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FRANCHISEE'S GUIDE

AN INFORMATION PACKAGE FOR THOSE CONSIDERING
BUYING A FRANCHISED BUSINESS

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PURPOSE OF THIS GUIDE

This is a guide for prospective franchisees who may be considering purchasing and entering into a franchise system.

It seeks to cover many of the issues that need to be considered. It is not intended to be exhaustive and franchisees are recommended to obtain professional advice from advisors and experts in this area.

1. THE FRANCHISE BUSINESS MODEL





Franchising is not a business itself, but a way of doing business. It is essentially a means of marketing and distributing goods and services. It is also an extremely successful and rapidly growing aspect of Australia's small business sector.

Types of Franchises

The word "franchising" is used to describe several different business relationships.

The most well-known type of franchise is the **Business Format Franchise** where the franchisor uses a network of franchisees to market a service or product under a common name and standardised system. Examples include franchise systems like McDonalds, Boost Juice or 7-Eleven, In this type of franchise, the franchisor offers a comprehensive system for operating the business and permits the franchisee to use the full system, including the brand, manuals, procedures, marketing programs, quality assurance systems, and the franchisor provides training and support services to franchisees. Standardisation, consistency and uniformity across all aspects of the chain are hallmarks of such franchises. This business format is the main focus of this Guide.

Other types of arrangements also may fall within the definition of "franchise agreement" under the Code. These include:

-  **Licensing or Manufacturing Franchise:** This type of arrangement involves the franchisor granting a licensee the right to use certain technology or "know how" to manufacture and distribute the franchisor's product. Unlike a business format franchise, the rights only extend to the licence of technology, designs, formulations or other intellectual property, not to a business model. This is common in the information technology industry, soft drink, cosmetics and automotive industries.
-  **Dealer Relationship:** Under this arrangement franchisees may be granted the right to distribute a manufacturer's product within a specified territory or at a specific location, generally with the use of the manufacturer's identifying name or trademark, in exchange for fees or royalties. A prime example is in the motor vehicle industry, mobile phones (eg Telstra shops) and business equipment stores. These relationships are clearly caught by the Code.
-  **Distributorship:** This type of arrangement involves the franchisee acting as a wholesaler of the franchisor's products within a defined territory. This is only likely to be a franchise if it carries with it the right to use a trade mark or name. This is found in instances such as petrol, food services, confectionery, computer software and building industries.
-  **Agency Arrangements:** This type of arrangement can involve wholesaling or retailing, often within an identified territory. Agents provide products and services on behalf of the franchisor to the franchisor's customers. Examples include post offices, the TAB, Australia Post, banks and car rental companies. These arrangements may or may not fall within the definition of a Franchise Agreement under the Code.

2. THE FRANCHISOR – FRANCHISEE RELATIONSHIP

Business format franchising requires an ongoing relationship between the franchisor and franchisee. This relationship includes the product, service and trademark, as well as the entire business concept from marketing strategy, operational standards and systems, to training, quality control and ongoing assistance and guidance.

The business format relationship confers benefits to both parties. The franchisee, normally a small business, benefits from marketing, expertise and established business systems that it could not otherwise afford, and at lower risk. For its part, the franchisor is able to expand its market presence without eroding its own capital, and ensure that the reputation associated with its name and trademark is protected, as a result of being able to control the way the business operates.

The relationship between franchisor and franchisee is a legal one, with the obligations and responsibilities of the parties outlined in a detailed franchise agreement. By the nature of the relationship, the agreement will favour the franchisor, as they must retain control of standards vital to the continued success of the franchise. Moreover, the franchisee is buying into an already established and successful enterprise, and thus generally has less bargaining power.

Maintaining Standards Through the Franchise Agreement

The franchisee owns their own business, however may only operate it in accordance with the terms of their agreement with the franchisor. These terms are vital, as they define and protect the quality of the products or services provided by the franchisee to the consumer. A poor performing franchisee can have an adverse effect, not only on their own business, but indirectly on the whole of the franchise chain and other franchisees. The franchisor therefore imposes standards and demands that they are to be maintained, via the franchise agreement, for the benefit of all franchisees. Franchisees accept that control in return for the advantages of their association with the franchisor, other franchisees and the system.

This regulation of standards is not intended to stifle entrepreneurship and innovation at franchisee level. In fact many marketing, product or service innovations existing in major franchises are the result of ideas generated by franchisees. Most franchisors encourage their franchisees to contribute to the development of the business.

3. BUYING A FRANCHISE

In Australia today there is a franchise operating in almost every type of business category, with varying levels of complexity and cost.

