



# Franchising

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## ***What is a Franchise?***

“Franchise” is a loose term that embraces many forms of business activity. Franchising is a system of cloning a business. A franchise is a local operation of a business that operates from many sites.

The essence of a franchise is an agreement between the local operator, “*the franchisee*” and the controlling body of all such operations, “*the franchisor*”.

The controlling body may be based regionally, national or international

Tiered structures are common where the franchise system owner (for instance a national body) authorises one group (for instance a set of companies one for each state ) to manage the business operations of the franchise system by franchisees in particular territories (for instance a set of franchisees within a particular state ).

## ***What types of franchises Are There?***

There are three main categories of franchise.

1. Product and trade name franchises; Product and trade name franchises are arrangements where franchisees are granted the right to distribute a manufacturer's product within a specified territory or at a particular location, using the manufacturer's trade mark or trade name, in exchange for fees or royalties. Petrol stations are a prime example of this.
2. Manufacturing and production franchises A process or manufacturing franchise is an arrangement where a franchisor provides an essential ingredient or know-how to a processor or manufacturer. Franchises of this nature are common, for instance, in the soft-drink industry.
3. Business format or system franchises; Business format or system franchises add an extra layer, through the imposition of a business format or an entire system for running a business, including a business plan, management system, location, appearance, image, and quality of goods and services.

In a business format franchise, each franchised outlet or business should look and act the same. It should provide an identical product or service of identical quality. While each is independently owned and operated, this should make

no difference to what the customer receives. McDonalds' hamburgers should taste the same wherever you buy them.

The defining characteristics of a business format franchise are:

- The ownership by the franchisor of a name and trade mark, an idea, a secret process or a piece of equipment, and the goodwill and know-how that is associated with it.
- The grant of a licence (the franchise) by the franchisor to another person (the franchisee) permitting the franchisee to exploit this.
- The inclusion in the franchise agreement (and elsewhere such as a manual) of regulations and controls relating to the way the franchisee exploits its rights.
- Payment by the franchisee to the franchisor for the right to operate the franchise. This can take various forms, such as a royalty on turnover, or a surcharge for the product supplied by the franchise.
- Provision of trading and support by the franchisor to the franchisee to enable the franchisee to carry on its business according to the franchisor's system.

### ***What are the Advantages and disadvantages of franchises?***

A franchise system develops and expands the coverage of a franchisor's business and trade name without the need for the franchisor to find the capital or directly operate the individual business.

Franchises who are inexperienced in business are often attracted by ready access to a business system with a developed brand and expertise on call.

Franchises do not suit everyone.

Strict conformity with their franchisor's prescribed methods can be stifling to some franchisees who believe they can "do it better".

The franchisee must be prepared to work in conformity with the franchise system, otherwise the franchise system will be weakened by a series of the franchisees each "doing their own thing". This is not to say that the franchise system cannot change and be improved. One of the roles of the franchisor is to constantly add value to the system by bringing in innovation and improvement in methods and strengthening the brand, but this must be done consistently throughout the franchise network.

The franchise system and the franchise agreement maintain a level of control over what happens in those businesses, but the franchisor is at arm's length

from the operation. The franchisor needs to manage and deal with the relationships with franchisees who run independent businesses.

### ***Are Franchises Safer than other Businesses?***

The risk of business failure is significantly less where a business is conducted through a franchising structure. The survival rates for small business without franchise support is as low as one third. The survival rate for franchises has been assessed as greater than 75%.

It is no coincidence that the failure rate for start-up franchised businesses is much lower than it is for non-franchised start-up businesses. A franchise operator carrying on business with a recognised brand name and proven business system should be less likely to fail than an independent operator. Pooled advertising and bulk buying gives the franchise operator advantages over the independent. The franchisee has the advantages of hopefully a proven business system and the accumulated knowledge and experience of the franchising company. The new business does not have to learn by its own mistakes.

### ***Are some Franchises safer than others?***

A prospective franchise operator needs to take extra care when dealing with a new franchisor rather than a franchisor having a large and long established system. The franchise operator depends on the franchisor to remain in business in the long term. It is harder to predict long term success with a new franchisor than with an established and successful franchisor.

### ***What is a good business to franchise?***

Not all businesses make successful franchises.

A franchise needs to be something that is durable, and not a fleeting fad. A single-product franchise is a risky venture because that product may become obsolete.

A franchise system needs to have been thoroughly tested and proved in practice to be successful. The business also needs to have a distinctive name, branding, image as well as well-developed systems and methods of operation. Without this sort of distinctiveness, it has nothing to differentiate it from an ordinary business, or attract franchisees.

