



Précis Paper

Franchising agreements

A discussion about the legalities of a franchising agreement, understanding the perspectives of a franchisee and franchisor, mediation, risk management and the steps which clients are advised to take after termination.

Discussion Includes

- What is franchising?
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Franchising agreements

1. In this edition of BenchTV, Andrew Grima (Principal lawyer at Coleman Greig) and Catherine Sedgley (Senior Associate at Coleman Greig) comprehensively discuss the legal process before, during and after a franchising agreement has been signed. There is a special focus on the complex mediation process and the element of control.

What is franchising?

2. Franchising is one of the most popular business models, as it enables ownership of a famous label in addition to brand security. Though franchising gives scope to a plethora of opportunities, it is important to understand that this is accompanied with legalities.
3. A franchised relationship is centred on a 'franchisor' (owner of the brand/trademark) who has the opportunity to pass on their rights for a cost and the 'franchisees' (who are focused on brand growth and profitability). Contractually, this relationship is bound by a 'franchise agreement'.
4. Franchising has majorly expanded employment opportunities among a range of industries such as health and fitness. Today, even law firms; accounting organisations and other professionals offer individuals, with the opportunity to franchise. Due to the popularity and mass appeal of franchising within service sectors, the Australian government has responded with strict legislation, which is aimed at protecting the rights and obligations of parties.
5. Franchising is often viewed as a 'surety' for customers, as franchised firms have a greater access to resources and support networks compared to boutique firms which can often sink in financial or any other externally generated (e.g. Coronavirus) vulnerability.
6. Franchisees need to be aware of the due diligence obligations in relation to occupying premises. Firstly, franchisees must never make decisions based on verbal hearsay/face value. They must conduct solo research into prospective opportunities and setbacks for profitability. Beyond analysing the brands' financial performance, it is integral for franchisees to review external issues, which may affect them (e.g. a

shopping centre might be redeveloped or governmentally rezoned due to local council pressure).

7. Tips for franchisees

8.

- I. Always seek independent legal advice
- II. What the required fees (e.g. initial franchise fee) as specified under the franchised agreement?
- III. At what point of time, should the fees be paid?
- IV. Be aware of ongoing fees/royalties (a percentage of gross profits)
- V. How good is your access to services (e.g. How can you further develop of point of sale system. Do you have access to specialist computer software)?
- VI. What are the payable fees when you exit? 7. Assess the intellectual property (brand) of the business. This should involve researching whether trademarks are registered properly or not.
- VII. What are your limits on using this intellectual property?
- VIII. What are the rules surrounding a personal guarantee?
- IX. Look into the terms and conditions of your franchise agreement (e.g. Is there an option to renew?)
- X. What are the grounds for termination?
- XI. Pay special attention to your obligations regarding the use of premises.

Leases

9. When a franchisor and franchisee negotiate over who takes the head lease, the decision ultimately comes down to a question of liability. For example, a business which thrives of a popular and accessible location, will ideally wish to have control over its premises. However, over time this might result in many leases and if not managed properly, may inevitably require the business model to be restructured.
10. In terms of purpose, a sub lease aims to give the franchisee, an exclusive possession of the premises/location. The notion of exclusive possession enters a niche dimension of franchising law. An occupant is not guaranteed exclusive possession when they receive a licence.

Step in/ tri partite deeds

11. What is a step in/tripartite deed?: It refers to a landlord power, whereby he/she can take the deal back if a franchisee decided to go under. A franchisee with a lease under his/her name incurs a major liability. Regardless of the situation, priority must be given to conducting a detailed and thorough legal review. In retail contexts, a disclosure statement (covers the passing on of rights) is absolutely key.

Risk management

12. Major franchisees involved with notable brands like 'Westfields', wish to include the franchisor in their mundane operations to obtain a sense of watchdog-centred security. On the other hand, smaller franchisees give more thought to risk management through safety measures like a bank guarantee.

Steps to start a franchise

13.
 - I. Have at least 2-3 units of stores before thinking about franchising . Create something with a good track record so that people will consider buying into it.
 - II. Make sure that your day to day systems (e.g. cash flow, staffing, operations) is stable. Is it ready to be upscaled?
 - III. Adopt the mindset of a franchisor - think about growing the corporate network, change your leadership style and always focus on the 'big picture'.
 - IV. Document all the systems in place (the process needs to be communicated effectively).
 - V. Capital is needed (roughly \$500 000-\$1 million.
 - VI. Surround yourself with a network of reliable advisors (e.g. accountants).

