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Submission by the Franchise Council of Australia in relation to the likely economic impacts of introducing an automatic right to renew a franchise agreement into the Franchising Code of Conduct

FRANCHISE COUNCIL OF AUSTRALIA

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1. Purpose of this submission

The purpose of this submission is to provide additional information for the consideration of the Joint Standing Committee on Corporations and Financial Services (**the Committee**) in the context of the inquiry into the operation of the Franchising Code of Conduct (**the Inquiry**).

This submission concentrates upon the legal position of the franchisor and franchisee at the end of the term of the franchise, and considers the possible economic impact of any change to the current legal position.

It has been suggested in apparently coordinated submissions to both the current Federal review and recent State reviews conducted in South Australia and Western Australia that the laws relating to franchising require amendment to provide existing franchisees with a guaranteed right of extension at the end of the term of a franchise agreement. The proposition has also been described, somewhat misleadingly, as a good faith or fair dealing obligation at end of term.

Each of these concepts is essentially a variation on a theme. In essence the submissions suggested that the Code should be amended so as to provide that a franchisor cannot and should not be able to refuse to renew a franchise agreement other than in specific circumstances or without compensation. This suggestion was manifested in various ways in different submissions. For instance, some submissions suggested that there should be certain conditions under which the franchisor would be permitted to refuse to renew a franchise agreement, whereas other submissions referred more opaquely to "security of tenure" and "good faith and fair dealing" at end of term. In later submissions there appears to be a proposition that there be a statutory creation or recognition of a right to a payout, which has for cosmetic reasons been described as a right to recognise and "share" goodwill. There has even been a recent attempt to define the issue as a specific ground of unconscionable conduct.

However cloaked, at law the Proposal in essence seeks to provide franchisees with either an automatic right of renewal at the end of the term of their franchise or a right to receive a payout from the franchisor (**the Proposal**).

The Franchise Council of Australia and others have already provided detailed reasoning to support their contention that no such change should be contemplated. The purpose of this submission is to further explain the legal position for the benefit of the Committee, and consider the economic effects that the implementation of the Proposal would have on franchising, and therefore the Australian economy.

2. The legal position

The current legal position is clear and certain. As a matter of law all parties presenting to the Inquiry concede that at the end of the franchise term the franchisee has no legal right to an extension, and no right to compensation. The position is summarised in the authoritative Australian text *Franchising Law & Practice* as follows:-

> *Under a franchise agreement the franchisee simply acquires the right to use the franchisor's name and business system for the term specified. Absent contractual provisions to the contrary the franchisee has no right to have the franchise renewed and, on termination or non-renewal has no right to the goodwill and other features of the franchise which belong to the franchisor.*[1]

This legal principle derives from areas such as leasing and intellectual property licensing, where it has always been understood that when an agreement is over, it is over.

In the context of the dispute between [redacted] and [redacted] that has motivated a number of submissions to the Inquiry it is important to note that the legal principle was expressly considered and confirmed by the High Court of Australia in Ranoa Pty Ltd v BP Oil Distribution Ltd. In this case BP advised Ranoa Oil that it would not be granting a further franchise agreement for a service station on expiry of the existing franchise agreement. BP in fact took over the operation of the business at the premises at the end of the agreement, and operated the business itself. So the facts are fundamentally identical to those in the current dispute between [redacted] and [redacted]

Ranoa Oil argued that it had a right to renewal, or a right to compensation. The High Court disagreed. In confirming the legal position to be as stated above, the High Court noted:–

> *"On expiry or termination of the agreement, the franchisee has no right to continue operating the business and no right to share in any goodwill that may have accrued to the system during the franchisee's tenure."*[2]

Submissions to the Inquiry have endeavoured to give the impression that this is an area of law that is not well understood or is in need of clarification. Nothing could be further from the truth. The law is crystal clear, and any reform proposal would not only specifically overrule a High Court decision but have implications well beyond franchising into areas such as commercial leasing, IP licensing, outsourcing contracts and numerous other forms of commercial agreements.

