PARLIAMENTARY JOINT COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

INQUIRY INTO FRANCHISING CODE OF CONDUCT

SUBMISSION:

COMPETITIVE FOODS AUSTRALIA PTY LTD

SEPTEMBER 2008

EXECUTIVE SUMMARY

Despite the current climate of deregulation, there will still be occasions when additional regulation is necessary, desirable and in the best interests of participants in an industry and the economy as a whole.

Franchising regulation is one such example. Although the Franchising Code appears to work reasonably well in relation to pre-contractual disclosure, it is defective in its regulation of post contractual conduct by franchisors. Additional regulation is therefore needed to complete the existing regulatory scheme in two key respects:

- Express recognition of a duty of good faith, to reflect the relational nature of franchising and to protect franchisees against the improper use of power by franchisors under standard form contracts.

- Establishing minimum standards of appropriate conduct in relation to franchise renewals, by adopting a good cause test that removes the incentive for franchisors to engage in opportunistic conduct and make unwarranted profits at the expense of their franchisees.

These reforms are long overdue and are consistent with the main principles of regulation in the franchising industry that have been developed and identified time and time again since the Swanson and Blunt Committees in the late 1970s, and more recently by the Reid and Matthews Committees.

Competitive Foods Australia Pty Ltd's experience with the closure of its KFC restaurant at Rockingham (shown on the cover of these submissions) in November 2007 provides a clear case study of how the current regulatory void enables franchisors to engage in opportunistic conduct, with the potential to impose significant economic and human costs on franchisees and their employees.

This submission proposes some model provisions for regulatory change to the Franchising Code and to s.51AC of the Trade Practices Act, and the reasons why those changes should be implemented as soon as possible by the Federal Government.

30 August 2008

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OVERVIEW

1. It is timely and appropriate that a Parliamentary Committee in 2008 should review franchising in Australia, ten years after two important reforms were introduced as a consequence of an earlier Parliamentary Inquiry – the Reid Committee in May 1997.[1]

2. The two Commonwealth initiatives that resulted from the Reid Committee were:

   a. Introduction of the Franchising Code, which is enforceable under s.51AD of the Trade Practices Act 1974 (TPA) – this was expressly recommended as Recommendation 3.3 of the Reid Committee Report;

   b. Introduction of a broad-based prohibition against unconscionable conduct, which now appears as s.51AC of the TPA. A model for that provision was contained in Recommendation 6.1 (para 6.73) of the Reid Committee Report. However, when Parliament enacted s.51AC it substituted the term "unconscionable" conduct, for the Reid Committee's preferred term, "unfair" conduct.

3. Competitive Foods Australia Pty Ltd (CFAL), is one of Australia's oldest and largest franchisees operating the Hungry Jack's brand nationally and the KFC brand in WA and the Northern Territory. It is now also a significant franchisor under the Hungry Jack's brand. CFAL employs approximately 15,000 Australians in over 300 outlets nationwide, with an estimated 2,500 employees amongst its 59 sub-franchisees. As a measure of its national reach, CFAL and its sub-franchisees are represented in 122 of the 150 federal electorates, with 21 electorates having between 5-12 outlets.

4. There is strong evidence that not only is franchising widespread in Australia, but that on the whole franchising has been conducted successfully for the benefit of the

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[1] House of Representatives Standing Committee on Industry Science and Technology (Reid Committee), *Finding a Balance: Towards fair trading in Australia*, May 1997; ch.3 'Franchising'; ch.6 ' Legislative protection against unfair conduct'. [CFAL Resource Materials Bundle, tab 10]

economy and individual franchisors and franchisees. These features are clear from an independent report commissioned by CFAL for the purposes of this Inquiry by Jason Gehrke of the Franchise Advisory Centre in Brisbane.[2] However, despite this general success, there are still a number of problems that keep recurring in the industry, despite 10 years of regulation under the Franchising Code.

5. In November 2007 CFAL experienced the needless closure of one of its fully operational KFC restaurants at Rockingham in Perth. Three more restaurants are scheduled for closure in December 2008, with another 46 to close progressively as their terms expire over the next 20 years. These closures have exposed a serious void in franchising regulation in Australia that affects not only CFAL and its employees, but all franchisees, large and small.

6. We therefore commend the Joint Committee for inquiring into the two key issues that lie at the heart of dissatisfaction about the regulation of franchising in Australia:

    a. What aspects of the Franchising Code need improvement;

    b. What aspects of s.51AC unconscionability need amendment.

7. Fundamental to the Committee's task, in CFAL's view, is the need to distinguish between two different problems that lead to franchising failures, each of which requires a different regulatory response:

    - ***Unsuitable franchisees*** – some franchising failures are the consequence of people entering into franchising who should not have done so at all. The disclosure based regime provided in the Code is largely directed at reducing the risk of unsuitable people taking up a franchise. This regulation is necessarily *pre-contractual.*

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[2] J. Gehrke, *An Overview of the Franchise Sector in Australia: A summary of key features and data relating to the Australian franchise sector* (2008), Franchise Advisory Centre, Brisbane.

- ***Unethical or "rogue" franchisors*** – these are franchisors who do not act consistently with accepted industry norms and practices. The Code and s.51AC are generally inadequate to prevent franchisors from abusing their stronger bargaining and contractual powers to the disadvantage of franchisees. This regulation is necessarily *post-contractual.*

8. So far as *pre-contractual disclosure* is concerned, this has been a key focus of the Franchising Code. It is generally accepted, as Griffith University has noted in its 2006 Franchising Survey, that the franchise industry has flourished since the introduction of the Code,[3] despite gloomy predictions by those who were opposed to its introduction. Whilst there are undoubtedly further refinements to the Code that could be suggested and implemented in relation to matters such as disclosure and education, these are not matters that CFAL has canvassed in these submissions.

9. There is also some, limited, regulation of *post-contractual conduct* in clauses 20-23 of the Code, in relation to termination for minor breaches and in other special circumstances, as well as facilitating sale and transfer of franchises. However it is the area of post-contractual "opportunism" by franchisors that is in urgent need of regulatory reform to protect franchisees against bullying and other power-driven tactics by franchisors. This is the key focus of these submissions by CFAL.

10. We also recognise that there are a range of views that have been expressed in recent State Inquiries[4] in relation to franchising about other issues of a procedural nature, particularly those concerning mediation and dispute resolution. CFAL does not wish to comment on these matters, except to observe that the ability of parties to achieve a successful mediation depends upon the existence of substantive protections in the Code itself. Unless the Code stipulates that franchisors must act in a particular way, any mediation or other dispute resolution process is almost certain to fail.

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[3] L.Frazer, S. Weaven & O. Wright, *Franchising Australia 2006 Survey*, Griffith University.

[4] The inquiries in Western Australia and South Australia in 2008 in relation to franchising can be found at tabs 16 and 18 of CFAL's Resource Materials Bundle.

11. The same point, about the need for substantive reform, can be made in relation to the recent High Court decision in *Ketchell's case*. The High Court clearly recognised that the purpose of the Code was to protect franchisees against the power imbalance that exists in franchise relationships, and made special mention of the fact that all of the remedies under the Trade Practices Act would be available for a breach of the Code, including the ability to rewrite the contract if necessary. [5] However these remedies are of little use to franchisees unless and until the Code specifically provides for minimum standards of post-contractual conduct to be observed by franchisors.

12. These submissions argue that additional regulatory protection against unethical or rogue franchisors is needed in the interests of franchisee protection and in the long-term interests of Australia's thriving franchise industry. The submissions proceed on the basis of three core propositions:

    - The only way to achieve minimum appropriate and ethical standards in franchising is by regulation in the Code, due to inherent power imbalances between franchisors and franchisees, the "relational" nature of franchising and the role played by standard form contracts.

    - It is in the interests of the franchising industry and the economy generally, on both efficiency and equity grounds, for regulation to establish minimum enforceable standards in franchising to minimize the risk of opportunistic conduct by franchisors.

    - Given the maturing of the franchise industry in Australia, the introduction of these minimum enforceable standards is now a matter of urgency for the protection of franchisees and the long-term health of the industry generally.

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[5] *Master Education Services Pty Ltd v Ketchell* [2008] HCA 38 (27 August 2008), paras [21], [38].

13. To give focus to the Committee's deliberations, CFAL has prepared some model provisions and draft explanatory notes (Attachments 1 and 2) that we believe would achieve the appropriate regulatory outcomes:

    a. Amendment to the Franchising Code to insert new clauses 23A (good faith), 23B (renewal of franchise agreements) and 23C (renewal procedures).

    b. Amendment to s.51AC of the TPA to ensure that the provision applies to conduct relating to the renewal of an existing agreement (to overcome the uncertainty created by the High Court's decision in *ACCC v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51).

14. There is strong support in existing government reports and the academic literature for the additional regulation that CFAL proposes. The Committee has the advantage that a large body of work in relation to regulation of the franchising industry already exists in government reports dating back to the Swanson Committee in 1976. Relevant extracts from these reports have been assembled in CFAL's Resource Materials Bundle, with particular reference being made to the bi-partisan Reid Committee in 1997. A synopsis of the relevant aspects of these inquiries is contained in Part II of these submissions.

15. CFAL has sought to supplement this work by commissioning an independent report for the Inquiry from Professor Elizabeth Spencer of Bond University.[6] Her report draws upon a substantial body of academic work that highlights the unique features of franchising from a regulatory perspective – particularly the dual problems for franchisees of *relational* and *standard form* contracts, which are an inherent feature of franchising. Professor Spencer's expertise in this area includes a detailed study completed in 2007 which examined the franchising contracts of 19 different franchising systems in Australia.

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[6] E.C. Spencer, Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Franchising Code of Conduct, Bond University, September 2008.

16. CFAL's ultimate submission is that franchising is, by its very nature, a commercial partnership between the franchisor and franchisee, and requires its own regulatory framework. It is a case where regulation is not only good, but appropriate, to ensure that the industry achieves its economic potential, and that all parties are rewarded for their investment of time, money and effort in building franchise businesses. This regulation must necessarily be embodied in the Code, so that is applicable to all industry participants. Part III of these submissions contains an analysis which demonstrates that the model provisions proposed by CFAL satisfy the six key principles of good regulation proposed by the 2006 Regulation Taskforce.

17. At present, the Code is defective in its failure to make provision for an overarching duty of good faith, and an enforceable standard of conduct to apply in relation to franchise renewals. In CFAL's view, the proposed model provisions represent key "missing pieces" from the existing regulatory scheme. As these proposals reflect existing industry practice, particularly in the case of renewals where over 90% of franchises are renewed on expiry,[7] the benefits of protecting all franchisees can be expected to be significant, whilst the costs can be expected to be minimal.

18. With the evolution of franchising in Australia over the last 40 years, concerns like those about opportunistic renewal practices which were first recognised by the Swanson Committee in 1976 are now a reality, and require an urgent government response to finish off the regulatory scheme.

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[7] Griffith University Franchising Australia 2006 Survey, pp.62-63.

I. THE PROBLEM OF FRANCHISOR OPPORTUNISM: KFC ROCKINGHAM AS A CASE STUDY

1. This Part illustrates the problem of franchisor opportunism, by examining the case study provided by the closure of KFC Rockingham. As noted in Professor Spencer's submissions, renewal conduct is one example of opportunistic conduct by franchisors – other issues relate to encroachment, supply requirements, performance requirements and unilateral variation of contracts. The purpose of the Rockingham case study is to reveal a systemic issue that potentially affects all franchisees, rather than being a one-off commercial dispute between CFAL and the franchisor [redacted] International.

Franchisor Opportunism

2. Franchisor opportunism is the name given to predatory conduct and strong arm tactics by franchisors which involve an exploitation of a preexisting power relationship between a franchisor and franchisee, and make the franchisee vulnerable or economically captive to the demands of the franchisor.

3. In one of the leading franchising textbooks, by [Professors] Blair and Lafontaine, franchisor opportunism is described as follows:

> Historically, franchisees have voiced concerns that franchisors may use contract termination and non-renewals to appropriate the units that are most profitable within the chain. In other words, franchisees complained that they do not reap the benefit of their hard work because once they make a market profitable, the franchisor behaves opportunistically and simply terminates or does not renew their contract. The franchisor then presumably appropriates the profits of the outlet either by operating the outlet directly, or by selling it to a new franchisee under a contract involving higher fees.[1]

4. It is important to distinguish opportunism from what is often called "hard bargaining", which appears to be linked to notions of negotiating skill rather than

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[1] R.D. Blair & F. Lafontaine, *The Economics of Franchising*, Cambridge University Press, New York, 2004, p.271.

overarching economic power. Unlike retail tenants, franchisees in an existing franchise relationship do not have the ultimate option of 'voting with their feet',[2] as the closure of KFC Rockingham demonstrates. If a franchise agreement is not renewed, the franchisee has no option to take its business elsewhere but must close the business. In addition, there will usually be restraints of trade provisions that prevent a franchisee from starting up any competing business– again unlike retail tenants who can take their business and set up elsewhere when their leases expire.

5. The economic logic of franchisor opportunism is that, in the absence of regulation, it is attractive for the franchisor to take over profitable outlets for less than their full market value. Three ways in which a franchisor can reap substantial profits by this conduct include:

    a. buying the business cheaply and then selling it for full value to another franchisee;

    b. operating the business as a company owned store and taking 100% of the business profits (now that its viability has been established) and not merely collect a small percentage royalty;

    c. 'clipping the ticket' by churning through successive new franchisees who pay franchising fees, and higher royalties (ie. an established business may support a higher royalty due to the lower risks, than a start-up site).

6. Blair and Lafontaine conclude that high levels of renewal rates of over 90% observed in the US (p.263), which parallel the Australian evidence, suggest that there are countervailing factors that reduce the franchisor's incentive to act opportunistically:

> "We conclude that in terms of non-renewals and termination, as with other aspects of the contract, the benefits of "mistreating" franchisees is typically low, and the cost of doing so can be quite high.

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[2] See Productivity Commission, *The Market for Retail Leases in Australia,* Inquiry Report No. 43, 31 March 2008 (released 27 August 2008), pp.113-115.

> Having said all this, it is important to recognise also that reputation effects do not discipline all franchisors to the same extent..." (p.274)

7. There are three important qualifications to the confidence expressed by Blair and Lafontaine about reliance upon reputational effects to minimize opportunism:

   - Opportunistic conduct is hidden within the 90+% renewal statistic, because franchisees may renew but on substantially disadvantageous terms – this was CFAL's experience in relation to the Domino's issue in 1999 (discussed below);

   - Reputation effects will depend on the life-cycle of the franchise system: during the start-up and growth stages of a franchise business, attracting new franchisees will be critical to the franchisor's business success, and a good reputation for how franchisees are treated will be very important. However, in a mature or declining franchise system, the financial benefits of opportunism may well outweigh any reputational costs of profiting at the franchisee's expense;

   - Reputation effects are a poor disciplinary mechanism in any event, because they are likely to be more effective in ensuring that ethical franchisors remain faithful to good franchising practices, and less effective against franchisors who are more concerned with their own profits than the effect of their conduct on their franchisees or the industry generally.

8. The important point to note is that, in the absence of regulatory intervention, franchisor opportunism is lawful conduct. As [redacted] have told CFAL in relation to the Rockingham closure, they are doing it "because we can". Implicit also in this statement is the premise that the economic benefits to [redacted] of engaging in this conduct exceed the costs, not only in terms of reputation but also the loss of royalties from having a fully operational restaurant open at Rockingham. CFAL's experience with the closure of the Rockingham restaurant provides a good case study of the context in which franchisor opportunism plays out in practice.

CFAL Overview

9. CFAL was established by Jack Cowin in the late 1960s, and he opened its first KFC restaurant at Melville in Perth in 1969, at about the time franchising began in Australia. CFAL is a private company that has largely funded its expansion to its current size through cash flow and the reinvestment of its earnings in the business over the last 40 years.

10. The two key operating divisions of the CFAL business relevant to franchising are:

    a. KFC Division – this now operates 49 restaurants in WA and the NT and is the only operator of KFC restaurants in these markets. CFAL has consistently been one of the top two ranked KFC franchisees in Australia, the other large operator being Collins Food, which operates over 112 KFC franchises in Queensland. As at 31 December 2006 there were 38 KFC franchisees operating 173 of the 326 KFC restaurants in Australia, with the other 153 being operated as company owned stores.

    b. Hungry Jack's Division – CFAL opened its first Hungry Jack's restaurant in 1971 at Innaloo, WA. The franchisor of this brand is Burger King Corporation, based in Miami. Following the conclusion of 4½ years of Supreme Court litigation, Burger King appointed CFAL as its Master Franchisee for Australia in 2005. CFAL owns 259 Hungry Jack's stores as company owned stores (ie. CFAL as franchisee) and now has 59 Hungry Jack's franchisees (ie. CFAL as franchisor).

11. The statistics provided by Jason Gherke's Overview of the Franchise Industry provide some indication of CFAL's position in the Australian market.[3] In terms of the number of outlets, CFAL is outside the top 10 franchise systems, which is dominated by

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[3] J. Gehrke, *An Overview of the Franchise Sector in Australia : A summary of the key features and data relating to the Australian franchise sector (2008)*, Submission to the Inquiry by the Franchise Advisory Centre, Brisbane.

Australia Post and Jim's Group. However, in terms of the number of employees, CFAL would rank very highly. The aggregate number of employees in the McDonald's system is clearly the largest with 75,000 jobs across all of its franchisees. Yet, with approximately 15,000 direct jobs in a single company, CFAL is larger than any of the other top 10 franchise systems.