Prior to buying a franchise, potential franchisees should consider the following;

- ☞ Their reasons for wanting to own a business;
- ☞ Assess the lifestyle and income implications of owning and operating a franchised business as opposed to an independent business;
- ☞ Assess the franchise opportunities consistent with 1 and 2 above;
- ☞ Understand the nature of a franchise relationship;
- ☞ Narrow the search to a few franchises, then request further information;
- ☞ Select the franchise system with which they are most comfortable before commencing the application process;
- ☞ Ensure adequate borrowing capacity, including working capital, to successfully establish this type of business;
- ☞ Evaluate all disclosure material during the application process;
- ☞ Seek legal and accounting advice from lawyers and accountants with franchise experience before making any final commitment; and
- ☞ Use the cooling-off period to check information before final commitment.

This is not an exhaustive list to consider however consideration of these issues will lead to a more informed decision.

Costs & Fees

Franchises can range in price from up front franchise fees and set-up costs as little as \$5,000 to as much as \$1 million or more. Typically, franchisees are also required to pay ongoing fees for franchise support in the nature of a royalty, which may be a fixed monthly amount, or calculated as a percentage of turnover on a margin charged by the franchisor on the supply of goods or services. Fixed monthly amounts may range from \$50-\$\$\$ per month, while percentage royalty fees may range from 2% up to 15% with the average royalty falling in the range of 5% to 10%. A further fixed or percentage of turnover fee, may be charged to cover the costs of group marketing and this can be in the range of 2% to 4%.

If Possible, Deal with FCA Members

A franchisee should enquire whether a franchisor is a member of the Franchise Council of Australia. FCA Members commit to following FCA's Code of Conduct in addition to the Federal Government's Franchising Code of Conduct.. This increases protection to franchisees from unscrupulous operators.

The Membership List can be viewed on the FCA website at www.franchise.org.au, or phone your FCA state office. Wisewould Mahoney Lawyers are a member of the FCA and you can view our link at the following address:

http://www.franchisebusiness.com.au/Service/Wisewoulds-Lawyers_40126

4. WEIGH UP THE ADVANTAGES & DISADVANTAGES OF FRANCHISING

Like any course of action, there are pros and cons to consider, including how well-suited they are to being self-employed.

Advantages of Franchising

There are countless benefits to becoming a franchisee, which is why franchising is one of the fastest-growing sectors of the Australian economy. These include:

- ☞ The franchisee's lack of business experience or specialised knowledge is overcome by the training program and systems available by the franchisor.
- ☞ The franchisee has the incentive of owning their own business with the additional benefit of continuing support and assistance from the franchisor. This provides the opportunity through hard work and effort to maximise the return from their business and the value of their investment.
- ☞ Often the franchisee's business benefits from operating under a name and image with an already well-established reputation. Of course, there will be new franchises whose name will not yet be well known. Buying into a young franchise may eventually generate greater rewards than buying into an established one, and for a cheaper start-up cost, but the risks are likely to be greater and that potential may take time to be realised.
- ☞ The franchisee will usually need less capital than they would if they were setting up a business independently as the franchisor, through their pilot operations and experience, will have eliminated unnecessary expense.
- ☞ The franchisor provides the franchisee with a range of services calculated to ensure, so far as possible, the franchisees success. These services include:
 - Identifying and assessment of suitable sites or, if the franchise is based upon a mobile operation, the area of such operation;
 - Assistance in complying with planning laws, preparation of plans for fitout and assistance in stock mix and levels;
 - The training of the franchisee and their staff in the operation of the business format and the provision of an operational manual;
 - The training of the franchisee and staff in any methods of manufacture and preparation which may be appropriate;
 - The training of the franchisee in methods of accounting, business controls, systems management, marketing and promotion and merchandising;
 - The purchase of suitable equipment (if necessary);
 - Avenues of finance for the establishment of the business. Some franchisors may even negotiate better rates of finance, or more favourable conditions for franchisees with financial institutions; and
 - Opening store promotions.
- ☞ The franchisee receives the benefit of promotion of the franchised system. It is usual for franchisee to make contribution to a promotional fund for this purpose.
- ☞ The franchisee benefits from the bulk purchasing power and negotiating capacity of the franchisor by reason of the size of the franchised network.
- ☞ The franchisee has access to the specialised knowledge and experience of the franchisor's head office organisation while remaining self-employed in their business.

- ☞ The franchisee's business risk is greatly reduced because they are under the umbrella of a franchisor. Despite this however, a franchised business, like all others, involves some risk. To be successful, the franchisee will still need to work hard and drive its own business utilizing the benefits of the system.
- ☞ The franchisee has access to field staff of the franchisor who are there to assist with problems that may arise from time to time in the course of business.
- ☞ The franchisee has the benefit of access to the franchisor's patents, trade marks, copyrights, trade secrets, and any secret processes.
- ☞ Franchisees benefit from the franchisor's ongoing and development programs, which are designed to improve the business and keep it up-to-date and competitive.
- ☞ The franchisor provides a knowledge base developed from their own experience, as well as that of all franchisees in the system, which would otherwise be impossible for a non-franchised business to access.
- ☞ There are often territorial guarantees protecting a franchisee from competition from the franchisor and other franchisees within their territory and in the case of a mobile franchise, a defined area of operation.
- ☞ Lending institutions are now recognising the success rate of franchised systems.
- ☞ A franchisee can always speak to their franchisor or a fellow franchisee to discuss their business challenges or problems – sometimes this is via a formal forum, or meetings or annual events.