The FCA does not believe this is a genuine franchise industry issue. It has come to prominence solely as a result of a commercial dispute between two large corporations, one of which is now using political leverage to achieve a result it would be unable to achieve in the courts. The issue was not the subject of complaint at the time of the High Court decision in 1989, as it reinforced the accepted legal view. It was also not raised in 1996 when the Government considered the regulatory framework in its entirety, and introduced the *New Deal Fair Deal* reforms featuring the Franchising Code of Conduct and the enactment of s51AC of the Trade Practices Act in 1998. Nothing in this legislation contradicts or seeks to overturn the High Court decision. Similarly the fundamental principle (that the agreement is at an end with no residual rights to renewal or compensation at expiry) continues to apply unchallenged in areas such as commercial leasing.[3]

It has been suggested that the current law may be certain, but it is unfair. This assertion flies in the face of the structure of the Code, which is not to regulate the content of franchise agreements but to provide a fair and effective process for business owners to make informed decisions and reach commercial agreement. The critical issue in business contracts is certainty, not vague concepts of fairness that may be applicable in consumer transactions. In the context of franchising, the certainty is enhanced by the Code process and the requirements for franchisees to seek legal and business advice. As the law is currently so certain, all legal and business advisors would be well aware of the legal position, and would advise their clients accordingly. The same applies to banks lending to

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[1] See Franchising Law & Practice Paragraph 17.0130

[2] (1989) 91 ALR 251 at p257

[3] See for example the recommendations of the recent Productivity Commission Inquiry Report on the Market for Retail Tenancy Leases in Australia.

franchisees. Further, because the situation has been so clear since at least 1989, the FCA believes there is a widespread understanding within the commercial community of the law. This is possibly because the same situation applies in arrangements such as commercial leases. So it is not possible to genuinely assert that there is some hidden issue of unfairness or trick of commercial practice.

As the FCA has argued in its detailed submission, there are good commercial reasons why an existing franchisee is in a strong position to secure a further extension. Further, it is undesirable to create legal uncertainty where there is such certainty at present. The FCA refers the Committee to the detail of its prior submission on these issues.

3. The economics of the franchise relationship

Franchising is a proven and successful business method used across almost all industries. The success of the Australian franchise sector has been well chronicled. In 2005 total sales turnover in the franchising sector was $128 billion representing approximately 5% of Australia's gross domestic product. There are over 1,000 franchised systems, and approximately 60,000 franchisees. Elsewhere in this submission we set out other relevant statistics.

These figures are not only impressive but highly significant when considering the possible economic consequences of any amendments to the Code. Any change that impacts the underlying financial obligations of the parties will have significant economic consequences to many people.

In the context of the industry impact of the Proposal we make the following observations to assist the Committee in its deliberations:-

- If enacted retrospectively, most of the 60,000 franchise agreements would be affected, as the vast majority are fixed term and have been negotiated based on the current state of the law. The law has been certain and unchallenged since at least 1989. Any change to the legal position must by definition therefore have significant economic consequences.

- The inclusion of a statutory right of automatic renewal or some right to a payout at the expiration of the franchise term unless an extension is granted would directly contradict the current legal position and essentially overrule the decision of the High Court of Australia in Ranoa Oil case;

- If a statutory right of renewal was granted it would, by virtue of clause 20 of the Code, be able to be transferred, thereby essentially giving the franchisee the right to sell the same rights;

- Conversely a franchisor would lose (depending upon the ultimate legislation) the value of system and location goodwill. In the Ranoa case an oil company successfully argued that at the end of the term it could re-take possession of the premises and operate the business itself. A change in the law would therefore change the economics of the deal, such that there would be a transfer of value to the franchisee;

- Presumably the Committee could not possibly contemplate retrospectively changing the commercial position of the parties to existing franchise agreements. Yet such a change is being advocated by some of those making submissions to the Inquiry. The enormous potential economic impact of such a decision is set out in paragraph 5.2 below;

- A new franchise agreement negotiated after the introduction of any law changing the legal position of franchisee and franchisor would need to consider any change in the legal rights of the parties when calculating the desired respective return on investment;

- To achieve the same return on investment franchisors would need to adjust the initial fees, the ongoing fees or other revenue streams or include provisions that provided some for of capital return or fee on each subsequent renewal. The most likely area of adjustment would be initial fees and transfer fees. The outcome would be an increase in the entry cost to franchising, a consequent increase in the cost of borrowing to franchisees and possibly an increase in other fees if there was a resistance to changing up front fees. The estimated economic impact is set out in paragraph 5.2 below.