12. In order to put these statistics in perspective, CFAL remains a very small operator compared with its two major franchisors:

    a. [redacted] Inc is the ultimate franchisor of the KFC brand, and is listed on the New York Stock Exchange. It claims to be the world's largest restaurant company, with annual revenues of US$10 bn, 35,000 restaurants and 1 million staff worldwide through its brands which include KFC, Pizza Hut, Long John Silver's and Taco Bell.[4]

    b. Burger King Corporation is the franchisor of the Hungry Jack's brand. BKC is also listed on the New York Stock Exchange, and claims to be the second largest fast food hamburger chain with 11,200 restaurants worldwide and annual revenues of $2.2 bn.[5]

13. CFAL also has an enviable employment record, with its staff representing a broad cross-section of the working community and in particular provides employment opportunities for students, young people, single parents and other permanent part-time workers. In the case of the KFC division of CFAL, 7 members of the management team have worked with CFAL between 22-35 years, and the top 50 restaurant managers have an average of 12.1 years service with the company. In 2005, CFAL also won the Prime Minister's Employer of the Year Award for the Northern Territory in recognition of its employment programs for disabled workers.

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[4] < www.yum.com/about> (accessed 28 August 2008).

[5] www.burgerking.com/companyinfo/corporation/facts.aspx (accessed 28 August 2008).

KFC Rockingham

14. The KFC restaurant at Rockingham was the 14th KFC restaurant to be opened by CFAL, on 19 November 1977. CFAL found and purchased the site, obtained local government approval and built the building entirely from its own resources. CFAL was also responsible for finding and employing the staff, and for managing the supply chain to the restaurant. At that time neither KFC nor [redacted] had a corporate presence in Western Australia – rather, it has always been based in Sydney.[6]

15. The initial cost to CFAL of building and opening the Rockingham restaurant was $205,000. The initial term of the franchise was 20 years, and this was renewed in 1997 for a further 10 years. During this 30 year period:

    - CFAL has made further capital investments in upgrading the restaurant of $107,800 in 1985 and $300,000 in 1998;
    - CFAL has paid substantial royalties to [redacted]. (Details of the precise financial arrangements can be provided confidentially to the Committee upon request).

16. The terms of the Rockingham franchise agreement dated 17 May 1999 will be provided to the Committee as a Confidential Attachment. This agreement was [redacted] standard form Australian KFC contract at the time. The Australian contract differs from [redacted] standard form US contract – which provides for a rolling 10 year right of renewal if certain pre-conditions are satisfied.

17. On 19 November 2007, the Rockingham franchise agreement expired and the restaurant was closed. It remains closed, the KFC signage has been removed, the windows boarded up and a steel ring fence placed around it. CFAL was able to

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[6] Yum's only presence in WA, other than through the KFC franchises operated by CFAL has been 18 franchised Pizza Hut restaurants, and a KFC restaurant at Karratha, which is due to open later this year.

relocate, or at least offer to relocate the 40 staff members directly employed at the restaurant.

18. [redacted] plainly wanted the KFC restaurant to continue operating, because it had sought to enter negotiations with CFAL in May 2007 to obtain a novation of the lease, and a transfer of the staff. It later emerged that [redacted] had also lodged a Development Application with the Rockingham City Council to build a new KFC restaurant about 100m down the road from the CFAL site, which the Council rejected.

19. CFAL also wanted to keep the restaurant open and offered to enter into various interim arrangements to keep it open whilst discussions took place between [redacted] and CFAL. In this respect, even though CFAL did not have the restaurants on the market for sale, in October 2006 [redacted] offered to purchase the network of 50 restaurants for an amount which was said to represent their pre-expiry cash flows. CFAL estimates that the sum offered represented a discount of approximately 40% to their true value on a going concern basis.

20. Therefore the restaurant closed needlessly due to three reasons:

- CFAL had no right to keep the restaurant open past the expiry date, no protection under the Franchising Code and no clear rights under s.51AC to bring court proceedings to keep the restaurant open.

- [redacted] had no contractual right to acquire the restaurant upon expiry of the franchise contract, nor did it have any contractual right to the goodwill in the business. Its contractual rights were limited to the goodwill in the trade marks and the intellectual property (cl. 8.1) and the ability to acquire the stock, signage, equipment and any supplies at cost or written down value (cl. 16.3).

- CFAL was not prepared to give in to bullying behavior by [redacted] and simply hand over the restaurant for [redacted] to operate, in circumstance where [redacted] was trying to use its right of renewal to exert negotiating leverage to achieve benefits not provided for in the contract – ie. taking over a fully operational

restaurant without paying for it, and forcing CFAL to sell its restaurant network to [redacted] at a significant discount.

21. It is easy to envisage a franchisee in the position of CFAL, which did not have either the financial resources or the resolve to stand up to [redacted] tactics, being forced in this situation to accept whatever terms the franchisor dictated as the price of securing a renewal, or else to accept a payment out for the sale of the business. This is not "hard bargaining" in any conventional sense of the term, but a clear case of franchisor opportunism. That is, where the franchisor seeks to extract unwarranted benefits from the franchisee because the franchisee is an economic captive due to the franchisor's overwhelming power to destroy the franchised business if chooses to do so.

22. As the closure of Rockingham indicates, the consequences of taking a stand against opportunism can be dire for a franchisee – namely the loss of the business, as well as being subject to stringent restraint of trade provisions in the contract that would make it difficult to start again and use existing skills and contacts acquired in the course of the franchise to build a competitive business.

23. Regrettably, this was the second occasion in which [redacted] (then owned by [redacted], [redacted] predecessor) has used its power of renewal to obtain opportunistic benefits. The earlier occasion occurred in 1999 when [redacted] advised CFAL that it would renew 12 of CFAL's franchise agreements which were then under consideration only on the condition that CFAL either (i) agreed to divest its interest in the [redacted] business; or (ii) agreed to sell all of its [redacted] restaurants to a third party approved by [redacted].

24. The background to this issue was the fact that CFAL had acquired an interest in [redacted], as it had in [redacted], at a time when [redacted] then current franchise agreements permitted multi-brand franchising (provided CFAL did not hold an interest in a competitive cooked chicken brand). When [redacted] subsequently changed its franchise agreements to exclude an interest in any other fast food brand, it allowed CFAL to maintain its interest in [redacted] but not [redacted] CFAL understood

that this was due to the fact that [redacted] parent company also owned the Pizza Hut brand, which was a direct competitor to [redacted] and [redacted] was losing market share at the time to [redacted]

25. But for [redacted] threat to not renew these 12 restaurants, CFAL would have had no reason to divest its interest in [redacted] at the direction of [redacted] and should have been entitled to keep its interest in [redacted] just as it kept its interest in [redacted] However, the true position is that [redacted] was not engaging in any "hard bargaining" but was engaging in a naked exercise of power for a completely unrelated purpose by threatening not to renew the 12 franchise agreements.

26. Thus, not only did CFAL experience a direct application of franchisor opportunism, but it is noteworthy that this example of franchisor opportunism would be hidden in the statistics that indicate over 90% of franchises are renewed on expiry. Thus, it might be inferred that the 90% headline statistic actually masks the extent to which opportunistic conduct occurs in one form or another in relation to franchise renewals.

27. In the absence of any regulation in the Franchising Code, there is nothing to prevent a franchisor doing to any other franchisee precisely what [redacted] and [redacted] did to CFAL. That is, to use the threat of non-renewal to extract benefits from the franchisee that were not part of the original contract and did not form part of the basis on which the parties entered into their franchising relationship.

The Berbatis Decision

28. One alternative that might have been available for CFAL to contest the actions of [redacted] in relation to Rockingham was s.51AC of the Trade Practices Act, which prohibits a corporation from engaging in unconscionable conduct. However that alternative appears to have been precluded by the decision of the High Court in

ACCC v CG Berbatis Holdings Pty Ltd,[7] a test case brought by the ACCC in relation to unconscionability under s.51AA of the TPA.

29. The facts in the Berbatis case look to be a case of opportunism by a landlord who used the occasion of a lease renewal to force a tenant to relinquish a legal claim which it had against the landlord for refund of some management fees. Whilst the High Court recognised that continuity of the lease was essential for the tenant to be able to sell its business, they held that the landlord's conduct was not "unconscionable" in the traditional sense of the term. In that case, Chief Justice Gleeson observed:

> "Unconscientious exploitation of another's inability, or diminished ability, to conserve his or her own interests is not to be confused with taking advantage of a superior bargaining position....
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> In the present case, there was neither a special disadvantage on the part of the lessees, nor unconscientious conduct on the part of the lessors. All people involved were business people, concerned to advance or protect their own financial interests. **The critical disadvantage from which the lessees suffered was that they had no legal entitlement to a renewal or extension of their lease; and they depended upon the lessors' willingness to grant such an extension or renewal for their capacity to sell the goodwill of the business for a substantial price**. They were thus compelled to approach the lessors, seeking their agreement to such an extension or renewal, against a background of current claims and litigation in which they were involved. They were at a disadvantage, but there was nothing "special" about it." [8] (emphasis added).

30. In view of the High Court's approach in the *Berbatis* case it must be doubtful whether the concept of unconscionability under either s.51AA or s.51AC could ever be used in a situation involving a failure to renew an agreement – whether it be a lease or a franchise. It is, of course, open to the Parliament to make it clear that

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[7] *ACCC v CG Berbatis Holdings Pty Ltd* [2003] HCA 18; 214 CLR 51. [CFAL Franchising Resource Materials Bundle tab 13]

[8] *Berbatis* at paras [14] – [15].

unconscionability is not limited in the way that the High Court indicated in *Berbatis*, and there are certainly views that s.51AC may have a broader ambit than s.51AA. However, without any amendment to s.51AC of the type which CFAL has suggested in the proposed model amendments in Attachment 2 to these submissions, franchisees will have to wait until a case is taken to the High Court under s.51AC before the position is clarified, and this may be many years hence.

Case Study Summary

31. In summary, the closure of KFC Rockingham is a useful case study to illustrate how and why franchisor opportunism works, and the powerlessness of the franchisee under the current Australian law to respond to this type of conduct by the franchisor. This was not the case of a non-performing franchisee or a badly run outlet. Nobody wanted the restaurant closed, but the franchisor had the power to ensure that the franchisee and all of its employees would suffer if it did not get its way.

32. The true position disclosed by the KFC Rockingham case study is a story about three things concerning franchisor opportunism and franchise renewals:

    a. the weight of the economic circumstances at the end of a franchise mean that franchisors have a free option to take over a business built up jointly by the franchisee and franchisor when the contract term expires on terms that the franchisor is able to dictate;

    b. franchisors do not have to include a provision in their standard form contracts to generate this right – commercially no franchisor would ever do so, because no franchisee would ever enter into a contract where the benefit of its investment of time, money and capital could simply be taken away for nothing by the franchisor;

    c. the franchisor's option arises because franchisees are economically captive at the time of renewal, as they stand to lose everything in terms of their investment in the franchise business unless they give in to whatever demands

the franchisor makes – the only difference with CFAL's position at Rockingham was that it had the financial capacity to stand up to this form of bullying, although it did so at its peril.

33. The Rockingham scenario, and its close cousin – the imposition of collateral demands, as per the earlier [redacted] example – is not "hard bargaining" but a straight forward case of abuse of power. It is contrary to any acceptable standard in Australia of good business practice, morality and conscience, and needs to be eradicated.

34. The only way that franchisees can receive some form of protection against franchisor opportunism, and abuse of power at the time of renewal, is by regulation that applies across the board to set minimum standards of conduct for all franchising relationships. There are many examples where the law in Australia, particularly in the Trade Practices Act, protects weaker parties against similar abuses of power. Franchisees should have the same protection, preferably under the Code, but at the very least by ensuring that s.51AC is not confined by the analysis applied by the High Court in the *Berbatis* case.

35. As the model provisions contained in Attachment 1 demonstrate, CFAL does not seek perpetual rights of renewal, but simply the application of minimum standards of conduct that remove the opportunity for franchisors to abuse their power during the contract term (duty of good faith) and in relation to franchise renewals (good cause renewal obligations). These duties have been moulded on the basis of current industry practice, are well supported by existing Government report and academic literature, and most importantly will impose no additional burdens on franchisors who behave in a proper and ethical manner.

II. A SYNOPSIS OF GOVERNMENT REPORTS AND FRANCHISE REGULATION IN AUSTRALIA

Introduction

1. This Part illustrates the support that is provided by a large body of existing government reports for the provisions proposed by CFAL in relation to the duty of good faith (draft clause 23A) and associated good cause renewal obligations (draft clause 23B, 23C). CFAL ultimately submits that these duties are "missing pieces" in the existing regulatory scheme embodied in the Franchising Code. As such they represent critical, but incremental, regulatory changes that are consistent with and give full effect to the basis on which the franchise industry in Australia is regulated.

2. Supporting the analysis contained in this Part, and the work of earlier Government Inquiries, is the work encapsulated in Professor Spencer's submissions. In those submissions, Spencer shows how the application of first principles in relation to franchising supports the imposition of a duty of good faith and good cause renewal obligations due to:

    a. ***The "relational" nature of franchising contracts*** – this is the well recognised doctrine that highlights the partnership-type nature of the obligations existing between franchisor and franchisee, as they work together to create a business over time. *Relational contracts* are flexible, discretionary contracts that rely heavily on reciprocity and trust (which is the hallmark of good faith), compared with one-shot '*discrete contracts*', that more closely conform to the ideals of traditional contract law.

    b. ***The prevalence of standard form contracts in franchising*** – standard form contracts are an inherent feature of franchising, and are needed to achieve uniformity of systems and procedures between franchisees. The reputation of the brand, upon which the franchisor and all franchisees must depend, requires franchisors to hold considerable power to ensure that uniformity can be

enforced. However this power is also susceptible to abuse, and Spencer notes that standard form contracts written by the franchisor allow the franchisor to monitor and closely control the conduct of its franchisees although they impose a minimum of obligations upon the franchisor in relation to how these powers should be exercised.

3. Many of the arguments raised against duties of good faith and good cause renewal obligations are based on traditional 'freedom of contract' doctrines. However, for the reasons set out in the past Government reports, and in Professor Spencer's submissions, 'freedom of contract' is a myth. Instead, regulatory responses to problems such as that illustrated by the KFC Rockingham case study must take account of the special nature of the franchising relationship, and the inherent problems posed by standard form contracts in franchising.

4. Most of the reports and other documents referred to in this Part are contained in CFAL's Franchising Resource Bundle at the tabs indicated.

Initial Proposals for Regulation – Swanson 1976 and Blunt 1979 [tabs 1, 2]

5. CFAL opened its first KFC restaurant in 1969 at about the time that franchising began in Australia. Five years later the *Trade Practices Act 1974* (Cth) was enacted. Two major reviews of the TPA were conducted shortly thereafter- the first by the Swanson Committee in 1976[1] and the second by the Blunt Committee in 1979.[2] Both of those reviews gave consideration to franchising and made recommendations for regulation of franchisor conduct in the TPA.

6. The Swanson Committee identified a theme which became consistent in all of the later reports, namely that (at para 5.3):

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[1] Trade Practices Act Review Committee (Swanson), *Report to the Minister for Business and Consumer Affairs*, AGPS, Canberra, 1976, ch. 5 'Rights Upon Termination of Franchise Agreements'; [CFAL Resource Material Bundle tab 1].

[2] Trade Practices Consultative Committee (Blunt), *Small Business and the Trade Practices Act*, AGPS, Canberra, 1979, ch. 11 'Franchising' [CFAL Resource Materials Bundle tab 2]

> "The terms of the contract relating to termination or non-renewal will often reflect a balance of power weighted heavily in favour of the franchisor".

7. This observation can, of course, be understood now in terms of Professor Spencer's analysis of the special interaction between relational and standard form contracts in franchising. Nevertheless, despite franchising then being in its infancy, the problem posed by this imbalance of power, as well as a solution, was identified at this early point.

8. Swanson's solution was to include a provision in the TPA that implied a term into every franchising agreement, like the implied terms relating to sale of goods in the Consumer Protection sections of the TPA.[3] The implied term proposed was to give franchisees a right to claim just and equitable compensation for their investment which was dependent upon the circumstances of the termination or non-renewal. (paras 5.7, 5.13).

9. The policy rationale for regulatory intervention was threefold, encompassing fairness, support for small business and the need to assist "*competition generally*" (para 5.8). Swanson said that the law should not require franchisors to continue in business if they wanted to discontinue franchising, nor should it impede marketing changes. Rather, the sole purpose and effect of the law was to provide "*some minimum, fair terms of settlement for terminated franchisees*" (para 5.9).

10. Three years later, the Blunt Committee returned to the same theme. It noted the rapid take-up of franchising in Australia (para 11.2). It noted that the debate in relation to the Swanson Committee recommendations with respect to franchising "did not die away", but had resurfaced in relation to the retail petroleum industry, where the then Minister announced proposals to draft special legislation to protect petrol station franchisees. However Blunt went further and proposed a series of provisions to be introduced in the TPA that would apply to all franchisees (paras 11.5-11.9).

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[3] This approach also parallels Spencer's analysis which draws a clear analogy for regulatory purposes between franchisees and consumers.

11. Blunt's treatment of franchising was more detailed than Swanson, undoubtedly reflecting greater experience with the industry at that time. It identified as the three "*principal problems*" in franchising the following: adequate disclosure, compensation for unjustified termination, and rights of assignment (para 11.23). Both fairness, and the effects of the imbalance of bargaining power on competition generally, were cited as reasons why it was necessary to *stabilize the relationship* through regulatory intervention (paras11.38-11.41)

12. In relation to unjustified termination, Blunt proposed terms for introduction into the TPA based on a "shopping list" approach for termination and non-renewal (paras 11.41, 11.47). Specifically a franchisor was entitled to terminate or not renew a franchise agreement for breach by the franchisee, if it was uneconomic to renew the franchise agreement, or if the franchisor "bona fide decides to withdraw from the particular market area for legitimate business reasons". The incentive proposed by Blunt to ensure that franchisees complied with these obligations was the ability of franchisees to obtain compensation for goodwill if they were terminated for any other reason. Franchisors would also be required to provide notice and reasons for any termination, which by implication included non-renewal.[4]

13. CFAL has built a number of the protections proposed by Swanson and Blunt into its model provisions for the Franchising Code amendments at Attachment 1, as noted in the Explanatory Notes accompanying those model provisions.