Disadvantages of Franchising

- ☞ The franchisor-franchisee relationship involves the imposition of controls that regulate the quality of the service or products provided by franchisees.
- ☞ The franchisee pays the franchisor fees for the services provided and for the use of the system, i.e. the initial franchise fee and continuing franchise fees. The franchisor therefore needs to see a return of its investment.
- ☞ It may be difficult for potential franchisees to assess the quality of a franchisor. For example:
 - The franchisor's offer of a business-format package may not amount to what it appears to be on the surface; or
 - The franchisor may be unable to provide ongoing support services which the franchisee requires and expects to sustain their business.
- ☞ The franchise agreement may contain restrictions against the sale or transfer of the business. This inhibits the franchisee's ability to deal with their own business. The reason for these terms is that the franchisor will wish to maintain some control and approve the incoming franchisee.
- ☞ In practice, there is normally little difficulty in assigning the franchised business. Some agreements provide for the payment of fees to the franchisor to cover the costs of dealing with applications and training the replacement franchisee.
- ☞ The franchisee may become dependent on the franchisor and fail to produce the effort required to make the business succeed. Some franchisees believe that the franchisor has a duty to ensure that it has a flow of customers, and to provide a day-to-day involvement. However, this is inconsistent with the concept of franchising.
- ☞ The franchisor's policies may affect the franchisee's profitability. For example, the franchisor may wish to see the franchisee build a higher turnover, whilst the franchisee

may be more concerned with increasing his profit, which does not necessarily occur from increased turnover.

- ❏ The franchisor may make mistakes in their policies. They may make decisions for the business which turn out to be unsuccessful and detrimental to the franchisee. Franchisors should test innovation in their own company-owned outlets or be able to demonstrate their cost-effectiveness before introducing them.
- ❏ The name and brand image of the franchised business may become less reputable for reasons beyond the franchisee's control, such as the behaviour of another franchisee or of the franchisor, which in turn may reflect on the franchised system.

5. LAWS REGULATING FRANCHISING IN AUSTRALIA


Franchising in Australia has been regulated by the Franchising Code of Conduct since 1 July 1998, which is administered by the Australian Competition and Consumer Commission (ACCC). The most recent amendments to Code commence on 1 March 2008.





The Code provides for a number of clauses which act to protect franchisees, perhaps in recognition of the fact that the franchisor-franchisee relationship is skewed in favour of franchisors. This includes the following protective mechanisms:


- ☞ Mandatory disclosure of information from the franchisor, including financial details, directors' interests, franchisee list, and litigation information;
- ☞ Seven-day cooling-off period after signing the contract; and
- ☞ Recourse to mediation in the event of a dispute.

Below is a brief summary of the provisions of the Code which act to safeguard the rights of franchisees:

- ☞ **Clause 6B:** Provides that franchisors must give a current disclosure document to prospective franchisees or franchisees proposing to renew or extend the scope of a franchise agreement.
- ☞ **Clause 7:** Provides that a disclosure document must be set out in the form set out in Annexure 1 or 2 as the case requires. The Annexures (Part 4 of the Code) specify the precise form that a Disclosure Statement must take, and the information that must be contained therein.
- ☞ **Clause 10:** Provides that franchisors must give a copy of the Code and a disclosure document to prospective franchisees along with a copy of the franchise agreement at least 14 days before they enter a franchise agreement or make a non-refundable payment to the franchisor.
- ☞ **Clause 11(1):** Provides that the franchisor must not enter into, renew or extend a franchise agreement or receive a non-refundable payment under a franchise agreement unless the franchisor has received from the franchisee or prospective franchisee a written statement that they have received, read and had a reasonable opportunity to understand the disclosure document and the Code.
- ☞ **Clause 11(2):** States that before a franchise agreement is entered into, a franchisor must have received signed statement from the franchisee indicating that they have been given advice about the proposed franchise agreement or business, by either an independent legal adviser, business adviser, or accountant, or alternatively a statement that they have been told to seek such advice but have decided not to seek it.
- ☞ **Clause 13:** Provides that franchisees may terminate a franchise agreement within seven days after the earlier of entering into the agreement or making any payment under the agreement.
- ☞ **Clause 14:** States that if a franchisee leases the franchised business premises from the franchisor, the franchisor must within one month give the franchisee a copy of the agreement to lease, or a copy of the lease.
- ☞ **Clause 16:** Provides that a franchise agreement cannot contain, or require a franchisee to sign, a release of the franchisor from liability towards the franchisee or a waiver of any verbal or written representation made by the franchisor.