4. Background statistical information

To develop some idea of the possible industry impact it is necessary to extrapolate from some of the published information, and make some assumptions. In reaching our preliminary conclusions we have drawn from the following published statistical information.

4.1 Initial fees / start up costs

The Franchising Australia Survey of 2006 (**Survey**) conducted by Griffith University identified that in relation to the establishment of a franchised business:

- the average start up costs of a retail unit franchise were $262,500;
- the average total start up costs in a non-retail franchise system were $50,500;
- the average initial franchise fee was $30,000;
- the average start up fee for a retail franchise was $38,250;
- the average start up fee for a non-retail franchise was $26,250;
- The average franchise term is 5, with a 5 year option also common outside shopping centres where longer leases are available;
- Franchisees stay in their businesses an average of 7 years.

Of particular relevance to the current Proposal are the initial franchise fees, which the Survey notes are charged by over 95% of franchisors. They are charged by franchisors for the grant of the right to the franchisee use the franchisor's intellectual property – i.e. they are an upfront licence fee for the right to use the intellectual property associated with the brand. So to some extent they reflect a pre-estimate of the goodwill pertaining to the system for the term of the franchise, on the assumption that even in a start up franchised business the strength of the brand, system and reputation enables the business to trade profitably from an earlier stage. These fees are usually used by franchisors to recover the franchisor's costs of recruiting, selecting and training the franchisee.
Start up fees vary between franchisors and depend on various factors, such as the value of the brand, the size and maturity of the system, the initial training and support the franchisor will provide, the nature and business value of the intellectual property the franchisor will provide, the term for which the franchisee will have access to the intellectual property, the capital investment the franchisee will have to make in the business and the likely return the franchisee will make on the investment. Where the franchisor establishes the business and then transfers it to the franchisee it is common for the initial fee to include a specific goodwill component over and above the initial fee.

The key variable in the context of this submission and reform proposals is the term of the agreement. The longer the term, the greater the value. In most cases franchisors will not randomly determine a start up fee but will determine a start up fee based on substantial financial modelling, taking into account many, if not all, of the factors detailed above.

A critical factor in setting the term is not just the desired return on investment of each party, but the capacity of the franchisee to fund the purchase. In a competitive market for franchisees, and with lack of capital still the major impediment to franchisees, franchisors are keen to keep the initial fees as low as possible. The trade off for a lower initial fee is a shorter term. So if by operation of law franchisees are given a longer term, the initial fee will have to increase or some adjustment will need to be made to other revenue streams.

4.2 Other fees / ongoing costs

In addition to start up fees there are other fees associated with establishing and operating a franchised business. In particular, the Survey notes that:

- over 85% of franchisors charge ongoing franchise fees;
- 62% of franchisors charge marketing or advertising fees;
- 17% of franchisor respondents charge fees for ongoing IT services; and
- 7% charge fees for training.

In the context of this inquiry ongoing fees are less relevant, as they only apply during the currency of the agreement. The Proposal would not directly affect ongoing fees unless for some reason

franchisors felt they were unable to increase initial fees and transfer or renewal fees if there were any increase in the length of term.

Ongoing fees do however play an important role in ensuring that existing franchisees generally do receive an extension of their term. Commercially a franchisor will be keen to retain an existing franchisee, who is trained and experienced, and enjoy the ongoing revenue stream particularly when an existing franchisee will usually run the business with higher sales (and therefore higher royalty to the franchisor) and more profitably than either a new inexperienced franchisee, or the franchisor would run it as a corporate store. Similarly granting an extension of a franchise at the end of term saves the franchisor recruitment costs. So the existence of ongoing fees acts as an incentive for franchisors to grant an extension, and explains why anecdotally most franchisors would grant an extension to an existing franchisee at end of term. It makes good economic sense to do so.