14. The concerns expressed by Swanson and Blunt are equally valid in 2008 as they were in the late 1970s. With the exception of a general power in relation to non-renewal, regulation now exists in respect of all of the other problems identified by Blunt: disclosure, limits upon termination for minor breaches and provisions to facilitate franchisee assignment. Even in relation to non-renewal, Parliament acted to deal with the problem in the petrol industry, where pressure for regulatory response appears to have been greatest. It is now time to finish off the regulatory scheme.

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[4] See Blunt, pp.116-119, clauses 4(2), 4(3), (4) and 9(e)

Petroleum Retail Marketing Franchise Act 1980 [tab 3]

15. Parliament responded to pressure in relation to franchisee churning and other opportunistic practices in relation to petrol station franchises with the enactment of legislation to protect the renewal rights of those franchisees.[5] That legislation has served the test of time – after 28 years it still exists today in a slightly different form in the Oilcode.[6] Although specifically tailored for the petrol industry, it provides a ready precedent for a more general regulation of franchise renewals.

16. A critical feature in the drafting of the PRFM Act was the express recognition given to the role of *good faith* in regulating the rights of franchisors and franchisees in relation to renewal. Specifically, s.17 recognised three good causes that a franchisor could rely on for not renewing a franchise, which struck a fair balance between the interests of both the franchisor and franchisee:

    a. Breach of an existing obligation or other disqualifying conduct by the franchisee;

    b. The franchisee did not consent to a variation in then new franchise agreement which was proposed by the franchisor "*in good faith and in the normal course of business*".

    c. Sale of the petrol station to a true third party in the ordinary course of business.

17. In drafting the model provisions in relation to non-renewal for inclusion in the Franchising Code at Attachment 1, CFAL has adopted a number of elements of the provision of the PRFM Act as noted in the Explanatory Notes.

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[5] S.17 of the *Petroleum Retail Marketing Franchise Act* 1980 (Cth) (PRMF Act); replaced by ss.17, 17A of the Petroleum Retail Marketing Franchise Amendment Act 1984 [CFAL Resource Materials Bundle tab 3]. The legislation included a time limit, which had the effect of deferring but not preventing franchisee churn when the time limit expired – this can be seen in the facts of one of the cases that was taken to Court in relation to the Act: *Ranoa Pty Ltd v BP Oil Distribution Ltd* (1989) 91 ALR 251, concerning the BP service station at Engadine in Sydney.

[6] Trade Practices (Industry Codes - Oilcode) 2006, cl. 32.

Failed Exposure Drafts of a Franchise Agreements Bill 1986 [tabs 4, 5]

18. The first attempt to introduce specific regulation in relation to franchising involved the preparation of two exposure drafts of a Franchise Agreement Bill, that was never enacted.[7]

19. The draft Bills were prepared with the authority of the Ministerial Council as part of the Commonwealth/State cooperative companies and securities scheme. It appears to have been envisaged that the proposed Act would form part of the national scheme of companies regulation that included the Companies Code, and the Securities Industry Code, rather than forming part of the regulation of competition policy under the Trade Practices Act.

20. In the Explanatory Notes, the drafters of the Bill emphasized the need for adequate disclosure (para 10), sought to ensure that franchisors dealt fairly with franchisees (para 11), noted the need for regulation to reflect the unique nature of franchising (para 16), were concerned to avoid indefinite security of tenure (para 25), rejected the approach taken in the PFRM Act to renewals (para 27), noted the existence of "good cause" renewal provisions in various other jurisdictions (para 186) but were concerned to avoid the difficulty associated with the "shopping list" approach suggested by the Blunt Committee because of the differences that existed between different types of franchise systems (para 187).

21. The first draft of the Bill therefore contained a regime for disclosure (clauses 16-19), an express prohibition on unilateral variations of the franchise agreement (clause 22), provisions governing termination procedures (clause 26) and a requirement for notice of an intention not to renew of either 90 or 180 days duration (clause 27).

22. The second draft of the Bill focused primarily on disclosure issues, and removed even the limited protections for franchisees in relation to termination and renewal that had

[7] Consultative Paper and Draft Franchise Agreements Bill, 1986 [CFAL Resource Materials Bundle, tab 4], and Second Exposure Draft of the Franchise Agreements Bill 1986 [CFAL Resource Materials Bundle, tab 5].

been part of the first draft, by removing clauses 26 and 27, and reducing the scope of the protection in relation to unilateral variations.

23. This early attempt at drafting regulation for the franchising industry clearly started off with good intentions, but became mired in the recurring theme which dominated later debates about whether or not regulation should be limited to disclosure issues only. However the consequence of this debate was to forestall any substantive efforts at regulation throughout the 1980s.

Beddall Committee Report 1990 [tab 6]

24. Debate about franchise regulation resumed in 1990 with a report by the House of Representatives Standing Committee on Industry, Science and Technology (Beddall Committee).[8]

25. The Beddall Committee reviewed the failure of Franchise Bills, and reaffirmed a continued and growing need for specific purpose franchise legislation to ensure fair dealing between franchisees and franchisors (para 8.33). In doing so, the Committee reaffirmed the significance of the work done by the Swanson and Blunt Committees (para 8.34).

26. In particular, the Beddall Committee noted that franchisee groups were particularly critical of the second draft Exposure Bill, given the exclusion of the fairness protections noted above (para 8.24):

> Franchisee groups saw the narrowing of the focus of the draft bill to exclude fairness provisions and the draft's recognition of the dominant position of the franchisor as a reaction by the Ministerial Council to "pressure from franchisors, potential franchisors and presumably larger business interests".

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[8] Small Business in Australia: Challenges, Problems and Opportunities, Report by the House of Representatives Standing Committee on Industry, Science and Technology (Beddall Committee), January 1990 [CFAL Resource Materials Bundle tab 6]

27. The Beddall Committee concluded by recommending that the Commonwealth Attorney General and the Ministerial Council reexamine the case for specific franchise legislation to deal with four topics, including "*conditions for termination/renewal or transfer of franchises*".

Voluntary Franchising Code 1993 and Related Reports [tabs 7-9]

28. The first step in relation to specific franchise regulation began with the Voluntary Franchising Code of Practice that was introduced in February 1993.[9] The genesis of the Voluntary Code was a Report of the Franchising Task Force prepared for The Hon. David Beddall MP, the then Minister for Small Business and Customs in December 1991, with a supplement in March 1992.[10]

29. In relation to questions of post-contractual conduct and goodwill, the Task Force approached the issues as follows:

    a. It recommended that franchisors and franchisees should not engage in unconscionable conduct. It said that this concept was best not defined, but it did recommend a list of criteria to be considered in determining whether there had been unconscionable conduct in a commercial transaction (paras 5.35-5.38 and Recommendation 37);

    b. It recommended against any protection for goodwill on termination or non-renewal at that stage, but concluded that the issues should be monitored as franchising continues to mature (paras 5.44-5.51).

30. The Task Forces recommendations in relation to unconscionable conduct were taken up in the Voluntary Code in clause 12 as follows:

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[9] Franchising Code of Practice, 1 February 1993, [CFAL Resource Materials Bundle, tab 8]

[10] Franchising Task Force, Final Report to the Minister for Small Business and Customs, the Hon. David Beddall MP, December 1991; Franchising – Australia and Abroad, Supplement to the Franchising Task Force Final Report, March 1992.

12.1 Franchisors and Franchisees will not participate in unconscionable conduct, which is unlawful, in relation to Franchise arrangements.

12.2 Franchisors and Franchisees should also at least observe the following commercial standards/ethical conduct whenever possible in their dealings with one another:

(a) avoid significant departure from general franchise business practice of the time and place;

(b) avoid significant departure from normal commercial arrangements of the particular franchise involved;

(c) avoid substantial over-valuation in fees or prices that are significantly detrimental to either party's business;

(d) avoid conduct which is unreasonable in relation to the risks incurred by one party; and

(e) avoid conduct not reasonably necessary for the protection of the legitimate business interests of the Franchisor, Franchisee or Franchise System.

31. If the obligations embodied in clause 12 of the Voluntary Code were enforceable under the current Franchising Code, CFAL would likely have had a clear right of action to contest [redacted] decision not to renew the Rockingham franchise agreement based on the grounds stated in at least sub-clauses 12.2 (a), (b), (d) and (e).

32. In October 1994 Minister Schacht commissioned Robert Gardini to conduct a review of the Voluntary Code.[11] Gardini noted that a substantial number of franchisors had not registered under the Voluntary Code and recommended a system of mandatory regulation to provide universal coverage for franchise systems.

33. In relation to the standards of post-contractual conduct in clause 12 of the Voluntary Code, Gardini made the following observations and recommendations:

- That the unconscionable conduct provisions in clause 12.1 be extended beyond their common law meaning to ensure that it applies to conduct

[11] R. Gardini, Review of the Franchising Code of Practise, October 1994 [CFAL Resource Materials Bundle tab 9].

engaged in during the course of the franchise agreement, and be amended to include conduct that was 'harsh or oppressive' (Recommendation 5, para 3.5, pp. 23-24, 39).

- There was no redress for breaches of clause 12.2, despite independent survey evidence of substantial disputation between franchisors and franchisees over a range of matters ranging from charging excessive prices, secret rebates and commissions, encroachment, substantial increases in renewal fees, use of advertising levies for other purposes, intimidation and victimization, and unfair termination. (para 3.5, pp.24-25).

- Any attempt to strengthen the standards of conduct within a voluntary code would lead to a loss of registrations under the Code (pp. v, 34).

34. Gardini's observations in 1991 have not lost any force over the ensuing 17 years. With the sole exception of unfair termination, which is now regulated to some extent by clauses 21-23 of the Code, none of the conduct which Gardini has described is regulated by the Code, despite the fact it is now a mandatory and not a voluntary code.

35. The specification of the standards of conduct in clause 12.2 have been of particular assistance to CFAL in framing the model provisions contained in Attachment 1, particularly in defining the scope of the duty of good faith. The principal difference between the model provisions and the clauses in the Voluntary Code is that the adoption of the model provisions in the Franchising Code would render them enforceable under s.51AD of the Trade Practices Act, and thus provide franchisees with a remedy that they lacked in 1991 and still lack now.

Reid Committee 1997, Franchising Code and s.51AC [tabs 10-13]

36. The next major development in relation to franchisee protection occurred with the report of the House of Representatives Standing Committee on Industry, Science and

Technology (Reid Committee) in relation to small business issues in May 1997.[12] As previously noted, this landmark report led to two matters of significance to the present Inquiry:

- The introduction of the Franchising Code as an Industry Code enforceable under Part IVB of the Trade Practices Act.[13] The Reid Committee recommended that this occur, to ensure that the code was enforceable (Recommendation 3.3).

- The introduction of a new unconscionable conduct provision in s.51AC of the Trade Practices Act. This provision was based on a model provision contained in Recommendation 6.1 of the Reid Report, with the exception that the Reid Committee proposed that the section prohibit conduct that was "*unfair*", rather than "*unconscionable*".

Franchising Code

37. Franchising was one particular area of concern for the Reid Committee, and was discussed in Chapter 3 of the Report. The Committee believed that there were widespread abuses occurring in practice. Like the Gardini Review, the Reid Committee was critical of the voluntary nature of the existing franchising code of practice, stating bluntly that "*Clearly self-regulation has not worked*" and noting that self-regulation is not a viable strategy "*when there is such a disparity in the powers of the parties*". Instead the Reid Committee recommended the introduction of a mandatory code underpinned by the Trade Practices Act (paras 3.80-3.112)

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[12] *Finding a balance: Towards fair trading in Australia*, Report by the House of Representatives Standing Committee on Industry, Science and Technology, May 1997, [CFAL Resource Materials Bundle tab 10].

[13] Trade Practices (Industry Codes-Franchising) Regulations 1998, [CFAL Resource Materials Bundle tab 11].

38. The Reid Committee did not design the detail of the Franchising Code, which was promulgated by Regulation in 1998 under the Trade Practices Act as an Industry Code for the purposes of s.51AD.[14] Unlike the voluntary code which it replaced, the Franchising Code did not contain any equivalent provisions relating to the standards of conduct for franchisors and relied principally upon a scheme of precontractual disclosure. There is also no provision relating to renewals, and the only provisions regulating post-contractual conduct by franchisors are:

    - clause 20 provides that a franchisor shall not unreasonably withhold consent to a transfer of a franchise;

    - clause 21 is directed at preventing franchisors from terminating for minor breaches, by requiring franchisors to give the franchisee at least 30 days to cure a breach before exercising any power of termination;

    - clauses 22 and 23 relate to other circumstances in which a franchisor can terminate an agreement without breach by the franchisee.

39. As noted in Part I, the potential strength of the Code has recently been confirmed by the High Court in *Ketchell's case.* Although that case was decided against the franchisee on the facts, the High Court made a point of observing that a breach of the Code could allow the Court to exercise any of the broad range of remedial powers provided in Part VI of the TPA. These include the ability to rewrite contracts under s.87 if necessary to remedy the complaint in question.

Unconscionable Conduct

40. The Reid Committee also examined the problems confronting franchising in Chapter 6, in the context of a proposed legislative protection to guard against unfair conduct. The Committee raised the question *"why, if the economic and moral case for effective*

[14] Trade Practices (Industry Codes – Franchising) Regulations 1998. [CFAL Resource Materials Bundle tab 11].

legislation action is so persuasive, Governments have been so reluctant to act" (6.26). In this respect the Committee cited with approval the early work done by the Swanson and Blunt Committees. The answers provided by the Committee to this question included:

- The pervasive myth that the doctrine of freedom of contract should apply without limitation to franchise contracts. As Reid noted, freedom of contract is not a totally unfettered right but exists within social and legal obligations, which the Parliament should define and protect – this includes appropriate standards of fairness (6.29-6.32).

- The costs of *uncertainty* were overstated. Instead, the Committee concluded that businesses which enforced high ethical standards had little to fear, that the majority of firms would comply with the community's expectations, and that any transitional costs would be outweighed by the very real economic and social costs of not acting (6.33-6.41).

- The power of franchisor lobbying to stifle change was also noted (3.109, 6.27).

41. Although the Reid Committee recommended that the new general provision which ultimately became s.51AC,[15] should not use the word "unconscionable" to define the conduct, the then Minister decided to continue with the use of that established legal term. This was no mere semantic difference, as the Reid Committee had chosen the term "unfair" conduct to give a clear signal to the courts that the provision was broader than the equitable doctrine of unconscionability and was also intended to include conduct that was *harsh* and *oppressive* (6.72).

42. Whilst the Courts have recognised that unconscionability in s.51AC has a broader reach than the traditional equitable notion, it remains an elusive concept. In *Hurley v McDonald's* in 1999, the Full Federal Court accepted that "*serious misconduct or*

[15] A copy of s.51AC is set out at tab 12 of the CFAL Resource Materials Bundle.

something clearly unfair or unreasonable, must be demonstrated", whilst in the *World Best Holding case* in the New South Wales Court of Appeal, Spigelman CJ held that '*a high level of moral obloquy*' is required.[16] It is far from clear that the approach taken by the Courts to the interpretation of s.51AC is what the Reid Committee intended by its broad prohibition against unfair conduct.

43. As previously noted in Part I, the 2003 *Berbatis* case in the High Court has cast significant doubt on the ability of the unconscionability provisions in s.51AC to deal with unfair or opportunistic renewal conduct. This is the problem which CFAL has sought to address in its draft model amendments to the TPA in Attachment 2.

Matthews Review 2006 and Code Amendments [tabs 14, 15]

44. In October 2006 the Matthews Committee, with the assistance of the Office of Small Business in the Department of Industry, Tourism and Resources, produced a Review of the Disclosure Provisions of the Franchising Code of Conduct for the then Minister Fran Bailey MP.[17]

45. The Matthews Review was not a comprehensive review of the Code, but was limited to a review of the operation of the disclosure provisions contained in Part 2 of the Code. A formal response from the Government was provided in February 2007,[18] and amendments were introduced to a number of the disclosure provisions which took effect in March 2008.

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[16] *Hurley v McDonald's Australia Ltd* (1999) FCA 1728, *Attorney General (NSW) v World Best Holdings Ltd* (2005) 63 NSWLR 557, and other authorities collected in *Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd* (No. 2) [2008] FCA 810 at [410]-[427] per Rares J.

[17] *Review of the Disclosure Provisions of the Franchising Code of Conduct: Report to the Hon Fran Bailey MP, Minister for Small Business and Tourism*, October 2006 [CFAL Resource Materials Bundle tab 14].

[18] *Australian Government Response to the Review of the Disclosure Provisions of the Franchising Code of Conduct*, February 2007 [CFAL Resource Materials Bundle tab 15].

46. Pre-contractual disclosure, whilst important, is not a panacea for all of the issues that arise in franchising. In particular, as previously noted, disclosure provisions do not address post-contractual opportunism by franchisors. Further, as Professor Spencer has indicated in her submissions, disclosure is not optimally effective in any event because the conditions for optimal disclosure are not met – such as reliability, accessibility, and useability of the information. However it is not the purpose of these submissions to comment on the disclosure regime or its provisions, beyond noting its limitations as a regulatory tool.

