

Let's pretend we are not a franchise

License -v- Franchise rights

There are many ways to commercialise and expand a business apart from the traditional sometimes tried, sometimes successful, sometimes disastrous models.

As a keen advocate of Edward De Bono – let's put our woolly thinking cap on and think outside the square!

Partnerships – Shareholders – Mergers & Acquisitions – Employee Incentive Schemes – Profit Share Schemes – Licensing – Franchising – Distribution... The options go on.

Which one is the right model for you?

You can look at self-funding growth or take the risk of bringing in new partners and equity investors accepting you will need to relinquish some ownership and control.

One essential difference in the models is the degree of control you may want or need. If you have a successful business and brand and want to expand at a more rapid rate, there are a number of options without giving up equity or taking on the risks of partnership.

You can grant a Licence, Franchise or appoint a Distributor or an Agent. Each model and the rights created by that relationship has advantages, disadvantages, risks and obligations.

You need to consider issues such as tax, liability and risk and seek advice from your lawyer and accountant as to the appropriate corporate structure. It requires a detailed understanding of your existing business, the proposed market, and developing a business plan and strategy. You need to involve your team of experienced advisors, legal and financial early in the development phase, to avoid delays and wasted costs.

We have seen over the years many clients spend thousands of dollars on a prepaid suite of franchise documents that are outdated, non-compliant or just plain poor in form and presentation. They are difficult documents for potential franchisees to read and understand, so the better they are presented in terms of format and plain language the easier for everyone.

Buying a suite of franchise documents for a fast food retail format franchise will not be suitable for a business to business service franchise model! The documents need to be tailored to the business model.

Why can't I just license the rights?

Clients often ask me or have developed a model which they call a License or distribution right and ask why they can't just offer a license, rather than a franchise right

They don't want to incur the costs to set up a franchise model.

Granted there is a big difference in the set-up costs.

A license agreement may cost in the range of \$3,000 to \$5,000 whereas a franchise suite of documents may cost between \$15,000 to \$20,000 depending on complexity and setting up a franchise system can be anywhere from \$40,000 to \$60,000 with operations manuals, corporate structures and financial analysis.

The dilemma:

The client would like to keep it simple, but at the same time they want to have control over their “licensee”.

If the License arrangement includes the provision of training, access to an operation’s manual, access to a system and a requirement to operate under the Licensors brand then it meets the criteria of a franchise arrangement under the mandatory Franchise Code.

Other indicators of a franchise relationship are where the Licensee must provide financial reports and where the Licensor charges a fee to the Licensee whether it is an upfront license fee, a margin on supply of products, a fixed monthly fee or a percentage of the Licensees revenue.

There are many arrangements that fall outside the Franchise Code but they involve less “control” of the Licensee. The Licensee is simply acquiring products or services it can resell in any way it chooses under its own business name.

Licensing:

A license is a contractual right granted by one party to another for a fixed term, for example it could be a license to use a party’s trademark, name or operating system or a license to supply or distribute a service or product.

There may be an upfront license fee payable.

An example of a license or simple contractual right is an occupancy license, a right often granted under franchise agreements which gives the franchisee a right to operate their business from a site where the franchisor holds the head lease. The Franchisor grants the license right to the franchisee with the Landlord’s consent.

The “Licensor” (party granting the rights) has to own or have its own License in the first place, or they with a right to sublicense to others.

The “Licensee” (party receiving the rights) only has the contractual rights set out in the agreement. They do not have any ownership, only a contractual right that can be terminated usually on notice or default.

Therefore, if the Licensee (say a Distributor) holding those rights has had to invest a substantial amount to set up its business for those rights, the risk lies heavily with them if it is terminated.

A license right generally does not build asset value or goodwill, as that is the nature of the right it is fleeting, in that it can be taken away, and there is usually an end date.

A license or even a distribution right may be deemed a franchise arrangement, by reason of the broad definition of a “franchise arrangement” under the Franchise Code, for the reasons stated above.

Summary:

- Granting a license may seem attractive, as it is less regulated than a franchise and less costly to establish, but a license will mean less control over the licensee.
- Less control means that the Licensee is not bound by the same obligations to follow a system provided by the Franchisor.
- The service delivery and operation of the business is solely in hands of the Licensee, not the Franchisor.
- If the Licensee performs poorly, it can impact the brand and cause reputation damage to the Licensor/Franchisor.

Therefore, if you want to control the standard of service or product to the end consumer and have the Licensee operate under your brand, then you would need to look at a franchise model.

A license right does not build value as an asset, as do Franchise rights.

There may be cases where granting a License is appropriate, but it needs to be carefully assessed.

Franchising:

A franchise right is effectively a contractual licensed right, but with additional obligations on the franchisee and rights and protections to the franchisor. The franchisor has a greater degree of control over its brand and system and the standard of product and service delivery to the end consumer.

A franchise right grants the franchisee not only a license to use the franchisor's operating business system, training and support but also its supply chain, buying power and its marketing or brand power.

The franchisor will usually have negotiated approved supplier agreements based on volume discounts or rebates.

