Small Business Management MGMT5601

Topic 10: Franchising and Legal Issues

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Learning outcomes

In this topic you should learn how to:

• Define the term franchise.
• Understand the difference between franchising a product or service and an entire business operation.
• Recognise the importance of franchising as a business model.
• Consider the advantages and disadvantages of franchising.
• Recognise the legal structures applicable to small businesses in Australia and the advantages and disadvantages of each.
• Understand the key legal issues facing small businesses and how they impact on operations.
• Describe the nature of intellectual property and identify each of the main types.
The importance of franchising in Australia

• In Australia in 2016 there were:
  – 1,120 business franchisors in Australia
  – 79,000 business format franchise units in operation
  – 470,000 employees working directly within franchises
  – $146 billion in sales turnover
  – 90% of franchise systems were developed in Australia
  – 35% were engaged in online sales with consumers
  – 35% were engaged in international markets

• Major Industry segmentation:
  – Retail trade = 25.2%
  – Other services (i.e. personal, pets, car repairs, IT support etc.) = 26.5%
  – Financial and insurance services = 9.6%
  – Admin support services (i.e. travel agencies, cleaning, gardening etc.) = 7.3%

The nature of Franchising

A franchise is a contract by which a parent company (the franchiser) gives an individual operator (the franchisee) the right to use a trade name or a business format to sell a particular product/service.

– The franchiser will usually provide the franchisee with their knowledge, operating and marketing techniques.
– In other words, a franchise is prepackaged business that you can operate under agreement with a franchiser.

In the case of services the franchisee is licensed to use a trading name and intellectual property associated with delivering the service.
Types of franchising systems

Product and Trademark Franchising
Where the franchisee is granted the right to sell a particular product or brand e.g. Coca-Cola.
Franchiser is mainly concerned with product quality and integrity of brand not daily business management.

Business Format Franchises
Broader in scope.
The franchiser not only provides the product, service and trademark, but also the entire business format consisting of a marketing plan and support, operating methods and manuals, training, and ongoing control
Examples are McDonalds, KFC and Pizza Hut.
When Ray Kroc set up McDonald’s he:
- controlled the brand name (*McDonalds*)
- Symbol (Golden Arches)
- Operating systems

All aspects of the quality and process are controlled by the Franchisor
Conversion Franchising

- The conversion of existing independent firms to franchise members
- Common in the U.S. where firms operate in similar industry sectors:
  - restaurants
  - computer retailers
  - Accountants
- Can assist small businesses in need of capital, brand equity or management support
Operating a Franchise

- Survival rates among franchisees are often better than independent SMEs
- However the franchisee must still undertake risk and management tasks
- Persons with strong desire for autonomy or creativity may not find franchising appropriate
Issues to consider when selecting a franchise

- The territory assigned to you
  - location suitability, protection from encroachment
- Success of other franchisees
  - seek comment from those already in the system
- Terms of the franchise contract
  - Is it fair and flexible?
- Level of on-going support, training
  - What do you get for your fees and outlay?
- Quality of management systems
  - Do they offer a good formula for success?
- Termination of the contract
  - Can you get out without loss?
Franchise Start-Up Costs

- Cost of average US franchise
  - US$143,260
- Cost of average AUS franchise
  - AUD$100,000
- Outlays:
  - Initial franchise fee
  - Equipment
  - Stock
  - Premises
  - Legal & accounting expenses
  - Stamp duty
  - Working capital
  - Royalties (on-going)
- Fees and Costs:
  - Up-front fees range from $1,500 to $1.23 million
  - Fixed monthly fees range from $50 upwards
  - Variable fees range from 2% of turnover to 15% of turnover

<table>
<thead>
<tr>
<th></th>
<th>Retail</th>
<th>Non-Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Fees</td>
<td>$31,500</td>
<td>$28,000</td>
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<tr>
<td>Inventories</td>
<td>$10,000</td>
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<tr>
<td>Fit-out costs</td>
<td>$150,000</td>
<td>$4,000</td>
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<tr>
<td>Training costs</td>
<td>$5,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Legal &amp; accounting fees</td>
<td>$3,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Initial Working Capital</td>
<td>$2,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total Costs</td>
<td>$287,500</td>
<td>$59,750</td>
</tr>
</tbody>
</table>

Sources: Franchise Council of Australia & Frazer et al. 2016
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Franchising Code of Conduct

Under the Franchising Code of Conduct franchisors are required to provide to potential franchisees:

• disclosure
• cooling off periods
• copy of lease
• association of franchisees
• general releases from liability
• use of marketing & cooperative funds
• transfer/termination of franchise agreements
• prohibits “unfair conduct”
Franchising Code of Conduct
Franchising Code of Conduct

- Established 1998, amended 1 July 2010
- Applies to all franchises & similar structures
- Both franchisors & franchisees covered
- Enforced by the ACCC
- Franchising Policy Council
- Establishes a Mediation Adviser
- Key Changes as of July 2010 require franchisors to:
  - Disclose to Franchisees what will happen at the end of a franchise agreement (e.g. right to renew).
  - Give six months advance notice prior to end of agreement.
  - Disclose that a franchise can fail, plus a dispute resolution process and ensure that they don’t breach any common laws.
  - Disclose circumstances in which unilateral variations to the agreement might take place, if additional significant capital outlays will be required by franchisee and if such investment will affect renewal.
  - If the agreement might change at time of sale plus allocation of costs and if confidentiality clauses apply.

