was being said.

In another case (*Hayward*)⁸ an insurer settled a claim for personal injury against their insured after having reduced the claim because of evidence that it had been exaggerated by the claimant. Later, the insurers discovered further evidence, which established that the claim was altogether bogus and sought to have the settlement set aside on grounds of fraudulent misrepresentation. The Court of Appeal held that the settlement should not be set aside on the basis that the insurer had not been “induced” to enter into it by any misrepresentation of the claimant in circumstances where it could not establish that it believed the representations made to be true; the insurer was aware, from the evidence it already had, that the representations may not have been true but accepted that risk by entering into the contract. An appeal was allowed to the Supreme Court which overturned the decision of the CA⁹. The case therefore raised the question of what suffices for inducement in what was a case of fraudulent misrepresentation¹⁰. Inducement does not require the claimant to show that he believed the representation to be true. A representation may still have caused the claimant to act in a way in which it would not otherwise have done even if it was aware that the representation might not be true. The insurers did not know that what was left of the claim was based on misrepresentation (or could not be sure of proving this) and had to take into account the risk that the court hearing the personal injury claim might believe the insured. They were therefore induced to enter into a settlement they would not have entered into had they known the true position (or been certain of proving it).

Property Alliance is another important case on mis-selling by banks. Most of the misspelling case have ultimately been unsuccessful, because of non-reliance clauses, ie clauses which explain that the basis of the agreement is a sale without any advisory duty, or that no representations have been made, or been relied upon. Such clauses were used in the Property Alliance case¹¹. PAG was sold several interest rate swaps as a condition of a loan facility from RBS. It was left “out of the money” when the base rate went low and stayed there and incurred significant break costs. PAG alleged that the swaps had been mis-sold and invoked several causes of action.

On appeal, the following claims were still being pursued: (i) misrepresentation claims based on an express representation that the swaps were to act as a “hedge”, and implied representations about the setting of LIBOR; (ii) a “negligent mis-statement” claim which was said to involve the breach of what has sometimes been referred to as a “mezzanine duty”; and (iii) a claim for breach of contract, based on an implied obligation of “good faith”. A brief summary follows of the approach of the CA to each of those claims and the issues they raised:

(i) Misrepresentation – express representations:

⁸ [2016] UKSC 48.

⁹ The CA could see that the result it reached was unattractive, but was concerned about potential uncertainty. As Briggs LJ put it (at [35]: “If the mere making of a misstatement rather than belief in its truth is to be a sufficient influencing factor, then there is no telling in what contractual contexts it may be applied, with debilitating effects upon contractual force and certainty”).

¹⁰ All of the reasoning of the Court is in the context of fraudulent misrepresentation and there have been observations from time to time that, in cases of fraud, a more generous approach may be taken to the question of causation, or the burden of proving causation. What is decided by the SC may not therefore necessarily apply to non-fraudulent misrepresentation, but the core reasoning does appear equally applicable and it is questionable whether the fundamental requirement of causation should vary depending upon the absence or presence of fraud. These issues are explored in a recent very helpful article by The Hon KR Handley in 2015 LQR 277.

¹¹ See the first instance decision of Asplin J. at [2016] EWHC 3342 (Ch).

PAG's claim in this respect was that while the swaps were a hedge against an increase in rates, they did not provide protection more generally against adverse movements in interest rates of the type which had occurred. The CA held that the reasonable representee¹² would not have understood "hedge" in the way for which PAG contended, so that there was no misrepresentation; and to find that PAG had not relied on the hedging representations, in any event. There was insufficient evidence to find that the relevant RBS employees appreciated that PAG had interpreted "hedge" to have the meaning which PAG contended.