47. Despite the limitations on its terms of reference, the Matthews Committee nevertheless included a recommendation that:

> "A statement obligating franchisors, franchisees and prospective franchisees to act towards each other fairly and in good faith be developed for inclusion in Part 1 of the Code"

48. The Committee reached this conclusion after surveying the law in foreign jurisdictions as well as the developments in some Australian Courts. The detailed findings in this regard are contained in Attachments E and F to the Matthews Report. In particular the Committee noted that the interdependency between franchisors and franchisees was a fundamental feature of the franchise sector, and it expected that a duty of good faith and fair dealing would lead to improved dealings between franchisors and franchisees (Recommendation 25).

49. The Government did not act on that recommendation, although it stated its agreement with the intention that franchisors, franchisees and prospective franchisees act towards each other fairly and in good faith. However it noted that good faith was one of the factors that could be taken into account in s.51AC to determine whether unconscionable conduct had occurred.

50. The ALP, however, did endorse the introduction of a good faith obligation as part of its franchising election policy, provided the scope of this obligation was well

defined.[19] It is to this end that CFAL has sought to define the content of the good faith and good cause renewal provisions that form the basis of the model amendments to the Franchising Code in Attachment 1.

State Inquiries – WA and SA 2008 [tabs 16, 18]

51. In 2008 there have been two state inquiries in relation to franchising. The first was a report by Chris Bothams to the WA Minister for Small Business in April 2008.[20] The second was a report by the South Australian Parliament's Economic and Finance Committee in May 2008.[21] The ambit of the SA Report was wider than that of Bothams, and the SA Inquiry was also conducted as a public inquiry by a bi-partisan Parliamentary Committee.

52. The analysis of franchising in the South Australian Report covered a broad ambit and included the following observations:

- Freedom of contract is not typically met in franchise arrangements, and that franchisees typically hold an inferior position to their franchisor "partner" (4.3);
- The Franchising Code had been ineffective in dealing with the major problems with franchising that it was supposed to fix, including unilateral variation of terms, churning and encroachment issues (4.4);
- S.51AC has not been that effective, because judicial interpretation of the provision has been restricted to serious cases of misconduct, and excluded the consideration of harsh contractual terms (5.2);

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[19] ALP Franchising Policy Statement (October 24, 2007), <www.franchiseadvice.com/content/view/78/1/>

[20] *Inquiry into the Operation of Franchise Businesses in Western Australia: Report to the Western Australian Minister for Small Business*, Small Business Development Corporation, April 2008 [CFAL Resource Materials Bundle tab 16].

[21] *Franchises Report*, No. 65, Economic and Finance Committee of the South Australian Parliament, 6 May 2008, [CFAL Resource Materials Bundle tab 18].

- There are currently unacceptable limits on the ability of franchisees to seek redress for abuse by franchisors of their contractual powers and discretions (5.4)

- Provision of a codified duty of good faith and fair dealing in relation to renewals, rather than automatic renewals, ought to be included in the Code (5.7)

53. The South Australian Committee recommended that the Franchising Code be amended to include duties of good faith and fair dealing, as well as specific provisions imposing a duty to negotiate in good faith in relation to contract renewals. CFAL subsequently obtained an Advice from Mr Alan Robertson SC, an expert in administrative law, who confirmed that the implementation of those recommendations in the Code would not involve any element of retrospectivity, nor would they otherwise be invalid. A copy of Mr Robertson's Advice is included at Attachment 4 to these submissions.

54. The approach of the Bothams' report was to adopt an approach more in keeping with the existing scheme of regulation under the Code, namely to emphasise the importance of pre-contractual disclosure in relation to the renewal issue. The Report does however contain a review of existing overseas practice in relation to various topics, including franchise renewals in Chapter 5. In this respect also, CFAL has obtained a summary of the key provisions in 19 states in the US relating to franchise renewals which appears at Attachment 5. As the Bothams report noted (p.41), "good cause" is a pivotal consideration in the US state legislation, and this phraseology has also been adopted by CFAL in its draft model provisions in Attachment 1.

Summary

55. The purpose of this brief synopsis of Government reports and franchise regulation was to indicate two recurring themes: (i) the strong support from existing work by Government Inquiries and Committees of the need to expressly regulate in relation to

good faith and non-renewal, which is the purpose of the model provisions that CFAL has put forward in these submissions; and (ii) despite all the regulatory attempts that have been made over the last three decades to respond to the problems of abuse of power inherent in franchising relationships, the problems have not been fixed and a further regulatory response is required.

56. In short, nothing has changed to alter the analysis conducted at the outset by the Swanson and Blunt Committees in support of this type of regulation. The only difference between then and now is that franchising was in its infancy in the late 1970s, whereas parts of the industry have now reached a state of maturity which places different economic pressures on franchisors. During the growth phase of a franchise system, a franchisor's emphasis is much more likely to be on revenue growth through expanding the number of outlets (and thus franchisees can be expected to be well treated), whereas revenue growth in a mature system will be more concerned with maximizing revenue from existing outlets (in which case the benefits of opportunistic conduct becomes much more attractive to franchisors).

III. CONCLUSION: GOOD REGULATION TO CLOSE THE REGULATORY VOID

Introduction

1. These submissions have identified a systemic defect in the regulatory framework's lack of response to the problem of franchisor opportunism, both in relation to post-contractual conduct generally and in relation to franchise renewals particularly.

2. The recent High Court decision in *Ketchell's case* has demonstrated the power of the Franchising Code, a breach of which will attract the full range of remedies available under the Trade Practices Act. However, the ability of franchisees to access those remedies, or to conduct mediations in a context where such remedies are available, fundamentally requires that clear, post-contractual duties upon franchisors are written into the Code.

3. There is also a strong and consistent body of opinion in Australia in Parliamentary and Government Reports which recognises the need for legislation of the type proposed by CFAL in the model provisions for the Franchising Code contained in Appendix 1. These Reports are also supported by a substantial body of academic literature on the special nature of franchising which has been summarized in Professor Spencer's submissions to this Inquiry. Taken together, this work also supports CFAL's proposed amendments to s.51AC of the TPA in Appendix 2, which is designed to remove any doubts about the application of the High Court's decision in the *Berbatis* case to the operation of s.51AC.

4. This Part provides further support for Parliament and the Government to act now to close the regulatory void, by considering the case for regulation against the six key principles of good regulatory process proposed by the Regulation Taskforce in 2006.[1]

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[1] Report of the Taskforce on Reducing Regulatory Burdens on Business, Commonwealth of Australia, January 2006.

5. However, it must be borne in mind when considering the application of these principles, that what is proposed by CFAL is additional and incremental regulation designed to make an existing regulatory scheme more effective, rather than the introduction of a wholly new code of regulation.

Six Key Principles of Good Regulatory Process

6. CFAL believes that the model amendments it has proposed will meet the requirements of the six principles of good regulatory practice endorsed by the Regulation Taskforce. These principles may be summarized as follows:

    1) Regulation should not be introduced unless a case for action is established.

    2) A range of feasible policy options needs to considered on a cost/benefit basis, including self-regulation and co-regulation.

    3) The option that generates the greatest net benefit for the community (taking into account economic, social, environmental and equity impacts) should be chosen, even if it is not the easiest option to administer.

    4) There needs to be effective guidance to relevant regulators and regulated parties about what conduct is being regulated.

    5) There need to be mechanisms such as sunset clauses and periodic reviews to ensure that regulation remains relevant and effective over time.

    6) There needs to be effective consultation with regulated parties over the course of the regulatory cycle, both prior to and after introduction of the regulation.

Principle 1: A case for action

7. There can be no question that a case for action exists in relation to franchisor opportunism. It is a systemic problem in the Australian franchise industry that will persist until appropriate regulation is introduced to prevent the unwarranted exploitation of power by franchisors to the detriment of their franchisees.

8. The problem of franchisor opportunism was identified in the early days of franchising in Australia by the Swanson and Blunt Committees in the 1970s. It was reaffirmed by independent surveys conducted for the Gardini review in 1991, observations made by the Reid Committee in 1997 and most recently by the South Australian Parliamentary Inquiry. That material is referred to in detail in Part II of these submissions.

9. The needless closure of the KFC restaurant at Rockingham is testament to the failure of the law to protect a franchisee and its employees from the naked exercise of opportunistic power. This episode, and the preceding conduct by [redacted] predecessor in relation to the [redacted] issue is fully explored in Part I of these submissions.

Principle 2: Identification of a range of feasible policy options

10. The present regulatory environment under the Code is the culmination of over 30 years of consideration of franchising regulation by Australian governments. Every single possible policy option has been considered for regulating the franchising industry and producing a fair outcome for franchisees, including (1) reliance upon franchise contracts themselves, (2) the adoption of voluntary mechanisms of regulation, (3) regulation of pre-contractual conduct by franchisors and (4) use of the current general provisions of the TPA as a way to curb franchisor opportunism.

11. As to the first of these, franchise contracts cannot be relied upon to provide protection for franchisees. Freedom of contract in franchising does not occur in franchising, as the Reid Committee noted. The need for uniformity in franchise systems requires (i) standard form contracts; and (ii) significant powers to be vested in the franchisor. In addition, the relational nature of franchising means that the exercise of these powers by franchisors will typically be cast in wide and discretionary terms.

12. In relation to the second policy option, voluntary mechanisms, whether through self-regulation or co-regulation, have been tried and have failed. The Gardini Report is evidence that the ethical standards of conduct prescribed in clause 12 of the voluntary code was clearly ineffective in addressing key aspects of post-contractual franchisor opportunism. Instead mandatory and enforceable provisions are required.

13. That is not to deny that some franchisors will behave fairly and ethically towards their franchisees. The Jim's Group, for example, has specific provisions in its franchise agreements for rolling ten year rights of renewal, which are consistent with the draft model provisions in these submissions.

14. In the USA, the standard form KFC franchise contract also provides for rolling 10 year renewal rights along the same lines as the Jim's Group and consistently with the draft model provisions. CFAL understands that this contract was negotiated as part of a settlement of class action litigation brought by KFC franchisees against KFC in the United States. However, CFAL also understands that KFC has given notice in the US that it is contemplating changing the US contract to remove this rolling 10 year right of renewal for a certain class of new restaurant franchises.

15. What these two examples illustrate is that franchisors can choose to frame their contract in a way that conforms with ethical standards of conduct. However, the point of the draft model provisions is not to adopt a prescriptive approach to the drafting of these contracts, but merely to establish minimum enforceable standards to counteract a franchisor's economic incentive to engage in opportunistic conduct by abusing its powers.

16. The third option, reliance on regulation of pre-contractual disclosure as a means of preventing franchise failure, which is the principal regulatory mechanism in the current Code, has also proved ineffective in responding to post-contractual franchisor opportunism. In this respect it is telling that the Matthews Committee, which had limited terms of reference to consider the disclosure obligations in the Code, felt the need to make a recommendation for the introduction of a duty of good faith generally in the Code (ie. a duty which was not limited to pre-contractual conduct).

17. Finally, the use of general powers in the Trade Practices Act, as opposed to industry specific regulation, has also been rejected over the years by policy-makers as set out in Part II above. Whilst a general provision such as s.51AC may be of some benefit to franchisees in some circumstances, the considerable doubt cast on that provision by

the *Berbatis* decision renders it ineffective as a regulatory tool to deal with franchise renewals. The other problem with s.51AC was that identified by the Gardini Report's critique of clause 12.1 of the Voluntary Code – namely, the provision was too closely tied to existing principles of equity and needed to be broadened.

18. Thus, the only feasible and effective policy option to respond to franchisor opportunism is the one which has not been tried in the past four decades in Australia – namely, enforceable duties in the Code of good faith and good cause renewals. This is the option represented in the draft model provisions in Appendix 1 to these submissions.

Principle 3: Net benefit of regulation

19. The application of this principle in the present case, given the lack of any other realistic option to address franchisor opportunism, requires consideration of both the benefits and the costs of adopting enforceable duties to deal with post-contractual conduct by franchisors. The Regulation Task Force did not envisage that regulation would be free of any costs. As it noted in para 7.1 (3): *"Importantly this may not be the easiest option to administer"*.

20. Dealing first with the benefits of adopting the model provisions proposed by CFAL. There are two main economic benefits, which also encapsulate the social or human benefits: equity and economic efficiency.

21. ***Equity*** is concerned with the alignment of risk and reward. That is, a person should be entitled to reap the benefits of his or her investment of time, money and entrepreneurial skill in bringing a business or idea to fruition. This concept applies equally to franchisors in respect of their intellectual property, systems and reputation, as it does to franchisees who contribute time, money and effort in establishing the individual franchised businesses.

22. However, the difference between franchisors and franchisees in relation to questions of equity, is that franchisors can and do protect their position through the standard

form contracts they prepare. They do this by means such as express contractual provisions retaining ownership of goodwill in the trade marks and by imposing restraint of trade provisions on their franchisees. By contrast, franchisees have no equivalent contractual power or means to protect their positions to ensure they are able to reap the rewards of their own efforts and investment – this of course was clearly illustrated for CFAL when it was powerless to stop the closure of its Rockingham restaurant.

23. The purpose of the model provisions drafted by CFAL is not to strip franchisors of any rights to recoup their investment, but instead to ensure that both parties to the franchise relationship can access the benefits which they have jointly created. The various considerations listed in cl.23A(2) are framed in neutral terms to allow this process to happen – for example by comparing the risks taken or investments made by each of the franchisor and franchisee in the establishment of the business.

24. Thus, there is a clear benefit to franchisees in terms of equity considerations – both for existing franchisees, and as an incentive for future franchisees. Indeed, almost by definition, franchisor opportunism involves a breach of the equity principle, through the abuse of economic power by the stronger party, the franchisor, to appropriate unwarranted benefits from the weaker contractual party, the franchisee.

25. ***Efficiency benefits***, which accrue to the industry and economy generally, are also strongly indicated by creating a fair process in relation to the exercise of contractual powers and introducing an element of predictability in relation to renewal decisions. Put simply, franchisees will be more willing to invest in their businesses, and willing to invest more in their businesses, if they have confidence in the regularity of the renewal process.

26. Common sense, supported by economic modeling, indicates that a franchisee who faces an uncertain renewal process will limit his or her investment by reference to the expected time frame for recovery of that investment. Alternatively, a franchisee concerned that it might not obtain a renewal will allow the franchised business to run

down through to the expiry of the franchise. Thus, uncertainty in relation to renewal processes will produce sub-optimal investment in franchising. This point has also been illustrated mathematically by Blair & Lafontaine in their consideration of the costs of franchisor opportunism.[2]

27. CFAL's model provision in relation to good cause renewals provides an element of predictability to the renewal process that is missing in franchising at present. Franchisees must still take the risk, for example, that the franchisor might fail or might quit the industry entirely, or have some other good faith reason not to renew the franchise. However, the imposition of a good cause requirement signals to franchisees that they can and should keep investing in their businesses right up to the time of expiry, because in the ordinary course this will lead to a renewal for a further term.

28. No less importantly, the model provision preserves significant scope in a franchisor to bring the business relationship created by a franchise agreement to an end by way of non-renewal, subject to the requirement of good cause. That requirement should not be thought to constitute a significant abridgment of a franchisor's entitlement, in circumstances which demonstrate good faith, not to renew a franchise agreement. Franchisors will not be tied to franchisees in perpetuity. Accordingly, the CFAL's model provision will not have a "chilling" effect upon the franchising industry. On the contrary, the creation of an environment in which franchisees are more prepared to invest in franchised business would bring benefits to franchisors which may otherwise not have accrued.

29. Thus, there is a clear economic benefit for the franchising industry as a whole, and for the economy generally, in terms of economic efficiency to have minimum rules established that regulate franchisor conduct and provide maximum incentive to franchisees to invest in their businesses. As a consequence of their lack of contractual power, franchisees will not be able to secure these benefits by any means other than regulation.

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[2] R.D. Blair & F. Lafontaine, *The Economics of Franchising*, Cambridge University Press, New York, 2004, pp. 266-268.

30. ***Regulatory costs*** must be contrasted with the equity and efficiency benefits described above. There are no direct compliance costs associated with the introduction of regulated minimum norms of conduct, unlike for example the need to prepare documents to meet new disclosure requirements.

31. In fact, the only foreseeable costs associated with the introduction of duties of good faith and good cause renewals would be the loss to franchisors of their current ability to act opportunistically. However these costs are substantially less than the benefits to franchisees of eliminating opportunistic conduct; that is, the costs and benefits are not mirror images of each other. If it is assumed that most franchisors comply with usual industry practices, act in good faith towards their franchisees, and do not abuse their powers, the cost of eliminating opportunistic conduct becomes minimal.

32. On the other hand, if franchisees act rationally and prudently in making their investment decisions, they will under-invest in their businesses to allow for the possibility that their franchisors might seek to act opportunistically, even if the franchisor (with the benefit of hindsight) would not act in this way. Thus, it is the removal of the threat or possibility of opportunistic conduct that represents the benefit to the franchisee of the proposed regulation, whilst the cost to the franchisor is determined by the actual value a franchisor puts on its ability to act opportunistically.

33. Thus, it may be concluded that not only is the use of regulation as set out in the draft model amendments the only realistic response to franchisor opportunism, it also has clear net benefits, thus satisfying principle 3.

Principle 4: Clear Policy Guidance to Regulators and Regulated

34. Whilst norms of conduct will frequently have an imprecise quality to them at the margins, the draft model amendments have sought to provide clear and readily understandable guidance to both regulators and regulated about the content of the duties imposed.

35. The considerations that can be taken into account in relation to the good faith duty in cl. 23A(2) are all matters that are capable of objective consideration, and hence can provide ready guidance to franchisees, franchisors and the ACCC as regulator as to the content of the duty in any given fact situation. As indicated in the Explanatory Notes, many of these factors are derived from earlier formulations of ethical standards as stated in the voluntary code.

