

## **A Franchisors Guide for 2020 and beyond**

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## Purpose of this guide

This is a guide for those considering establishing a franchise system.

It covers many of the issues that need to be considered, however it is not exhaustive, and you should always seek specialist advice from a **Franchise Law Specialist**.

**MMRB** are members of the Franchise Council of Australia (**FCA**) and the International Franchise Lawyers Association (**IFLA**) with a network of International Franchise Lawyers around the world.

We are regular contributors and thought leaders in the sector and know what is happening legally and commercially from our active involvement acting for Overseas Companies, Franchisors, Franchisees and in Dispute resolution, mediations and all levels of Court.

## **What is a Franchise?**

Franchising is a means of marketing and distributing goods and services.

It is an extremely successful and entrenched part of Australia's small business sector but also highly regulated under the national Franchise Code and Australian Consumer Laws (ACL).

There are strict mandatory obligations' of disclosure and ongoing compliance for Franchisor's a breach of which, can mean fines and penalties on the company, its Directors and managers.

This guide raises key issues for anyone considering entering the world of franchising whether it is the right model for your business expansion.

We will always consider other models to expand such as Distribution, Licensing, Joint ventures Partnership's and equity raising while considering whether Franchising is the right model for you.

## **What is the definition of "Franchise Agreement"**

The term "Franchise Agreement" is defined in the Franchising Code of Conduct ("the Code"). If the model proposed ticks the boxes below the Code applies whether you call it a License or Distribution agreement.

The essential components that will determine if it is deemed a franchise arrangement are:

- (a) An **agreement** oral or in writing or implied (from the circumstances) in which a person grants another the right to carry on the business of offering, supplying or distributing goods or services in Australia;
- (b) **under a system or marketing plan** substantially determined, controlled or suggested by the franchisor (or an associate);

- (c) under which the business will be substantially or materially **associated with a trade mark**, advertising or a commercial symbol owned, used or licensed by the franchisor (or an associate) or specified by the them;
- (d) under which, the franchisee pays the franchisor (or an associate) an initial capital investment fee; and
- (e) there is a payment for goods or services; a fee based on a percentage of gross or net income, whether or not called a royalty or franchise service fee; or a training fee or training school fee.

### What is not a franchise?

It does however exclude a number of other relationships the main ones being an employer and employee, a partnership, landlord and tenant, mortgagor and mortgagee and members of a cooperative as well as genuine wholesaling arrangements.

### Elements of control

The more control you wish to have over your licensee or distributor the more likely it will be considered a franchise relationship.

If you want the other party to operate under your Brand, they undergo training, you provide an operation's manual, or they need to use approved suppliers and pay fees whether fixed weekly or monthly or a percentage on turnover it is more than likely to be a franchise.

The less control you have may mean that it falls outside the definition of a Franchise and therefore not regulated under the Code, although it will still be subject to Unfair Contracts Act provisions, the Australian Consumer Laws (**ACL**) and other laws that may apply to the business sector.

### Types of Franchises

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

- **The Business Format Franchise**

This is the most common where the franchisor uses a network of franchisees to market a service or product under a common name and standardised system for example, Boost Juice, 7-Eleven, Domino's under a comprehensive "system" including training and support, manuals, procedures, marketing programs, quality assurance systems.

- **Licensing or Manufacturing Rights**

This may be granting a licensee the right to use technology or "know how" to manufacture and distribute a product and the license may grant rights to technology, designs,

formulations or other intellectual property for example in IT, soft drink, cosmetics and automotive industries.

- **Dealer Relationship**

This is a right to distribute a manufacture's product within a specified territory or at a specific location generally under the manufacturer brand and trade mark, in exchange for fees or royalties examples being motor car dealers, Telco/mobile phones (e.g. Telstra stores). These relationships are clearly caught by the Code.