5. The likely economic impact of the Proposal

5.1 Increase in initial fee

The term of the agreement is not only directly relevant to the amount of the initial fee, it is in fact used to calculate the amount of the initial fee. In a typical situation the initial fee and the ongoing fees are determined through financial modeling which takes into account the revenue stream expected to be received during the term, the initial and ongoing costs and the capacity of the franchisee to afford to acquire and then operate the franchised business. This exercise also involves consideration of the desired return on investment of both the franchisor and the franchisee. Any statutory change that increases the term of the franchise agreement or entitles the franchisee to a payout will necessitate a consequential change to the franchisor's fee structure.

If a new statutory right is created that is different to the current law, but that right only applies to new franchise agreements, the parties will adjust their commercial positions. The likely outcome will be an increase in the amount of the initial fee. If the change impacts all existing agreements the franchisor will have no opportunity to recover the lost value, so there is a wealth transfer from franchisor to franchisee. The amount of this wealth transfer can be calculated in the same way, by noting what the initial fee ought to have been at the time compared to what it was.

According to the Survey, the average period of time that franchisees remain in a system is 7 years. This is marginally longer than the average length of a franchise agreement (being 5 years) suggesting that many franchisees succeed in gaining an extension of their agreements, and then sell part of the way during the second term when the business value is probably at its optimum. For the purposes of illustration we have calculated the appropriate initial fee for a 7 year term and for a 10 year term.[4]

So we have used the initial fee as the basis for our calculations. The calculations in the table note the dollar increases if franchisors increase their initial franchise fees proportionately to the likely increase in the term of the franchise agreement. In summary, we postulate that if a franchisee essentially has a right of ongoing renewal the initial fee for new agreements would at least double. This is also the measure for the amount of the wealth transfer if the new law applied retrospectively to existing agreements.

<u>Retail</u>

Initial fee	Term
$38,250, (current average fee)	5 years (current average term of franchise agreement)[5]
$53,550,	This is the estimate of the new fee if the term is extended if the franchise agreement is extended beyond the term, say to 7 years. The 7 year term is 40% longer than the current average term of franchise relationship of 5 years, hence the fee has been increased by 40%.
$76,500	10 years or more

[4] We could have attempted to calculate the optimum goodwill value of a franchised business, but there is no statistical information on the sale prices achieved by franchisees. It would be normal to expect a sale at a multiple of 1.5 – 3 times net profit, but there is no information on average profitability of franchisees and this would vary greatly. However we consider it is reasonable to postulate that the introduction of a new statutory entitlement would see a business increase in value by at least the same percentage as the amount of increase in the term. So to keep the business equation the same, if the term is extended the franchisor would need to increase the initial franchisee fee by the same proportion to achieve the same return on investment.

[5] Note – there is logic to the 5 year term. A 5 year return on investment model is common in small business generally, and in essence equates to a 20% per annum return on investment. 20% ROI would be a reasonable return for any small business owner, and a bank would typically be comfortable lending over such a period.

Service industry

Start up fee	Term
$26,250	5 years (current average term of franchise agreement)
$36,750	This is the estimate of the new fee if the term is extended if the franchise agreement is extended beyond the term, say to 7 years. The 7 year term is 40% longer than the current average term of franchise relationship of 5 years, hence the fee has been increased by 40%.
$52,500	10 years or more

5.2 Industry impact

In the following examples we assume (based on industry statistics) that there are 60,000 existing franchise agreements that would be affected, and that there are around 9,000 new franchise agreements signed each year. Therefore, taking an industry perspective, the possible total economic impact on 60,000 existing and 9,000 new franchise agreements could be modeled as follows:-

1. Wealth transfer on 60,000 current agreements assuming no capacity to re-negotiate the commercial terms and the agreement is effectively extended from the current industry average to 7 year and 10 years. We have also assumed agreements are on average half way through their term, so the economic impact is moderated by 50%.

   The total economic impact could be between $387,000,000 and $967,500,000, calculated as follows:-

   (1) 50% x [30,000 retail franchise agreements x ($53,550 - $38,250)] + [30,000 service franchise agreements x ($36,750 - $26,250)] = 50% x ($459,000,000 + $,315,000,000) = 50% x $774,000,000 = $387,000,000.

   (2) 50% x [30,000 retail franchise agreements x ($76,500 - $38,250) + [30,000 service franchise agreements x ($52,500 - $26,250)] = 50% x ($1,147,500,000 + $787,500,000) = 50% x $5,815,000,000 = $967,500,000.

