

Chapter 33

Franchising

‘The most enlightened judicial policy is to let people manage their own business in their own way.’

OLIVER WENDELL HOLMES (1841–1935)

ASSOCIATE JUSTICE ON THE SUPREME COURT OF THE UNITED STATES

What is covered in this chapter

1	What is a franchise?	w52
2	The benefits of owning a franchise	w52
3	Outline of a typical franchise system	w53
4	Types of franchise	w54
5	Things to consider before selecting a franchise	w55
6	Selecting a franchise	w55
7	Franchise exhibitions or trade shows	w57
8	Investigating what the franchise has to offer	w59
9	The franchise contract	w64
10	Additional sources of information	w66
11	Laws and protection for the public	w67
	This chapter in essence	w69

WHY THIS CHAPTER IS IMPORTANT

Many people dream of being an entrepreneur. By purchasing a franchise, you can sell goods and services that have instant name recognition and can obtain training and ongoing support to help you succeed. But you should be cautious. Like any investment, purchasing a franchise is not a guarantee of success.¹

Business format franchising is the most typical form of franchise operating in South Africa. This type of franchise includes the right to use a name or provide a service, and a full business system to which the franchisee must adhere. For the franchisee, the major advantage is that a lot of trial and error is avoided by having a tested business formula. There is also ongoing back-up and support for the business from the franchisor.²

The franchisee owns the business. They pay an upfront fee and a royalty or management service fee to the franchisor. All procedures are laid down in a detailed operations manual.³

1 *A Consumer Guide to Buying a Franchise*, Federal Trade Commission, December 1994. Available at <https://www.ftc.gov/business-guidance/resources/consumers-guide-buying-franchise>, accessed 19 January 2017.
2 Singh, N, Trusts, *Investing in South Africa*, Johannesburg: Webber Wentzel Bowens, April 2005. Available at <https://web.archive.org/web/20190111163944/http://www.webberwentzel.com/wwb/content/en/ww-investing-in-south-africa>.
3 *Ibid.*

Franchisees have closely linked relationships to their parent company, and typically have the rights to use their parent company's trademark and logo. The parent company is usually therefore more closely involved and offers levels of support or even training to franchisees and their employees. This maintains the levels of service and standards and ensures continuity in the already established brand.

FRANCHISING

1 What is a franchise?

A franchise is an agreement in which a franchisor grants a franchisee the right to carry on business within a specific part of South Africa. In exchange for payment, the franchisee is allowed to use a system or marketing plan that is controlled by the franchisor.⁴

The company that grants an independent third party the right to distribute its trademarks, products, or techniques is known as the 'franchisor'. The independent third party is called the 'franchisee'.

2 The benefits of owning a franchise

Investment in a franchise enables a franchisee to operate a business. By paying a franchise fee, which may cost several thousand rand, the franchisee is given a format or system developed by the franchisor, as well as the right to use the franchisor's name for a limited time, and assistance from the franchisor in running the business. For example, the franchisor may help you find a location for your outlet; provide initial training and an operating manual; and advise you on management, marketing, or personnel. Some franchisors offer ongoing support such as monthly newsletters, an internet website, a toll-free telephone number for technical assistance, and periodic workshops or seminars.

While buying a franchise may reduce investment risk by enabling a franchisee to associate with an established company, it can be costly. The franchisee may also be required to relinquish significant control over their business, while taking on contractual obligations with the franchisor.

Franchising allows a business to expand its operations and grow geographically. Unlike a chain system, the franchisor does not have to provide capital, management or employees for each location. This allows a franchisor to increase its profits more rapidly than by expanding on its own.

The franchisees, as individuals who each own their own business, have every possible incentive to work hard to make their businesses a success. Because they are owners, their motivation is likely to be greater than that of a manager, even one who receives a percentage of the profits of the business.

With each new location, the franchisor immediately earns a profit in the form of the initial franchise fee. The franchisor also receives a continuing royalty, usually a percentage of the gross income of the franchisee.

4 Consumer Protection Act 68 of 2008.

3 Outline of a typical franchise system

3.1 The cost

In exchange for obtaining the right to use the franchisor's name and its assistance, the franchisee may pay some or all of the following fees:

- **Initial franchise fee and other expenses:** The initial franchise fee, which may be non-refundable, may cost several thousand rand. You may also incur significant costs to rent, build, and equip an outlet and to purchase initial inventory. Other costs include operating licences and insurance. You also may be required to pay an 'opening fee' to the franchisor to promote your new outlet.
- **Continuing royalty payments:** The franchisee may have to pay the franchisor 'royalties' based on a percentage of your weekly or monthly gross income. Depending on the contract, royalties may have to be paid even if the business has not earned significant income during that time. In addition, royalties are usually paid for the right to use the franchisor's name. So even if the franchisor fails to provide promised support services, the franchisee may still have to pay royalties for the duration of the franchise agreement.
- **Advertising fees:** The franchisee may have to pay into an advertising fund. Some portion of the advertising fees may go for national advertising or to attract new franchise owners, but not to target your particular outlet.