Source: Government of Australia, 2010
Advantages & Disadvantages of Franchising

**Advantages**

- Offers a ‘system’ of management and helps reduce risk
- Other benefits:
  - Training & Guidance
  - Branding
  - Track Record
  - Financial Support

**Disadvantages**

- Franchising fees
  - 2-15% of gross
- Franchiser control
  - Franchisee is hybrid
  - half owner-manager and half employee
- Unfulfilled promises
  - does it deliver?
How Risky is Franchising?

• Most franchise systems involve small firms
  – Average investment less than $250,000
  – 50% have less than 20 locations or business units
  – Smaller systems have less than 5 years of operational history
• IFA claims survival rates are 5 times better for franchise firms
• FCA suggests that:
  – 17% of franchisors experienced disputes with franchisees
  – Average lifecycle of franchisee is 7 years
• However, research (Stanworth, Purdy, Price and Zafiris 1998) shows no significant differences between franchise and non-franchise firms

Sources: Franchise Council of Australia 2008; Stanworth et.al., (1999)
Model of franchise growth

- **Hatchling**
  - Concept Development
  - Getting started with “hands on” management

- **Nestling**
  - Business Development
  - Proving the concept and designing the systems

- **Fledgling**
  - Initial Franchisees
  - Developing the network

- **Adult Stage**
  - Development of Head Office
  - Manuals and procedures
  - Handling relationships

Sources: Floyd & Fenwick, 1999
What makes a successful franchise?

• Study by Fenwick and Strombom (1999)
  – Case studies of 42 franchisees in New Zealand

• Concluded:
  – Franchisee performance was likely to be linked to the level of entrepreneurial capacity of the franchisee, as well as their management experience or training
  – Franchisees with strong entrepreneurial tendencies and past management experience were found to be poor performers
  – Non-management, low-entrepreneurial franchisees were less likely to question the franchiser and systems

Sources: Fenwick & Strombom, 1999
Business Structure
## Business Legal Structures

<table>
<thead>
<tr>
<th>Business Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
<td>A company or corporation is a separate legal entity or person. It can enter into agreements in its own name. If a company breaches an agreement the liability for that breach generally rests with the company itself, rather than with the directors of the company. This is unless there is misconduct by the directors, or offences such as breach of duty, misrepresentation or misleading or deceptive conduct. If a company owes money and there is no dispute over the debt the creditor can serve a statutory demand which must be dealt with immediately. If a company cannot pay its debts it becomes insolvent and the directors may be liable for debts incurred while insolvent.</td>
</tr>
<tr>
<td>Partnership</td>
<td>A relationship or association between two or more persons with a view to profit. They may be individuals or companies, but are not incorporated. Rights are governed by a partnership agreement and the Partnership Act. A partnership enters into an agreement in the name of its partners. Each is usually jointly liable for any agreements.</td>
</tr>
<tr>
<td>Sole Trader</td>
<td>Where an individual sets up an operates a business in their own name without any partners or co-workers. They are usually personally and individually liable for any agreements.</td>
</tr>
<tr>
<td>Trust</td>
<td>A relationship or association between two or more persons whereby one party holds property on trust for the other. The first party is vested with property and the holder of the property is called the trustee. The other party (for whom the property is held) is called the beneficiary. Trusts may be made expressly in writing or implied from the circumstances. A company may trade as a trustee of a trust.</td>
</tr>
</tbody>
</table>

Sources: [www.sblegal.innovation.gov.au](http://www.sblegal.innovation.gov.au)
Contingency factors in determining legal structure

- Ease and cost of formation
- Ability to bring in capital and other owners
- Amount of personal control
- Compliance costs and requirements
- Taxation
- Continuity of the enterprise
- Risk and liability exposure
- Image

Business Legal Structures in Australia

- Company: 49%
- Sole Traders & Partnerships: 33%
- Trusts: 18%

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Setting up a Partnership

• Agreement should set out:
  – What will be the partners’ share holdings?
  – What are the partners’ assets?
  – How are profits to be distributed?
  – Arrangements for contributing further capital when needed by the partners.
  – Partners’ liability and how liability is to be apportioned between partners.
  – Terminating arrangements and share buy back.
  – How disputes will be handled.
Partnership Success Model

