



WOULD YOU LIKE FRANCHISE WITH THAT?

Franchising

Introduction

Think retail, think services, think fast food outlets, think cars, think furniture, think home loans.

Think franchising.

Wander around Chadstone or Southland and spot how many businesses are now franchised stores.

KFC, Pizza Hut, McDonalds, Subway, 71, Forty Winks, Captain Snooze, Oz Design, Boost Juice, Brumby's, Bakers Delights, Muffin Breaks, Donut King, Fluid Drive, Pedders, Mr Muffler, Kwik Kopy, Snap Printing, Fernwood Fitness Centres, Jetset, Mortgage Choice.....and on it goes servicing every need of the consumer.

It is now one of the most proven and successful models to develop and promote a business system.

What is franchising?

Franchising is a business relationship in which the franchisor assigns to independent parties, (the franchisee), the right to market and distribute the franchisors goods or service and to use the franchisor business name for a fixed period of time.

The International Franchise Association defines 'franchising' as a "continuing relationship in which the franchisor provides a licenced privilege to do business, plus assistance in organising training, merchandising and management in return for a consideration from the franchisee".

The licensing relationship can involve:

- i) a **manufacturing licence** where a franchisor sells an essential component or ingredient to the franchisee who then produces the final product e.g. Coca Cola bottling; or

- ii) a **product franchise** where the franchisee acts as a distributor or retailer in a dealership such as automotive retailers and petrol resellers; or
- iii) a **business format franchise** where the franchisee is entitled to use the complete package developed by the franchisor. The business format franchise is the most rapidly growing area of franchising.

The Regulation

Franchising in Australia is regulated. A mandatory industry code was implemented under Section 51AD of the Trade Practices Act which commenced on the 1st July 1998.

The Act was then amended by the Trade Practices Industry's Code Franchising Amendment Regulations 2001 which commenced on the 1st October 2001.

The Code provides mandatory disclosure via a disclosure document of 23 categories of information to existing and prospective franchisees, mediation for disputes, and a cooling-off period, among many other things.

The Code of Conduct must be provided to each franchisee with a Disclosure document by a Franchisor not less than 7 days prior to entering into a franchise agreement. Disclosure documents need to be carefully prepared in order to ensure that all relevant and material disclosures have been made by the franchisor under the Code.

What Business Arrangements does the Code Cover?

A Franchising Agreement is defined in the Trade Practices Act as follows:

1. An agreement:
 - a) that takes the form, in whole or part, of any of the following:
 - i) written;
 - ii) oral; or
 - iii) implied;
 - b) in which a person (***the franchisor***) grants to another person (***the franchisee***) the right to carry on the business of offering, supplying or

distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and

- c) under which the operation of the business will be substantially or materially associated with a trade mark, advertising or a commercial symbol;
 - i) owned, used or licensed by the franchisor or an associate of the franchisor; or
 - ii) specified by the franchisor or an associate of the franchisor; and
- d) under which, before starting business or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including, for example:
 - i) an initial capital investment fee; or
 - ii) a payment for goods or services; or
 - iii) a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or
 - iv) a training fee or training school fee;

but excluding:

- v) payment for goods and services at or below their usual wholesale price; or
- vi) repayment by the franchisee of a loan from the franchisor; or
- vii) payment of the usual wholesale price for goods taken on consignment; or
- viii) payment at market value for purchase or lease of real property, fixtures, equipment or supplies needed to start business or to continue business under the franchise agreement.

2. For the purposes of subclause 1, each of the following is taken to be a franchise agreement:

- a) a transfer, renewal or extension of a franchise agreement;
 - b) a motor vehicle dealership agreement.
3. However, the following do not of themselves constitute a franchise agreement:
- a) an employer and employee relationship;
 - b) a partnership relationship;
 - c) a landlord and tenant relationship;
 - d) a mortgagor and mortgagee relationship;
 - e) a lender and borrower relationship;
 - f) the relationship between the members of a co-operative that is registered, incorporated or formed under any of the Co-operatives Acts in each State on the Corporations Law.

Why Choose Franchising?

Benefits for the franchisor

Typically a franchisor is an entrepreneur who wants to rapidly expand a successful business model or brand that has been proven.

Franchising allows fast expansion and rapid market penetration. The capital costs of growth are reduced due to the franchisees payment of franchise fees which provide capital to the franchisor to support and maintain the system.