3.2 Controls

To ensure uniformity, franchisors typically control how franchisees conduct business. These controls may significantly restrict your ability to exercise your own business judgement. The following are typical examples of such controls:

- **Site approval:** Many franchisors pre-approve sites for outlets. This may increase the likelihood that your outlet will attract customers. The franchisor, however, may not approve the site you want.
- **Design or appearance standards:** Franchisors may impose design or appearance standards to ensure customers receive the same quality of goods and services in each outlet. Some franchisors require periodic renovations or seasonal design changes. Complying with these standards may increase costs.
- **Restrictions on goods and services offered for sale:** The franchise contract may restrict the goods and services offered for sale. For example, as a restaurant franchise owner, you may not be able to add to your menu popular items or delete items that are unpopular. Similarly, as a car exhaust repair franchise owner, you might not be able to perform other types of motor vehicle work, such as brake or electrical system repairs.
- **Restrictions on method of operation:** The franchise contract may require the franchisee to operate in a particular manner. For example, you may be required to operate during certain hours, use only pre-approved signs, employee uniforms, and advertisements, or abide by certain accounting or bookkeeping procedures. These restrictions may limit you from operating your outlet as you would prefer.

The Consumer Protection Act⁵ applies to every franchise, and limits the ability of a franchisor to force you to buy certain goods or services only from itself or from suppliers it nominates. However, the franchiser may require you to do so only if it can

5 Consumer Protection Act 68 of 2008.

show that the goods or services are reasonably related to the branded products or services that are the subject of the franchise agreement. The franchiser can also require you to do so if it shows that the convenience to you outweighs the limitation of your right to choose, or if it is of economic benefit to you.

- **Restrictions of sales area:** Franchisors may limit your business to a specific territory. While these territorial restrictions may ensure that other franchisees will not compete with you for the same customers, they could impede your ability to open additional outlets or move to a more profitable location.

3.3 Terminations and renewal

You can lose the right to your franchise if you breach the franchise contract. In addition, the franchise contract is for a limited time; there is no guarantee that you will be able to renew it.

- **Franchise terminations:** A franchisor can end your franchise agreement if, for example, you fail to pay royalties or abide by performance standards and sales restrictions. If your franchise is terminated, you may lose your investment.
- **Renewals:** Franchise agreements typically run for 15 to 20 years. After that time, the franchisor may decline to renew your contract. Also be aware that renewals need not provide the original terms and conditions. The franchisor may raise the royalty payments, or impose new design standards and sales restrictions. Your previous territory may be reduced, possibly resulting in more competition from company-owned outlets or other franchisees.

4 Types of franchise

There are many different structures to consider:⁶

- **Single unit:** A single unit is owned and operated by the franchisee and is the simplest type of franchise.
- **Multi-unit:** More than one franchise is owned by the same franchisee.
- **Area franchise:** A franchisee buys the right to operate the franchise solely for themselves, and can also sell sub-franchises to others within the same territory.
- **Satellite franchise:** A smaller food franchise that is only allowed to sell a small part of the menu.
- **Fractional franchise:** A franchisee operates within the property of another business. For example, a food franchise within a petrol station.
- **Branch conversion:** A company-owned shop is converted and in future trades as a franchise operation.
- **Master license agreement:** A foreign company grants franchise rights to a South African entity for the whole country or part of it.
- **Manufacturing franchise:** A manufacturer grants a franchise to another to produce goods.
- **Tandem franchising:** A small part of the business is given to a B-BBEE employee; profits made are used to purchase the rest of the business.
- **Conversion franchise:** A similar type of independent business is given a make-over and converted to a franchise.

6 Doussy, J and Grobler, J, Purchasing a franchise, *De Rebus*, Pretoria: Law Society of South Africa, July 2017 p 22.

5 Things to consider before selecting a franchise

Before investing in a particular franchise system, carefully consider how much money you have to invest, your abilities, and your goals. The following checklist may help you make your decision.

5.1 Your investment

- How much money do you have to invest?
- How much money can you afford to lose?
- Will you purchase the franchise by yourself or with partners?
- Will you need financing and, if so, where can you obtain it?
- Do you have a favourable credit rating?
- Do you have savings or additional income to live on while starting your franchise?

5.2 Your abilities

- Does the franchise require technical experience or relevant education, such as auto repair, home and office decorating, or tax preparation?
- What skills do you have? Do you have computer, bookkeeping, or other technical skills?
- What specialised knowledge or talents can you bring to a business?
- Have you ever owned or managed a business?

5.3 Your goals

- What are your goals?
- Do you require a specific level of annual income?
- Are you interested in pursuing a particular field?
- Are you interested in retail sales or performing a service?
- How many hours are you willing to work?
- Do you want to operate the business yourself or hire a manager?
- Will franchise ownership be your primary source of income or will it supplement your current income?
- Would you be happy operating the business for the next 20 years?
- Would you like to own several outlets or only one?

6 Selecting a franchise

Like any other investment, purchasing a franchise is a risk. When selecting a franchise, carefully consider a number of factors, such as the demand for the products or services, likely competition, the franchisor's background, and the level of support you will receive.

6.1 Demand

Is there a demand for the franchisor's products or services in your community? Is the demand seasonal? For example, lawn and garden care or swimming pool maintenance may be profitable only in the spring or summer. Is there likely to be a continuing demand for the products or services in the future? Is the demand likely to be temporary, such as selling a fad food item? Does the product or service generate repeat business?

