

Franchising - The Nature of the Business and the Franchise Agreement

Franchising is a type of business ownership which allows an individual, partnership or company to operate an independent business under the banner of an already established business. Established and well-known franchises include Kwik Kopy Printing, Mr Ti Instant Screen Printing, Delifrance, McDonalds and KFC.

A franchise agreement is a written document outlining the rights and obligations of both the franchisor and the franchisee. It is a legal contract which contains the rules and regulations upon which a franchisee and franchisor's future income and security will depend.

This article will comment on the many aspects of the franchise agreement thereby providing some insight into the nature of franchising.

Factors considered in a franchise agreement

A franchise agreement is *not* truly capable of negotiation with each and every individual franchisee. The essence of a franchise is in the **uniformity**- not only in terms of the market presence- but in terms of the legal arrangements entered into by all franchisees.

Most franchise agreements run for several years. Whilst the franchise agreement is fixed in concrete, the **operations manual** is the document by which the system is controlled and operated. The franchisee acknowledges, in the agreement, that the operations manual contains confidential information and that it is the sole property of the franchisor.

In most cases, the franchisor grants to the franchisee a two-fold right and license:

- the right to make use of the franchisor's **business system** at a specific location only, for a specified term of years and in accordance with the standards and specifications of the franchisor; and
- the right to make use of the **names and marks** (i.e. trademark, marks, copyrights and logos) at the franchisee's premises in association with the business to be conducted by the franchisee.

Most franchisees will request some **geographic protection** whereas the franchisor will wish to retain the right to **expand** its business system. A reasonable compromise is to provide exclusivity only as long as the franchisee achieves a certain level of turnover.

In order to establish the business, a **site** must be selected, acquired and finally developed and improved to meet the franchisor's specified *image*. The franchise agreement must clearly state which of the parties has the obligation to perform, and pay for, each step of the process. Development of the premises by the franchisor affords the franchisor much greater control over the quality and standards of construction and appearance of the premises.

Most franchise agreements contain a general statement of the nature and extent of **operating assistance** to be provided by the franchisor throughout the term of the franchise. This would include advice and guidance concerning:

- sales techniques;
- training of franchisee's employees;
- personnel and public relations;
- new products and services;
- bookkeeping, inventory taking and accounting systems;
- advertising and promotional programs.

The franchise agreement should also contain a **covenant** on the part of the franchisee to scrupulously follow all standards and specifications of the franchisor concerning the operation of the business. The franchisee should be prohibited from conducting any business other than the licensed business at the premises. In addition, the franchisee

is usually required to offer for sale of all approved products and provide all approved services and may not limit his business to a portion only of the franchisor's system.

The franchisee should be required to **personally supervise** the operation of his business at all times, except for reasonable temporary absences.

Many franchisors provide an **insurance** package for franchisees under its own blanket policy. The franchisor should be assured that adequate levels of insurance are maintained.

Most franchise agreements provide that the franchisee pay to the franchisor a **continuing service fee** based in some manner upon sales. The following issues normally are addressed:

- the basis for payment-most agreements base payments upon gross sales;
- minimum royalty levels;
- periodicity of fee payments;
- the date upon which the payment must be made.

Typically, the franchisee is required to deliver with his payment of service fees a **report** of his business activities for the period in question. Franchisees should also be required to deliver an annual financial statement prepared by an independent accountant. The franchisor should have the right to audit the franchisee's business records, inspect and/or place its representative on the premises, at any time during or within a specified time after the end of the term.

If the franchisor intends to control part or all of the advertising of the franchised system, the franchisor should consider establishing and administering a national or regional advertising program paid by an **advertising fund** to which all franchisee contribute a certain percentage of sales.

The franchise agreement should also state that the franchisor may **assign**, in whole or part, all its rights and obligations under the franchise agreement and that the franchisee will acknowledge any such assignment. In many cases, the franchisor will be unable to support its refusal to allow the franchisee to **sell** his franchise unless the proposed transferee is clearly objectionable.

Conclusion

Recent reports indicate that in Australia franchising is growing at over 40 per cent a year. There are now more than 1,000 separate franchise systems. However, it is also reported that 300 or more franchises have collapsed and 35 per cent of franchisees are dissatisfied with their franchise.

It is therefore imperative that the franchise agreement is drawn up such that it satisfies the special needs of both the franchisor and the franchisee. A carefully drawn up agreement is essential to avoid potential future misunderstandings and provide the foundations for a lucrative long-term relationship between the franchisor and the franchisee.

Comasters is able to advise a franchisor, or a franchisee, on franchising matters. We are also able to set up a franchise business for a franchisor, entailing the production of suitable franchise agreements, disclosure documents and operations manuals.

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Important: This is not advice. Clients should not act solely on the basis of the material contained in this paper. Our formal advice should be sought before acting on any aspect of the above information.

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