However, there is now a tendency to charge a smaller franchise fee as franchisors recognise that they require their own capital resource to support and expand the system.

The franchisor takes advantage of bulk buying and achieves faster market recognition from group advertising and the distinctive appearance of the franchised outlets using the franchisor's branding.

Franchisees effectively own their own operation and therefore deliver a high level of commitment and motivation which leads to higher sales through franchise outlets than can be achieved through company owned outlets operated by employees.

Benefits for the franchisee

It reduces the high risk of business failure often caused by lack of experience, training, insufficient management and/or marketing skills and establishing a business with insufficient capital.

The franchisor provides a proven product or service, a depth of management, marketing skills and support and hopefully an existing market acceptance of the product.

The day a new franchise opens their doors, there should be a ready market for the product.

The Franchise Relationship

Franchising is however a complex relationship and there are risks.

There are three essential elements for a successful franchise:

1. A sound proven initial concept.
2. Adequate funding of the franchisors business with appropriate and proven operating systems and controls.
3. An ongoing positive relationship with franchisees, based on stable and efficient management principles with mutual gain to benefit the franchisor and the franchisee.

The Ones that Fail

Franchised business fail for a number of reasons including:

1. The business concept is not sufficiently "new" or "innovative".
2. The business is based on a fad or trend which does not have a long term market.
3. The franchisor is undercapitalized and using it as means of financing his own business expansions (this is a short term growth as against long term substantive growth). They may rely on the franchise fees for maintaining the franchisor's structure.

4. The franchisor attempts to expand the business rapidly and leaves insufficient market demand to support all franchisees i.e. sells too many territories or franchisees.
5. The franchisor fails to allow sufficient time to establish a market appearance and acceptance for its product or service.
6. The franchisor fails to provide a “package of services” to a franchisee including a number of elements such as:
 - i) appropriate site selection and analysis;
 - ii) a detailed operations manual;
 - iii) a training program;
 - iv) store design and selection;
 - v) purchasing, advertising;
 - vi) promotional support;
 - vii) merchandise selection and assistance;
 - viii) accounting and financial systems advice and in some cases financial assistance to establish and operate a franchise.

All of these components are necessary for there to be a successful business model.

The Franchising Code

The concept of a franchise is quite simple - an association in business that operates to a common business plan under a common “banner” or “mark”.

It can be subject to stringent regulation by the franchisor, an extreme example being the recent **Community Bank** models under the Bendigo Bank which allow for independent communities to establish a public listed company operating under the Bank’s Reserve Bank Licence which is tightly and strictly controlled; or alternatively it can be as simple as the grant of a licence allowing use of a name for payment of a fee.

The Code provides a number of minimum requirements, for example:

1. A cooling-off period – A franchisee may terminate an agreement within 7 days of entering into it or paying any money and receive a refund.
2. Where a franchisee is to occupy premises, supplied or controlled by the franchisor, the franchisor must provide the franchisee with all documentation i.e. licence agreements or leases or sub-leases.
3. Certain provisions cannot be included in a franchise agreement:
 - i) A franchisor cannot require a franchisee to sign a general release from liability to absolve the franchisor from illegal or unconscionable actions.
 - ii) A franchisor cannot induce franchisees to form an association with other franchisees, or prevent franchisees from forming an association.
4. Where there is a marketing fund, franchisors must audit the marketing fund that franchisees contribute to.
5. Franchisors must not unreasonably withhold consent to a transfer of a franchise.
6. A franchisor must follow a set procedure when terminating a franchise agreement, depending on the circumstances as set out in the Code.
7. A franchisor must not enter into a franchise agreement until it has received written statements from the franchisee stating the franchisee has received independent legal and financial advice as to the franchised business.
8. All franchise agreements entered into after 1 October 1998 must contain a Dispute Resolution clause in accordance with the Code. This provides a system of mediation that can be followed at either parties request. The parties are not however compelled to use the methods contained in the Code rather, they may opt to use that method if they believe it will provide the best outcome.

Disclosure under the Code

The most important aspect of the Code is the requirement of compulsory disclosure. Franchisors must provide a Disclosure Document to all franchisees:-

- i) At least 14 days before a prospective franchisee enters into a franchise agreement or pays any money to the franchisor.
- ii) At least 14 days before renewal or extension of an existing agreement.
- iii) Within 14 days of a request by a current franchisee for a copy.

