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MAKING LIFE A PIECE OF CAKE™

16 September 2008

Committee Secretary,
Parliamentary Joint Committee
on Corporations and Financial Services,
Department of the Senate,
PO Box 6100, Parliament House,
Canberra. ACT 2600

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I wish to reinforce the concerns and representations of The Franchise Council of Australia, regarding emotional and inaccurate statements that have been made in Federal Parliament and in State inquiries regarding conduct in the Australian franchising sector. In addition submissions by our own master franchisee/s currently before the Committee Secretary are in, our view, one sided and in some respects may constitute opportunistic misrepresentations.

Essentially I refer to submissions arguing that master franchise agreements should be renewed at the end of the term or that the master franchisee should receive a goodwill payment.

The major justification appears to be the assertion that the master franchisee generates the goodwill. This neglects the fact that the master franchisee has used the franchisor's brand and significant brand awareness, marketing expertise, and the franchisor's systems. It fails to take into account the necessary contribution of the franchisor's training and on-going assistance to the franchisees success. All this has helped the master franchisee earn significant income throughout the term of the franchise. In the case of The Cheesecake Shop master franchisees this income has (in the main) been a significant 6 figure sum for a long time.

In setting the financial split of the royalty from sales by sub-franchisees between franchisor and master franchisee, and what work franchisor and master franchisee had to do to earn the income, the franchisor had to ensure that the risk/reward allocation was fair to the master franchisee. If not, there would have been no incentive for the master franchisee to expand the network and provide on-going support to sub franchisees.

A TASTE WORTH FINDING™

In providing via the franchise agreement a split of the royalty stream from sub franchisees that is favourable to the master franchisee, the franchisor tried to ensure that the master franchisee could be well rewarded financially on an annual basis for good performance. This has occurred.

Throughout the term of the master franchise agreement, the master franchisee receives a substantial amount of money for each franchisee that joined the system. Asking for a goodwill payment at the end of the term when the master franchisee has already received a lump sum for every franchisee that joined and an ongoing royalty for providing ongoing support would, put simply, be double dipping. The master franchisee should not be paid twice for the same thing.

As the master franchise agreement explicitly states that there is to be no goodwill payment at the end of the term, there could not have been, and there should not now be an expectation of a payment. Fundamentally, the franchise agreement gave the master franchisees the right to earn a potentially significant income stream for up to 15 years (in the majority of cases). The business arrangement was not designed to give a capital gain by way of goodwill at the end of the term.

All master franchisees were initially instructed, have been regularly reminded and have always known there was no requirement for a goodwill payment. To require a payment now would be completely contrary to the master franchise agreement and would fundamentally alter the nature of the arrangement. The master franchise agreement was designed to give the master franchisee a significant annual income in return for expanding and providing support services to the network of sub franchisees in its territory. It was not designed to give a goodwill payment at the end of the term. Such a payment would be a bonus payment that was never envisaged, and not budgeted for by the franchisor.

A State General Manager who might perform similar support and training services would not be entitled to receive a goodwill payment at the end of the term of a fixed term employment contract.

An Area Developer (i.e. one that performs the same functions as a master franchisee but does not enter into franchise agreement with sub franchisees) is not entitled to a goodwill payment at the end of the term. As such a concept is not covered by the Code, there would be significantly different consequences depending simply on the type of legal structure employed. Legislation would start influencing the type of structures used. Businesses may choose structures that may not be the most efficient, but would avoid legislative interference. This would create inefficiencies Australia can hardly afford right now.

If the law is changed to allow for goodwill payments to master franchisees at the end of the term, I believe franchisors will not appoint master franchisees so as to avoid having to make goodwill payments. They will appoint area developers. The Cheesecake Shop will have to look at the franchise model to see if it is financially worthwhile to continue with franchising.

There is only a finite amount of profit from the sale of product to consumers that can be split between franchisor and franchisee. If TCS is forced to pay goodwill payments, it will have to increase the royalty it receives from franchisees to ensure it has the funds to pay the goodwill. This would result in franchisees earning less annual income. That is not something TCS wants to do and may threaten the successful franchise model that now exists.

A blanket rule that franchisors pay a goodwill sum at the end of the term of a franchise agreement if the agreement is not renewed:

- ignores the unique status of every franchise system;
- ignores the fact that any goodwill generated is generated by the efforts of master franchisee, sub franchisee and franchisor and not solely by the franchisor sub-franchisee or master franchisee;
- would require the franchisor to pay for goodwill it generates;
- ignores the risk and reward allocation that the franchisor and franchisee freely agreed upon at the start of the arrangement;
- ignores the fact that rarely does the master franchisee or franchisee pay a goodwill payment to the franchisor at the start of the agreement;
- would treat franchise agreements from other similar arrangements such as exclusive distributorships, fixed term service contracts and exclusive manufacturing agreements that are not franchise agreements within the meaning of the code;
- may put at risk the franchise model which has proved very successful over a number of years and is the cornerstone of small business in Australia.

Yours sincerely,

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Managing Director