Franchisors need to make sure that the system and business methods can be transferred to others and are not dependent upon a particular person. A franchise system dependent on one person may be at risk of collapse if that person leaves. The franchise must be profitable.

Franchisees should not just buy themselves a job. Returns should earn more than a basic wage to be a profitable business.

### ***What does a Franchise Cost?***

In addition to the business set-up costs such as fitting out of shop and buying equipment, uniforms, vehicles and so on, an initial franchise fee is typically payable by the franchisee as the key to access into the franchise business including the system and the trade marks.

There will also be on-going fees such as royalties on turnover and advertising levies.

Some franchise systems make their money from collecting up-front fees, and rely far less on royalties.

Beware of under capitalisation by both the franchisor and franchisee. Franchises who over extend themselves to get into the business may not have enough funds to survive the early lean times or a crisis. Similarly, a franchise network can fail, if its continuation is dependent on the sale of franchises, and insufficient investment is returned to the system from the royalties remitted by franchisees.

### ***What is the nature of the Franchise Relationship?***

A franchise is based on the relationship between the franchisor and franchisee and the foundation of that relationship is the franchise contract.

The relationship between a franchisor and franchisee is a continuing one, in which each party is reliant on the other for their respective businesses to succeed.

The franchise relationship is one which requires mutual trust and confidence between the parties. It is a relationship which cannot work effectively if supported only by the bare bones of the franchise agreement. In this respect it is similar to a partnership agreement. Inevitably a franchise agreement

cannot have the precision of an agreement such as a mortgage or lease which is based on a more narrow relationship. Inevitably a franchise agreement is broad in operation and contains some imprecision.

The franchisor also has contracts and relationships with a number of other franchisees. The franchisee can be seriously affected by the health of the relationship between the franchisor and its other franchisees. A group of disgruntled franchisees can damage the health of the franchise network, and have a seriously adverse affect on the successful operation of other franchises.

### ***What is in the Franchise Agreement?***

There is no standard franchise agreement. Each agreement is unique.

Some business agreements are standardised in nature such as a typical bank mortgage or a typical guarantee. It is more important to understand the nature of such a document than the specific individual terms. This is not the case with a franchise. You need to read and understand each paragraph, each sentence of the franchise documents. There is no substitute for careful reading of the franchise documents. Note any sections you do not understand and discuss them with your lawyer.

Often a definitive statement of rights and obligations under a franchise is not possible because the agreement is broad and opened ended. To some extent that is inevitable considering the broad open ended nature of the franchise relationship.

### ***How Does The Franchise Agreement Work?***

Franchise agreements are usually very comprehensive and cover a wide range.

The franchise agreement is both the linchpin of the franchise network and the framework for the setting up of the franchisee's business.

Unsurprisingly they are heavily weighted in the franchisor's favour, and are not readily negotiable for individual franchisees, consistency being a primary requirement for a successful franchise network. The franchise agreement specifies the franchisee's obligation to:

- conduct the business,
- protect the franchisor's intellectual property,
- pay royalties.

The franchise agreement specifies the franchisor's obligation to:

- protect the brand,
- provide assistance, advice, training and consultation, and
- promote good relationships between franchisees.

The franchise agreement will also have an regulate:

- advertising,
- transfers,
- termination,
- dispute resolution.

Usually the franchisee must regularly provide the franchisor with detailed reports.

Sometimes the franchisor may own the lease or site of the business, or have a right of first refusal on an assignment in the event that a franchisor wishes to cease trading.

Besides the franchise agreement there may be other documents involved in a franchise:

- Disclosure documents .
- Manuals: these contain the instructions to a franchisee on how the franchised business is to operate. The operations manual for the franchise should provide a detailed "bible" for the day to day operation of the franchise business.
- Confidentiality agreements: these should be signed before a prospective franchisee has a look at the internal workings of a franchise system otherwise there is a risk of the franchisee picking up the knowledge of the franchisor and instead of signing up for a franchise, starting up his own independent business.
- Lease documents.
- Fit-out Contracts.

### ***Who are you Dealing with?***

The success of a franchisee's operation will be intimately connected with the success of the franchisor. If the franchisor's business is unsound your business is equally unsound.

If the franchisor fails or becomes insolvent the franchisee business will also fail. You need to carefully assess the franchisor.

The franchisee needs a detailed knowledge of the prospective franchise.



As far as possible, the franchisee should verify the representations made by the franchise operator.

One of the best sources of information about a franchise system is the existing and former franchisee. Speak in depth to existing operators under the franchise system.

Carefully review disclosure documents which gives details of the franchise system and the franchisor. In consultation with accounting advisers check the accounting statements of the franchisor.