- **Distribution arrangements**

The appointed distributor may act as a wholesaler of the franchisor's products within a defined territory. This is only likely to be a franchise if the rights include or require the distributor to use a trade mark or name for example petrol, food services, confectionary, computer software and building industries. Not all distribution arrangements are caught as franchise arrangements under the Code.

- **Agency Arrangements**

This involves wholesaling or retailing, often within an identified territory. Agents offer products and services on behalf of the franchisor/supplier or importer to the franchisor's customers. These arrangements may or may not fall within the definition of a Franchise arrangement under the Code.

Step one therefore is to determine if the business model you propose to roll out to the market may be considered a franchise arrangement. If it is you must comply with the mandatory Code Australia wide.

## **The Steps to Franchising**

**Franchising is like building a house if you don't get the foundations right cracks will appear!**

- Get the corporate structure right from a legal and tax perspective;
- Protect your existing business from the risks of the Franchise model;
- Ensure your IP and Trademarks are registered for the brands/names you wish to License;
- Do your financial modelling for you and the Franchisee;
- Consider demographics and territory research - will you offer franchisees a Territory or just a site?
- Are your Operating manuals suitable for a franchise relationship? – your in-house company manuals won't be adequate;

- Get the Legal documentation right, before you go to market;
- How will you market and promote the franchise opportunity?

### **What most clients want to know!**

**How long does it take to Franchise?** - A realistic guideline is 8 to 12 weeks and up to 6 months dependant on complexity, financial modelling and demographic research.

**How much does it cost?** - Overall costs generally fall in the range of (low end) \$45,000 to (high end) \$80,000 dependant on complexity of the model and existing in-house resources.

**Now please read on!**

### **Why Franchise?**

Franchising is a well-established business model for expansion worldwide and Australia has embraced Franchising as a model for business expansion.

The many advantages include:

- The franchisees fund the setup cost of the new business reducing the capital required by a franchisor;
- faster market penetration than via company owned “organic” growth;
- development of a stronger brand and marketing;
- perceived sharing of risk;
- leveraging off highly motivated owner-operators;
- the ability to service marginal locations, through franchisees who have local industry knowledge and access;
- reduced middle management costs;
- increased marketing and buying power; and
- the ability to provide ongoing product and systems development.

### **What to consider before Franchising - Plan!**

#### **Basic Criteria**

- Is your existing business well established (at least two to three years of successful trading) and financially secure?
- Do you have sufficient capital to fund the cost of establishing a franchise system?
- Are you an effective communicator to motivate others?

- Are you willing to train, assist and support franchisees?
- have you formulated a detailed 3 to 5-year business plan?
- Can you delegate roles to others and deal with difficult and demanding individuals?
- Do you provide quality products and services with a distinctive public image difficult to imitate?
- Can you duplicate success and create profits?
- Do you have a management team to support franchisees?
- Does the business have systems and procedures to assist franchisees?
- Are you patient, non-reactive and able to manage people and personalities?

The above does not mean Franchising is the **right** model for you but it is a helpful guide.

*At MMRB we say having a dozen franchisees is likened to being a school teacher or parent - some of the kids play by the rules and are easy to deal with but ten percent will want to push the envelope and run amok doing their own thing -so you need to set clear boundaries and rules!*

You may have some of the skills needed but not all which is usually the case, so you may need to bring on key people to assist you in the set up of a franchise system.

**Running a franchise is completely different to running your own business.**

You become accountable to other parties who have rights and often will test the boundaries of the relationship. You can not treat them as you do employees.

### Why Franchisor's sometimes fail

Despite best intentions from over 35 years advising clients in the sector we have seen many franchise failures and advise many franchisees seeking to exit a failing system.