36. Further, as the South Australian Franchising Inquiry noted, whilst an abstract formulation of a good faith duty may be indistinct, "*the courts have demonstrated that they know it when they see it, or more properly, they know a breach of it when they see it*".[3] CFAL can also draw on its experience as both a franchisor and franchisee in respect of this duty to indicate that common experience of industry norms will usually provide a practical test for determining whether particular conduct by a franchisor is consistent with a duty of good faith.

37. A similar analysis can be made in relation to the good cause renewal provisions in cl. 23B(2). As this provision relates to a specific type of conduct, and as the circumstances mentioned align closely with ordinary industry practice, there should be little doubt about what the regulation requires. It was precisely the lack of conformity with industry practice and [redacted] past conduct in granting restaurant renewals that cast into relief the misuse of power by [redacted] in relation to the Rockingham non-renewal and closure.

Principle 5: Mechanisms to ensure effectiveness

38. CFAL has no objection to any additional provisions being added to the proposed draft regulations to ensure that they maintain their effectiveness over time. If anything, regular reviews of these provisions will ensure that the ambit of these provisions can be aligned with any changes in market practices, whether in relation to performance of obligations between franchisors and franchisees, or to extend the regulations to any new forms of opportunistic conduct that might emerge.

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[3] South Australian Parliament, Economic and Finance Committee, *Franchise Report*, 6 May 2008, p.55.

Principle 6: Effective consultation with parties

39. The final principle has been well satisfied in the present case by the convening of three inquiries in the last 12 months to examine franchise regulation, following the closure of KFC Rockingham. The state inquiries in WA and SA have allowed for a robust exchange of views between the FCA (which has largely taken the franchisor's side of the debate, although purporting to speak on behalf of the industry) and CFAL (which has taken the franchisee's side of the debate, whilst recognising that it is also a significant franchisor as well).

40. It is expected that a further level of refinement in relation to the competing arguments will occur in this Inquiry, partly because of the national reach of the Inquiry and partly because it follows not only the recent state inquiries but also a long history of Federal inquiries into franchising.

41. Thus, any regulation resulting from recommendations made by this Inquiry will clearly satisfy the public consultation test identified in principle 6. Further, as stated in relation to principle 5, CFAL has no objection to any additional mechanisms being added to the draft model regulations to provide for additional stakeholder consultation and review once any recommended regulations take effect.

Summary and Way Forward

42. The Regulation Task Force noted that good regulation is not a rarity. The draft model regulations proposed in this submission by CFAL have been designed by taking into account the large body of opinion that exists about appropriate regulation of post-contractual conduct in relation to franchises, and clearly conform with the six principles of good regulation endorsed by the Taskforce.

43. At the last Federal election, Dr Emerson indicated that Labor would follow the recommendations of the Matthews Committee and introduce good faith obligations into the Code provided those obligations were well defined. The recommendations of

the South Australian Parliamentary Inquiry support this commitment, and it has also been endorsed recently by the Small Business Ministerial Council.

44. CFAL believes that the draft model regulations it proposes provide an appropriate definition of a good faith obligation, as well as a specific provision to deal with the issue of renewals (modeled on earlier oil industry precedents) that reflects existing industry practice. So far as the renewal provision is concerned, the former Minister, Fran Bailey, also promised to introduce a regulatory change to respond to abuses by franchisors of their renewal powers.

45. CFAL therefore submits that the draft provisions which it has proposed represent sound policy that are deserving of bi-partisan approval by the Joint Committee. We would further hope that the Government might then act quickly to implement the necessary regulatory changes recommended by the Committee, and close the loophole which has remained open as a consequence of the last 30 years of inaction. Such an outcome would severely curtail, if not solve, the dual problems of franchisor opportunism and abuse of power by franchisors in the interests of franchisees and the industry generally.

ATTACHMENT 1:

DRAFT MODEL AMENDMENTS TO THE FRANCHISING CODE

DRAFT MODEL AMENDMENTS TO THE FRANCHISING CODE

(28.08.08)

Insert the following new Part 3A

Part 3A Franchising in good faith

23A Obligation to act in good faith

(1) A franchisor and a franchisee shall act towards each other in good faith in the exercise of any rights or powers arising under, or in relation to, a franchise or the renewal of a franchise.

(2) For the purposes of sub-clause (1), good faith in relation to conduct by a franchisor or a franchisee means that the party has acted:

(a) honestly and reasonably; and

(b) with regard to the interests of the other parties to the franchise,

in all the circumstances, including without limitation:

(c) the commercial and business objects of the franchise;

(d) the legitimate business interests of each of the parties, and what is reasonably necessary for the protection of those interests;

(e) the respective financial and non-financial contributions made by each of the parties to the establishment and conduct of the franchised business;

(f) the risks taken by each of the parties in the establishment and conduct of the franchised business;

(g) the alternative courses of action available to the parties in respect of the matter under consideration; and

(h) the usual practices in the industry to which the franchise relates.

23B Renewal and non-renewal of franchise agreements

(1) A franchisor shall not fail or refuse to renew a franchise agreement without good cause.

(2) For the purpose of sub-clause (1), good cause in relation to the renewal of a franchise agreement means:

(a) the franchise agreement contains provisions for the franchisee to renew the franchise agreement and the franchisee has failed or refused to renew in accordance with those provisions; or

(b) the franchisee has been offered a new franchise agreement by the franchisor and has failed to enter into that new franchise agreement in circumstances where the new franchise agreement:

(i) contains terms and conditions which are substantially the same or similar to those in the existing franchise agreement; or

(ii) to the extent that there are any variations to the existing terms and conditions, those variations have been proposed by the franchisor in good faith within the meaning of clause 23A(2); or

(c) the franchisor, at the date of expiry of the franchise agreement:

(i) proposes to terminate the franchise agreement in accordance with clause 21; or

(ii) terminates the franchise agreement for one or more of the reasons set out in clause 23(a) to (g); or

(d) the franchisor, as the owner or lessor of the site on which the franchised business is conducted, has decided in good faith within the meaning of clause 23A(2) that it will:

(i) lease the site for a purpose unrelated to the franchised business or a business similar to the franchised business; or

(ii) dispose of the site; or

(iii) operate the site for a purpose unrelated to the franchised business or a business similar to the franchised business; or

(e) the franchisor has offered to purchase the franchised business on expiry of the franchise for a fair market value, valued at the time of expiry, on a going concern basis; or

(f) the franchisor has otherwise acted in good faith, within the meaning of clause 23A(2), in failing or refusing to renew the franchise agreement.

23C Procedure for renewal and non-renewal of franchise agreements

(1) Not later than 90 days before the expiry of a franchise agreement, the franchisor shall serve on the franchisee a notice of intention (**Notice of Intention**) which specifies:

(a) the terms and conditions of the proposed renewal and the reasons for any variation in those terms or conditions from the existing franchise agreement; or

(b) if the franchisor does not intend to renew the franchise agreement the reasons why it does not so intend.

(2) If the franchisor fails to serve a Notice of Intention in compliance with clause 23C(1), the term of the franchise agreement is extended until a date which is 90 days after a Notice of Intention is served by the franchisor.

(3) Where a renewal is proposed by a franchisor in accordance with a Notice of Intention in compliance with clause 23C(1), the franchisor and franchisee shall negotiate in good faith within the meaning of clause 23A(2) for a maximum period of 30 days with a view to agreeing the terms and conditions of the renewal.

(4) The dispute resolution provisions in Part 4 apply to any dispute arising under this clause.

DRAFT MODEL AMENDMENTS TO THE FRANCHISING CODE

EXPLANATORY NOTE

Purpose

1 The draft model amendments to the Franchising Code of Conduct (**Franchising Code**) propose the insertion of a new Part 3A (Franchising in Good Faith). The purpose of these provisions is to protect franchisees from unfair practices by franchisors in relation to post-contractual conduct and franchise renewal.

Notes on Individual Clauses

Clause 23A(1)

2 Clause 23A(1) imposes an obligation on both franchisors and franchisees to act in good faith in the exercise of any rights or powers arising under or in relation to a franchise or the renewal of a franchise. The statement of the obligation in general terms reflects recommendation 25 of the Matthews Committee report and recommendation 5.4 of the 2008 South Australian Franchise Inquiry. Clause 23A(1) also reflects the developments in the common law where a duty of good faith has been implied into commercial contracts (see *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187; *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWSC 15).

Clause 23A(2)

3 Clause 23A(2)(a) and (b) define the obligation of good faith. This obligation has been defined by reference to two principle sources.

4 Firstly, Professor Elisabeth Peden, in a leading text in this area, has said that:

> "*...it is suggested that the true meaning of good faith must be a requirement to behave honestly and to have regard to the interests of the other party without subordinating one's own interests*".[1]

[1] E. Peden, *Good Faith in Performance of Contracts*, LexisNexis Butterworths, Sydney, Australia, 2003

5 Secondly, Sir Anthony Mason (quoted in Peden) has said that the concept of good faith relates to three related notions:

> *"(1) an obligation on the parties to co-operate in achieving the contractual objects (loyalty to the promise itself);*
>
> *(2) compliance with honest standards of conduct; and*
>
> *(3) compliance with standards of contract which are reasonable having regard to the interests of the parties"*

6 Clauses 23A(2)(c) to (h) list six factors which may be taken into account by a court in determining whether or not conduct by a franchisee or franchisor has been in good faith:

(a) Clause 23A(2)(c) is based on the first limb of Sir Anthony Mason's formulation as set out in paragraph 5 above, namely by taking into account the commercial and business objects of the franchise.

(b) Clause 23A(2)(d) is based on section 51AC(3)(b) of the *Trade Practices Act* 1974 (Cth) **(TPA)** as well as the formulation of the obligation of good faith as set out by Professor Peden in paragraph 4 above.

(c) Clauses 23(A)(2)(e) and (f) are based on clause 12.2(d) of the voluntary Franchising Code of Practice of 1992 (**Voluntary Code**) which provided that the franchisor and the franchisee should avoid conduct which is unreasonable in relation to the risks incurred by one party under the franchise agreement. Financial and non-financial contributions represent one specific aspect of the risks thereby taken.

(d) Clause 23(A)(2)(g) is based on the notion that in determining whether conduct has been in good faith the alternative courses of action available to either the franchisor or the franchisee should also be taken into account.

(e) Clause 23(A)(2)(h) is based on clause 12.2(a) of the Voluntary Code which provided that the franchisor and the franchisee should avoid significant departure from general franchise business practice of the relevant time and place.

Clause 23B(1)

7 The structure of clause 23B follows the structure of clause 23A. Clause 23B(1) includes a new standard of conduct in the Franchising Code by providing that a franchisor shall not fail or refuse to renew a franchise agreement without good cause. This is not a perpetual right of renewal, and is based on clause 17(1) of the *Petroleum Retail Marketing Franchise Act 1980 (Cth)* (**PRFMA**), which was repealed in 2006 and replaced with clause 32 of the *Trade Practices (Industry Codes - Oilcode) Regulation 2006* (**Oilcode**).

Clause 23B(2)

8 Clause 23B(2) then exhaustively lists six criteria capable of constituting good cause for the purposes of proposed clause 23B(1) as follows:

(a) Clause 23B (2)(a) makes it clear that the provisions of clause 23B are intended to supplement rather than replace existing contractual rights of renewal.

(b) Clause 23(B)(2)(b) is based on clause 17(1)(b) of PRFMA and clause 32(8) of Oilcode and acknowledges current industry practice that new franchise agreements may include updated terms so long as those terms are imposed by the franchisor in good faith.

(c) Clause 23(B)(2)(c) is based on clause 17(1)(a) of PRFMA and clause 32(8) of Oilcode. It provides that an existing right to terminate is a good cause for non-renewal, consistently with existing requirements in relation to termination in clauses 21 and 23 of the Franchising Code and current industry practice in relation to renewals in circumstances where franchisees are in breach of their obligations under their franchise agreements.

(d) Clause 23(B)(2)(d) is based on clause 17(1)(d) of PRFMA and clause 32(6) of Oilcode, and addresses the specific case where a franchisor also owns the premises on which the franchise business is being conducted.

(e) Clause 23(B)(2)(e) is based on recommendations 5.12 and 5.13 of the Swanson Committee, which reported to the Minister for Business and Consumer Affairs in 1976 on the rights upon termination of franchise agreements. This proposed clause provides the franchisor with an option to acquire the franchised business at the expiry of the franchise agreement on a fair and equitable basis.

(f) Clause 23(B)(2)(f) gives a residual power to franchisors not to renew a franchise agreement. This power would encompass circumstances like those contemplated by the Blunt Committee (who reported to the Minister for Business and Consumer Affairs in 1979) in clause 4(4) of their proposed amendments to the TPA – eg. where the continuation of the franchise is likely to be uneconomical to the franchisor or where the franchisor bona fide decides to withdraw from the particular market area of the franchise operation for legitimate business reasons.

Clause 23C(1)

9 Clause 23C provides for a workable mechanism to ensure that renewal procedures happen in a timely manner prior to the expiry of the franchise agreement.

(a) Clause 23(C)(1)(a) is based on clause 17A(1) of PRFMA and clause 32(7) of Oilcode but imposes a 90 day period rather than a 120 day period, which allows for a more timely process.

(b) Clause 23C(1)(b) is based on clause 17A(5) of PRFMA and clause 4(2) of the proposed amendments to the TPA recommended by the Blunt Committee, but requires the notice to be provided no later than 90 days before the expiry of the franchise agreement to ensure consistency with proposed clause 23C(1)(a).

Clause 23C(2)

10 Clause 23(C)(2) is based on clause 17A(9) of PRFMA and provides that if the franchisor fails to serve a Notice of Intention, the franchise agreement will continue until such a notice is served.

Clause 23(C)(3)

11 Clause 23C(3) is based on clause 17A(4) of PRFMA and provides that, after a Notice of Intention is served, the franchisor and the franchisee have 30 days in which to agree the terms and conditions of the renewal. This, in effect, provides for a "cooling off period" to enable discussions between the franchisor and the franchisee in relation to any renewal. This procedure must be undertaken prior to the parties engaging in the dispute resolution procedure set out in Part 4 of the Franchising Code. Clause 23C(3) also allows for this negotiation to occur 60 days prior to the expiry of the franchise agreement, which is a tight but workable time period.

Clause 23C(4)

12 Clause 23C(4) is based on clause 21(5) of the Franchising Code which also provides that in the event of a dispute arising from termination, Part 4 of the Franchising Code will apply.

ATTACHMENT 2:

DRAFT MODEL AMENDMENTS S.51AC OF THE TRADE PRACTICES ACT

DRAFT MODEL AMENDMENTS:

SECTION 51AC OF THE *TRADE PRACTICES ACT 1974* (CTH)

[Changes are marked up by underlining]

(28.08.08)

51AC Unconscionable conduct in business transactions

(1) A corporation must not, in trade or commerce, in connection with:

(a) the supply or possible supply of goods or services to a person (other than a listed public company); or

(b) the acquisition or possible acquisition of goods or services from a person (other than a listed public company);

engage in conduct that is, in all the circumstances, unconscionable.

(2) A person must not, in trade or commerce, in connection with:

(a) the supply or possible supply of goods or services to a corporation (other than a listed public company); or

(b) the acquisition or possible acquisition of goods or services from a corporation (other than a listed public company);

engage in conduct that is, in all the circumstances, unconscionable.

(3) Without in any way limiting the matters to which the Court may have regard for the purpose of determining whether a corporation or a person (the ***supplier***) has contravened subsection (1) or (2) in connection with the supply or possible supply of goods or services to a person or a corporation (the ***business consumer***), the Court may have regard to:

(a) the relative strengths of the bargaining positions of the supplier and the business consumer; and

(b) whether, as a result of conduct engaged in by the supplier, the business consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the supplier; and

(c) whether the business consumer was able to understand any documents relating to the supply or possible supply of the goods or services; and

(d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the business consumer or a person acting on behalf of the business consumer by the supplier or a person acting on behalf of the supplier in relation to the supply or possible supply of the goods or services; and

(e) the amount for which, and the circumstances under which, the business consumer could have acquired identical or equivalent goods or services from a person other than the supplier; and

(f) the extent to which the supplier's conduct towards the business consumer was consistent with the supplier's conduct in similar transactions between the supplier and other like business consumers; and

(g) the requirements of any applicable industry code; and

(h) the requirements of any other industry code, if the business consumer acted on the reasonable belief that the supplier would comply with that code; and

(i) the extent to which the supplier unreasonably failed to disclose to the business consumer:

(i) any intended conduct of the supplier that might affect the interests of the business consumer; and

(ii) any risks to the business consumer arising from the supplier's intended conduct (being risks that the supplier should have foreseen would not be apparent to the business consumer); and

(j) the extent to which the supplier was willing to negotiate the terms and conditions of any contract for supply of the goods or services with the business consumer; and

(ja) whether the supplier has a contractual right to vary unilaterally a term or condition of a contract between the supplier and the business consumer for the supply of the goods or services;

(k) the extent to which the supplier and the business consumer acted in good faith;

(l) any pre-existing contract between the supplier and the business consumer;

(m) the extent to which the supplier required or sought to require, as a condition of a renewal of a contract:

(i) the inclusion of terms and conditions in the new contract which differ from the terms and conditions of the prior agreement and could not reasonably have been required if there had been no prior contract between the parties; or

(ii) entry into any other contract, arrangement or understanding that the business consumer would not have otherwise entered into.