(ii) Misrepresentation – implied representations: LIBOR rate

PAG also claimed that by offering a certain LIBOR rate RBS impliedly represented that they had no involvement in any manipulation of the LIBOR rate. The judge rejected the submission that the proffering of this rate was conduct from which any representations could be implied about LIBOR, or RBS's involvement in setting it. The CA agreed that some of the implied representations were not sustainable, but held that others were, eg that RBS was not itself seeking to manipulate LIBOR and did not intend to do so in the future.

The following test can be used to determine whether a representation can be implied from conduct:

"In evaluating the effect of [D's] conduct a helpful test is whether, having regard to [D's] conduct in such circumstances, a reasonable [person] would naturally assume that the true state of facts did not exist and that, had it existed, he would in all the circumstances necessarily have been informed of it."¹³ There must be clear words or clear conduct of the representor from which the relevant representation can be implied."¹⁴

(iii) Negligent mis-statement

It has been said that a bank selling a financial product to a customer may owe what has been referred to as a "mezzanine" duty. This is so called because it fits somewhere between a duty not to make false statements of fact and a duty to take care in advising as to the suitability of the product:

"... a bank negotiating and contracting with another party owes in the first instance no duty to explain the nature or effect of the proposed arrangement to that other party. However, if the bank does give an explanation or tender advice, then it owes a duty to give that explanation or tender that advice fully, accurately and properly. How far that duty goes must once again depend on the precise nature of the circumstances and of the explanation or advice which is tendered."

In other words, if a franchisor does not say anything about the profitability of the franchise business, there is no duty to disclose key facts but if the franchisor does give explanations and recommendations it may be required to provide a "full" and "proper" explanation. Usually in negligent misrepresentation cases, the challenge faced is whether enough has been said to create a duty to say more.

"Concentration should be on the responsibility assumed in the particular factual context as regards the particular transaction or relationship in issue. The ... duty would extend to correcting any obvious misunderstandings communicated by the customer and answering any

¹² What has been represented and whether it is false is determined objectively.

¹³ *Geest plc v Fyffes plc* [1999] 1 All ER (Comm) 672; also approved in *IFE Fund S.A. v Goldman Sachs International* [2007] 1 Lloyd's Rep. 264 at [50]; and *Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland plc* [2011] 1 Lloyd's Rep. 123 at [82]-[85].

¹⁴ At [132].

reasonable questions the customer might ask about those products in respect of which the bank had chosen to volunteer information might, depending on the particular factual context, be consistent with the standard Hedley Byrne duty not to misstate, including by omission.

In PAG there was no breach of any such duty. PAG was made fully aware that (1) breaking any of the Swaps could carry adverse financial consequences, (2) the size of those financial consequences would depend upon interest rates at the time the Swaps were broken. Ultimately the court also upheld the standard language in the contracts whereby the customer represented that it understood and assumed the financial risks of the transaction and was capable of assuming, and assumed, those risks. The same approach should continue to be helpful in franchise agreements.

The PAG case provides important reassurance to franchisors that a well drafted non-reliance clause in the franchise agreement should defeat a claim for misrepresentation. But there is no guarantee. In the leading UK franchise case on the matter, *Papa Johns v Doyley*, the non-reliance clauses did not protect the franchisor. This case involved earnings claims and financial performance representations by the franchisor, that were found to have been untrue. The non-reliance clause did not protect the franchisor because it failed to satisfy the requirement of reasonableness under the Unfair Contract Terms Act. Non-reliance clauses are a form of exclusion clauses and need to be reasonable to be valid. In the case of *Papa Johns v. Doyley* this test was not satisfied. When assessing whether an exclusion clause is reasonable the UK courts will look at the bargaining power of the parties, at who is better placed to bear a certain risk and to insure against it. In the *Doyley* case it was also relevant that the non-reliance clauses had not been highlighted in anyway to the franchisee and that the franchisor had insisted that the franchise agreement was non negotiable.

