SUNDAY TIMES SUPPLEMENT **2016/09/25** **Page: 54-55**

AVE: 212097.26 (ZAR)

LOOKING AT THE FINE PRINT

THE SUCCESS OF A FRANCHISE PARTNERSHIP DEPENDS ON A GOOD RELATIONSHIP (AND AGREEMENT) BETWEEN THE FRANCHISOR AND FRANCHISEE. **CARYN GOOTKIN** TAKES A MAGNIFYING GLASS TO THE FINE PRINT.

A franchise is a legal arrangement where one party (the franchisor) grants another party (the franchisee) the right, in return for a fee, to use its intellectual property and business systems to produce goods or provide a service.

While the franchise model has distinct advantages for both parties (the franchisor gets to expand their business without having to set up costly branches; the franchisee operates under a tried and tested business model with an established trademark), the symbiotic relationship can be fraught with complications. To avoid this, it is essential to read and understand the fine print before signing a franchise agreement.

According to The Franchise Association of South Africa (FASA), the franchise industry accounts for about 12.5% of South Africa's gross domestic product. It's perhaps surprising, then, that there are no specific laws dedicated to regulating the unique aspects of this thriving sector.

Running a business in South Africa requires one to walk a complex tightrope of regulation laws (tax, company, contract, labour, competition, intellectual property) and public interest (consumer protection, environmental law, health and safety standards).

The burden on franchisors and franchisees is even greater, as they have to operate within this regulatory framework while also complying with the (often very prescriptive) terms of the franchise agreement.

"Despite there being no codified franchise law in South Africa, there are several pieces of law that are relevant to the relationship between franchisor and franchisee, and that affect the way the franchise agreement must be framed," says Jyoti Narshi of Werksmans Attorneys. "The legal framework within which franchises operate is both complex and vast, and one should never enter franchise negotiations without seeking legal advice."

Because the franchisee is often in a weaker position than the franchisor at the time of negotiating the agreement, they must think very carefully before agreeing to terms that could have far-reaching implications.

"A well-considered agreement should be a strategic business decision, taken after evaluating risks and rewards," advises Narshi. "Every decision you make will be affected by the franchise agreement."

The following areas of law directly affect franchise agreements:

Intellectual property law. An important part of what the franchisor makes available to the franchisee, to enable them to operate their business in accordance with the franchise agreement, is the franchisor's intellectual property. This may take the form of trademarks, copyrighted material, business know-how, patents or a combination of these. This is usually dealt with in the agreement by granting the franchisee a licence to use the franchisor's intellectual property to run the franchised business. The laws relating to the various forms of intellectual property apply equally to franchise agreements.

Competition law. On the face of it – and although not intended by the drafters – the Competition Act of 1998 prohibits several aspects of franchise agreements. So, in 2005, the Competition Commission published a note clarifying its stance on franchising. The commission touched on the following aspects of Competition Law that relate to franchise agreements:

- **Resale Price Maintenance.** The prohibition in the Competition Act on resale price maintenance is of particular importance in the franchising business model, because previously franchisors would often impose a minimum resale price on the franchisees' sale of the product or service. "The commission clarified that this prohibition does apply to franchisors," says Narshi. "While they may recommend a price, they can't bind the franchisee to the price, nor can they penalise the franchisee's failure to sell at that price. Also, the franchisee must be free to give discounts without fear of repercussion."
- **Territorial Restrictions.** Agreements that divide up the market by allocating exclusive territories or customer groups to certain franchisees are obviously problematic in terms of competition law. However, where the relationship is strictly vertical (the franchisor is only a supplier and doesn't trade in potential competition with franchisees), it may be possible to defend such restrictions using efficiencies in distribution or other pro-competitive arguments. Also, franchisors may apply to the commission for exemption from the prohibition against territorial exclusivity.
- **Exclusive Dealing.** An obligation on a franchisee to only buy goods from the franchisor or its nominated supplier can limit competition. Exclusive dealing provisions may be justifiable, however, only if necessary to protect the franchisor's know-how and goodwill. "The inability to trade outside the confines of the franchise agreement is very limiting to franchisees," says Narshi. "A franchisee should not, without good reason, be prevented from buying from a supplier other than the franchisor if the goods are of the same quality and would not harm the trademark or reputation of the franchisor."
- **Tying** occurs when a franchisee is made to buy products from the franchisor that are not really needed (tied products) to qualify to buy the products that are needed (tying products). A franchisor should not force franchisees to buy products that are not critical to the running of the business, unless there are valid justifications.