6.2 Competition

What is the level of competition, nationally and in your community? How many franchised and company-owned outlets does the franchisor have in your area? How many competing companies sell the same or similar products or services? Are these competing companies well established, with wide name recognition in your community? Do they offer the same goods and services at the same or lower price?

6.3 Your ability to operate the business

Sometimes, franchise systems fail. Will you be able to operate your outlet even if the franchisor goes out of business? Will you need the franchisor's ongoing training, advertising, or other assistance to succeed? Will you have access to the same or other suppliers? Could you conduct the business alone if you must lay off personnel to cut costs?

6.4 Name recognition

A primary reason for purchasing a franchise is the right to associate with the company's name. The more widely recognised the name, the more likely it will draw customers who know its products or services. Therefore, before purchasing a franchise, consider:

- The company's name and how widely recognised it is.
- If it has a registered trademark.
- How long the franchisor has been in operation.
- If the company has a reputation for quality products or services.
- If consumers have filed complaints against the franchise with a consumer protection agency.

6.5 Training and support services

Another reason for purchasing a franchise is to obtain support from the franchisor. What training and ongoing support does the franchisor provide? How does their training compare with the training for typical workers in the industry? Could you compete with others who have more formal training? What backgrounds do the current franchise owners have? Do they have prior technical backgrounds or special training that helps them succeed? Do you have a similar background?

6.6 Franchisor's experience

Many franchisors operate well-established companies with years of experience both in selling goods or services and in managing a franchise system. Some franchisors started by operating their own business. There is no guarantee, however, that a successful entrepreneur can successfully manage a franchise system.

Carefully consider how long the franchisor has managed a franchise system. Do you feel comfortable with the franchisor's expertise? If franchisors have little experience in managing a chain of franchises, their promises of guidance, training, and other support may be unreliable.

6.7 Growth

A growing franchise system increases the franchisor's name recognition and may enable you to attract customers. Growth alone does not ensure successful franchisees; a company that grows too quickly may not be able to support its franchisees with all the promised support services. Make sure the franchisor has sufficient financial assets and staff to support the franchisees.

7 Franchise exhibitions or trade shows

Attending a franchise exhibition allows you to view and compare a variety of franchise possibilities. Keep in mind that exhibitors at the exposition primarily want to sell their franchise systems. Be cautious of salespersons who are interested in selling a franchise that you are not interested in.

Before you attend, research what type of franchise best suits your investment limitations, experience, and goals. When you attend, comparison shop for the opportunity that best suits your needs and ask questions.

7.1 Know how much you can invest

An exhibitor may tell you how much you can afford to invest or that you can't afford to pass up this opportunity. Before beginning to explore investment options, consider the amount you feel comfortable investing and the maximum amount you can afford.

7.2 Know what type of business is right for you

An exhibitor may attempt to convince you that an opportunity is perfect for you. Only you can make that determination. Consider the industry that interests you before selecting a specific franchise system. Ask yourself the following questions:

- Have you considered working in that industry before?
- Can you see yourself engaged in that line of work for the next twenty years?

7.3 Do you have the necessary background or skills?

If the industry does not appeal to you or you are not suited to work in that industry, do not allow an exhibitor to convince you otherwise. Spend your time focusing on those industries that offer a more realistic opportunity.

7.4 Shop around

Visit several franchise exhibitors engaged in the type of industry that appeals to you. Listen to the exhibitors' presentations and discussions with other interested consumers. Get answers to the following questions:

- How long has the franchisor been in business?
- How many franchised outlets currently exist? Where are they located?
- How much is the initial franchise fee and any additional start-up costs? Are there any continuing royalty payments? How much?
- What management, technical, and ongoing assistance does the franchisor offer?
- What controls does the franchisor impose?

Exhibitors may offer you prizes, free samples, or free dinners if you attend a promotional meeting later that day or over the next week to discuss the franchise in greater detail. Do not feel compelled to attend. Rather, consider these meetings as one way to acquire more information and to ask additional questions. Be prepared to walk away from any promotion if the franchise does not suit your needs.

7.5 Get proof of the amount the franchisor claims to make as a profit

Some franchisors may tell you how much you can earn if you invest in their franchise system or how current franchisees in their system are performing. Be careful. Make sure you ask for and obtain written proof of any income projections, or income or profit claims. If the

franchisor does not have the required information, or refuses to provide it to you, consider its claims to be suspect.

The financial statements and the earnings claims statement provide crucial information necessary to evaluate the financial health of the company selling you the franchise and projections of what you might expect from operating one of its franchises, before the purchase is made.

7.6 Take notes

It may be difficult to remember each franchise exhibit. Bring a pad and pen to take notes. Get promotional literature that you can review. Take the exhibitors' business cards so you can contact them later with any additional questions.

7.7 Avoid high-pressure sales tactics

You may be told that the franchisor's offering is limited, that there is only one territory left, or that this is a one-time reduced franchise sales price. Do not feel pressured to make any commitment. Legitimate franchisors expect you to comparison shop and to investigate their offering. A good deal today should be available tomorrow.

7.8 Study the franchise contract

Do not sign any contract or make any payment until you have the opportunity to investigate the franchisor's offer thoroughly. Study all the documents and information provided to you. Take time to speak with current and former franchisees about their experiences. Because investing in a franchise can entail a significant investment, you should have an attorney review the documents and franchise contract and have an accountant review the company's financial disclosures.