3. Exemption Clauses

Provisions requiring notification of claims within a certain time and setting out details of the claim have proved very effective at defeating what might otherwise be valid and enforceable claims. They are commonly encountered in SPAs in the context of claims for breach of warranty but can also be found in franchise agreements. The latest example can be found in the *Teoco* case where a claim for breach of warranty was defeated because the notice relied upon by C did not specify the claim in sufficient detail¹⁵. The particular issue for the CA was whether the notice had to identify the particular warranties which C claimed to have been breached. That will, of course, depend on the wording of the clause in question. In *Teoco* it stated as follows:

“No Seller shall be liable for any Claim unless the Purchaser has given notice to the Seller of such Claim setting out reasonable details of the Claim (including the grounds on which it is based and the Purchaser’s good faith estimate of the amount of the Claim (detailing the Purchaser’s calculation of the loss, liability or damage alleged to have been suffered or incurred)).”

The Court noted, the notice does not necessarily have to refer expressly to the particular warranties, which have been breached, if it is clear which they are from the details which have been provided¹⁶:

“In general...it seems to me that ‘setting out’ the ‘grounds’ of a claim required explicit reference to particular warranties or other provisions. Moreover, the present case was not one

¹⁵ Of course, a defect in the level of detail might be remedied by a further notice but not if, as in *Teoco*, the time limit has also passed.

¹⁶ At [27].

in which either the Purchaser erroneously referred to the wrong warranty. To the contrary, there was real scope for doubt...about which provisions were thought by the Purchaser to be relevant. As the Judge said, the ‘omnibus reference to Warranty Claims or Tax Claims’ was not good enough.

4. Good faith

The principle of good faith is relatively new to English law. As such new cases that clarify the obligation of good faith, when it arises and what duties it entails are important for the franchise industry. Ever since it was held in *Yam Seng*¹⁷ that a duty of good faith can be implied in relational contracts” such as franchise agreements, the extent to which the franchisor is subject to an implied duty of good faith has been of much interest to the UK franchise community. Decisions continue to be handed down by the courts, which raise issues of good faith, whether in the interpretation of an express obligation of good faith, or in finding or rejecting an implied obligation. Such decisions are usually very context- and fact-specific.

(i) Breach of contract – implied obligation of good faith

In the misrepresentation case discussed above, the question of good faith came up in the following context. Under the loan facility in the PAG case discussed above, RBS was entitled to require valuations of the property provided as security, the cost of which was for PAG. PAG argued that in calling for repeated valuations, RBS breached the implied term that a contractual discretion will not be exercised in a way which is contrary to “good faith”, ie arbitrarily, capriciously, irrationally, or for an improper purpose¹⁸. Asplin J. rejected such an implied term¹⁹. Whilst the court concluded that the power to call for a valuation was “not wholly unfettered” and was one which, while it allowed RBS to act in its own interests, required it to do so in pursuit of legitimate commercial aims rather than to vex maliciously²⁰. There was, however, no evidence to support a finding that RBS had infringed such a limitation.

(i) Good faith exercise of contractual decision – the “Braganza” duty²¹

Good faith is often argued in franchise cases. In *MGB Printing v Kalkwik*²² the franchisee was successful in persuading the court to imply a duty of good faith to the effect that the franchisor had to use reasonable skill and care when providing services to the franchisee (even though the franchise contract did not contain such an obligation). The court felt that to give the contract “business efficacy” it was necessary to imply such a duty. In the case of *Stream Healthcare v. Pitman*²³ the court implied a contractual obligation of the franchisor to provide services to the franchisee when reasonably requested. Another example of an implied obligation of good faith is that the exercise of a contractual discretion will need to comply

¹⁷ See footnote 29 below

¹⁸ This has recently been referred to as the “Braganza duty” and is considered under “Good Faith” below. In *Property Alliance* reliance was placed on an earlier banking case: *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116, [2008] Bus LR 1304.

