

Franchising Alert

Rafferty Rules: is your agreement really a Franchise Agreement?

September 2012

The *Franchising Code of Conduct* applies to all franchise agreements. Whether an agreement is in fact a franchise agreement is therefore a matter of significant legal and commercial consequence.

In its recent decision in *Rafferty v Madgwicks* the Federal Court considered the factors to be taken into account in deciding this question. It is a decision that could have serious implications for anyone involved in distribution or licensing arrangements and for those who have recorded their arrangements informally in, say, a heads of agreement in anticipation that the *Code* will not apply.

What is a Franchise Agreement?

An agreement is a franchise agreement under the *Code* if it meets four criteria:

- there is an agreement, whether written, oral or implied;
- a person (franchisor) grants another person (franchisee) the right to carry on a business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by that person;
- the business is substantially or materially associated with a trade mark, advertising or commercial symbol owned, used or licensed by the franchisor; and
- the franchisee is required to make certain types of payments to the franchisor (such as initial capital investment or ongoing percentage based fees)

"System or marketing plan"

In *Rafferty v Madgwicks* the Court considered the concept of a "system or marketing plan" under the *Code* and what might be sufficient to constitute a franchise. It found the following factors relevant:

Specific requirements for:

- accounting and record keeping;

- signage and merchandising;
- management structures
- badging requirements (mandatory use of trading name, uniforms, stationary, etc).
- retail pricing structures, sales structures and sales quotas;
- specific reporting systems in relation to profit or turnover;

Reservation by the franchisor of the right to:

- audit books of account and other records;
- approve promotional and advertising material;
- approve sales staff;

Restrictions on the right of the franchisee to:

- sell competing products;
- use the brand and trade names;
- carry on business outside of specific marketing or sales territories;

The provision by the franchisor of:

- bonus structures for those selling its goods or services; and
- training for staff selling its goods or services.

"Substantially determined, controlled or suggested..."

The system or marketing plan must be "...substantially determined, controlled or suggested by the franchisor...". In determining whether the relevant level of control existed in this case, the Court had regard to:

- the extent to which the franchisee's business involves the sale of the franchisor's goods and services;
- the degree to which the franchisor assumes

responsibility for centralised management and for uniform standards regarding quality;

- whether the franchisee is under an obligation to the franchisor in relation to advertising and promotional campaigns; and
- the extent to which the franchisor controls the franchisee's business, having regard to advertising and financial support, auditing of books, inspection of premises, hiring of staff, sales quotas, management and training and the like.

The Court said that details of the system and marketing plan do not need to be set out in the franchise agreement. It will be sufficient that the agreement contains rights and obligations that enable the franchisor to substantially determine, control or suggest a system or marketing plan.

Other issues raised by *Rafferty*

The Full Court's decision may also have a number of other significant practical and legal effects including:

- the definition of "franchisee" may include the shareholders of the franchisee and others who in substance and fact stand behind the franchisee. This may result in the franchisor having obligations to parties other than the named franchisee;
- the definition of "franchisor" may include a sole director of the franchisor, so that persons standing behind the franchisor have personal obligations under the *Code*;
- a *heads of agreement* may be an agreement to enter into a franchise agreement. If so, the the obligations under *Code* will apply, even if the proposed franchisee has not yet been incorporated and there is no franchise system yet in place; and

- where a *heads of agreement* grants an option to enter into a franchise agreement, it will attract the operation of the *Code* as an agreement to enter into a franchise agreement if it is practically certain that the prospective franchisee will take up the option.

What does this mean for you?

Distribution, licence or similar agreements (or heads of agreements) that allow another to use a trademark, advertising or commercial symbol in the sale of goods and services in Australia should be carefully reviewed. They may be a "franchise agreement" and subject to all that the *Code* imposes, irrespective of what was intended and what they are called.

The review should be undertaken at the earliest possible opportunity in the development of the agreement and the commercial opportunity it records, as the *Code* imposes obligations on parties before they formally consummate their franchise agreement.

Failure to properly identify an agreement (or heads of agreement) as a franchise agreement may result in a breach of the *Code* (and as a consequence, the *Competition and Consumer Act 2010*). In that event orders including an award of damages, an injunction preventing entry into the proposed franchise agreement, the variation of the franchise agreement or the termination of the franchise agreement may result.

Rafferty now rules!

Written by:

David Gaszner
Partner

+61 8 8236 1354

dgaszner@thomsonslawyers.com.au

Kirsty Dunn
Senior Associate

+61 8 8236 1349

kdunn@thomsonslawyers.com.au

For further information, please contact:

Sydney

Sean O'Donnell

Partner

+61 2 9020 5770

sodonnell@thomsonslawyers.com.au

Philip Smith

Partner

+61 2 9020 5755

psmith@thomsonslawyers.com.au

Melbourne

Shaun Steffensen

Partner

+61 3 8080 3551

ssteffensen@thomsonslawyers.com.au

Michael Warren

Partner

+61 3 8080 3562

mwarren@thomsonslawyers.com.au

Brisbane

Tony Conaghan

Partner

+61 7 3338 7502

tconaghan@thomsonslawyers.com.au

Ben Coogan

Partner

+61 7 3338 7503

bcoogan@thomsonslawyers.com.au

Adelaide

David Gaszner

Partner

+61 8 8236 1354

dgaszner@thomsonslawyers.com.au

Stephen Voss

Partner

+61 8 8236 1305

svoss@thomsonslawyers.com.au

www.thomsonslawyers.com.au