Understanding Franchising

TOWNSENDS BUSINESS & CORPORATE LAWYERS

What I need to know about...
Franchising

Franchising is the fastest growing business system in Australia today. It is therefore surprising that it is so poorly understood.

A franchise is the right granted by the franchisor to permit the franchisee to use the franchisor's logo and systems to market and operate a business which is owned by the franchisee.

The terms can be a bit confusing. The franchisor is the main business eg McDonalds Head Office, while the franchisee is the owner of the local business eg the McDonalds at, say, Hurstville.

The systems involved can be both marketing systems and operational systems. That is, systems relating not only on how to sell the product but also how to conduct the business to maximum advantage. For example, anyone who wants to own a McDonalds has to undergo substantial training in order to understand how the business works and how to make it a success. (They even have the Hamburger University in Chicago designed to train McDonalds owners).

Franchises must comply with the Franchising Code of Conduct which is a mandatory code of practice under the Australian Competition and Consumer Act.

The Code sets out certain minimum information that the franchisor must supply to a potential franchisee before being able to sign up a franchise. This has to be provided in a Disclosure Document regulated under the Code. There is also a minimum cooling-off period during which a franchisee can pull out.

The franchise agreement must include certain things set out in the Code.

A typical franchise agreement covers things like:

- the term
- the territory
- use of the logo
- standard of conduct of the franchise
- adherence to the franchise operational manual
- hours
- legal compliance
- staff conduct and uniforms

- franchise fee (up-front)
- royalty fees (periodical based on turnover)
- compulsory stock purchasing
- no selling of unauthorised goods
- training fees
- advertising levies
- equipment purchases
- issues regarding the premises from which the franchise is conducted
- financial record keeping
- operational record keeping
- display standards
- termination
- assignment
- sub-franchises
- no running other businesses
- sale of the franchise

The franchisor's main focus will (or at least should) be on:

- standardising arrangements so that all franchisees are on identical contracts
- ensuring the franchisee has enough experience, motivation, skill and training to successfully conduct the franchise
- complying with the Franchising Code
- drafting the franchise agreement so that it ensures the franchisee must conduct the franchise in a way that will maximise the chances of success
- recovering from the franchisee the franchise fee, royalties and other fees the franchisee must pay.

A franchisee not interested in these things is likely only interested in getting the upfront fee for the franchise and not offering the help that a franchise actually involves. These types of franchisors should be avoided.

The franchisee should focus on:

- understanding their rights and obligations
- investigating the market for the franchised product
- justifying the franchisor's fees
- ensuring that the term of the franchise is long enough to recover the franchise fee (that is, that the term of the franchise is long enough to enable the franchisee to make enough money from sales to recover the upfront franchise fee and a satisfactory profit as well).

What is often forgotten, especially in small franchises, is that it is (or at least should be) a team approach. Each of the franchisor and franchisee does well if the other does well.

For the franchisee the main risk is that the franchisor spends so much time and effort on selling new franchises (to get the large upfront franchise fees) that they have no time, resources, money or interest left to provide the marketing, training and support that they should be providing to their existing franchises. We hear all the time the constant complaint "the franchisor does nothing for me" or "the franchisor was no help at all".

For the franchisor the main risk is that they grant franchises to people who have the money to buy one but not the skill, enterprise, determination or work ethic you need to operate a successful franchise. The purchase of a franchise does not guarantee success – it is just the first step on the ladder to success. There's a lot of hard work still to go.

Franchisees can use our checklist for potential franchisees to assess the franchise. Be aware that the single most important thing a potential franchisee can do to assess a franchise is to contact as many of the existing franchisees as possible to find out how well (or badly) the franchisor treats their franchisees. There are plenty of horror stories in franchising – don't become the next one.