Failure to do so is a breach of the Code. It may also render the Franchise Agreement unenforceable as against the franchisee. The franchisor may not at a later date sue for unpaid fees.

The Disclosure Document itself must follow a set format contained in the Code. It needs to be amended by Franchisors once a year and within three months of the end of the Franchisors financial year.

A franchisor must notify franchisees within 60 days:

- a) If there is change in ownership of the franchisor;
- b) If the franchisor is sued for breach of the franchise agreement under the Trade Practices Act or the Corporations Law;
- c) If judgment by a Court is made that the franchisor has entered into unfair contracts with sub-contractors;
- d) Where a franchisor is being sued by 10% or 10 in number, whichever is the lesser, of franchisees;
- e) Where there is order by a Court to pay money to another party and that money is not paid for at least 28 days (an amount of at least \$100,000.00 for small proprietary companies and \$1,000,000.00 for any other company);
- f) Where the franchisor commits an act of bankruptcy or insolvency.

Disclosure Requirements of Franchisees

Where there is a transfer of a franchise the outgoing franchisee must provide a disclosure document to the incoming franchisee. This is a short form disclosure document. At the same time a franchisee must also provide a copy of the existing franchise agreement and a copy of any relevant lease or licence agreement to the new franchisee.

Breach of the Franchise Code

Section 51AD of the Act states that Corporations must not contravene an applicable industry code.

A breach of the Code constitutes a breach of the Act. Therefore all of the remedies available under the Act are available to both franchisors and franchisees, whereas previously a breach of an agreement would probably only give rise to action for a breach of contract with the remedy being damages. It is now possible to seek other remedies where payment of damages does not of itself provide an adequate remedy.

These can include:

1. Injunction - an order stating that a person or company must or must not undertake certain actions.
2. Undertakings given to the ACCC to cease certain actions.
3. Corrective advertising.
4. The Court is given a wide discretion to make any other orders it feels are appropriate.

The severity of an order made by a Court will depend on the severity of the breach. A simple failure by a franchisor to provide a disclosure document within 14 days will not necessarily lead to damages. Conversely a gross failure to comply with the Code may result in punitive damages as a penalty against the defendant.

The Code is part of a broad spectrum of provisions and there are other provisions that can be relied on in respect to misleading representations, unconscionable conduct and unfair trade practices such as exclusive dealing, price fixing etc.

Recent Cases

1. *The Federal Court made declarations by consent that a Newcastle based business was in fact a franchising scheme and its franchises were accordingly protected by the Code. The ACCC alleged that the directors had tried to characterise the operation as a licensing arrangement and thereby denied franchisees certain rights.*

The ACCC alleged that Synergy in Business Pty Ltd (in liquidation) had advertised throughout Australia to sign up consultants. It then entered into licence deeds with these people to promote and sell Synergy's small business training and development program, known as the Best Practice Program.

The court was satisfied that more than 30 licence deeds, sold for between \$19,000 and \$24,000 each, were franchise agreements.

The ACCC alleged that Synergy specifically attempted to exclude the licence arrangement from being characterized as a franchise by including a clause in the licence contract to that effect and by making oral representations to prospective licencees to that effect. By posing as a licensor Synergy failed to provide franchisees with disclosure information and did not afford licencees reasonable opportunity to obtain independent advice.

The court also declared by consent that the company directors were knowingly concerned in misleading and deceptive conduct in breach of sections 52 and 59(2) of the Trade Practices Act in relation to future profit projection of \$100,000 plus per annum promoting its "Best Practice Program".

The court ordered the directors to:

- Inform the franchisees of full particulars of the court's findings;*
 - Disclose the existence of the proceedings to any prospective purchaser of any franchise in which the directors are involved over the next three years; and*
 - Implement a trade practice compliance program if they become in any way concerned with the business of promoting or selling franchises within the next three years.*
- 2. Lawson's Trading offered for sale, by way of licence and supply agreements, the opportunity to take part in a business system involving the application of sprayed polyurethane protective coatings known as "Armour Linings" commonly found in utilities, trucks and vans.*

Although Lawson's Trading claimed the licence and supply agreements offered did not constitute a franchise operation, the ACCC was of the view that the agreements were, in fact, properly characterized as franchise agreements and that Lawson's had contravened the Code.