The following is compulsory and must be contained in every franchise agreement in terms of the Consumer Protection Act:⁷

- **In writing:** The franchise agreement must be in writing and signed by or on behalf of the parties.
- **Plain language:** The franchise agreement must be written in plain language that can reasonably be understood by a potential franchisee with average literacy skills and minimal experience of franchising.
- **Cooling-off period:** The agreement must have at the top of the first page a statement saying: *'A franchisee may cancel a franchise agreement without cost or penalty within 10 (ten) business days after signing such agreement, by giving written notice to the franchisor'*.
- **Prevention of certain conduct:** The agreement must contain provisions which prevent unreasonable fees or prices; conduct that is unreasonable in relation to risks to be incurred; and conduct that it is not reasonably necessary to protect the legitimate business interests of the franchisor, franchisee or franchise system.
- **Disclosure of benefits:** The agreement must also say that the franchisor is not entitled to any undisclosed direct or indirect benefit or compensation, unless this is disclosed and explained in writing.
- **General principles of honesty:** The agreement must contain a clause that says that the general principles of honesty, fairness, reasonability and equity must guide the interpretation of the agreement and relationship between the parties.

⁷ Consumer Protection Act 68 of 2008; Stoop, P, Selected Aspects of the Consumer Protection Act Regulations, *De Rebus*, Pretoria: Law Society of South Africa June 2011.

List of the minimum information that must be included in a franchise agreement:⁸

- A description of the goods or services.
- Obligations of the franchisor and the franchisee.
- A description of the business system.
- All the amounts that must be paid to the franchisor.
- Details of territorial rights.
- A description of the proposed business premises.
- Details of any intellectual property licensed.
- Details of the master franchisee, if there is one.
- Details of training and assistance.
- Terms and conditions relating to the duration, renewal, goodwill and assignment.
- Full details of any marketing fund and a promise to provide full financial statements of all receipts and expenses.
- Any restrictions imposed on the franchisee.
- Full details of the financial requirements, including the initial fee, working capital, royalties, and total investment required.
- The effect of termination of the franchise.

The Act also states that if the franchisee does not understand the terms of the franchise agreement, they can request the franchisor to provide an explanation of the sections that are not understood.

8 Investigating what the franchise has to offer

Before investing in any franchise system, be sure to get a copy of all documents that will govern the franchise arrangement, including the franchise contract. Make sure you understand all of the provisions. Get answers to your concerns before you invest.

A disclosure document must be given to a franchisee at least 14 days before the contract is signed. The disclosure document must contain:⁹

- The number of individual franchised outlets.
- The growth of the franchisor's turnover, net profit and the number of individual new franchised outlets for the year before.
- A statement that says the franchisor is able to pay its debts when they fall due.
- Written financial projections of the business, together with details of any financial assumptions.

The disclosure document must be accompanied by an accounting officer or auditor's statement that the franchisor's business is able to meet its financial commitments and that the franchisor's annual financial statements have been prepared in accordance with generally accepted accounting practice. In addition the disclosure document must have a list of current franchisees, their contact details, and a statement that the prospective franchisee may contact any of the franchisees. A diagram must be included to show the support system in place for franchisees.

8 Stoop, P, Selected Aspects of the Consumer Protection Act Regulations, *De Rebus*, Pretoria: Law Society of South Africa June 2011.

9 Louw, L, *The CPA and franchise agreements*, Johannesburg: Werksmans 1 July 2011.

8.1 Business background

The documents provided to you should identify the executives of the franchise system and describes their prior experience. Consider not only their general business background, but their experience in managing a franchise system. Also consider how long they have been with the company. Investing with an inexperienced franchisor may be riskier than investing with an experienced one.

8.2 Litigation history

You should request a document setting out the prior litigation history of the franchisor and its executives. This should tell you if the franchisor, or any of its executive officers, has been charged or convicted of any offences involving, for example, fraud, or any violation of the law involving dishonesty. You should also be told in writing whether the franchisor, or any of its executives, has been held liable or settled a civil action involving the franchise relationship. A number of claims against the franchisor may indicate that it has not performed according to its agreements, or, at the very least, that franchisees have been dissatisfied with the franchisor's performance. Be aware that some franchisors may try to conceal an executive's litigation history by removing the individual's name from their disclosure documents.

8.3 Insolvency

You should request a document setting out whether the franchisor, or any of its executives, has recently been involved in an insolvency. This will help you to assess the franchisor's financial stability and general business acumen and predict if the company is financially capable of delivering promised support services.

8.4 Costs

The documents provided to you should tell you the costs involved to start one of the company's franchises. It should describe any initial deposit or franchise fee, which may be non-refundable, and costs for initial inventory, signs, equipment, leases, or rentals. Be aware that there may be other undisclosed costs. The following checklist will help you ask about potential costs to you as a franchisee:

- Continuing royalty payments.
- Advertising and promotional payments, both to local and national advertising funds.
- Opening or other initial business promotions.
- Business or operating licences.
- Product or service supply costs.
- Real estate and leasehold improvements.
- Discretionary equipment such as a computer system or business alarm system.
- Training.
- Legal fees.
- Financial and accounting advice.
- Insurance.
- Compliance with local council by-laws and Provincial Ordinances, such as zoning, waste removal, and fire and other safety codes.
- Health insurance.
- Public liability insurance.
- Security requirements.