The 'catch up' game

14. Many franchisees tend to ignore the above mentioned rules. As a consequence, most of them are forced to play a 'catch up' game because they become involved in site selection wish to grow extremely fast (without taking the practicality factors into consideration like capital). Having to catch up, means that other day to day tasks of a business need to be outsourced to employees and this can give scope to inconsistent business goals and motives. It is important to note that marketing falls victim to the 'catch up' game.

15. A large proportion of clients tell lawyers that their brand has not been registered but that they wish to franchise. A dilemma of back peddling is instantly created. Franchisees must register their trademark as it is the best way to protect their brand (gives rights, exclusivity and a competitive advantage). Franchisees need to understand that the licence they obtain, is temporary and will eventually expire unless it has been renewed.
16. It is not difficult to search for a registered trademark as the database is a public platform/register. This platform is known as the 'Australian Trademarks Register'. Clients can also see the context of registration (e.g. legal industry, education, food). Subsequently, this will help clients to understand what is exactly protected (e.g. Is the chicken products in a fast food shop protected?).
17. Clients who enter an agreement knowing the negatives of what they enter into, are likely to demonstrate adaptive and proactive business behaviours to mitigate liability.
18. Franchisees are sometimes too consumed in their goal to make the business venture happen. This can lead to them unintentionally ignoring the fine print and seemingly insignificant details which is in fact significant. It is in the midst of this transition period that lawyers step in with advice and contractual reflection. The broader framework is viewed as a 'jigsaw puzzle' where one mistake has the potential to collapse the big picture.
19. Franchising is often compared with the game of musical chairs, as 'once the music stops' (when it time to exit the relationship), the franchisee's financial position will prevent them from ending the relationship. This proves that is not easy to exit by will in a franchising agreement.

The element of control

20. A franchisee should never assume that the franchisor has got all the obligations and liabilities under control (vice versa). Most issues between a franchisor and franchisee can be traced back to the element of 'control'. Misinterpretations can be avoided if a client understands the level of control they have before entering into the agreement. The control aspect of companies cannot be changed in most cases. Restructuring directorship and gaining the landlord's consent is vital to get the process started. Given that a company is somewhat profitable, landlords will generally agree to bring on shareholders on board. Franchisors tend to receive an incentive.

21. Restructuring the way in which invoices are paid will lead to increased time-centred business efficiency. This may involve re assessing bank guarantees. Keeping copies of notices and other relevant documentation is absolutely imperative for both parties. The notions of refurbishment and branding should be in sync with each other, in terms of timing. Franchisees/franchisors are frequently caught right in the middle of heated arguments between the bank and landlord. Certain franchisors are picky, when it comes to permitted use.

The mediation process

22. The Australian retail sector is currently down spiralling. As an outcome, the opportunity for negotiating leases between a franchisee and franchisor is minimal. Due to this, the potential for misinterpretations and disputes increases which then brings in the need for mediation (if the parties can't come to a mutually agreed resolution within 21 days). Mediation may not achieve ideal outcomes, but nevertheless, it acts as a 'forum' to get the parties talking.
23. In the mediation process, the mediator should attempt to offer low cost resolutions at first instance. This is good practice to trigger conversations. In mediation, both parties are mandatorily made to act in good faith. Good faith can be demonstrated by any one of the following examples (these don't specify all the possibilities): turning up to mediation, not going behind someone's back etc. Most disputes are resolved at the mediation stage. It is in the best interest of the parties to not allow the dispute to escalate, as it naturally incurs higher procedural costs.
24. When the parties in dispute write out/map out their problem, an entirely new problem arises. Invariably, this affects the outcomes and potential resolutions at play in addition to the over riding principle of confidentiality. The core point to note within this often chaotic process, is that clients should always seek a lawyer (not an operations manager) to negotiate on their behalf.

What causes disputes?

25. Sometimes there can be inconsistency between leasing and franchising agreements. Under the NSW jurisdiction in regards to rent, a landlord can lock a tenant out without notice. This legal principle has more power than the terms set out in a leasing agreement.
26. The key legislation is s 129 of *Conveyancing Act 1919*.

27. Other types of disputes are generally governed by the statutory regime. A breach notice must always comply with the *Conveyancing Act*. However, this is only required to be done within a reasonable time frame. Since this is not specified, judicial discretion comes into the picture.