Similar orders to those in the Synergy matter were made but including an order for refund of the purchase price to the franchisees.

The intended effect of the Code is to provide obligations of compulsory disclosure of information to franchisees. In this way franchisees can make informed decisions and hopefully this leads to less litigation. It is also aimed to protect small business in their dealings with big business, therefore the provisions with regard to unconscionable conduct and prohibiting certain conduct is intended to stamp out certain behaviours perceived to exist in the industry.

Does the Disclosure Regime Work?

Although there are obvious benefits to franchisees, it has had the effect that some franchisors have simply decided not to comply with the Code due to the cost of compliance. This can be anywhere from \$20,000.00 to \$50,000.00.

Some franchisors still tend to take a very dominant position in dealing with franchisees.

Also, some franchisors only disclose the bare minimum information and a number are reluctant to provide any financial information such as expected profit or turnover of the franchise and actual turnover of the franchisor, for fear that it may lead to allegations of misrepresentation.

Further the requirements of the Code have led to an increase in the volume of documentation required.

A disclosure document may now contain over 20 documents including franchise agreements, disclosure documents, licence agreements, guarantees, acknowledgments and certificates. These costs are inevitably passed on to the franchisee as part of the cost for establishing a system.

By following the provisions of the Code a franchisor can be reasonably assured that they have taken reasonable steps to treat the franchisee fairly.

Franchisors should always insist that franchisees receive independent legal advice and provide appropriate certificates to that effect.

The Franchise Agreement

The agreement is a binding legal agreement between the franchisor and franchisee which sets out the nature and extent of the franchise relationship.

The agreement will outline the franchisees rights and obligations to ensure the corporate image and identity of the systems are maintained. It sets out the financial aspects of the relationship and mechanisms to enforce the franchisors rights against a defaulting franchisee.

Where prior disclosure documentation has been supplied any warranties or statements contained in the documents which are considered to be important to a franchisee should be repeated in the agreement together with any financial projections.

The nature of the rights given and the term of the agreement should be clearly expressed e.g. does it include use of name, logos, trademarks and other intellectual property.

It may provide for confidential information and ongoing training and management.

It may grant exclusive or non-exclusive rights to the franchisee.

It will stipulate the site or territory granted. This can raise issues as to whether the franchisor has competing rights within the territory, such as whether there are restrictions on other franchisees and/or the franchisor in competing with the franchisee within the territory and whether there is a right of the franchisor to appoint additional franchisees within the territory.

Other Related Issues to Consider In Reviewing a Franchise – Planning/Licence Regulations

Does the business require particular planning approval and special licenses to operate e.g. obligations to obtain food handling certificates and liquor licensing courses to operate under the Food Act and Liquor Licenses Act.

It is not uncommon for franchisors to take a head-lease securing the rights in the event of a franchisee defaults and granting a licence or sub-lease to the franchisee.

In these cases the consent of the head-landlord is required. This brings in issues of Disclosure under the Retail Leases Act 2003 which effectively now covers the lease of business premises where the total occupancy costs are less than \$1 million and the business is involved in the retail provision of goods and services. This could be the subject of a paper all by itself. Wisewoulds Lawyers have specialised knowledge and considerable experience in retail and commercial leasing.

Due to tax treatment there is little benefit in a franchisor seeking a large upfront franchise fee, as it is treated a capital receipt and therefore non deductible to a franchisor. It is also non deductible to a franchisee as a capital expense and is not treated as a revenue deductible expense.

Commercially however franchisors will seek a substantial upfront franchisee fee with ongoing royalty payments.

Other fees that should be considered, to ascertain the true cost of a franchise to the franchisee are contributions to advertising and promotional funds.

The Agreement Term and Renewal

Where the agreement clearly expresses a term of i.e. ten years, the Court will uphold the right of the franchisor at the end of that period to terminate the agreement.

There is no automatic right to renewal unless it is specifically stated. Therefore it is important to ensure there are adequate option terms and the basis upon which they can be exercised is reasonable. Other issues to consider on renewal are:

- Is there a renewal fee chargeable?
- Does it relate to a fixed sum or formula?

If the franchise term is for a shorter period and there is a renewal after five years is the renewal fee nominal?

Ownership of Goodwill

There is an issue as to whether a franchisee owns "goodwill" or effectively the goodwill remains with the franchisor.