Consumer protection law. Before the Consumer Protection Act (CPA), there was often an imbalance of power between franchisor and franchisee when negotiating the contract. Despite considerable work in 2002 on a draft South African Franchise Bill, the Department of Trade and Industry chose to regulate franchises under the umbrella of the CPA.

"The CPA places the franchisee in the position of an ordinary consumer, which is a strange fit as the franchisee usually has access to legal resources, and the agreement is often a negotiation," explains Narshi. "This makes compliance with the act's compulsory provisions tricky for the parties to a franchise agreement, and brings every franchise agreement, regardless of size, within the ambit of the CPA."

The regulations to the CPA set out what a franchise agreement must contain and how it should look:

- Franchise agreements and all related documents and notices must be written in plain language. The law protects a franchisee by stipulating that these documents must be in clear and understandable language. Franchisees who don't understand any part of the agreement should ask for it to be rewritten in plain language.
- Every agreement must contain the text of Section 7(2) on the first page: A franchisee may cancel a franchise agreement without cost or penalty within 10 business days after signing such agreement, by giving written notice to the franchisor. "Franchisees therefore have a cooling-off period of 10 days within which to get out of the agreement without penalty and should use this time wisely," cautions Ina Meiring of Werksmans Corporate Advisory Services.
- The regulations prescribe both mandatory and prohibited content for franchise agreements.
- The regulations prescribe information the franchisor must make available in a disclosure document, to give the franchisee information about the financial state of the franchisor's business at least 14 days before signing the agreement.

Tax law. Earlier this year the South African Revenue Service (SARS) issued a Draft Guide on the Taxation of Franchisors and Franchisees, which summarises the payments typically made by a franchisor to a franchisee, and the various income-tax implications of each payment.

An example of the complexities of this area of law is that initial franchise fees for the right to use the franchisor's intellectual property, which is an essential component of almost all franchise arrangements, are capital in nature and therefore not deductible in the hands of the franchisee. However, royalty payments for the ongoing use of the franchisor's intellectual property and business processes are generally deductible in the hands of the franchisee.

Jenna Mason, a senior manager at KPMG Tax & Legal, explains: "Often a franchisee will enter into a franchise agreement that requires the payment of an upfront, initial franchise fee to the franchisor. In many instances, the franchisee deducts this payment in full for tax purposes in the year of payment. However, in our experience, this fee (or at least a large portion thereof) is usually not tax deductible."

In some instances, a portion of the fee may be tax deductible if it relates to initial advertising or training costs. The franchisee must get a breakdown of exactly what the initial fee covers, to correctly determine what portion of the amount can be claimed for tax purposes. "The incorrect deduction of initial franchise fees by franchisees is definitely on SARS' radar," adds Mason. "The recent guide by SARS has been issued to assist SARS assessors and auditors with tax audits of the industry." ■

DID YOU KNOW?

The Consumer Protection Act, No. 68 of 2008 was signed on 24 April 2009. It aims to, among other things: promote a fair, accessible and sustainable marketplace for consumer products and services; and promote responsible consumer behaviour.

DISCLOSURE DOCUMENTS

1 THEY MUST CONTAIN THE FOLLOWING MINIMUM CONTENT:

- The number of individual outlets franchised by the franchisor;
- The growth of the franchisor's turnover, net profit and number of individual outlets franchised for the previous financial year;
- A statement confirming no significant or material changes in the franchisor's financial position since date of the last certificate, attesting that the franchisor has reasonable grounds to believe it will be able to pay its debts as they fall due; and
- Written projections in respect of levels of potential sales, income, gross or net profits or other financial projections for the franchised business or franchises.

2 THEY MUST BE ACCOMPANIED BY AN AUDITOR OR ACCOUNTING OFFICER'S CERTIFICATE STATING THAT:

- The business of the franchisor is an ongoing concern;
- To the best of their knowledge, the franchisor can meet its current and contingent liabilities;
- The franchisor can meet all of its financial commitments in the ordinary course of business as they fall due; and
- The franchisor's audited annual financial statements for the most recently expired financial year have been drawn up in accordance with South African generally accepted accounting standards, and fairly reflect the financial position at that date and for the period to which they relate.

3 THE DISCLOSURE DOCUMENT MUST HAVE A LIST OF CURRENT FRANCHISEES AND INCLUDE:

- The name under which each franchisee conducts business;
- The name of its representative;
- Its physical address, email address and office telephone number, together with a clear statement that the prospective franchisee may contact or visit any of them to assess the information given by franchisor; and
- An organogram depicting the support system in place for franchisees.

Information provided by Ina Meiring of Werksmans Corporate Advisory Services.

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