-  **Clause 18:** Lists a range of matters that must be contained in a disclosure document, or otherwise disclosed by the franchisor in writing within a reasonable time (no more than 14 days) after becoming aware of it. These matters include:

 - a change in majority ownership or control of the franchisor;
 - proceedings, judgments, or awards issued against the franchisor or a director of the franchisor;
 - civil proceedings in Australia against the franchisor by franchisees;
 - the franchisor becoming an externally-administered body corporate; and
 - changes in the intellectual property that is material to the franchise system or ownership or control of the intellectual property.
-  **Clause 20:** States that a request for a franchisor's consent to a transfer of a franchise is to be made in writing, and that a franchisor cannot unreasonably withhold their consent.
-  **Clause 21:** Where a franchisor proposes to terminate a franchise agreement due to a breach by the franchisee, they must give the franchisee reasonable notice of that intention, and must inform the franchisee of how they can remedy the breach. The franchisor must allow the franchisee a reasonable time to remedy the breach, although they do not have to allow more than 30 days. If the breach is remedied in that time the franchisor cannot terminate the franchise agreement as previously intended.
-  **Clause 22:** Provides that if a franchisor proposes to terminate a franchise arrangement in accordance with the franchise agreement where the franchisee has not breached the agreement the franchisor must first give the franchisee reasonable written notice of the proposed termination and the reasons for it.
-  **Clause 23:** Provides for special circumstances under which the franchisor can terminate the franchise agreement. They include where the franchisee:

 - no longer holds a licence that they need to operate the franchised business;
 - becomes bankrupt, insolvent under administration or an externally-administered body corporate;
 - voluntarily abandons the franchised business or the franchise relationship;
 - is convicted of a serious offence;
 - operates the franchised business in a way that endangers public health or safety;
 - is fraudulent in connection with the operation of the franchised business; or
 - agrees to termination of the franchise agreement.
-  **Clauses 25-30A:** Sets out the mediation procedures to be used in the event of a dispute between franchisor and franchisee.

A prospective franchisee should read the Code prior to buying a franchise in order to understand their rights.

6. FACTORS TO CONSIDER BEFORE PURCHASING A FRANCHISE

The position of the franchise in the market in which it trades is a vital consideration. You should not only look at the particular franchised business in relation to its own activities, but also assess the prospects for the industry of which it is a part.

Listed below are various considerations which should help in making an assessment:

- ☞ Is the franchise based on a proven concept that works? If it is a successful franchise newly imported from overseas, will it hold a similar appeal in the Australian market? Has it been tested in Australia?
- ☞ Does the franchise have staying power, or is it exploiting a fad or current trend which is transient and short-lived? Are the products/services vulnerable to shift in market demand or new technologies?
- ☞ How competitive is the market for the particular products/services? Is it in a market area which is in growth or decline?
- ☞ Does it appear that the system is growing or has it reached maturity? A newer franchise has higher risk but potentially may have greater reward getting into ground level. A long-established franchise has less risk but consider the return.
- ☞ Do the franchisor's products/services have a distinct advantage over their competitors' products/services, for example by having a novel or distinctive element which distinguishes it from other similar and competitive businesses?
- ☞ How reliable is the franchisor's experience? Did they have an established and successful business which was operating for some years prior to franchising it?
- ☞ Has the franchisor developed a system with proper marketing, training and support personnel? Or are they effectively a "one man band" giving you a licence to use a logo and not much else?
- ☞ What do existing franchisees say about their franchisor? Do they have commitment to the products/services? Are they comfortable with the terms and arrangements and do they obtaining the right franchisor support? Do they feel part of a successful team?
- ☞ Are you prepared to adopt work in and promote the franchise system rather than trying to change it? Remember that you are buying an established system.
- ☞ Are you simply buying yourself a job? That's fine if that is your goal and expectations.
- ☞ How competitive is the price at which the products/services are to be offered? Can this be maintained?
- ☞ If the franchise involves a retail site, how suitable is the site? Is it an A-grade site?
- ☞ Are the products/services associated with a distinctive trade mark? Are the products/services patented or is there an exclusive process? Are alternative sources of products/materials of comparable quality and price available?
- ☞ What is the reputation of the product, service or process?

- ❏ Does the franchisor have their lines of supply of product/services secure or are there alternative sources for their product/services? How certain is it that supply will be available for the future? What is the reputation of the supplier?

Make sure that the business model has been tested for a sufficient period of time for you to be satisfied that the market really exists and has long-term prospects.

Above all, get good advice from a franchise specialist.

7. CONTACT INFORMATION

For Specialist Franchising Legal Advice contact **Wisewould Mahony Lawyers:**



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