(4) Without in any way limiting the matters to which the Court may have regard for the purpose of determining whether a corporation or a person (the ***acquirer***) has contravened subsection (1) or (2) in connection with the acquisition or possible acquisition of goods or services from a person or corporation (the ***small business supplier***), the Court may have regard to:

(a) the relative strengths of the bargaining positions of the acquirer and the small business supplier; and

(b) whether, as a result of conduct engaged in by the acquirer, the small business supplier was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the acquirer; and

(c) whether the small business supplier was able to understand any documents relating to the acquisition or possible acquisition of the goods or services; and

(d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the small business supplier or a person acting on behalf of the small business supplier by the acquirer or a person acting on behalf of the acquirer in relation to the acquisition or possible acquisition of the goods or services; and

(e) the amount for which, and the circumstances in which, the small business supplier could have supplied identical or equivalent goods or services to a person other than the acquirer; and

(f) the extent to which the acquirer's conduct towards the small business supplier was consistent with the acquirer's conduct in similar transactions between the acquirer and other like small business suppliers; and

(g) the requirements of any applicable industry code; and

(h) the requirements of any other industry code, if the small business supplier acted on the reasonable belief that the acquirer would comply with that code; and

(i) the extent to which the acquirer unreasonably failed to disclose to the small business supplier:

(i) any intended conduct of the acquirer that might affect the interests of the small business supplier; and

(ii) any risks to the small business supplier arising from the acquirer's intended conduct (being risks that the acquirer should have foreseen would not be apparent to the small business supplier); and

(j) the extent to which the acquirer was willing to negotiate the terms and conditions of any contract for the acquisition of the goods and services with the small business supplier; and

(ja) whether the acquirer has a contractual right to vary unilaterally a term or condition of a contract between the acquirer and the small business supplier for the acquisition of the goods or services;

(k) the extent to which the acquirer and the small business supplier acted in good faith;

(l) <u>any pre-existing contract between the acquirer and the business supplier;</u>

(m) <u>the extent to which the acquirer required or sought to require as a condition of a renewal of a contract:</u>

<u>(i) the inclusion of terms and conditions in the new contract which differ from the terms and conditions of the prior contract or lease and could not reasonably have been required if there had been no prior contract between the parties; or</u>

<u>(ii) entry into any other contract, arrangement or understanding that the business consumer would not have otherwise entered into.</u>

(5)A person is not to be taken for the purposes of this section to engage in unconscionable conduct in connection with:

(a) the supply or possible supply of goods or services to another person; or

(b) the acquisition or possible acquisition of goods or services from another person;

by reason only that the first-mentioned person institutes legal proceedings in relation to that supply, possible supply, acquisition or possible acquisition or refers to arbitration a dispute or claim in relation to that supply, possible supply, acquisition or possible acquisition.

(6) For the purpose of determining whether a corporation has contravened subsection (1) or whether a person has contravened subsection (2):

(a) the Court must not have regard to any circumstances that were not reasonably foreseeable at the time of the alleged contravention; and

(b) the Court may have regard to circumstances existing before the commencement of this section but not to conduct engaged in before that commencement.

(7) A reference in this section to the supply or possible supply of goods or services is a reference to the supply or possible supply of goods or services to a person whose acquisition or possible acquisition of the goods or services is or would be for the purpose of trade or commerce.

(8) A reference in this section to the acquisition or possible acquisition of goods or services is a reference to the acquisition or possible acquisition of goods or services by a person whose acquisition or possible acquisition of the goods or services is or would be for the purpose of trade or commerce.

(9) A reference in this section to the supply or possible supply of goods or services does not include a reference to the supply or possible supply of goods or services at a price in excess of $10,000,000, or such higher amount as is prescribed.

(10) A reference in this section to the acquisition or possible acquisition of goods or services does not include a reference to the acquisition or possible acquisition of goods or services at a price in excess of $10,000,000, or such higher amount as is prescribed.

(11) For the purposes of subsections (9) and (10):

(a) subject to paragraphs (b), (c), (d) and (e), the price for:

(i) the supply or possible supply of goods or services to a person; or

(ii) the acquisition or possible acquisition of goods or services by a person;

is taken to be the amount paid or payable by the person for the goods or services; and

(b) paragraph 4B(2)(c) applies as if references in that paragraph to the purchase of goods or services by a person were references to:

(i) the supply of goods or services to a person pursuant to a purchase; or

(ii) the acquisition of goods or services by a person by way of purchase;

as the case requires; and

(c) paragraph 4B(2)(d) applies as if:

(i) the reference in that paragraph to a person acquiring goods or services otherwise than by way of purchase included a reference to a person being supplied with goods or services otherwise than pursuant to a purchase; and

(ii) a reference in that paragraph to acquisition included a reference to supply; and

(d) paragraph 4B(2)(e) applies as if references in that paragraph to the acquisition of goods or services by a person, or to the acquisition of services by a person, included references to the supply of goods or services to a person, or the supply of services, to a person, as the case may be; and

(e) the price for the supply or possible supply, or the acquisition or possible acquisition, of services comprising or including a loan or loan facility is taken to include the capital value of the loan or loan facility.

(11A) For the purposes of this section, conduct that is capable of being unconscionable includes, without limitation:

(a) conduct engaged in for the purpose of, or in connection with, a decision whether or not to renew any contract; or

(b) conduct by which the party engaging in the conduct requires, or seeks to require, as a condition of the renewal of a contract:

(i) the inclusion of terms and conditions that differ from the terms and conditions of the prior contract; or

(ii) entry into any other contract, arrangement or understanding that the would not have otherwise entered into.

(12) Section 51A applies for the purposes of this section in the same way as it applies for the purposes of Division 1 of Part V.

(13) Expressions used in this section that are defined for the purpose of Part IVB have the same meaning in this section as they do in Part IVB.

(14) In this section, ***listed public company*** has the same meaning as it has in the *Income Tax Assessment Act 1997*.

DRAFT MODEL AMENDMENT TO SECTION 51AC OF THE *TRADE PRACTICES ACT 1974* (CTH)

EXPLANATORY NOTE

Purpose

1 Section 51AC of the *Trade Practices Act 1974* (Cth) ("**the Act**") prohibits unconscionable conduct by a corporation or person, in trade or commerce, in connection with:

(a) the supply or possible supply of goods or services to a person (other than a listed public company); or

(b) the acquisition or possible acquisition of goods or services from a person (other than a listed public company).

2 It is proposed to amend s 51AC to clarify its scope and operation in relation to the renewal of contracts so as to overcome any possible application of the reasoning in *ACCC v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51 to that section.

Notes on individual clauses

The Key Provision – Proposed Subsection 51AC(11A)

3 The key provision is proposed new subsection 51(11A). This subsection recognises that a decision to renew a contract may involve a series of steps:

(a) Paragraph 51AC (11A)(a) relates to conduct both preliminary to, and constituted by, the decision whether or not to renew the relevant contract. At this stage of the process a party may decide not to renew an agreement for an improper purpose or to threaten non-renewal in order to extract some benefit from the other party.

(b) Paragraph 51AC(11A)(b), concerns conduct subsequent to or giving effect to a decision by a party to renew the contract and indicates the means by which any threat of non-renewal may be implemented. This conduct may result in:

(i) the inclusion of terms and conditions in the renewed contract that differ from the terms and conditions of the original contract (sub-para (i)); or

(ii) the entry into a collateral contract, arrangement or understanding that would not otherwise have been entered into by the renewing party (sub-para (ii)).

Clause 51AC(3)(l) and (m) and Clause 51AC(4)(1) and (m)

4 Proposed new paragraphs 51AC(3)(l) and (m) and (4)(l) and (m) are enabling provisions, to ensure the concurrent application of s 51AC(2) and (11A). Consistently with the scheme of section 51AC, these paragraphs will permit consideration by the court of additional factors that would be relevant in a renewal context, such as:

(a) the pre-existing relationship between the parties generally (paragraphs 51AC (3)(l) and (4)(l); and

(b) a comparison between the terms of the existing and the new arrangements between the parties in relation to:

(i) the inclusion of terms and conditions in the new contract which differ from the terms and conditions of the prior contract and could not reasonably have been required if there had been no prior contract between the parties (subparagraphs (l)(i) and (m)(i));

(ii) entry into any other contract, arrangement or understanding that the other party would not have otherwise entered into (subparagraphs (l)(ii) and (m)(ii));.

5 Again, these amendments will clarify the scope of s 51AC and overcome any effect of the decision in *Berbatis* consistently with the existing scheme of the section.

ATTACHMENT 3:

JASON GEHRKE, 'AN OVERVIEW OF THE FRANCHISE SECTOR IN AUSTRALIA'

An Overview of the Franchise Sector in Australia

A summary of key features and data relating to the Australian franchise sector (2008).

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A former CEO of a nationally-awarded mobile service franchise, Jason has also worked at franchisee and advisor level, and been involved in the franchise sector for more than 18 years.

He founded the **Franchise Advisory Centre** in 2004 to help business owners planning to grow through franchising, as well as support new, developing and mature franchise systems. In addition to its extensive consulting services, the Centre also provides a wide range of quality franchise education programs to help franchisors and franchisees run more efficient and profitable businesses.

Jason publishes ***Franchise News & Events***, a national franchising news bulletin, writes a fortnightly franchise column, frequently presents at franchise and business conferences, and comments about franchising in the media. He has provided input to state and federal government franchise policy and legislation, and in late 2007 was reappointed by the Australian Competition & Consumer Commission (ACCC) to its national 12-member Franchise Consultative Panel.

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This report has been commissioned by Competitive Foods Australia Limited as an independent compilation of the available information of the franchise sector in Australia, however all opinions are expressly those of the author.

What is Franchising?

Franchising is a business concept that has been around in one form or another for centuries, but today is commonly identified as the business format model, where a franchisor grants the right (under certain conditions) to a franchisee to use a business name and trademark, operating systems and know how to operate their own business. In turn, the franchisor usually receives initial and ongoing fees for the use of the brand, and the provision of ongoing business guidance and support to the franchisee.

Franchising in Australia is regulated nationally by the Franchising Code of Conduct (1998), a mandatory code under the Trade Practices Act which is administered by the Australian Competition and Consumer Commission (ACCC). Among other things, the Code specifies the nature and extent of information that should be provided to a franchisee prior to investing in the franchise (mandatory disclosure), as well as a timeframe for the provision of the information, and a cooling-off period once a franchise contract is signed. The Code does not require any pre-registration by franchisors with the ACCC. Rather, franchisors are deemed to be operating in compliance with the Code until such time as the ACCC have cause to launch an investigation, or are prompted by a complaint from the public. Consequently, statistics on the size and scope of franchising, particularly in relation to the number of franchisors in Australia, are not available from the very body which is responsible regulating the sector.

The Entrepreneurial Alliance of Franchising

Franchising is, at its core, a large-scale entrepreneurial growth strategy for the franchisor. (Spinelli, Rosenberg & Birley, p.5).

According to the Australian Federal Government's AusIndustry website, entrepreneurialism is defined as:

> *"...proactive and innovative business management aimed at identifying and exploiting new commercial opportunities for the growth and/or sustainability of the business."* (AusIndusty 2007).

When looking at the franchisor, the term entrepreneur readily comes to mind. The franchisor has developed a business over time, proven its profitability and systems, then granted franchises for its successful and rapid duplication to exploit market potential while minimizing capital outlays. Entrepreneurs are innovators and risk-takers (Schaper & Volery, p.32) though are not always creative in themselves.

But what is often neglected is that the franchisee is also an entrepreneur, risking their cash and labour on a business model they plan to operate for themselves, and often with no prior experience in business. Spinelli et al draw the link clearly by stating that franchising is an "entrepreneurial alliance" between franchisor and franchisee, and that their book on franchising is as much about entrepreneurship (p.2).

Legislative Framework

In addition to the Trade Practices Act 1974 (TPA), the franchise sector is regulated by the Franchising Code of Conduct (the Code), a mandatory industry code prescribed under the TPA and introduced on July 1, 1998 and is applicable to all franchises granted or renewed after that date. The mandatory Code replaced an earlier and voluntary Franchising Code of Practice. It is administered by the Australian Competition and Consumer Commission (ACCC), a federal statutory authority formed in 1995 to promote competition and fair trade in the marketplace to benefit consumers, businesses and the community (ACCC).

The Code arose from the Howard Government's New Deal Fair Deal business reforms 1997, with an initial exposure draft released in September 1997, followed by another in April 1998, both of which were substantially different (and badly drafted according to observers at the time) from the version introduced on July 1, 1998. The Code's key purpose was "*to regulate the conduct of participants in franchising to other participants in franchising*", with its principal innovations being the requirement to provide specified information in a disclosure document to prospective franchisees prior to purchase, a cooling-off period, and dispute resolution via a mediation process.

Despite international franchisors who grant just one franchise in Australia (such as a master franchise) being exempt from the requirement to provide disclosure information (since introduced on March 1, 2008), international observers including respected Canadian franchise attorney and author Alex Konigsberg declared in 1998 that the introduction of the Code would actively dissuade foreign franchisors from entering the Australian market (Konigsberg).

International concerns that the introduction of the Franchising Code of Conduct would stymie franchise growth in Australia may have been initially vindicated due to the steady number of franchisors from 1998 to 2002 (See Table 1, page 6), but has not been supported in the long run when compared against the significant growth of franchise system numbers since 2002.

There have been two revisions to the Code, introduced on the following dates:

October 1, 2001
Minor drafting changes, as well as the deletion of the requirement for unit franchisees to provide a disclosure document to prospective purchasers of their businesses (in addition to the disclosure document provided by the franchisor);

March 1, 2008
These changes were adopted following the Matthews Report, instigated by the then Federal Small Business Minister in late 2006. Changes were made to the disclosure provisions of the Code, affecting the nature and timing of information to be included in disclosure documents for the granting or renewal of franchises. Significant changes included the requirement to include a contact of past franchisees for the previous three years, as well as a list of suppliers who pay rebates to the franchisor.

Both of these requirements were met with concern by many franchisors, fearing a scenario where just one disaffected ex-franchisee could unduly influence all future prospects against buying a franchise. Furthermore, the requirement to disclose the names of suppliers which pay rebates was viewed as a loss of competitive advantage, with the likelihood that disclosure information would find its way into the hands of competitors.

Another significant change introduced on March 1, 2008 was the requirement to provide a copy of the franchise agreement for disclosure in its final form, creating the potential for multiple disclosure for the same agreement where relatively minor changes occur (eg. changes of commencement date, etc).

Background to Franchising in Australia

Franchising in Australia is widely regarded as a highly successful way of doing business, providing new business entrants the opportunity to be in business for themselves, but not by themselves. The Franchise Council of Australia compares the success of franchising against the high level of failure of independent small business, with its website quoting an 85% failure rate for small businesses in their first five years compared to 85% of franchised businesses (ie. those operated by franchisees) still operating after five years.

The Franchising Australia 2006 Survey (Frazer, Weaven & Wright) revealed there were 960 franchise systems operating in Australia with a combined turnover in excess of $128 billion through more than 60,000 outlets. Franchisees are in the main believed to be satisfied with the performance of their businesses, with the Survey revealing less than one percent of franchisees were in serious dispute with their franchisor. Similarly, a study by the Franchise Relationships Institute (Nathan, p.203) showed that 93% of franchisees were satisfied with their business investment.

Sector Size – By Franchisors

Establishing the number of franchisors operating in Australia is an inexact science. The Australian Bureau of Statistics 2001 Small Business in Australia (Trewin) survey estimated there to be 1.23 million private sector small businesses in operation, but did not distinguish between those which were franchised and those which were not, let alone further distinguish between numbers of franchisors and franchisees.

The Franchising Australia 2006 Survey (Frazer, Weaven & Wright) identified 960 franchisors operating in Australia as at June 30 that year. Conducted by Griffith University academics and sponsored by the Franchise Council of Australia, the survey is conducted approximately every two years. It gathers franchisor contact information by monitoring newspaper and magazine advertisements to identify those businesses offering franchises.

Other sources provide different figures for franchisors operating in Australia. The printed 2006 Franchise Directory published by Reed Business lists 612 franchise opportunities, while the online version of the directory (www.franchisebusiness.com.au - produced by the same company) lists 1,143 franchisors as at August 27, 2008. New South Wales-based consultancy, the Franchise Counselling Centre, estimates the true figure of franchisors in Australia is in excess of 1,500, however the most accurate number is that available from the Franchising Australia surveys.

The number of franchisors operating in Australia has increased by approximately 58% in 10 years from 693 in 1998 to an estimated number of 1,100 in 2008. This number of franchisors serves a national population estimated at 21,400,000 at August 25, 2008, or one franchise system for every 19, 454 Australians.

This compares with a franchisor count in the United States of approximately 3,000 franchise brands, against a national population of 293,000,000, or one franchise system for every 97,666 Americans – a system density nearly five times less than Australia.

Franchising Australia (year)	Total Business Format Franchisors	Average Number of franchise outlets	Average Number of company owned outlets	Average number of years franchising	Average number of years in business	Franchisor increase from one survey to the next	Av. number of years franchising increase from one survey to next
1998	693	17	1	7	11.5		
1999	708	22	1	8	11	2.16%	14.28%
2000	No survey						
2001	No survey						
2002	700	24	1	9	15	-1.14%	12.50%
2003	No survey						
2004	850	26	1	11	14	21.43%	22.22%
2005	No survey						
2006	960	22	1	10	16	12.94%	-9.09%
2008	1,100*	*2008 Franchising Australia Survey due for release in October 2008*					

Table 1: The Population of Australian Franchisors & Related data
(*Sourced from the Franchising Australia Surveys, 1998-2006*)

The 10 largest franchise systems in Australia account for approximately 12,225 outlets. In other words, less than 1% of the total number of franchise systems account for 17.4% of total franchised outlets, and employ on average just under 11 people per outlet (including franchisees).