Partnership Attributes
- Commitment
- Coordination
- Interdependence
- Trust

Communication Barrier
- Quality of communication
- Information sharing
- Participation

Conflict Resolution
- Joint problem sharing
- Persuasion
- Smoothing
- Domination
- Harsh words
- Arbitration

Partnership Success
Taxation

- All registered businesses must pay tax and have obligations for:
  - ABN – Australian Business Number
  - Business Activity Statement (BAS)
    - Paid throughout the year
    - Covers
      - PAYG withholding tax
      - Goods & Services Tax (GST)
      - Fringe Benefits Tax (FBT)
      - Deferred company and superannuation instalments
      - Wine Equalization Tax (WET)
      - Luxury Car Tax
  - GST exemptions
    - Businesses with annual turnover below $75,000
    - Some not-for-profit organisations


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Record keeping for Taxation
Fair Trading Act (Key Issues)

• **Pricing**
  – Resale price maintenance
    • Suppliers cannot impose a minimum sale price on goods and services.
  – Price Fixing
    • Businesses cannot collude to fix prices (or control discounts, rebates and credits).

• **Warranty of Goods & Services**
  – Goods must be:
    • fit for purpose and of merchantable quality, they must match any description on labels or adverts.
    • You must have the right to sell the goods.
  – Services must be:
    • Supplied with due care and skill, and any goods used in their delivery must be fit for purpose.

• **Refunds**
  – There is no obligation to refund, exchange or credit a consumer where they have:
    • Changed their mind about a product.
    • Discovered the same goods at a cheaper price
    • Had a defect drawn to their notice before they purchased the goods.

• **Misleading or Deceptive Conduct**
  – A business cannot engage in conduct that is deliberately misleading or deceptive or is likely to mislead or deceive.

• **Unconscionable Conduct**
  – A business cannot behave in a manner that is against ‘good conscience’
    • Avoid pressure selling, complex agreements

Sources: [www.sblegal.innovation.gov.au](http://www.sblegal.innovation.gov.au)
Legal protection of ideas

- **Business Names**
  - Business names should be registered with relevant state authorities. Registration protects right to use that name. ASIC maintains a national business names register. Not all names can be used.

- **Copyright**
  - Is the exclusive right to publish, print or copy work or material. Whoever creates the work owns it unless there is an agreement to the contrary. Employees cede their rights to the employer in most cases.

- **Designs**
  - Designs can be formally registered but must be new and have a functional purpose not otherwise registered by another person.

- **Passing Off**
  - Where someone sells goods under a false or misleading name (e.g. fake brands)

- **Patents**
  - A patent is a right to use and benefit from a new invention or process. Must be formally registered and cannot be already claimed by others or previously published or disclosed and must have some practical value or use.

- **Trade Marks**
  - A distinctive sign associated with a business, can be a name, logo, sound or smell. Can involve distinctive colours and should be formally registered.

- **Trade Secrets**
  - Confidential business information including financial, customer and employee data, product information and business strategies. Should be protected by agreements.

Sources: [www.sblegal.innovation.gov.au](http://www.sblegal.innovation.gov.au)
Product safety, liability, privacy and insurance issues

• **Product Safety & Liability**
  – Some products have mandatory safety standards or require specific consumer warnings (e.g. tobacco, cosmetics). All suppliers are responsible for ensuring that the goods they supply comply.

• **Issues to consider**
  – Defamation
  – Negligence
  – Nuisance
  – Trespass

• **Privacy**
  – Small firms with turnover < $3 million are exempt from Privacy Act in most cases.

• **Insurance**
  – Public liability insurance
  – Employment insurance
  – Property & General
  – Casualty & Life
  – Workers’ Compensation
  – Professional Indemnity Insurance

Sources: [www.sblegal.innovation.gov.au](http://www.sblegal.innovation.gov.au)
Contract conditions and results of breach of contract

Contract Conditions

• An offer is made. It can be oral or written but is not binding until voluntary acceptance of offer is given.
• Voluntary acceptance of offer
• Consideration (something of value) is given by both parties
• Both parties are competent and/or have the right to negotiate for their firms
• Contract must be legal. Any illegal activities under a contract are not binding (e.g. gambling or drug dealing).

Results of Contract Breach

• The party in violation of a contract may be required to live up to the agreement of pay damages
• If one party fails to live up to its end of a contract, the second party may also agree to drop the matter and thus not live up to the agreement as well. This is called contract restitution.

Sources: www.sblegal.innovation.gov.au

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Exercise: Legal issues for new venture

Consider you are setting up a new business venture:

- Would a franchise offer a superior business model to a solo business?
- What legal structure would you need to establish to proceed with your new venture and why?
End of Presentation