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## **Franchising**

### **A summary of issues Franchisees should consider**

#### **What is Franchising ?**

- It essentially involves an arrangement between a Franchisor and a Franchisee whereby the Franchisor's knowledge, reputation, procedures, intellectual property and access to its good and /or service is licensed to a Franchisee.
- The Franchisor also offers training, guidance, advice and assistance with marketing in relation to the franchised business.
- In return the Franchisee pays certain fees and royalties to the Franchisor and agrees to comply with certain obligations typically set out in a Franchise Agreement and Operations Manual.
- Many well known brands have utilised the franchising concept, such as: McDonalds, Dymocks, Gloria Jeans, Subway, Pizza Hut, The Coffee Club – there are many more.

#### **How do you know the business venture you are entering into is a Franchise ?**

- Franchising in Australia is regulated through the Trade Practices (Industry Codes — Franchising) Regulations 1998, known as the Franchising Code of Conduct.
- The Code applies to all agreements which satisfy the definition of a franchise agreement set out in the Code. There are essentially four (4) elements which must all be satisfied:
  - (a) is there an agreement ? – this could be in writing, oral or implied (although in most cases it is written);
  - (b) does the business incorporate the right to supply or distribute goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by another ?;
  - (c) will the business be substantially or materially associated with a trade mark, advertising or a commercial symbol of another ?;

(d) before starting the business or continuing the business, is there a requirement to pay to another person an amount of money by way of, 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 ? – clause 4(1)(d)

- Note: there are some exclusions under the Code as to amounts that can be taken into account.
- There are also certain other exclusions under the Code.
- So, if the criteria above is met any agreement you enter into (even if it is called a License) will be considered a franchise agreement and accordingly the Code will apply, which in turn will place certain statutory obligations and give certain rights in respect of the Franchisor and Franchisee.

### **What are some of the Advantages of Franchising ?**

- As the Franchisor's system is already functioning and typically proven there is less risk adopting that system as compared to a start - up business;
- Because the franchise system has a consistency of service and product across its franchisees, customers know what to expect;
- The size of a franchising network allows an increased brand presence and market penetration;
- Access to the know-how, procedures, training, management skills and assistance of the Franchisor helps the Franchisee to better operate and grow the franchised business – the Franchisee has someone to fall back on for advice;
- The Franchisor's greater purchasing power with supplier's may result in rebates and savings for the Franchisee;
- A successful franchised business is more likely to attract purchasers of that business in the event the Franchisee wishes to sell as opposed to a non-franchised business;
- Franchising in Australia is regulated – there is in addition to mandatory disclosure obligations, both a dispute resolution process under the Code and a complaints mechanism through the Australian Competition & Consumer Commission (ACCC).

### **What are some of the disadvantages of Franchising ?**

- Restrictions as set out in the Franchise Agreement and Operations Manual in relation to the way the business is operated. For example, only dealing with Franchisor approved suppliers; operating within a defined Territory; etc
- Commitment to pay fees and royalties to the Franchisor on an ongoing basis;

- Where a premises lease is involved you a Franchisee maybe required to not only pay for initial fitout costs but there maybe additional costs in the future to refurbish the Premises to meet the Franchisor's new or updated shop layout;
- Poor performance by other franchisees can impact on the reputation of the whole franchise system and thereby adversely impact on your franchised business;
- Lack of communications/assistance or poor management of the Franchisor can adversely impact on your franchised business;
- The Franchise Agreement is limited to a term in years – you may not be able to renew that term;
- Default under the Franchise Agreement can lead to your franchise being terminated.