	System	No. of Aust. outlets	Estimated no. of jobs (incl f'sees)*
1	Australia Post	2,969	6,200
2	Jims Group	2,635	3,600
3	Subway	1,035	10,000
4	VIP Home Services	1,000	1,500
5	Ray White Real Estate	1,000	10,000
6	Retail Food Group^	998	9,000
7	McDonald's	760	75,000
8	LJ Hooker Real Estate	700	7,000
9	Bakers Delight	625	5,400
10	Video Ezy	503	5,000
	TOTAL:	12,225 outlets	132,700 jobs
	^ Retail Food Group consists of four franchise brands: Donut King, Café BB's, Michel's Patisserie & Brumbys Bakeries.		
	* Figures estimated by Franchise Advisory Centre, or distilled from reported amounts.		

Table 2: The 10 Largest Franchise Systems in Australia (by outlet numbers)
(Sourced from franchisor websites)

Franchisor entries and exits – Australian figures

The continual growth in the number of franchisors shown in Table 1 shows ongoing net increases, but does not provide any indication as to franchisor exits during the same period. (For the purposes of this report, a franchisor exit is defined as a system which ceases to franchise). When releasing the Franchising Australia 2006 survey findings at the Franchise Council national conference on October 21 that year, the authors specifically commented on the number of entrants and exits when compared with the previous survey. While the overall number of franchise systems in Australia had increased by approximately 100 from 2004 to 2006, this increase was made up of 200 new entrants and 100 franchisors that had ceased franchising since the 2004 survey. In other words, for every two new franchisors, one franchisor exited over a two-year period, accounting for a loss of almost 12% of the 850 franchisors identified in the 2004 survey.

A content analysis of a 10-year-old issue of *Franchising Magazine* by the author of this report reveals further evidence of franchisor exits (see Appendix 1). Of the 113 franchisors listed in the magazine's index as advertising in the December 2006 / January 2007 issue of the magazine, only 78 (ie. 69%) could be identified as still franchising today by comparing against the Franchise Advisory Centre's database, internet and telephone directory searches. The remaining 30% had ceased to franchise, and in most cases, could not be found at all, suggesting that not only had those franchisors exited from franchising, but that they may have ceased operating altogether. (The remaining 1% could not be determined as to whether the business was still franchising or not).

Few statistics on franchisor exit or failure, are available. The Franchise Council of Australia has no information on franchisor exit numbers, and is critical of explorations of franchisor failure. A 2006 research report titled "*When the Franchisor Fails*" (Buchan, 2006) was condemned both publicly and privately by the FCA (author interviews, 2006).

Franchisor exit data from overseas

Overseas statistics also indicate that franchisors do cease to franchise at rates equal to, if not substantially higher than the limited Australian statistics currently available.

In the United States, often considered the home of modern franchising due to the profile of its fast food chains, there are an estimated 3,000 franchise systems with a combined total of more than three quarters of a million outlets. However system exit rates are high, reaching 75% over 10 years and 85% over 17 years (Shane, p.211).

Accurate data remains a problem – the United States does not have a central registry of franchisors, although some states require registration. Research conducted by the International Franchise Association in 1997 identified 1,156 franchisors operating in those states requiring registration, which rose by just 22 franchisors the following year. On comparing the registration lists from one year to the next, only 834 of the franchisors registered in 1996 were still registered the following year. The remaining 322 (28%) were absent (Stanworth, Purdy, English & Williams, p.60).

A tracking study conducted by Lafontaine and Shaw (reproduced in *Franchising: An International Perspective*) of franchisor start-ups in the United States from 1980 to 1992 showed a survival rate for the period of just 28.6%. Similarly, Shane tracked 138 US franchisors which commenced franchising in 1983, and found only a 24.6% survival rate after 10 years. In the United Kingdom, University of Westminster researchers analysed the database of franchisors listed as advertisers in the UK's two annual franchise directories in 1996 and found that in the 18 to 24 months since the directories were compiled that almost one third of the 704 franchisors identified had ceased franchising. Furthermore, of the 237 franchisors that had ceased franchising, 150 of these had ceased to trade altogether, or could not be traced despite the researcher's best efforts, and therefore presumed to have failed (Stanworth et al, p.58).

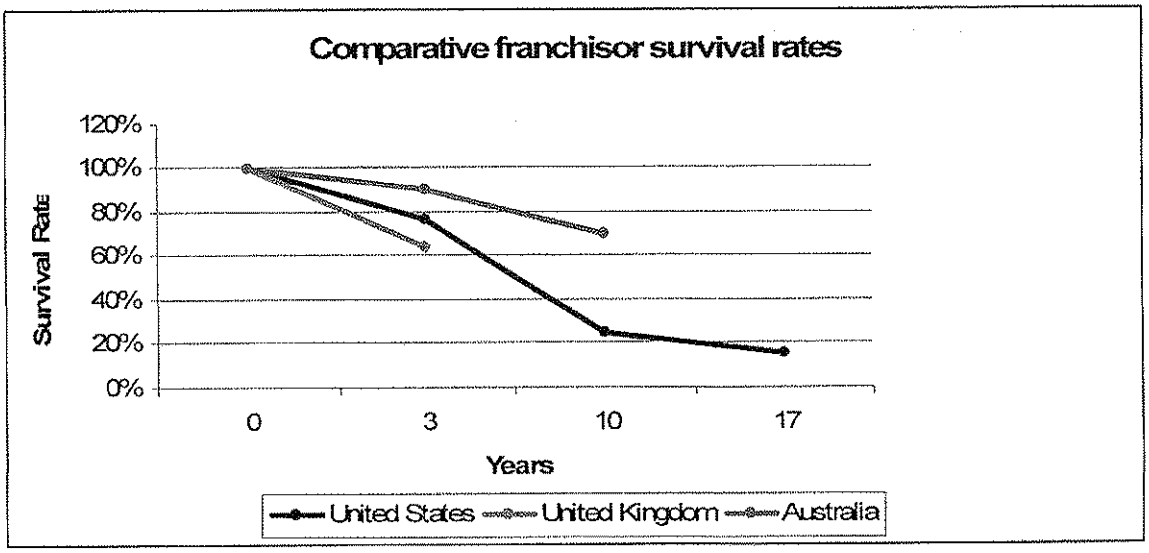

Figure 2: Comparative franchisor survival rates
(Compiled from Shane, Lafontaine & Shaw, Frazer et al, and Gehrke)

Reasons cited for franchisor failure in the international literature include inadequate piloting and testing of systems prior to offering them as franchises (Stanworth et al, p.63). Lafontaine and Shaw cite factors contributing to franchisor exit include the nature of the product or service offering itself, the financial and support capabilities of the franchisor's principals, franchisee selection and finally, the franchisor's prior business experience and level of education.

Consequences of franchisor failure

The groundbreaking work by Buchan (2006) on franchisor failure which specifically examined issues arising from the insolvency of the franchisor, found that the failure of 40 franchisors between 1990 and 2005 in Australia affected 1,090 franchisees and their families (many of whom lost their businesses), up to 11,500 employees, and also affected landlords, financiers and other suppliers. The economic consequences of failure were not calculated, however it was noted that when franchisors become insolvent, current Australian law gives franchisees no rights as creditors despite their significant stake in the franchisor's business.

Little, if any, other formal research into the consequences of franchisor failure has been conducted in Australia. A case study of the legal battles and subsequent demise of the Cut Price Deli chain (Tarling, Franchising Magazine January/February 1999) identified that at least 65 of the franchise's original 165 stores were forced to close following the collapse of the franchisor, with the remainder continuing to trade as best they could (either as independents or by joining a rival chain) or otherwise meeting an unknown fate. The emotional and economic cost for those involved in closures of stores that cost up to $400,000 to establish would have been substantial (Tarling).

Franchisees cut adrift from their franchisors have greatly reduced prospects of survival. Buchan's research linked the collapse of franchisee businesses with the demise of their franchisor, with franchisees subsequently suffering major financial and emotional distress resulting (in some cases) in bankruptcy and relationship breakdowns. Additionally, failed franchises are often the subject of media reports and the source of complaints to the ACCC and other government bodies, thereby consuming valuable public sector resources.

Sector Size – By Franchisees

A summary of the last five Franchising Australia surveys indicates that the total number of outlets in the franchise sector increased by 40% from 50,100 in 1998 to 70,250 in 2006, compared to a population increase of 8.43% for the same period (Australian Bureau of Statistics). In particular, the number of business format franchised outlets increased by 46% for the same period. While anomalies appear in the reported figures for company-owned outlets, motor vehicle and fuel retail outlets, the growth trend of franchised outlets, and all outlets overall, is relatively consistent.

With a total number of 70,250 franchise branded outlets in Australia in 2006, there was one outlet for every 304 Australians.

Franchising Australia (year)	Number of Business Format Franchised outlets	Number of company-owned outlets	Motor vehicle retail outlets	Fuel retail outlets	Total Outlets	Franchisor increase from one survey to the next
1998	38,500	5,300	3,400	2,900	50,100	
1999	40,900	5,200	5,900	2,600	54,600	8.98%
2000	No survey					
2001	No survey					
2002	44,400	6,700	3,300	2,000	56,400	3.29%
2003	No survey					
2004	50,600	3,400	2,400	8,000	64,400	14.18%
2005	No survey					
2006	56,200	5,660	2,690	5,700	70,250	9.08%

Table 3: The Population of Australian Franchised Outlets & Related data
(Sourced from the Franchising Australia Surveys, 1998-2006)

Typically, franchises are operated by males (68.6%) who also own the business outright or in partnership with a spouse or partner. Male franchise operators are likely to be aged 41-50 years (42%) or 31-40 years (28.1%).

Franchisee entry & exits

Unlike the franchisor population where exits may be more noticeable, establishing the number of franchisee exits in any given period is guesswork to say the least. An outlet may change hands once or more during a 12-month period, but to an external observer it would appear that because the outlet continues to trade it is being operated by the same franchisee, when this would not be the case. New

Franchisor obligations to report closed outlets in their disclosure documents provides little useful information without examining the disclosure document for each of the estimated 1,100 systems operating in 2008. Media claims by current or former franchisees about high numbers of closures, or allegations of churning, are unable to be validated by statistically relevant data, but only because such data does not currently exist.

Representative Bodies

Franchise Council of Australia (FCA)

The **Franchise Council of Australia** (FCA) describes itself as the peak body representing the franchise sector, including franchisors, franchisees and service providers. Formed in 1983 by a small group of franchisors who recognised a common interest in their method of doing business, the FCA was known at the time as the Franchisors Association of Australia (FAA), with a membership comprising of only franchisors, and later service providers (such as accountants, lawyers and banks) (Bell 2003).

During the following years, it established state chapters first in Queensland, and then progressively to the other mainland states. A New Zealand chapter was also established, and the name changed to Franchisors Association of Australasia in 1990, and later to the Franchisors Association of Australia & New Zealand (FAANZ) (Bell 2003).

In 1994, the association opened its membership to include franchisees, and changed its name to Franchise Association of Australia & New Zealand (FAANZ). In 1998 (the same year in which the Franchising Code of Conduct was introduced and in response to the New Zealand chapter wishing to form its own body), the association changed its name for the last time to Franchise Council of Australia (Bell 2003).

The FCA is a nationally-incorporated not-for-profit association headquartered in Melbourne with a staff of 12 people. Each of the five mainland state chapter committees elect a president, who is automatically appointed to the FCA national board. A further five board positions are directly elected by the membership, however three of the five must be franchisors, with the other two positions able to be filled from any membership category. A further two board positions may be filled by individuals invited by the FCA board. Since 2007, one of these positions has been occupied by a franchisee representative.

At the time of writing, the FCA website lists 568 members, of which approximately 420 or 74% are franchisors, with the balance comprising mostly of lawyers, accountants, banks and other providers of services to the franchise sector. The number of franchisee members is unknown.

Franchisee Associations

There is no franchisee association of the size and scale of the Franchise Council of Australia.

A number of different organizations have emerged since the mid-1990's to represent franchisees. The first of these was the **Australian Franchisees Association** (AFA), a privately-owned entity based in Brisbane. The AFA ceased operations approximately 18 months later amid concerns that it existed primarily as a for-profit business which benefited from conducting speculative litigation on behalf of franchisees against franchisors.

About two other franchisee associations were known to exist in the mid to late 1990's, none of which achieved any national recognition and lasted more than a few months.

Another and entirely unrelated **Australian Franchisees Association** (AFA) formed several years later based in Sydney, chaired by former Federal Business Minister David Beddall (who presided over an inquiry into franchising in the mid 1990's which resulted in a voluntary Code of Practice for the sector). This AFA was for a while successful in drawing media attention to its aims of representing franchisees. It became involved in several major franchise disputes, and a defamation action arising from one of these resulted in a judgment against the AFA, which unable to pay the damages awarded, was wound up.

In 2007, a new association, the **Franchisees Association of Australia Incorporated** (FAAI) was formed with similar aims to the immediate past AFA, and also involved some of the same office-bearers, including David Beddall as president. Its website (www.faai.com.au) remains largely under

construction but states that the FAAI is pro-franchising. No membership list is available online and the association's contact details are currently listed as care of the Lottery Agents Association of Victoria.

The **National Federation of Independent Business** (NFIB), a registered Australian body headquartered in Canberra has also spoken out on franchisee issues in the media. The NFIB website (www.nfib.com.au) provides scant information on its services and no specific reference to its franchisee representation activities.

Various retail associations (there are known to be eight representing the retail sector in Australia) also comment publicly from time to time on franchising issues as they affect retailing, but none claim to represent franchisees generally or the franchise sector at large.

Brand-specific Franchisee Associations

Where franchisees of a particular brand form their own lobby group or association outside the formal communication channels established by the franchisor, this becomes a brand-specific franchisee association. Unlike the franchise sector in the United States where the individual franchise chains on average are much larger than in Australia and such brand-specific associations are relatively common, only a few examples are known to exist in Australia. These include:

Post Office Agents Association Limited (POAAL) which represents the owner/operators of licensed post offices, mail contractors, sub-contractors and couriers;

National Pizza Association which represents the interests of approximately 130 Pizza Hut franchisees;

Other brand-specific associations may exist but are unlikely to be known outside the franchise systems in which they operate.

Sector Trends

Through constant ongoing interaction with participants in the franchise sector at franchisee, franchisor and advisor level in professional development forums and via feedback from its sector bulletin *Franchise News & Events*, the Franchise Advisory Centre has identified the following current trends:

Recruitment

Economic conditions featuring full or near-full employment and record high wages and salaries due to a shortage of workers has reduced the number of people looking at franchising as a form of self-employment according to many system executives. Inquiry rates from prospective franchisees are low, with marketing costs as high as nearly $20,000 to add just one new franchisee to a system. Currently 18% of franchisees are 51-60 years old, but as the population continues to age the proportion of franchisees 50 and above is likely to increase.

Retention

With a reduced rate of recruitment, franchisors are placing greater emphasis on retaining existing franchisees. On average, franchisees in Australia are staying seven years in a franchise system (compared to an average franchise term of five years). Retention incentives used by franchisors include additional stores or territories, master franchises, renewal fee waivers or reduced royalties for subsequent terms.

Occupancy Costs

A rapid escalation of rents in shopping centres and other retail locations continues to cause concern among premises-dependent franchisors, who can find that lease renewals often include ratchet-to-market rent increases that can make the difference between a profitable or unviable location. A 2008

report released following the federal government's Productivity Commission inquiry into the Market for Retail Tenancies in Australia recommended greater disclosure and transparency in dealings between landlords and tenants, but has stopped short of calling for specific legislation. Shopping centre occupancy costs in particular are a source of tension, with rents commonly increased by significant amounts on lease renewals according to both franchisors and franchisees, and which in turn can affect the ongoing viability of a site. This in turn has resulted in a greater focus on higher levels of franchisee performance during their first term (when the retail lease is less onerous) in case a second term lease is unviable.

Multiple-Unit Operations

More than a third of Australian franchisors reporting that their franchisees own more than one outlet (Frazer et al, p.65), multiple-unit ownership is a growing trend both in Australia and overseas, particularly in the United States where some franchisees own 100 or more outlets (Sherman, p.184 and Lowell, p.112).

Franchisors increasingly support the concept of multiple-unit ownership as a way of increasing franchisee retention. Multiple-unit ownership also assists the franchisor to meet its system growth targets with fewer franchisees, and can increase efficiencies for the provision of services by the franchisor to its franchisees.

Master Franchising

Commonly used by most franchisors during the 1990's, master franchising (the act of granting the rights to sell and support franchises in a given area in return for a percentage of the royalty fee) has declined in popularity as those systems which used in initially have matured and in some cases, buying back their master franchises. Additionally, franchisors dilute their revenue base by sharing royalties with a master franchisee, and recent litigation by franchisees against franchisors arising from the actions of master franchisees is a further disincentive to use master franchising.

Corporatisation

Corporatisation describes the process where franchisors sell part or all of their systems to extract some capital from the business, and eventually leading to a partial or full sale to new owners who may operate the business under management with little or nor direct owner involvement. It is estimated that 5-10% of Australian franchise systems are corporatized in some way, with many of these as listed entities or subsidiaries of listed entitites.

Appendix 1: Australian Franchisor Exit analysis - Franchising Magazine 10 years on.