### ***Who Owns Goodwill in a Franchise?***

An independent operator can do what he likes with his own business. The business and its good will is his to deal with as he likes. Any good will you develop in the franchise operation can only be exploited and disposed of in accordance with the franchise system.

Does the franchisor have a right of first refusal if you should wish to assign or sell the business. Usually even if the right of first refusal is not exercised the purchaser is subject to approval by the Franchisor. Often the assignment if approved is subject to an administration fee in favour of the Franchisor and in addition all costs of the Franchisor on the transfer.

Review any the restrictive covenant in the agreement

### ***Who owns the Intellectual Property?***

You need to be sure that all intellectual property which relates to the business is dealt with in the franchise agreement. You need to be sure you have the right to use all necessary business assets of the franchise whether those assets are a registered business name, a trademark or a piece of unique equipment.

Tierney Law have a separate booklet that explains general matters of Intellectual Property.

Trade marks are a key element of a franchise system. The franchisor's trade name is crucial to the strength of franchise and franchisees should expect these to be properly registered and looked after, and defended from encroachment by other traders. Trade marks should preferably be registered.

The possibility of expansion overseas should figure in the calculations. Too often franchisors have failed to secure trade mark rights in those countries where they later want to expand, and find to their dismay there is a small local outlet in the way of the expansion of the franchise network and have to re-brand.

Regulation of the business name is critical. Franchisees may want to own a separate name for use in conjunction with the Franchise name to give them exit opportunities independent of the franchise. The franchise agreement may as part of the regulation use of business names, prohibit use of alternate names .

There is usually copyright in manuals. If these are not written by the franchisor there may need to be an assignment of copyright to the franchisor. There can be copyright in logos and designs, in store fit-outs and in architectural drawings. It is crucial for the franchisor to have control of these rights. Sometimes an architect or designer may retain copyright ownership by spelling this out in the small type or even on the drawings themselves. When the franchisor wants to replicate the design elsewhere it may find it cannot do so without further payment.

The overall branding and get-up of a franchise can be protected by the Fair Trading Act and passing off (and to some extent copyright).

Confidential information protects business methods. Franchisors are likely to discuss a franchise with a prospect in detail only after there is a signed confidentiality agreement in case a prospective franchisee may elect not to buy a franchise but steal ideas to set up its own business.

Franchise manuals are typically marked as confidential and lent to the franchisee, to be returned at the end of the franchise, with no copies made.

There may also be issues relating to protection and licensing of patents and designs, depending upon the particular type of franchise.

### ***What is the Term of Your Rights and Commitments?***

A franchise is a long term commitment. You need to be satisfied that the franchise business has an equally long life span. You need to consider whether the term granted in the franchise document is sufficiently long for you to recoup your investment. That investment is not only the initial costs of the franchise but also establishing yourself in the franchise.

## *Is Franchising regulated?*

The basic law governing franchising is the law of contract.

The standard laws apply to franchises, particularly relevant laws include the trade practices Act and the Fair Trading Act.

The Franchising Code is special law regulating franchises requiring minimum standards of operation. For information on the Code refer to the Franchisee Manual published by the ACCC.

<http://www.accc.gov.au/content/index.phtml/itemId/795322>

## **Questions for franchisees – checklist**

- What are the rights of the parties when the franchise agreement expires?
- How can the franchise be terminated?
- What post termination restrictions are there?
- Can you sell the franchise and under what conditions?
- Can either party bring the commitment to a premature end?
- Can the franchisor takeover the operation just as it becomes successful?
- Are either parties bound with trading restrictions after the agreement ends?
- Does the agreement grant you a franchise territory of the area?
- How is it defined?
- Is it an exclusive territory?
- Does the franchisor have the right to grant other franchises within this area?

### Must you:

- pay any ingoing franchise or administration fee?
- pay a regular part ongoing fee such as a percentage of your gross turnover?
- increase your prices as directed?
- pay the legal fees of the Franchisor?
- pay interest on sums overdue?

### Can the Franchisor:

- appoint a receiver to take control of your business in the event of a breach by you.?
- take action on your behalf to carry out matters you are obliged to do?
- What is the cooling off period ?
- What training will be available from the franchisor?
- Is training is compulsory?
- What will be the cost, location and duration of the training.

This booklet is not a complete statement of the law. It does not deal comprehensively with your particular situation.

This booklet is to provide general information to supplement our specific advice to you.

Do not act in reliance on this booklet without our specific advice.

We are responsible only if you give us specific instructions and for the specific advice we give.

This booklet was originally prepared in 1995 and has been updated as at the 30<sup>th</sup> August 2012.

It does not reflect changes to the law after that date.

You need to take specific advice on the possibility or effect of any such changes.