Here is some common theme we have seen for Franchisors failing:

- their products or services were not distinctive, inferior or a “fad” that had no longevity;
- they rushed out to market when they were **not ready**, without sufficient planning;
- their existing business was not sufficiently developed and systemised;
- they rolled out a system “**on the cheap**” because they had people busting to take up a franchise;

- they didn't "test" the market before going to the market – insufficient feasibility research or rolling out too late into a saturated market;
- launching without any proper operations and systems in place- **building the plane while it is flying is an Air Crash investigation!**
- Insufficient capital and resources to run their own business and at the same time support a franchise system;
- Promising big things but failing to deliver;
- Getting too personal or unprofessional:
- Poor communication;
- insufficient financial modelling of fees to charge the franchisee;
- insufficient financial modelling for the franchisee to ensure it is viable for them!

### Business planning

Most business plans provide financials that project a return on investment around 3 years. This should also apply to franchisees.

Franchisees should be able to draw a market salary for their efforts and get a return on their investment (ROI) after say, 2 years.

If the financials don't work for the franchisee then **don't offer a Franchise model** to avoid the risk of being held liable. You need to make the model work for the franchisee and if it does then the franchisor should do ok.

Unhappy Franchisees take up a lot of time and money and the ACCC is active in supporting small business operators in the Franchise sector.

The ACCC can impose and Federal Court can impose hefty fines and penalties against companies, director's and managers.

### Benefits of a Business Plan

The business plan will help you Identify the objectives and outcomes you want to achieve, how to get there and identify the financial viability of the model.

Your business plan should include:

- profit and loss projections for at least 3 years;
- cash flow statements for the first 3 years;
- an understanding of market, products and/or services;



- who your customers are;
- potential industry trends are in the future;
- the differentiation of your product and/or services from others in the market;

You should also consider external factors and Government regulations that may in the future impact on your business, the size of the market in Australia and market trends.

For overseas Franchisors and companies looking to enter the Australian market there are other issues to consider such as:

- differences between the States and Territories- Melbourne is very different to Brisbane as a market;
- where to launch first? should it be Brisbane, Sydney, Melbourne or Perth?
- rental costs and wage costs in Australia;
- the technology required;
- supplier issues;
- warranty or service issues.

Always consider what other distribution methods are available.

### Franchise Trends in 2020 and beyond

Since the Parliamentary Inquiry into the franchise sector this past year further changes are likely to be made in 2020.

Here are some things to consider:

- Franchisees expect more from their franchisors- by way of support, technology, product development, social media, marketing;
- Franchisees have many options - It is a Franchisee market- they have many choices;
- Franchisees have limited ability to borrow from the Banks on the equity of their home so Franchisor's need to lower the entry costs and offer terms or funding to good prospects;
- There is a greater expectation of sharing the risk if a franchise fails;
- Other models such as co ownership, JV's, partnership's and Branchise Models should be considered (see my article on **Branchising** and New corporate models);

- The ACCC will be even more active on Franchisor compliance, so Franchisors need to get Specialist advice and ensure their compliance to avoid damage to their Brand and reputation;
- Trends currently are for lower up-front entry costs with franchise fees between \$25,000 to \$45,000 plus training costs;
- Careful selection of your Franchisee is even more crucial as once they are in the system, they are difficult to exit.

### Develop a Pilot Program?

Testing the model through a pilot store using a friendly first franchisee, or an employee of the company can be a great way to test the model and avoid costly mistakes.

If it doesn't work, you can iron out the bugs far more easily in house but you cannot always run a pilot program so you need to be patient and do everything you can to ensure your first franchisees are happy and successful even if it means making concessions on fees or additional training at no cost.

### Legal Compliance

The Competition and Consumer Industry Codes – Franchising 2014 applies to all franchisors (as defined by the Code) and is administered by the Australian Competition and Consumer Commission (ACCC).

The Code provides protective mechanism to franchisees by requiring a franchisor to:

- Provide mandatory 14-day **disclosure period** with a disclosure document setting out Franchisor details, financial details, directors' interests, franchisee list and litigation information;
- a 7-day cooling off period after signing the contract; and
- recourse to mediation in the event of a dispute.

Franchisors and Franchisees **can not** waive these mandatory requirements.

Disclosure Documents can **attract or deter** a franchisee or their advisors, but they must be accurate, not misleading and disclose all matters material so a franchisee can make an informed decision.