Franchising Magazine Dec 1996 / January 1997 Edition

Listed Franchisor Advertisers

Franchise System	Still Franchising? (Jan 2007)	
7-Eleven	Yes	
A4 Maths	Yes	
Abacus Bookkeeping	No	
Above All Ceiling Cleaning	No	
Absolute Management	No	
Ampol Road Pantry	Yes	Now Caltex Star Mart
Arnold's Ribs & Pizza	No	
Athlete's Foot	Yes	
Auditel	No	
Aussie Pooch Mobile	Yes	
Australia Post	Yes	
Autobarn	Yes	
Barbarella's	No	
Barry's The Home Improvement Specialists	Yes	
Bartercard	Yes	
Baskin-Robbins	Yes	
Bin Busters	No	
Bob Jane Corporation	Yes	
BP Express	Yes	
Bumpa T Bumpa	No	
Cake It Away	Yes	
Capt'n Snooze	Yes	
Car Care Co.	CND	Could not determine
Cargroomers Australia	Yes	
Cash Converters	Yes	
Chips Away	Yes	
Civic Video	Yes	
Clark Rubber	Yes	
Computer Gym	Yes	
Cookie Man	Yes	
Copperart	No	
Cuddles 'N' Mum	Yes	
Dick Smith	Yes	
Domino's Pizza	Yes	
Donut King	Yes	
Eagle Boys	Yes	
Elite Entertainment	No	
Expense Reduction Analysts	Yes	
Express Bookkeeping	Yes	
Fancy Fillings	Yes	
Fastway Couriers	Yes	
Fernwood Female Fitness	Yes	
Flea Stoppers	Yes	Renamed as Doggywash
Forty Winks	Yes	
Framing Corner	Yes	
Franchise Management Services	No	
Freedom Furniture	Yes	
Furniture Wizard	No	
Glass Art Australia	Yes	
Gobblers	No	
Granny May's	No	
Great Australian Ice Creameries	No	
Hallmark	Yes	
Handy Gardeners At Work	No	
Hire Intelligence	Yes	
Jani King	Yes	
Jim's Mowing	Yes	
Just Comfort	No	
Just Cuts	Yes	
Just Dents	No	
Kenkleen	Yes	
Kenny's Cardiology	Yes	
KFC	Yes	
Kleins	Yes	
Kwik Kerb	Yes	
Kwik Kopy	Yes	
Lenard's	Yes	
LJ Hooker	Yes	
Made in Japan	Yes	
Magna-Dry	Yes	
Mail Boxes Etc	Yes	
McGoo's Spitroast	Yes	
Mend-A-Bathroom	Yes	
Midas	Yes	
Mobil	Yes	
Mobile Car Bath	No	
Modern Roof Restoration	No	
Mostly Movies	No	
Mr Whippy	Yes	

Muffin Break	Yes	
Nectar	Yes	
New Zealand Natural	Yes	
No Complaints Cleaning Service	No	
Optus	Yes	
Oz Design	Yes	
Pack & Send	Yes	
Pix Printing	No	
Pizza Haven	Yes	
PoolWerx	Yes	
Prompt Bookkeeping	No	
Pure & Natural	Yes	
Red Baron	No	
Retireinvest	Yes	
Sign Biz	No	
Snack Systems	Yes	
Snap Printing	Yes	
Solatec	Yes	
Sportsco	Yes	
Stone Seal	No	
Subway	Yes	
Techclean	No	
The Cheesecake Shop	Yes	

The Touch Up Guys	Yes	
The Vinyl Doctor	No	
Think Big Images	No	
Total Building Maintenance	No	
Touch N Go	No	
United Home Services	Yes	
Valuecard	No	
VIP Home Services	Yes	
Wendy's	Yes	
WorldWide Refinishing	Yes	
Xpres Corporation	No	
	Number	**Percentage**
Total Franchisors listed	**113**	100%
Total still operating	**78**	69.02%
Total no longer operating / able to be found	**34**	30.08%
Could not determine	**1**	0.90%
Analysed, Brisbane, February 1, 2007 by Jason Gehrke.		

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ATTACHMENT 4:

ALAN ROBERTSON SC MEMORANDUM OF ADVICE

Re: THE FRANCHISING CODE

MEMORANDUM OF ADVICE

Introduction

1. My instructing solicitors act for Competitive Foods Australia Limited ("**CFAL**"), the franchisee of a number of KFC restaurants in Western Australia and the Northern Territory, pursuant to individual franchise agreements with [redacted] Pty Limited.

2. The Economic and Finance Committee of the Parliament of South Australia has very recently recommended in its Final Report on **Franchises** as follows:

> *Good Faith & Fair Dealing*
>
> *7.2.13 The Committee recommends amending the Franchising Code of Conduct by inserting a provision imposing a duty to act in accordance with good faith and fair dealing by each party of the franchise relationship.*
>
> *7.2.14 The Committee recommends the Franchising Code of Conduct be amended by inserting a provision imposing a duty to conduct renewal negotiations in accordance with good faith and fair dealing by each party.*

Questions

3. I am asked for my advice on the following questions:

   (i) Would an amendment to the Franchising Code along the lines of those

recommendations involve any retrospective alteration of existing franchise agreements; and

(ii) would any such amendment regulate future conduct of existing franchisees and franchisors.

4. The Franchising Code is prescribed as a mandatory industry code by reg 3 of the *Trade Practices (Industry Codes —Franchising) Regulations 1998* ("**Regulations**"). The Franchising Code is set out in the Schedule to the Regulations. The Regulations were made pursuant to s 51AE of the *Trade Practices Act*. Section 51AD of that Act prohibits a corporation, in trade or commerce, from contravening an applicable industry code. Any person who has suffered loss or damage as a consequence of breach of s 51AD may recover damages under s 82. Other orders under s 87 and injunctions under s 80 are also available.

5. The Franchising Code has also been prescribed for the purposes of s 51AC(3)(g) of the *Trade Practices Act*. This means that the Court may have regard to the requirements of the Code for the purpose of determining whether there has been unconscionable conduct in a business transaction, in contravention of s 51AC.

Advice

6. In my opinion such an amendment would be unlikely to be regarded by the courts as involving a retrospective alteration of existing franchise agreements. In *Chang v Laidley Shire Council* (2007) 237 ALR 482, Hayne, Heydon and Crennan JJ cited with approval (at 507) Jordan CJ in *Coleman v Shell Co of Australia Ltd* (1943) 45 SR (NSW) 27 at 30: an Act "*is not retrospective because it interferes with existing rights. Most Acts do. There is no presumption that interference with existing rights is not intended; but there is a presumption that an Act speaks only as to the future*".

7. The law presently permits a franchisor not to renew a franchise agreement. The Proposed Amendment would limit the circumstances in which non-renewal was permitted. This does not constitute retrospective operation in any relevant sense.

8. There is a distinction to be drawn between conduct, on the one hand, and contract on the other. To regulate future conduct does not involve the retrospective alteration of the contract pursuant to which that conduct will be or might otherwise would be engaged in.

9. In my opinion therefore any such amendment would do no more than regulate future conduct of existing franchisees and franchisors.

10. The immediate legal context in which these questions arise is the *Legislative Instruments Act 2003 (Cth)* since it is likely that any such amendment would be a "legislative instrument" as defined by ss 5 and 6 of that Act. Section 12(1) provides that a legislative instrument takes effect when it is specified to commence or the day after it is registered. Section 12(2) is set out below:

> *A legislative instrument, or a provision of a legislative instrument, has no effect if, apart from this subsection, it would take effect before the date it is registered and as a result:*
>
> > *(a) the rights of a person (other than the Commonwealth or an authority of the Commonwealth) as at the date of registration would be affected so as to disadvantage that person; or*
> >
> > *(b) liabilities would be imposed on a person (other than the Commonwealth or an authority of the Commonwealth) in respect of anything done or omitted to be done before the date of registration.*

11. It follows from what I have already written that, in my opinion, section 12(2) would not be engaged.

12. I answer the questions as follows:

Question (i) No.

Question (ii) Yes.

10 May 2008 ALAN ROBERTSON S.C.

Chambers

ATTACHMENT 5:

UNITED STATES FRANCHISE LEGISLATION

UNITED STATES LEGISLATION

Jurisdiction	Legislation Name	Provision	Comments
Arkansas	Arkansas Franchise Practices Act (1977)	"It shall be a violation of this subchapter for a franchisor to fail to renew a franchise except for good cause or except in accordance with the current policies, practices, and standards established by the franchisor which in their establishment, operation, or application are not arbitrary or capricious." § 4-72-204(a)(2).	
California	California Franchise Relations Act (1980)	"No franchisor may fail to renew a franchise unless such franchisor provides the franchisee at least 180 days prior written notice of its intention not to renew; and (a) During the 180 days prior to expiration of the franchise the franchisor permits the franchisee to sell his business … (b)(1) The refusal to renew is not for the purpose of converting the franchisee's business premises to operation by… franchisor for such franchisor's own account, …; and (2) Upon expiration of the franchise, the franchisor agrees not to seek to enforce any covenant … not to compete …; or… (e) The franchisor withdraws from distributing its products or services through franchises in the geographic market served by the franchisee, provided that . . . (f) The franchisor and the franchisee fail to agree to changes or additions to the terms and conditions of the franchise Agreement …" § 20025.	
Connecticut	Chapter 739. Trading Stamps, Mail Orders, Franchises, Credit Programs and Subscriptions, (1972)	"No franchisor shall . . . fail to renew a franchise, except for good cause which shall include, but not be limited to the franchisee's refusal or failure to comply substantially with any material and reasonable obligation of the franchise agreement or for the reasons stated in subsection (e) of this section." § 42-133f(a).	Amended: 1973, 1974, 1975, 1984, 1985. Subsection (e) states "A franchisor may elect not to renew a franchise which involves the lease by the franchisor to the franchisee of real property and improvement, in the event the franchisor (1) sells or leases such real property and improvements to other than a subsidiary or affiliate of the franchisor for any use; or (2) sells

			or leases such real property to a subsidiary or affiliate of the franchisor, except such subsidiary or affiliate shall not use such real property for the operation of the same business of the franchisee; or (3) converts such real property and improvements to a use not covered by the franchise agreement; or (4) has leased such real property from a person not the franchisee and such lease from such person is terminated or not renewed."
Delaware	Delaware Franchise Act (1970)	"The failure of a franchisor to renew a franchise shall be deemed to be "unjust,"or to have been made "unjustly," if such failure to renew is without good cause or in bad faith." § 2552(b).	
Hawaii	Franchise Investment Law (1974)	"[I]t shall be an unfair or deceptive act or practice or an unfair method of competition for a franchisor or subfranchisor to [t]erminate or refuse to renew a franchise except for good cause … unless and to the extent that the franchisor satisfies the burden of proving that any classification of or discrimination between franchisees is reasonable, is based on proper and justifiable distinctions considering the purposes of this chapter, and is not arbitrary. …" § 482E-6(2).	
Indiana	Indiana Deceptive Franchise Practices Act (1976)	"It is unlawful for any franchise agreement entered into between any franchisor and a franchisee … to contain any of the following provisions: (8) Permitting the franchisor to fail to renew a franchise without good cause or in bad faith. This chapter shall not prohibit a franchise agreement from providing that the agreement is not renewable upon expiration or that the agreement is renewable if the franchisee meets certain conditions specified in the agreement." § 23-2-2.7-1 (1)(8).	Amended: 1985, 1987
Illinois	Franchise Disclosure Act of 1987	"It shall be a violation of this Act for a franchisor to refuse to renew a franchise of a franchised business located in this State without compensating the franchisee	

		either by repurchase or by other means for the diminution in the value of the franchised business caused by the expiration of the franchise where: (a) the franchisee is barred by the franchise agreement . . . from continuing to conduct substantially the same business under another trademark, service mark, trade name or commercial symbol in the same area subsequent to the expiration of the franchise; or (b) the franchisee has not been sent notice of the franchisor's intent not to renew the franchise at least 6 months prior to the expiration date or any extension thereof of the franchise." § 705/20.	
Iowa	Iowa Franchise Act (2000)	"A franchisor shall not refuse to renew a franchise unless …[g]ood cause exists, provided that the refusal of the franchisor to renew is not arbitrary or capricious." § 537A.10.8.a.(2)(a).	The franchisor may also refuse to renew a franchise if "[t]he franchisor and franchisee agree not to renew the franchise" or "[t]he franchisor completely withdraws from … distributing its products or services in the geographic market served by the franchisee" provided that the franchisor agrees not to enforce any applicable noncompete covenants with the franchisee. See § 537A.10.8.a.(2)(b), (c).
Michigan	Michigan Franchise Investment Law (1974)	"Each of the following provisions is void and unenforceable if contained in any documents relating to a franchise: (d) A provision that permits a franchisor to refuse to renew a franchise without fairly compensating the franchisee by repurchase or other means for the fair market value at the time of expiration of the franchisee's inventory, supplies, equipment, fixtures, and furnishings." § 445.1527(d).	Amended in 1984. This subsection applies only if the term of the franchise is less than 5 years and the franchisee is prohibited by agreement from competing with the franchisor or the franchisee does not receive at least 6 months notice of the franchisor's intent not to renew the franchise. § 445.1527(27)(d).
Minnesota	Minnesota Franchise Act (1973)	"Unless the failure to renew a franchise is for good cause …, no person may fail to renew a franchise unless (1) the franchisee has been given written notice of the intention not to renew at least 180 days in	

		advance of the expiration of the franchise; and (2) the franchisee has been given an opportunity to operate the franchise over a sufficient period of time to enable the franchisee to recover the fair market value of the franchise as a going concern, as determined and measured from the date of the failure to renew. No franchisor may refuse to renew a franchise if the refusal is for the purpose of converting the franchisee's business premises to an operation that will be owned by the franchisor for its own account." § 80C.14(4).	
Mississippi	Mississippi Franchise Statute (1975)	"No person who has granted a franchise to another person shall cancel or otherwise terminate any such franchise agreement without notifying such person of the cancellation, termination or failure to renew in writing at least ninety (90) days in advance of the cancellation, termination or failure to renew, except that when criminal misconduct, fraud, abandonment, bankruptcy or insolvency of the franchisee, or the giving of a no account or insufficient funds check is the basis or grounds for cancellation or termination, the ninety-day notice shall not be required. § 75-24-53.	Sentence refers to franchises, but included in "pyramid scheme" section. The chapter defines "franchise" as "a written arrangement for a definite or indefinite period, in which a person for a consideration grants to another person a license to use a trade name, trademark, service mark, or related characteristic, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement or otherwise ..."
Missouri	Missouri Franchise Statute (1974)	"No person who has granted a franchise to another person shall cancel or otherwise terminate any such franchise agreement without notifying such person of the cancellation, termination or failure to renew in writing at least ninety days in advance of the cancellation, termination or failure to renew, except that when criminal misconduct, fraud, abandonment, bankruptcy or insolvency of the franchisee, or the giving of a no account or insufficient funds check is the basis or grounds for cancellation or termination, the ninety days' notice shall not be required." § 407.405.	Sentence refers to franchises, but included in "pyramid scheme" section. The chapter defines "franchise" as "a written or oral arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trademark, service mark, or related characteristic, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or

			otherwise."
Nebraska	Franchise Practices Act (1978)	"It shall be a violation of sections 87-401 to 87-410 for a franchisor to terminate, cancel or fail to renew a franchise without good cause. This section shall not prohibit a franchise from providing that the franchise is not renewable or that the franchise is only renewable if the franchisor or franchisee meets certain reasonable conditions." § 87-404.	"sections 87-401 to 87-410" refers to the "Franchise Practices Act."
New Jersey	New Jersey Franchise Practices Act (1971)	"It shall be a violation of this act for a franchisor to … fail to renew a franchise without good cause." § 56:10-5	
Tennessee	Tennessee Franchise Statutes (1989)	"No franchisor may fail to renew a franchise unless such franchisor provides the franchisee at least sixty days' prior written notice of its intention not to renew, such failure to renew is for good cause, and the franchisor has provided written notice of the facts and circumstances upon which it alleges that good cause exists to fail to renew." § 47-25-1505.	
Washington	Washington Franchise Investment Protection Act (1972)	"[I]t shall be an unfair or deceptive act or practice or an unfair method of competition and therefore unlawful and a violation of this chapter for any person to [r]efuse to renew a franchise without fairly compensating the franchisee for the fair market value, at the time of expiration of the franchise, of the franchisee's inventory, supplies, equipment, and furnishings purchased from the franchisor, *and good will,* exclusive of personalized materials which have no value to the franchisor, and inventory, supplies, equipment and furnishings not reasonably required in the conduct of the franchise business: PROVIDED, That compensation need not be made to a franchisee for good will if (i) the franchisee has been given one year's notice of nonrenewal and (ii) the franchisor agrees in writing not to enforce any covenant which restrains the franchisee from competing with the franchisor: PROVIDED FURTHER, That a franchisor may offset against amounts owed to a franchisee under this subsection any amounts owed by such franchisee to the franchisor." (emphasis added.) § 19.100.180. (2)	
Wisconsin	Wisconsin Fair Dealership Law (1973)	"No grantor…..may …fail to renew…without good cause" § 135.03	Amended: 1977, 1990. A "dealership" includes a "contract or agreement … by which a person is granted the right to sell

			or distribute goods or services, or use a trade name, trademark, service mark, logotype, advertising or other commercial symbol, in which there is a community of interest in the business of offering, selling or distributing goods or services at wholesale, retail, by lease, agreement or otherwise." A "grantor" is "a person who grants a dealership." § 135.02
Puerto Rico	Dealers' Contracts Act (1964)	"Notwithstanding the existence in a dealer's contract of a clause reserving to the parties the unilateral right to terminate the existing relationship, no principal or grantor may directly or indirectly perform any act detrimental to the established relationship or refuse to renew said contract on its normal expiration, except for just cause." PR ST T. 10 § 278a.	For purposes of this legislation, a dealer is a "[p]erson actually interested in a dealer's contract. A "dealer's contract" is defined as a "relationship established between a dealer and a principal or grantor whereby … the former actually and effectively takes charge of the distribution of a merchandise, or of the rendering of a service, by concession or franchise…. A "principal" or "grantor" is a "[p]erson who executes a dealer's contract with a dealer." T. 10 § 278.
United States Virgin Islands	Consumer Protection Law of 1973	"It shall be a violation of this chapter ….for any franchisor…to fail to renew….except that it shall be a complete defense …for the franchisor to prove that the [non-renewal] was for good cause." § 132.	