- Employee salaries and benefits.

It may take several months or longer to get your business started. Consider in your total cost estimate: operating expenses for the first year and personal living expenses for up to two years. Compare your estimates with what other franchisees have paid and with competing franchise systems. Perhaps you can get a better deal with another franchisor. An accountant can help you to evaluate this information.

8.5 Restrictions

Your franchisor may restrict how you operate your outlet. The documents provided to you should tell you if the franchisor limits:

- The supplier of goods from whom you may purchase.
- The goods or services you may offer for sale.
- The customers to whom you can offer goods or services.
- The territory in which you can sell goods or services.

Restrictions may significantly limit your ability to exercise your own business judgement in operating your outlet. The Consumer Protection Act¹⁰ limits the ability of a franchisor to force you to buy certain goods or services only from itself or from suppliers it nominates. However, the franchisor may require you to do so only if it can show that the goods or services are reasonably related to the branded products or services that are the subject of the franchise agreement. The franchisor can also require you to do so if it shows that the convenience to you outweighs the limitation of your right to choose, or if it is of economic benefit to you.

8.6 Terminations

The franchise agreement and the disclosure documents should tell you the conditions under which the franchisor may terminate your franchise and your obligations to the franchisor after termination. It also should tell you the conditions under which you can renew, sell, or assign your franchise to other parties.

8.7 Training and other assistance

The franchise agreement and the disclosure documents should explain the franchisor's training and assistance programme. Make sure you understand the level of training offered. The following checklist will help you ask the right questions:

- How many employees are eligible for training?
- Can new employees receive training and, if so, is there any additional cost?
- How long are the training sessions?
- How much time is spent on technical training, business management training, and marketing?
- Who teaches the training courses and what are their qualifications?
- What type of ongoing training does the company offer and at what cost?
- Whom can you speak to if problems arise?
- How many support personnel are assigned to your area?
- How many franchisees will the support personnel service?
- Will someone be available to come to your franchised outlet to provide more

¹⁰ Consumer Protection Act 68 of 2008.

individual assistance?

The level of training you need depends on your own business experience and knowledge of the franchisor's goods and services. Keep in mind that a primary reason for investing in the franchise, as opposed to starting your own business, is training and assistance. If you have doubts that the training might be insufficient to handle day-to-day business operations, consider another franchise opportunity more suited to your background.

8.8 Advertising

Some franchise arrangements require you to contribute a percentage of your income to an advertising fund even if you disagree with how these funds are used. The disclosure document should provide information on advertising costs.

The following checklist will help you assess whether the franchisor's advertising will benefit you:

- How much of the advertising fund is spent on administrative costs?
- Are there other expenses paid from the advertising fund?
- Do franchisees have any control over how the advertising money is spent?
- What advertising promotions has the company already engaged in?
- What advertising developments are expected in the near future?
- How much of the fund is spent on national advertising?
- How much of the fund is spent on advertising in your area?
- How much of the fund is spent on selling more franchises?
- Do all franchisees contribute equally to the advertising fund?
- Do you need the franchisor's consent to conduct your own advertising?
- Are there rebates or advertising-contribution discounts if you conduct your own advertising?
- Does the franchisor receive any commissions or rebates when it places advertisements? Do franchisees benefit from such commissions or rebates, or does the franchisor profit from them?

Seven Eleven Corporation of SA (Pty) Ltd v Cancun Trading No 150 CC¹¹

A franchisee claimed that from discussions and from information published in a document distributed to potential franchisees, the impression was created that the franchisee would be entitled to 'all the benefits' the franchisor would get from suppliers as a result of its bulk purchasing. This included rebates and discounts. However, the document expressly stated it was not a contract and could not be relied on to determine all the terms of the contract.

The court held that a discount is negotiated with a supplier before sales are made to the franchisees, and is thus reflected on the invoices given to the franchisee when goods are delivered to it. Rebates, on the other hand, were given by manufacturers or suppliers after sales had been made. They were given for reasons unrelated to the individual franchisees, for example, as a reward to a purchaser because its franchised stores had reached a certain number.

The court held that with proper regard to the agreement in question, as well as the background circumstances and the disclosure document, it was clear that it could never have been intended that rebates be passed on to the franchisee.

11 *Seven Eleven Corporation of SA (Pty) Ltd v Cancun Trading No 150 CC 2005 (5) SA 186 (SCA).*

8.9 Current and former franchisees

The disclosure document provides important information about current and former franchisees. Determine how many franchises are currently operating. A large number of franchisees in your area may mean increased competition. Pay attention to the number of terminated franchisees. A large number of terminated, cancelled, or non-renewed franchises may indicate problems. Be aware that some companies may try to conceal the number of failed franchisees by repurchasing failed outlets and then listing them as company-owned outlets.

If you buy an existing outlet, ask the franchisor how many owners operated that outlet and over what period of time. A number of different owners over a short period of time may indicate that the location is not a profitable one, or that the franchisor has not supported that outlet with promised services.

You should request the names and addresses of current franchisees and franchisees who have left the system within the last year. Speaking with current and former franchisees is probably the most reliable way to verify the franchisor's claims. Visit or phone as many of the current and former franchisees as possible. Ask them about their experiences. See for yourself the volume and type of business being done.