There are tricks and traps in developing these disclosure documents.

Many a Franchisor has been hung on the information they supplied or failed to supply in their Disclosure documents and or marketing material when they prepared it in house or pinched it from another franchise off the internet!

Seeking Specialist advice reduces the risk of fines, penalties, litigation and a whole lot of heartache.

With the recent Parliamentary Inquiry recommendations which will come into play in 2020 there will be greater need to be compliant.

At the same time the ACCC has the power to impose increased fines and penalties on franchisors, directors and advisors for a failure to comply.

There is a myriad of other laws that need to be considered such as the Occupational Health and Safety Acts, Workplace Relations Act, Unfair Contracts Act and other State specific laws.

### Enforcement – The ACCC

The ACCC can bring civil action against a franchisor and prosecute its directors for breach of the *Competition and Consumer Act 2010* ("CCA").

Some recent cases include:

- Sensa Slim, Coverall, All phones, Refund Home loans – these franchisors were found to have made misleading and deceptive representations to prospective franchisees about the profitability of the system;
- Husqvarna failed to provide a disclosure document where they offered a 'licence' or distribution right which the ACCC found was actually a franchise, a clear breach of the Code;
- Ultra-Tune Australia- a whopping \$2million fine for failing to provide a meaningful marketing statement to franchisees;

The Franchisor and directors may also have to give court enforceable undertakings, refund franchise fees, provide compensation and undergo compliance training at their cost.

Breaches of the **anti-competitive conduct provisions** of the *Competition and Consumer Act 2010* can also attract fines of up to \$2 million for Corporations and up to \$1.1m for breach of the consumer protection provisions against directors, employees, agents and advisors of a corporation if they are "involved in a contravention".

## Competition and Consumer Compliance

Implementation of a Competition and Consumer compliance program is critical in reducing franchisor exposure to prosecution, fines and penalties and also influence the enforcement action sought to be taken by the ACCC.

Education and training of Franchisors employees limits the risk and are critical together with monitoring the implementation of policies and procedures.

The Australian Standard on Compliance Programs (AS3806) sets out guidelines for compliance programs developed by Standards Australia.

### Key Compliance issues to consider include:

There are a number of other issues to consider under the *Competition and Consumer Act 2010* relevant to franchisors:

- **Misleading and deceptive conduct:** which prohibits franchisors from using misrepresentations (such as exaggerated earnings information) to induce franchisees to enter into a franchise agreement;
- **Unconscionable conduct:** Section 21 prevent franchisors from dealing with franchisees in a way that they know to be harsh or oppressive in the circumstances;
- **Restraints of trade:** These provisions are only enforceable to the extent they are reasonable, so need to be carefully drafted and are now subject to further restrictions under the new Code;
- **Third Line Forcing** - is a form of exclusive dealing where the Franchisor will only supply the goods or services on the condition that the franchisee buys goods or services from a particular **third** party, or the Franchisor refuses to supply because the franchisee will not agree to that condition;
- **Exclusive dealing:** Section 47 may also prevent a franchisor from requiring a franchisee to take stock solely supplied by the franchisor, "mandatory warehousing" is prohibited if the conduct substantially lessens competition in the market;
- **Re-sale price maintenance:** Section 48 prohibits the franchisor from specifying a **minimum** price at which franchisees can sell their goods and services. This does not prevent franchisors from specifying a **recommended price** as long as that price is only a recommendation.

Officers of a franchisor company may be personally liable for the conduct of the company under the *Competition and Consumer Act 2010* and *Corporations Act*.

*Still thinking of franchising?*

**CONTACT:**

**Robert Toth | [rtoth@franchisedevelopments.com.au](mailto:rtoth@franchisedevelopments.com.au)**

**Accredited Commercial Law and Franchisee Specialist | Member of the Franchising Council  
of Australia (FCA) | Member of the International Franchise Lawyers  
Associations (IFLA)**