### **What are some of the commercial considerations ?**

- As with any business or investment there are risks involved and careful consideration and due diligence needs to be undertaken. There are a variety of ingredients that go into making a successful franchise, these include for example:
  - (a) how long has the Franchisor operated the franchise system ?;
  - (b) is the Franchisor well known or do they have a good reputation ?;
  - (c) is the franchise system proven and does the system have a history of being profitable?;
  - (d) are there already in place a number of franchisees whom have been in operation for some years ?;
  - (e) is the Franchisor willing to give you the contact details of its existing franchisees so you can canvass their views of the system directly ?;
  - (f) do you have skills, education and experience in the industry relevant to the franchised business ? If not, how thorough is the training that is going to be provided by the Franchisor ?;
  - (g) do you have sufficient capital ?;
  - (h) is the Franchisor prepared to give you financial information to assist you to budget for income, liabilities and profit ?. In particular, will the Franchisor release the income/profitability statements of franchisees in similar territories to the territory you are acquiring ?;
  - (i) have you sought appropriate advice from a lawyer, accountant, business adviser and/or insurance broker ?;
  - (j) have you prepared a Business Plan ?;
  - (k) have you considered the commitment in hours needed to successfully operate the franchised business ?;
  - (l) have you sufficiently researched the franchise system, the Franchisor and the market in which the products/services are sold ? For example, is the product likely to be affected by seasonal fluctuations ?;
  - (m) have you researched the Territory which you are interested in acquiring ?. Demographics and spending habits in one territory may differ from another. Have you considered engaging the services of a demographer to assist you with this aspect ?;
  - (n) do you have the personality to deal with a Franchisor and comply with restrictions on your business management which may be imposed under the Franchise Agreement and Operations Manual ?;

- (o) have you considered whether you will fit in with the culture of the franchised system and Franchisor ?;
- (p) have you completed a SWOT analysis ?

Note: some of the answers to these questions will be set out in the Franchisor Disclosure Document.

**If I do enter into a Franchise Agreement is there a cooling off period?**

- Yes, under the Code a Franchisee may terminate a Franchise Agreement within 7 days after the earlier of:
  - (a) entering into the agreement; or
  - (b) making any payment under the Agreement.
- Note: The above does not apply to the renewal, extension or transfer of an existing Franchise Agreement.

**If I do terminate within the cooling off period do I get a refund of money I may already have paid to the Franchisor ?**

- If the Franchisee terminates during the cooling off period, the Franchisor must, within 14 days, return all payments made by the Franchisee to the Franchisor under the agreement.
- However, the Franchisor may deduct from the amount paid, the Franchisor's reasonable expenses if the expenses or their method of calculation have been set out in the Franchise Agreement.

**I have heard of the term “Churning” – what does it mean?**

- In this situation a franchised business fails, the Franchisor gets rid of the existing Franchisee and either buys it back itself and then re-sells or just re-sells. The problem is this cycle repeats itself over and over again. A franchised business that is being sold over and over is a sign of either poor management of the Franchisor in not getting the right Franchisee, a deliberate strategy of the Franchisor just to increase profits, the target market or demographic for the franchised business in that territory not matching up with the product/service, or some other reason for poor performance. Do your due diligence and don't get caught.

**What other issues should I consider?**

- Make sure the term of any premises lease you enter into correlates with the term of the Franchise Agreement.
- If there is a provision in the premises lease allowing the Lessor to relocate the premises within a Centre, make sure the Franchise Agreement also allows for the potential for relocation.
- There is no obligation set out in the Code requiring the Franchisor to offer an option or renewal term within a Franchise Agreement. Accordingly, if you require

an option term then you need to make sure provision is made for this within the Franchise Agreement.

- In addition to the Franchisor's obligations under the Code, the *Trade Practices Act 1974* (and the State Fair Trading legislation) provide broader consumer protection mechanisms such as in relation to misleading & deceptive conduct, false representations or unconscionable conduct and the like.
- Make sure the Franchise Agreement is clear as to what are the Franchisee's expected performance obligations.
- You should ideally obtain and review the Operations Manual and any related manuals prior to entering into the Franchise Agreement. At the very least before the cooling off period expires in case there is material in those manuals adverse to you.
- Make sure that your territory is exclusive and large enough geographically so that franchisees with adjacent territories do not encroach on your territory.
- Make sure the Franchise Agreement does not allow the Franchisor to sell directly into your territory in competition with you.
- Make sure you undertake proper due diligence, read the Disclosure Document, contact existing franchisees and gauge their opinion of the franchise system. Ultimately it is your risk and if proper due diligence is not undertaken you may lose not only the franchised business but risk bankruptcy or liquidation if the business fails.

## **Conclusion**

- There are a number of issues relevant to franchising. We have addressed a few above. To minimise your risk we encourage you to undertake as much due diligence as you can and seek professional advice.
- Quinn & Scattini has extensive experience within the franchising industry. We also can provide you with a breadth of advice in a number of other practice areas complimentary to franchising.
- We highly recommend you contact one of our franchising lawyers to get appropriate advice before entering into any Franchise Agreement.

Please contact Ray Duffy if you have a franchising query on (07) 5499 3622 during office hours: Monday to Friday 8:00 am to 5.30 pm.