

Insulating Franchises from Business Failure

This document provides practical hints to insulate a franchise from business failure. Use sections 2 and 3 to test your franchise's preparedness to avoid, minimise and overcome threats that can lead to failure in franchising.

1. LEGAL FRAMEWORK

Franchise relationships are typically close and long term with inherent risk for both sides. They are inter-dependant commercially, managerially and legally.

The collaborative nature of franchises means that breach of relevant law by one franchisee or the franchisor can affect an entire franchise system. There can have a cascading affect ending with litigation, business failure, collapse of a franchise, insolvency, suits against guarantors and directors, and personal bankruptcy.

Before looking at specific areas of risk and how to minimise and manage them, it is useful to begin with a framework to understand franchising and law relevant to franchise relationships.

What is business system franchising?

In franchising the franchisor is usually the owner of a business system. It licenses the system to franchisees. The system usually contains key trade marks, names or symbols and a common marketing plan and process. It is usually mandatory for each franchisee to follow these and other elements of the system.

What body of law governs franchising?

At its core the specific franchise-nature of a franchise relationship is governed in Australia by:

- a **franchise agreement** (eg a head franchisee agreement or a master franchise agreement), hence the broad field of contract law; and
- a **mandatory industry code** - the Franchising Code of Conduct which requires disclosure documents to be created, maintained and distributed.

Around this core is other law which governs franchise relationships and affects what should be said or done. This includes the Trade Practices Act 1974 (Cth), Corporations Act 2001 (Cth), Bankruptcy Act 1966 (Cth), and state-based law such as the Industrial Relations Act 1996 (NSW)).

Reliance on compliance with third parties requirements

The health of a franchise is also dependant on compliance with the requirements of third parties by a franchisor and its franchisees. Bad publicity and legal problems can arise from non-compliance with the legal rights or requirements of a landlord or head lessor, broker or agent, Australian Tax Office, Office of State Revenue, creditors and the Australian Consumer and Competition Commission.

2. PRACTICAL HINTS

Set out below are practical hints on ways to minimise, avoid or resolve threats and disputes in the field of franchising. The hints are particularly relevant for franchisors.

2.1 Franchise Establishment - Set-up Stage

- Tested franchisor-owned outlets are recommended. It is difficult to franchise a business until there is a business to franchise. It is usually good advice to have a successful and profitable company-owned and operated business before a franchisee is signed up.
- Don't franchise too soon.
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- Seek good professional advice in franchising. Among the advisers that may or should be consulted are specialist franchising business consultants, graphic designers, economists, statisticians, HR consultants, compliance advisers, accountants, solicitors and bankers.
- Join the Franchise Council of Australia (FCA) and abide by the principles of the Franchising Code of Conduct.
- Conduct a legal audit (ie thorough legal review) of your circumstances and activities, including marketing collateral, advertising, website information, and brochures.
- Ensure the application form for prospective franchisees is comprehensive.
- Create an organisational culture that genuinely treats the franchise relationship as a partnering relationship, and franchisees as allies. For example, provide or refer franchisees to appropriate training courses.
- Ensure your documentation and business structure will help and not hinder you if ever you get into a serious dispute. Here consider the potential impact of insolvency. Think through which person or entity should own the franchise intellectual property or delivered but unsold products.
- Ensure the franchise will cope during recessions and local or regional economic or business downturns and changes in consumer styles, fashions, tastes and standards.
- Have processes for the early detection of grievances and complaints. Implement proper internal controls and conduct regular external reviews (eg by using an external facilitator) to identify, draw out and assess the unexpressed difficulties and concerns of franchisees.
- Consider introducing a franchise buy-back fund, so this option is available to remove problem franchise outlets, channels or disputes.

2.2 Franchisee Entry - Sign-up Stage

- Use a planned process to assess the suitability of a prospective franchisee. All parties should exercise diligence to establish a "best fit" for mutual benefit. Thorough risk assessment is needed. Never just rely on standard agreements, representations, or disclosure statements.
- Introduce a codified in-house franchisee selection technique and marketing guide. Set your franchisee criteria, and adhere to your processes and guidelines. Don't recruit franchisees just for the money. A person who has just received a large redundancy or superannuation payment may not have all it takes to operate a franchise successfully. If in doubt, don't sign up.
- Think and select carefully before using any broker or master franchisor to attract prospective franchisees. Their "selling statements", may expose the franchisor to liability for misrepresentations or non-disclosure.
- Do not let inexperienced or under-trained people recruit.
- Be very careful if any person in your organisation has a vested financial interest in recruiting franchisees, eg gets a commission per recruit.
- Have a proper procedure for choosing franchisees' locations, and preparing, opening and promoting them.
- Note that site or channel selection and continuing success is dependant on a number of external environment considerations and market dynamics.
- If a statement needs to be made, make it in writing. If you are not prepared to write it down, don't say it.
- Do not make projections, eg expected profits from a franchise, if they are in any way dependent on the performance of others or factors for which you do not have complete control.
- Be extremely careful in making any claim, promise or statement as to a future event, eg about future earnings potential. Ensure you can prove reasonable grounds exist for making the statement.
- Ensure you make and retain proper records so you can prove what was and was not said in discussions; as well as what was provided or offered (eg disclosures and training), when and how.
- Train franchisees in company owned outlets.
- Consider trial periods, even though they are not usual.