The following checklist will help you ask current and former franchisees such questions as:

- How long has the franchisee operated the franchise?
- Where is the franchise located?
- What was their total investment?
- Were there any hidden or unexpected costs?
- How long did it take them to cover operating costs and earn a reasonable income?
- Are they satisfied with the cost, delivery, and quality of the goods or services sold?
- What were their backgrounds prior to becoming a franchisee?
- Was the franchisor's training adequate?
- What ongoing assistance does the franchisor provide?
- Are they satisfied with the franchisor's advertising programme?
- Does the franchisor fulfil its contractual obligations?
- Would the franchisee invest in another outlet?
- Would the franchisee recommend the investment to someone with your goals, income requirements, and background?

Be aware that some franchisors may give you a separate reference list of selected franchisees to contact. Be careful. Those on the list may be individuals who are paid by the franchisor to give a good opinion of the company.

8.10 Earnings potential

You may want to know how much money you can make if you invest in a particular franchise system. Be careful. Earnings projections can be misleading. Insist upon written substantiation for any earnings projections or suggestions about your potential income or sales.

If the franchisor makes earnings claims, they should have a reasonable basis for these claims and provide you with a document that substantiates them. This substantiation includes the bases and assumptions upon which these claims are made. Make sure you get

and review the earnings claims document. Consider the following in reviewing any earnings claims.

- **Sample size:** A franchisor may claim that franchisees in its system earned, for example, R500 000 last year. This claim may be deceptive, however, if only a few franchisees earned that income and it does not represent the typical earnings of franchisees. Ask how many franchisees were included in the number.
- **Average incomes:** A franchisor may claim that the franchisees in its system earn an average income of, for example, R275 000 a year. Average figures like this tell you very little about how each individual franchisee performs. Remember, a few, very successful franchisees can inflate the average. An average figure may make the overall franchise system look more successful than it actually is.
- **Gross sales:** Some franchisors provide figures for the gross-sales revenues of their franchisees. These figures, however, do not tell you anything about the franchisees' actual costs or profits. An outlet with a high gross-sales revenue on paper actually may be losing money because of high overhead, rent, and other expenses.
- **Net profits:** Franchisors often do not have data on net profits of their franchisees. If you do receive net profit statements, ask whether they provide information about company-owned outlets. Company-owned outlets might have lower costs because they can buy equipment, inventory, and other items in larger quantities, or may own, rather than lease, their property.
- **Geographic relevance:** Earnings may vary in different parts of the country. A surf-school franchise in Cape Town may expect to earn more income than a similar franchise in Tshwane. If you hear that a franchisee earned a particular income, ask where that franchisee is located.
- **Franchisee's background:** Keep in mind that franchisees have varying levels of skills and educational backgrounds. Franchisees with advanced technical or business backgrounds can succeed in instances where more typical franchisees cannot. The success of some franchisees is no guarantee that you will be equally successful.

8.11 Financial history

The disclosure document provides you with important information about the company's financial status, including audited financial statements. Be aware that investing in a financially unstable franchisor is a significant risk; the company may go out of business or into bankruptcy after you have invested your money.

Hire a lawyer or an accountant to review the franchisor's financial statements. Do not attempt to extract this important information from the disclosure document unless you have considerable background in these matters. Your lawyer or accountant can help you understand the following:

- Does the franchisor have steady growth?
- Does the franchisor have a growth plan?
- Does the franchisor make most of its income from the sale of franchises or from continuing royalties?
- Does the franchisor devote sufficient funds to support its franchise system?

9 The franchise contract

The franchise agreement is the cornerstone document of the relationship between the franchisor and the franchisee. It is this document that is legally binding on both parties,

laying out the rights and obligations of each. You should have it reviewed by an attorney familiar with franchise matters, especially since most agreements are extremely one-sided in favour of the franchisor.

The franchise agreement should be a well-considered document that clearly sets out the parties' rights and obligations.

Provisions that should be clarified to reduce the possibility of later problems include:¹²

- Time period of the agreement. The agreement normally endures for a period of five years. If its duration is shorter, the franchisee may be concerned that they will not be able to recoup their investment, and if it is longer, that they will not be able to withdraw from the deal. An option of renewal may be inserted.
- Amount of discretion to be granted to the franchisee in the operation of the business.
- Territory and any exclusivity.
- Keeping accurate accounts and records, since royalties owing are usually linked to turnover.
- Amount and mechanism of investment.
- Upfront fees and royalties payable.
- Obligation on the franchisee to purchase certain products or utilise certain services and to maintain specified standards.
- Operating practices.
- Rights of inspection of the franchisor.
- Obligations on the franchisor to assist in setting up, and operating the business (marketing, acquiring and decorating premises, training, procurement of equipment, granting of credit and provision of guarantees, software, general business advice).
- Restraints of trade.
- Advertising policies.
- Settlement of disputes.
- Termination of agreement in the event of the death or insolvency of the parties.
- Protection of the franchisor's intellectual property and confidential business information.
- Security of tenure for the franchisee in the premises of an outlet. Some agreements provide that the franchisor should be the lessee of the premises, the franchisee being the sub-lessee; alternatively, a clause can be inserted in the lease between the landlord and franchisee as tenant, to the effect that if the franchise is sold, the franchisor is entitled to retain the premises.