It is the fact that successful franchisees who are part of a successful system have been able to sell their franchise for a substantial gain. This has particularly occurred in the food franchises such as KFC and McDonald's where stores sell from between \$1 million to \$2 million. That said, there are just as many at the other end of the spectrum where at the end of the franchised term the franchisee has nothing to sell.

The franchisee is required to remove any association with the franchisor, hand in the keys and is restrained from competing in the territory in a similar business. In those circumstances there is no or little goodwill to sell as the association with the franchisor and the name has ended.

Industrial Property Issues

The agreement will provide for rights to use of franchisors trademarks, logos and other industrial property.

The agreement should provide a warranty by the franchisor that it holds such rights.

Some agreements may provide that the franchisee is entitled to be registered as a registered user of the mark where there is a master franchise granted.

In Australia this allows the master franchisee to effectively hold those rights and licence them to individual franchisees within the territory. Where there is no master franchise the franchisor will reserve those rights and simply grant a licence to use the intellectual property.

Performance Criteria

The agreement will generally provide conditions in relation to certain performance criteria for a franchisee in terms of gross sales, stock ordering, growth or other assessment. Annual targets may be set.

Trade Practices Issues

- Stock – Section 46 of the Trade Practices Act prohibits a franchisor supplying goods and services to a franchisee, from stipulating that a condition of supply is that the franchisee cannot, or cannot to a limited, extent acquire goods or services from a competitor.

- Section 47 is a provision which prevents exclusive dealing however it allows exclusive dealing where there is not a “substantial lessening” of competition. Exclusive supply is often a crucial aspect to the franchise system where the franchisor supplies the product to certain formulas or specifications.
- It appears that the Trade Practices Commission is of the view that the tying of a purchaser to the supply of items essential to the uniformity and quality of a system is acceptable, however arrangements tying supply for non essential or ancillary items is not acceptable.
- Factors to consider here are the definition of what is the relevant market, what percentage of the market is affected by the exclusive dealing restriction, the length of time of the exclusive dealing arrangement, the extent of the territory, any restriction on the franchisees freedom to change to another supplier and the general consequence to the public of the exclusive dealing arrangement.
- The agreement should make provision for a franchisee to seek alternate supply in times of shortage.

Stock and Product

- The franchise agreement may also provide a requirement for a minimum amount of inventory, display, payment terms or and responsibility for freight and insurance and product sale conditions.
- The manner of product sale and service can be regulated, however price fixing or resale price maintenance is prohibited. Price fixing for limited special promotions is for practical purposes is the only limited exception.
- A franchisor is not entitled to withhold supply to force a franchisee to sell goods or services at a recommended price. A franchisor using a price list which is understood to be a “minimum price” under which a franchisee is not entitled to sell, is caught by the legislation.
- Section 49 prohibits price discrimination between goods of a similar grade and quality. Effectively a franchisor can supply price costing information and rely on franchisees not to price cut for volume sales.

- A franchisor cannot afford even to suggest that the recommendations are minimum prices.

The agreement should not make any provision requiring compliance by franchisees with the franchisor's pricing policy as that would be a breach of the Act.

The franchise agreement will generally cover many other issues such as:

- i) advertising, promotions;
- ii) ongoing service;
- iii) compliance with the corporate image and identity;
- iv) uniforms;
- v) accounting and reporting requirements;
- vi) training of employees;
- vii) compliance with operating manuals;
- viii) maintenance of relevant insurances issues relating to guarantees and warranties;
- ix) supply of products and services;
- x) confidentiality provisions;
- xi) assignment provisions;
- xii) the grounds for termination;
- xiii) consequence upon termination; and
- xiv) and restrictive covenants.

In relation to restrictive covenants, reasonably drawn restrictive covenants are enforceable against delinquent franchisees. Restrictions against a franchisee after termination of a franchise for a period of between 12 months to 3 years within the territory, are generally considered reasonable.

Your Legal Advisors Role

A competent and experienced franchise lawyer will put themselves into the shoes of a prospective franchisee.

A good legal advisor will not be afraid to tell a client that the franchise is not all what it appears to be. Actively dissuading a client from proceeding with a franchise where there are very real concerns will save a client from unnecessary further cost and possible grief.

At the end of the day there is always risk and clients must make their own decisions. Our role is to ensure that clients make an informed decision and where possible we can negotiate some concessions if appropriate.

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