2. The additional capital cost to franchisees that sign under a new agreement would be calculated as follows, assuming the total additional cost was passed on and 9,000 new franchise agreements were signed each year, which is consistent with historical growth rates for the sector. The calculations also assume sign ups occur 50% in retail and 50% in service.

   (3) At average cost per franchise agreement of $387,000,000 / 60,000 = $6,450, the total industry cost would be multiplied by 9,000 = $58,050,000.

   (4) At average cost per franchise agreement of $967,500,000 / 60,000 = $16,125, the total industry cost would be multiplied by 9,000 = $145,125,000.

3. There is also likely to be an additional interest cost to new franchisees. In the following calculations we have assumed 100% borrowing of extra capital cost at 10% interest rate. The extra cost would at the various levels set out above be:-

   (5) $5,805,000; and

   (6) $14,512,500.

There is also likely to be an impact on growth. Franchising has enjoyed compound growth rates of around 7% for the past ten years, which if maintained would yield additional gross sector revenue of around $900,000,000 annually. If the costs of entry are impacted to this extent it is likely that this growth would slow dramatically at a time when the Government is seeking to encourage economic activity. When the Code was introduced, a relatively benign change, growth slowed by almost 50%. The same impact would slow growth by around $450,000,000 per annum. Further, the effect would be ongoing rather than one off.

These calculations are intended to be indicative only. However the extent of the possible economic impact of a change, being portrayed by some as simple and benign, is so significant that the FCA strongly recommends that the Government undertake further serious independent analysis before seriously contemplating the implementation of any such proposal. The FCA considers that the likely economic effect will be many hundreds of millions of dollars. This alone would appear to justify a rejection of the Proposal, particularly n the current economic circumstances.

6. Conclusion

The economic impact of several other proposed changes to the Code needs to be considered, notably the proposed introduction of a registration system and the introduction of fines and penalties for breach of the Code.

The Franchise Council of Australia is opposed to both changes for reasons articulated in its detailed primary submission to the Inquiry. However the economic costs could be significant, and would include:-

(1) The direct costs of establishing a registration system, with inherent documentation, forms, staff, administration and processes. Anecdotally we understand a previous Government costing for such an activity in 1998 exceeded $6,000,000 per annum.

(2) The additional compliance costs to franchisors. When the Code was introduced in 1998 additional compliance costs were estimated at around $30,000 per franchise system, or $30,00,000 for the sector. At even only 20% of this cost the industry cost would exceed $6,000,000.

(3) The cost of fines to the sector are difficult to determine, but conceivably could also run into several million dollars. Ample remedies already exist for failure to comply with the Code, including damages, the ability to vary or render void the franchise agreement and the right to seek injunctions and such other orders as a court shall think fit. This is a very broad array of remedies.

The FCA strongly opposes any change to the regulatory framework that increases compliance cost. The regulatory framework is acknowledged by all to be structurally sound. Major changes with substantial cost impact cannot be justified when the small business sector is under considerable financial pressure, and conduct such as misleading representations and fraud that merit pecuniary penalties are already separately addressed through other provisions of the Trade Practices Act.

While some have argued that the Code should be amended to provide franchisees with an automatic right of renewal, submissions in support of this proposition have failed to consider the full economic consequences of such an amendment.

Any such amendment would be likely to result in a substantial value transfer from franchisor to franchisee in relation to current agreements and have a significant impact on the costs of being involved in franchising. Indeed the changes would be likely to lead to a dramatic reduction in those choosing to use a franchise model, with a preference for licensing, distribution or some form of less regulated model. This is the impact observed in the petroleum industry, where franchise arrangements were replaced once the Government introduced statutory rights similar to those proposed in relation to the Code generally.

The calculations in this paper are indicative only. The FCA recommends Government undertake serious independent analysis before considering the implementation of any such initiative. The paper is intended to illustrate the gravity of the potential impact of the proposed change and its overwhelming undesirability.

The proposed Code changes run the risk of diverting people from the regulated and successful franchise sector to an unregulated area, with businesses seeking to avoid the Code rather than embracing it and its many beneficial aspects, as they currently do.