There is no standard form of franchise agreement because the terms, conditions, and the methods of operations of various franchises vary widely depending on the type of business involved. For example, franchises for printing, employment agencies, and automotive products will differ from the franchises for fast-food service, convenience stores, or clothing.

In almost every franchise agreement there are terms that can be negotiated – typically price, timing of payments, duration of the franchise, the number of people they will train, and territorial exclusivity. Some terms and conditions, however, probably cannot be negotiated, such as trademark issues. However, much depends on the relative bargaining position of the franchisor and you as a prospective franchisee, and how astute your attorney is.

¹² Singh, N, 2005.

As a first step, make sure the statements in the franchising agreement are consistent with the representations made in the documents and material provided to you. The first step in the process is the careful examination of the agreement to verify that it contains everything that was told to you previously.

If you are contemplating a franchising system you should first subject your concept to a careful feasibility study to see if the business you have in mind makes sense economically, and as a franchise concept. And, of course, the operation must be running and successful – no one is going to pay a franchise fee for an untested concept. Then, if you are convinced it does make sense, you should arrange an attorney for the intellectual property protections you'll need, in terms of trademarks, patents, and trade secrets before you start to sell the franchises.

If you are looking to buy an existing franchise, then the same: you should still very carefully study the terms of the existing franchise contract between the existing franchise and the franchisor. How long is its remaining term? Is the price reasonable? Will the operator compete with you afterwards? How does it compare with new franchises the franchisor sells to others? Will you be acceptable to the franchisor? Franchisors invariably have right to approve the transfer or sale of a franchise, or even to negotiate the right to buy back the franchise.

10 Additional sources of information

Before you invest in a franchise system, investigate the franchisor thoroughly. In addition to reading the company's disclosure document and speaking with current and former franchisees, you should speak with the following:

10.1 Lawyer and accountant

Investing in a franchise is costly. An accountant can help you understand the company's financial statements, develop a business plan, and assess any earnings projections and the assumptions upon which they are based. An accountant can help you pick a franchise system that is best suited to your investment resources and your goals.

Franchise contracts are usually long and complex. A contract problem that arises after you have signed the contract may be impossible or very expensive to fix. A lawyer will help you to understand your obligations under the contract, so you will not be surprised later. Choose a lawyer who is experienced in franchise matters. It is best to rely upon your own lawyer or accountant, rather than those of the franchisor.

10.2 Banks and other financial institutions

These organisations may provide an unbiased view of the franchise opportunity you are considering. Your bank manager will be able to provide you with details of other advisers to assist you to analyse whether the franchise is the right decision for you.

10.3 Credit bureau

Check with a local credit bureau to see if the franchisor has any court judgments against it, and what its credit history is like. Do a search on the internet to see if any people have complained about the company's products, services, directors or personnel.

11 Laws and protection for the public

There are no special franchising laws in South Africa. However, a code of ethics, based on international norms, has been published by the Franchise Association of Southern Africa (FASA). There is no obligation for a franchisor to belong to FASA.¹³

Both the Competition Authorities and the Business Practices Committee have commenced investigations into franchising with a view to formulating regulations or guidelines for the franchising community.

The public is protected to a limited extent by the Advertising Standards Authority (ASA), which is a body representing the media, advertisers and advertising agencies. The ASA is able to dictate what advertisements the media will refuse to publish. It has previously made rulings against franchise advertisements that were extravagant, wildly over-optimistic, and positively misleading.¹⁴

Several statutes regulate the protection of the rights of consumer. For additional information, please refer to chapter 29: 'Consumer protection'.

11.1 Competition Act¹⁵

Competition law is dealt with in chapter 35 of this text. Of particular importance to the franchisor are the provisions dealing with exclusive supply agreements as well as practices that enforce retail-price maintenance prohibited under the Competition Act.¹⁶

In exchange for payment, the franchisee is allowed to use a system or marketing plan that is controlled by the franchisor. In effect this creates a vertical relationship between the franchisor, as a supplier of goods and services, and the franchisee, as a consumer of those goods and services.

The Competition Act¹⁷ defines a 'vertical relationship' as a relationship between a firm and its suppliers, its customers or both; and a 'horizontal relationship' as a relationship between competitors. This means that a franchisee is always in a weaker position than the franchisor.

Cancun Trading No 24 CC and others v Seven-Eleven Corp SA (Pty) Ltd¹⁸

A group of franchisees applied for an interdict against their franchisor from forcing them to sell any goods in their Seven Eleven stores at minimum selling prices determined and fixed by the franchisor.

The Competition Commission granted the interdict, and confirmed that a franchise is a vertical structure in which the franchisor is in a more powerful position than the franchisee.

11.2 Consumer Protection Act¹⁹

Every franchise agreement is subject to the Consumer Protection Act,²⁰ which also covers every invitation to enter into a franchise business, and the supply of goods and services under a franchise agreement.²¹

13 Singh, N, 2005.

14 Ibid.

15 Competition Act 89 of 1998.

16 Singh, N, 2005.

17 Competition Act 89 of 1998.

18 *Cancun Trading No 24 CC and others v Seven-Eleven Corp SA (Pty) Ltd, (CT)* (unreported case no 18/IR/Dec99, 7-4-2000).

19 Consumer Protection Act 68 of 2008.

20 Consumer Protection Act 68 of 2008.

21 Whitelaw, B, Franchise agreements - Does the Consumer Protection Act 68 of 2008 point in the right direction? *De Rebus*, Pretoria: Law Society of South Africa March 2014.