¹⁹ She considered that RBS had “an absolute right to call for the valuation and accordingly, that the *Socimer* line of authorities and the necessary implication of terms in order to control the otherwise unfettered exercise of a discretion/assessment or formulation of opinion [do] not arise”. The distinction between an “absolute contractual right” and a discretion was drawn by the CA in *Mid Essex Hospital NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200 at [83].

²⁰ At [169].

²¹ In addition to *Faieta* case noted, here, see the *Property Alliance* case noted under “Misrepresentation/mis-selling” above.

²² High Court of Justice, Queens Bench Division, 2010, EWHC 624 (QB)

²³ High Court of Justice, Chancery Division 2010 EWHC 216 (Ch)

with a good faith limitation under which it is not to be exercised arbitrarily, capriciously, irrationally, or for an improper purpose. This has recently been referred to as the “Braganza duty”²⁴. However, this is not an onerous duty to discharge.

(ii) Implied obligation to perform in good faith

Another form of good faith takes the form of an implied term that the parties will perform their obligations in good faith, as advocated by Leggatt J. in the Yam Seng case²⁵. Leggatt J. returned to this theme in *Tahnoon v Kent*. The parties had entered into a Framework Agreement and C had executed a promissory note in favour of D. D claimed damages under the Framework Agreement and the promissory note. Among the counterclaims made by C were an allegation of duress and breach of a duty of good faith. Although the Court rejected a claim that the relationship between the parties amounted to a partnership or otherwise involved any fiduciary duty, it nonetheless found that it was one, which was in the nature of a joint venture and involved a duty of good faith.

As to scope of the duty of good faith Leggatt J said:

“Although the observations that I made in the Yam Seng case about the scope for implying duties of good faith in English contract law have provoked divergent reactions, there appears to be growing recognition that such a duty may readily be implied in a relational contract.”²⁶

“...I think it clear that the nature of their relationship was one in which they naturally and legitimately expected of each other greater candour and cooperation and greater regard for each other’s interests than ordinary commercial parties dealing with each other at arm’s length.”²⁷

“In the circumstances the contract made between these parties seems to me to be a classic instance of a relational contract. In my view, the implication of a duty of good faith in the contract is essential to give effect to the parties’ reasonable expectations and satisfies the business necessity test as the relevant standard for the implication of a term into a contract.”²⁸

As to content:

“It is unnecessary and perhaps impossible to attempt to spell out an exhaustive description of what this obligation involved.”²⁹

“...the obligation of fair dealing is not a demanding one and does no more than require a party to refrain from conduct which in the relevant context would be regarded as commercially unacceptable by reasonable and honest people...”³⁰

“For present purposes it is sufficient to identify two forms of furtive or opportunistic conduct which seem to me incompatible with good faith in the circumstances of this case. First, it would be inconsistent with that standard for one party to agree or enter into negotiations to sell his interest or part of his interest in the companies which they jointly owned to a third

²⁴ After the *Braganza* decision, above.

²⁵ *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111 (QB) (obligation implied in a distributorship agreement).

²⁶ At [168].

²⁷ At [173].

²⁸ At [174].

²⁹ At [175].

³⁰ At [175].

party covertly and without informing the other beneficial owner. Second, while the parties to the joint venture were generally free to pursue their own interests and did not owe an obligation of loyalty to the other, it would be contrary to the obligation to act in good faith for either party to use his position as a shareholder of the companies to obtain a financial benefit for himself at the expense of the other.”³¹

Without going into the very considerable details of the case, D was found to have induced C to enter into the Framework Agreement and the promissory note by conduct which amounted to a breach of the duty of good faith. This entitled C to damages.