2.3 Franchise Operation - Ongoing Relationship Stage

- It seems most franchise disputes involve a failing regarding lines of communication, designated responsibilities for communications and the absence or weaknesses of a complaints system.
- Listen to franchisees. Communicate regularly with franchisees, eg using occasional reports, a regular newsletter, intranets or email broadcasts. Sort out their problems, real or imaginary. Help them improve and grow their businesses. Make franchisor management staff available, approachable and regularly out in the field.
- Communication is challenged when the franchisor is perceived to be arrogant, busy or simply not interested or the franchisee is perceived to be nagging, incompetent or simply not committed.
- Monitor legal compliance for the franchise agreement marketing and signature process, income tax, GST, Pay As You Go tax, superannuation, real property lease procedures, stamp duty, trade practices and other law.
- Honour your promises. Don't make promises that you may not be able to keep.

3. COMMON TROUBLE AREAS

The bullet points below set out common "trouble areas" - subjects for franchising complaints, grievances and disputes. How well does your franchise rate against each consideration?

3.1 Franchisor's Misrepresentations or Performance Shortfalls

- Turnover never achieved what was represented
- Expenses are greater than represented
- Site is in the wrong location
- Performance of inspection sites are not easily duplicated
- Poor franchise systems discovered after entry by the franchisee
- Franchisor neglects, cannot or lacks resources to provide day to day assistance with product/service, marketing or business development
- Breakdown in communication or lines of responsibility between franchisor's management staff and franchisees
- Franchisor changed commercial arrangements to the detriment of franchisees
- Franchisor provides insufficient or unsatisfactory training
- The rights, if any, of the franchisee to be consulted regarding advertising
- Advertising has no application to the site as advertising is regional or national
- New franchisee permitted too close to the territory of an existing franchisee
- Competition by franchisor's company outlets against franchisee businesses

3.2 Franchisee's Naivety or Performance Shortfalls

- Lack of courtesy or customer relationship management skills
- Recruitment shortfalls, eg lack of assessment of the relevance of the franchisee's age, training, capital, level of small business or similar business experience or appreciation of the hard work involved in retailing
- Failing to cope with change as the market or customer preferences shift
- Taking on too much, eg a master franchise role and one or more sites
- Franchisee failed or refused to comply with and stay committed to the system
- Lack of commitment to hard work
- Franchisee fails to meet performance targets

3.3 Both Parties - Lack of Adaptability or Back-up

- Slow or no response to competition or market dynamics - a product, location or style that may be "in" today may be unfashionable tomorrow
- National, regional or local economic downturn or shifts in preferences, tastes, fashions, styles or standards
- Site fails and franchisor refuses to share any of the loss or cost of relocation
- Retail shopping centre redevelopment adversely affects pedestrian traffic eg centre management requires relocation under the lease to a poorer site
- Franchisee gets ill or injured

4. RESOLVING FRANCHISE DISPUTES

According to Griffith University's Franchising Australia 2004 survey, about two percent of franchisees are involved in disputes with franchisors, with significantly more disputes being resolved through mediation than litigation (The Australian Financial Review, 20 January 2005, p. 44)

4.1 Dispute awareness and avoidance

Disputes in franchising can arise at any stage of a franchise relationship and can involve many types of legal allegations:

- at the early stage of the relationship (eg misrepresentation of details or of the promised overall outcome or non-compliance with disclosure obligations);
- during the relationship (eg unauthorised use of the franchise trade marks); or
- on termination of the relationship (eg non-performance or under-performance).

As practical advice, to minimise and resolve franchise disputes, do not turn a blind eye or delay action. Communicate. Proactively assess weaknesses, concerns, grievances and complaints before they become disputes. Put important matters in writing. Always try to be dispassionate and objective. Discuss and resolve disputes professionally. Remember the Franchising Code of Conduct sets out a mandatory process for dispute resolution.

4.2 Why mediation of a dispute may not be appropriate

Mediation is available via the Federal Government's Office of the Mediation Adviser and other sources. However, mediation, conciliation, arbitration, expert appraisal and other "alternatives" to litigation are not always appropriate. They may not be appropriate where what has taken place is theft, fraud, or breach of intellectual property or where one of the parties is on the verge of bankruptcy or corporate insolvency. Mediation may also be ineffective if there is unwillingness to mediate, despite statements to a court or other authorities to the contrary.

4.3 Third party involvement in disputes

Resolution can become complex the more parties become involved. In serious trade practices law disputes the ACCC may participate in a court case or institute one itself. In an insolvency situation the Australian Tax Office may take an approach quite different to that that may be desired by franchisees in the interest of a franchise. These factors emphasise the importance of legal compliance.

Dilanchian Franchising Solution

See **Solutions (Franchising) Brochure** for the Dilanchian franchising solution, which is designed to build your big picture.

We regularly work with specialist franchising consultants who have professional services practices covering a range of areas vital for the operations of a successful franchise. These include liaison by us with strategic planners, human resources specialists and providers of marketing services.

As lawyers and consultants our firm serves franchisees and franchisors by drawing on knowledge of law as well as a range of disciplines broadly within professional services.

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