Understanding obligations and notices

28. Notices about breaches can range anywhere between 7-30 days notice. At times tenant franchisees don't understand what they are liable for, and this is largely due to a lack of proper bookkeeping (especially in relation to outgoing expenses). Even today clients struggle to understand the 'make good clause' - it covers the returning of property. Inevitably, the confusion aspect worsens when external and unforeseeable events like the Coronavirus emerge and cause business disruption.
29. A franchising agreement involves a number of ongoing obligations (e.g. make good clause) even after one of the parties exit. In about 95% of cases, not paying rent is the grassroots issue for disputes. Most of the time rent is not paid due to a lack of corporate profitability. Other grassroots cause of disputes is the refusal to sign bank guarantees and repair related issues. Referring to case law, many of these issues are inter-connected. The non-payment of rent benefits the receiving end party in forfeiture cases.
30. Clients need to be highly aware of what related agreements they are binded/associated with, so that they understand their degree of liability. One simple mistake such as not paying rent, can breach multiple clauses across numerous agreements. In some cases, terminating one agreement might make other void by contractual default. The most common problem-causing related agreements tend to be bank loans/guarantees.
31. Clients must be prepared to pay upfront costs. For example, an ongoing marketing levy at a shopping centre is usually paid in an upfront manner. Many franchisees struggle to pay 'Category 1 costs' - contingencies/variations to air conditioning costs, ventilation ducts, water, drainage etc. Both parties must discuss and agree upon who is going to regularly pay 'Category 1 costs'. If this is not sorted, businesses are most likely play 'catch up' for a couple of years and then will abruptly cease operations.

Post termination steps

32. Post termination steps:

- I. Remove stock and personal belongings.
 - II. Figure out who gets access to the paperwork and who gets it first.
 - III. Look at your obligations.
 - IV. Gut the place if necessary (e.g. take out carpets, wiring etc.)
 - V. Negotiate a cash settlement if appropriate.
33. The concept of 'termination' is often associated with Party A exiting the premises, whilst Party B enters. This is not always the case.
34. There are exceptional cases where the landlord allows the franchisee with extra time to stay on premises. This is known as an 'agreed surrender'. The type of documentation varies based on the parties' next move. When the franchising agreement and the occupancy agreement are not in line, legal inefficiencies are generated.

Findings of the enquiry

35. What did the enquiries into the franchising sector find?:
- I. 50 recommendations were made but only 1 has been implemented, thus far.
 - II. It is to establish a new task force.
36. The enquiries found that 'transparency' and 'accountability' is not emphasised enough. In turn this creates unequal power play situation in a franchising relationship.
37. The committee demanded franchisees to disclose more information especially in regards to business tactics (e.g. which suppliers do they value, are there any rebates from particular parties etc.). Franchisees who waive the right to legal advice, are most likely to walk in with less certainty and contractual clarity in comparison to their counterparts who sought legal advice. This topic is education-centred.

The foreseeable future

38. In the future, the economic factors will primarily shape Australia's franchising sphere and unfortunately, we are currently heading into a major recession (evidenced by current indicators like record low interest rates).
39. 7% of Australian consumers engage with online retail. However in the US, online retail consumers make up 20% of market.

40. Australian shopping centres are not currently classified as 'ghost towns' (unlike the US and China) but with the foreseeable economic downturn this will mostly certainly occur. Only the ones, which have resorted to the notion of 'premium retail', could survive among the hit. In the longer term, the franchising business model will shift more to services than retail. Western Sydney in particular is benefiting from a boost of infrastructural funding and commercialisation; hence the opportunity for franchising is bound to grow.

BIOGRAPHY

Andrew Grima

Principal lawyer, Coleman Greig, Parramatta

Andrew Grima is a Principal Lawyer at Coleman Greig and head of the firm's Property and Finance team. Andrew has significant experience and expertise in all facets of retail and commercial leasing, including assisting and advising both landlords and tenants in their negotiations, drafting leases and other related transactions, assignments, surrenders and enforcement of obligations. Andrew also has extensive experience in major leasing and construction projects.

In addition to his legal, economics and accountancy degrees, Andrew is a graduate of the Australian Institute of Company Directors and has a sound understanding of the financial and governance issues affecting companies. Andrew also has experience in commercial securities and has acted on behalf of major clients such as financial institutions, a listed pharmaceutical company and numerous manufacturing and supply companies with regard to drafting and registering securities and related transactions.

Catherine Sedgley

Senior Associate, Coleman Greig, Parramatta

Catherine Sedgley is a Senior Associate within Coleman Greig's Commercial Advice team. Having assisted clients across a wide range of commercial legal areas, she has developed a particularly high level of experience and practical knowledge in Intellectual Property, Branding and Franchising law.

Alongside her ability to assist clients with matters relating to Branding and Franchise law, Catherine is extremely well-versed in all aspects of Australian and International Trade Mark law, and recognises the critical importance of brand owners securing the correct level of organisational protection within the context of their franchise networks.

Catherine is both Coleman Greig's key representative for dealings with the Franchise Council of Australia, and is an active member of the Intellectual Property of Australia and New Zealand (IPSANZ) Trans-Tasman Committee.

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Legislation

S 129 of *Conveyancing Act 1919*