5. Non-Competes

Enforcing non-competition obligations

Enforcing non-competes against franchisees after termination of the franchise agreement continues to be an important area of case law and disputes. In *F45 Training Pty v Leo Star Ltd* the franchisee of the Australian gym company prepared to operate a competing business after termination of the franchise agreement. Inter alia, it wrote to its customers inviting them to join the new gym. The agreement provided that the franchise would be granted in a 'territory' but by omission the term “territory” was not defined in the agreement. The franchise agreement also referred to the protection of confidential information such as customer lists. Finally there was a restrictive covenant. The Franchisor applied for an injunction against the franchisee on the basis that setting up a new gym amounted to a breach of the non-competition clause and involved the use of its confidential information. The application was unsuccessful given that nothing in the agreement expressly gave the franchisor exclusive ownership of customer names. It was also considered whether an injunction was a proportionate remedy for a breach of a restraint of trade clause. The Judge held that damages were an adequate remedy and rejected the argument that irreparable damage would be caused to the business.

Oral Franchise Agreements and trademark protection

Caspian Pizza operated a pizza business in Birmingham since 1991 under the name “Caspian Pizza”. In 2002, D opened a pizza restaurant in Worcester also using the name Caspian. Caspian Pizza claimed it had entered into an oral franchise agreement with D, which permitted D to operate restaurants under the “Caspian Pizza” name in the Worcester area in consideration for a franchise fee. According to that oral agreement any goodwill generated by the use of the mark would belong to Caspian Pizza. In 2005 Caspian registered the word mark “Caspian” and a related logo mark in the UK as a national trademark. D did not pay any franchise fees and refused to enter into a written franchise agreement. Caspian therefore issued proceedings in the IP Enterprise Court claiming that D’s use of the Caspian name constituted trademark infringement. Caspian’s claim was unsuccessful. It was held that the word mark was invalid because at the date of registration in 2005, D had already established local goodwill in the name “Caspian” in its local area (Worcester). This invalidated the national trademark because there was no geographical restriction on the mark. However, at first instance the court decided that the related device mark was valid as the D had not used a similar logo. The Court of Appeal found that the decision at first instance was wrong to separate the word and logo marks because the main element of the logo mark was the word “Caspian”. It therefore found both marks to be invalid, dismissing the appeal. This was a blow for Caspian and the case shows that it is extremely important to register the trademark before starting the franchise business. Where localized prior rights exist it is important to carve them out at the application stage.

³¹ At [176]

6. GDPR

Franchisors that have not yet made their business GDPR ready have no time to lose. Any franchisor that collects and uses personal data will need to comply with the EU General Data Protection Regulation ("GDPR") which came into force on 25 May 2016 and must be fully implemented by all businesses by 25 May 2018. Franchisors and Franchisees need to ensure their business is compliant with GDPR. From 25 May 2018, the GDPR will apply to every business that offers goods and services to EU citizens or that monitors the activities of EU citizens. This will include UK franchisors, UK franchisees and US franchisors that have licensing relationships with EU or UK based persons. US and UK franchisors providing services or selling into Europe must comply with GDPR requirements. Brexit will not make a difference to those businesses that process data of EU citizens. The GDPR will apply to both data controllers and data processors. In a franchise set up, this means that both the franchisor and the franchisee must comply. The franchisor will usually be the data controller of franchisee data and customer data. The franchisee may also be a data controller or simply a data processor, depending on the arrangement between the parties. Often the franchisor and franchisee are independent data controllers as they both have rights to access and use the personal data for their own separate purposes. A franchisee may be a data controller of customer personal data even if the franchisor lays claim to IP rights in the data. Key changes include

- Privacy Notices need to be in a clear and easy to read form and include certain mandatory information specified by the GDPR.
- Consent must be "unambiguous". Franchisors that are relying on consent to process data must be able to demonstrate that the data subject has given valid consent.
- It must be as easy to withdraw consent, as it is to give it.
- Franchisors must introduce mandatory data breach reporting.
- Franchisors must have a system in place to evidence compliance. Under the GDPR the authority has the power to ask for evidence of compliance. This goes well beyond the record keeping.
- Mandatory terms that must be implemented in all contracts with external data processors. As stated above where franchisees are data processors this includes franchise agreements.

Non-compliant businesses are subject to fines of up to 4% of global turnover.