The Act limits the ability of a franchisor to force an 'exclusive dealing' arrangement. This is where the franchisee is required to buy certain goods or services only from itself or from suppliers it nominates. However, the franchisor may require the franchisee to do so if the goods or services are reasonably related to the branded products or services that are the subject of the franchise agreement. The franchisor can also require the franchisee to do so if it shows that the convenience outweighs the limitation of the franchisee's right to choose, or if it is of economic benefit to the franchisee.²²

The Act also prohibits 'tying' arrangements. A tying arrangement is where the franchisor refuses to sell one product to a franchisee unless the franchisee agrees to buy another product from the franchisor or some other person. The validity of a franchise agreement may not be made conditional on the franchisee entering into another agreement with the franchisor or someone else.

Franchisees have traditionally traded under a business name that includes the franchisor's intellectual property. For example, where *Spar* is the franchisor and registered owner of the trademark SPAR, it allows franchisees to trade as '*Spar, Kings Park*', '*Spar, Gugulethu*' or '*Spar, Kempton Park*'. In terms of the Consumer Protection Act,²³ a franchisee will not be able to use the '*Spar*' tradename without first registering it as a business name with the Companies and Intellectual Property Commission.

Registration of a business name must be in accordance with the Companies Act.²⁴ The Commissioner may refuse registration if the business name is the same as that of a registered company, or if it is confusingly similar. Registration may also be refused if the business name is the same as a registered trademark, unless the applicant is either the registered owner of the mark or has a licence to use the mark.

Franchise agreements should contain clauses that license a franchisee to use the franchisor's intellectual property. The franchisor's rights and ownership of its intellectual property forming part of the business name will need to be clearly acknowledged. This will allow the registration of the name. On termination of the franchise, the franchisee must then stop using the intellectual property by changing the business name to remove all reference to the franchisor's trademark.²⁵

Courts have great powers in terms of the Act to ensure fair and just conduct. If a court or tribunal determines that a franchise agreement is unconscionable, unreasonable or unjust, the court may:

- Make a declaration to this effect.
- Make an order it considers fair and reasonable in the circumstances. This can include an order to pay money or to give property back to the consumer, as well as to pay compensation to the consumer for any losses.
- Order the supplier to stop practice.

A court may also make an order cutting out or 'severing' any part of an agreement, or change it to make it lawful. It may also declare the entire agreement void and may make any order that is just or reasonable in the circumstances.

Franchisors should keep all the documents and records of all communications with franchisees. They should also ensure that these are accurate. Franchisors should point out

22 Gouws, M, The injunction against vertical restraints in franchise agreements under the Consumer Protection Act, *De Rebus*, Pretoria: Law Society of South Africa December 2010.

23 Consumer Protection Act 68 of 2008.

24 Companies Act 71 of 2008.

25 Scott, G, *Protecting business names*, Johannesburg: Edward Nathan Sonnenbergs, 2009.

any unusual clauses and should wait for the ten-day cooling-off period to end before doing anything further.

The franchisor should keep to all its promises in terms of the franchise agreement and in the disclosure document. Every statement, representation or non-disclosure may be important to legal proceedings at a later stage.²⁶

Aspects of laws relevant to franchising are dealt with in the chapters on contract, sale, credit agreements, lease, consumer protection, competition and delict.

THIS CHAPTER IN ESSENCE

- 1 A franchise agreement is one in which a franchisor grants a franchisee the right to carry on business within a specific part of South Africa. In exchange for payment, the franchisee is allowed to use a system or marketing plan that is controlled by the franchisor.
- 2 While buying a franchise may reduce investment risk by enabling a franchisee to associate with an established company, it can be costly. The franchisee may also be required to relinquish significant control over their business, while taking on contractual obligations with the franchisor.
- 3 To ensure uniformity, franchisors typically control how franchisees conduct business. These controls may significantly restrict your ability to exercise your own business judgement.
- 4 When selecting a franchise, carefully consider a number of factors, such as the demand for the products or services, likely competition, the franchisor's background, and the level of support you will receive.
- 5 The Consumer Protection Act provides for compulsory disclosures and certain terms to be contained in every franchise agreement. The Act also limits the ability of a franchisor to force you to buy certain goods or services only from itself or from suppliers it nominates. However, the franchiser may require you to do so only if it can show that the goods or services are reasonably related to the branded products or services that are the subject of the franchise agreement. The franchiser can also require you to do so if it shows that the convenience to you outweighs the limitation of your right to choose, or if it is of economic benefit to you.
- 6 The disclosure document provides you with important information about the company's financial status, including audited financial statements. Some franchise arrangements require you to contribute a percentage of your income to an advertising fund even if you disagree with how these funds are used. The disclosure document should provide information on advertising costs. The disclosure document also provides important information about current and former franchisees.
- 7 If the franchisor makes earnings claims, they should have a reasonable basis for these claims and provide you with a document that substantiates them. This substantiation includes the bases and assumptions upon which these claims are made.
- 8 There is no standard form of franchise agreement because the terms, conditions, and the methods of operations of various franchises vary widely depending on the type of business involved.

26 Honey, E, *Understanding important legal aspects of franchising*, Johannesburg: Bowman Gilfillan 2011.