In exchange for the grant of a franchise right the franchisee will usually pay the franchisor an upfront fee (franchise fee) and an ongoing royalty based on the franchisee's gross turnover, or sometimes a fixed fee, as well as other fees such as administration support, software license and marketing fees.

Therefore, the revenue stream for a Franchisor is generally much greater than for a licensor but at the same time the Franchisor is expected to deliver more to its franchisees.

A big advantage of a franchise model is that the franchisee funds the set up and capital costs to establish the business, not the franchisor. The franchisor can therefore expand its brand quickly and in areas where it might not otherwise have thought it could operate or reach for example interstate or overseas or regional areas where it would otherwise have to find and manage staff.

Franchisees also gain much more than a simple contractual right as they do under a license. The franchisor must also meet mandatory Franchise Code requirements for disclosure and there are restrictions on the franchisor's rights to terminate the franchise relationship.

Franchisees have additional protections under the Franchise Code to mediation, dispute resolution and under the Australian Consumer Laws.

Franchising rights can be exclusive or non-exclusive with rights granted to a territory or a site. Where they are not exclusive rights there may still be an exclusive marketing territory, in which the franchisor agrees not to compete nor allow other franchisees to compete.

The franchise agreement imposes greater obligations on the franchisee to ensure they adhere to the systems so that services to the end consumer are consistent and of unified standard. There may also be minimum performance criteria, imposed on a franchisee and consequences if they fail to meet them.

So, to be or not to be a Franchise?

The days are gone where companies can pretend to be something they are not. The fact remains it doesn't matter what you call the agreement. Articles

If it has the elements of a franchise relationship then the company will be bound to comply with the mandatory Franchise Code in Australia.

Whether it will be deemed a franchise arrangement will to a large degree depend on the degree of control and rights and obligations granted under the arrangement. For example, many license agreements and distribution arrangements incorporate and/or mirror many of the same obligations as a franchise and therefore will be caught under the Franchise Code.

A failure to comply with the mandatory Franchise Code in Australia since 1 January 2015 carries severe potential fines and penalties which may be imposed by the ACCC on the Company and individual directors and officers so if in doubt you should ensure compliance with the Franchise Code and seek expert advice.

Distribution rights:

A distributor buys goods from a supplier or manufacturer, takes title of them and sells the goods to another reseller, retailer or directly to consumers. The distributor is independent of the supplier and may distribute goods for a number of other suppliers and manufacturers. The supplier may appoint the distributor as its sole or exclusive or non-exclusive distributor for a country, area or region.

Under a distribution arrangement the distributor relies on the supplier's brand and may be given marketing collateral and assistance by the supplier to market the products, however the distributor ultimately is responsible to actively market and promote the goods or services.

A distributor often provides after sales, service and support to the end customer. Distributors generally add a margin to the price of the goods they purchase. Their costs are generally higher than an agent, as they usually carry and hold stock and extend credit to the reseller or retailer.

Distributors do not generally pay an initial fee or ongoing royalties to the supplier as the distributor will buy product and/or services at an agreed list price, on which it places a margin for on sale to consumers or retailers.

As we have said some distribution agreements may be deemed franchise arrangements under the Franchise Code.

Under the Australian Consumer Laws distributors may be liable to the reseller and/or the end consumer for statutory warranties as to fitness for purpose or for the supply of defective product.

Agency Agreements:

Agents are appointed to gain orders on behalf of their principal. The principal then generally delivers the goods directly to the end customer, and invoices the end customer directly. Unlike a distributor, the agents do not hold goods. They are generally appointed to seek out customers and promote the principal's products or services in a market.

Agents may act for more than one principal, on a nonexclusive basis or they may be appointed as a "sole agent" for a particular product in a market. Agents are paid either a commission on sales made, or an upfront retainer and part commission.

Unlike importers or distributors, agents do not take legal possession of goods and agents disclose they are acting as an agent for a named principal, to avoid direct liability.

Exclusive or non-exclusive rights:

- Many agents and distributors seek exclusivity in a market or territory as they will invest considerable money and their own resources to create the market;
- The stronger the brand the more value an exclusive right will have to them;
- Exclusivity usually carries with it greater obligations and responsibility and therefore usually the supplier may impose a minimum performance, and sales criteria, with termination rights for non-performance in exchange for exclusivity.
- The chosen representative, agent or distributor should have experience and understanding of the market, know the competition in the market and pricing, and advise the supplier on product modifications, necessary for local conditions.

- They should also have an established network and trading history and be enthusiastic and active in marketing and promoting the brand or product or services;
- It is important when granting any rights that enquiries and due diligence both financial, business experience and personal searches are conducted on the party that will be representing your company's interests.
- Once appointed, it is difficult to terminate these arrangements and considerable time, effort and cost goes into the process of appointing them.

Seeking expert legal advice to consider the right business model and ensure your compliance in the Australian market for local and overseas companies is now even more critical with the increased powers of the Australian Competition and Consumer Commission.

In summary if you are looking to commercialise your business opportunity, explore the options, consider the right model and get Specialist advice.

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