COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

(Subcommittee)

Reference: Franchising Code of Conduct

FRIDAY, 10 OCTOBER 2008

BRISBANE

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JOINT STATUTORY COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

Friday, 10 October 2008

Members: Mr Ripoll *(Chair)*, Senators Arbib, Boyce, Marshall and Mason and Ms Grierson, Mr Keenan, Ms Owens and Mr Robert

Members in attendance: Mr Ripoll and Mr Robert.

Terms of reference for the inquiry:

To inquire into and report on:

The operation of the Franchising Code of Conduct, with particular reference to:

1. the nature of the franchising industry, including the rights of both franchisors and franchisees;
2. whether an obligation for franchisors, franchisees and prospective franchisees to act in good faith should be explicitly incorporated into the Code (having regard to its presence as an element in paragraph 51AC(4)(k) of the *Trade Practices Act 1974*);
3. interaction between the Code and Part IVA and Part V Division 1 of the *Trade Practices Act 1974*, particularly with regard to the obligations in section 51AC of the Act;
4. the operation of the dispute resolution provisions under Part 4 of the Code; and
5. any other related matters.

WITNESSES

Subcommittee met at 9.31 am

FRAZER, Professor Lorelle, Private capacity

CHAIR (Mr Ripoll)—I declare open this public hearing of the Joint Committee on Corporations and Financial Services. This is the second in a series of public hearings that the committee is holding to inform its inquiry in the franchising code of conduct. The committee is to report on the operations of the present franchising code of conduct and to identify justified improvements to the code. The focus of this inquiry is on addressing broad structural and procedural issues relating to franchising agreements in Australia rather than on the details of individual disputes. The committee is investigating deficiencies in the operation of the franchising code of conduct and related legislation, and ways in which they might be improved.

I welcome you all here today. I remind everyone that witnesses giving evidence to the committee are protected by parliamentary privilege. Any act that may disadvantage a witness on account of their evidence is a breach of privilege and may be treated as contempt by the parliament. It is also contempt to give false and misleading evidence to a committee. Witnesses should be aware that, if in the giving of their evidence they make an adverse comment about another individual or organisation, that individual or organisation will be made aware of the comment and be given a reasonable opportunity to respond to the committee.

The committee prefers to hear evidence in public, but may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date, but it would consult the witness concerned before doing so. I ask people to turn off their mobile phones, or at least to make them inaudible. Professor Frazer, if you would like to make a brief opening statement about your submission, that would be welcome.

Prof. Frazer—I will give some personal background and then make some brief comments. I am a professor in marketing and the Dean of Learning and Teaching in the Griffith Business School. I am also the Director of the Asia-Pacific Centre for Franchising Excellence at Griffith University. It is a new centre that has been set up to provide high-quality franchising education and research in the sector.

I have a PhD in franchising, which was awarded in 1998. It involved investigating the nature of franchise fees in the contractual relationship. I am the co-author of the series of Franchising Australia Surveys, which have been produced every two years since 1998. These surveys have been sponsored by the Franchise Council of Australia. On two separate occasions, they have also been sponsored by the Commonwealth Bank and Austrade.

I have been involved in teaching and conducting research in franchising for the past 15 years. I am also a member of the Australian Competition and Consumer Commission Franchising Consultative Panel. The major thrust of my research has been on franchising relationships, including reasons why franchisees exit franchising and causes of conflict. My expertise is in these areas and not in the legal discipline, so I am unable to give an opinion on matters of a legal nature.

I am currently undertaking a major research project with Professor Jeff Giddings from the Griffith Law School and Dr Scott Weaven from the Griffith Business School. The project has

been jointly funded by the Australian Research Council and the ACCC. I point out, because often members of the public are unaware, that academic research is funded either by universities themselves or by the government or industry stakeholders. It is normal practice—and, indeed it is encouraged by universities—that we seek external funding for our research. But, of course, we conduct the research at arm's length and it is reported objectively. The funding bodies do not have access to the data, which is treated confidentially.

I will give a little bit of information about the main areas of research. The Franchising Australia Surveys are the only reliable source of data profiling the franchising sector. Unfortunately, the government does not identify franchising in its surveys of the small business sector. This is something it could easily do with a single question asking businesses to identify whether or not they are a franchising organisation. I would recommend that that be considered.

My submission to this committee highlights the main findings of the 2006 survey of the sector, so I will not go through that. But I will point out some areas of concern. One would be the sustainability of franchisor organisations. Half the sample reported that they held fewer than 20 units. They were not always younger systems. Of course, if they are young, they will need time to grow. But there is a concern then that if they do not maintain or achieve growth, they may not be sustainable.

Franchisor exits is another issue. Since we have been doing the survey, I would estimate that more than 10 per cent of franchisors have exited the sector every two years. Obviously, they would have franchisees attached to those systems. We do not have data on that, but we report that they were unable to be identified and therefore assumed to be no longer operating.

Another concern is the lack of preparation for franchising. In fact, 20 per cent of franchisors report that they franchise immediately, before they have even opened themselves. Another 13 per cent franchise within the first 12 months of commencing operation. That is not very much experience before they begin franchising. We know that pilot operations are very important and they are usually advocated. But there is a tension for franchisors because they are entrepreneurs. They have come up with a unique concept and their aim is to obtain rapid market share. If they wait around testing it in the market, someone else may beat them to it. There is always that tension. The 2008 survey report will be released next Friday. I will be happy to send a copy to the committee to provide it with current data about the sector.

The other main area of research that I have been involved in is conflict in franchising. I will give some context about that. The Australian Competition and Consumer Commission approached us to collaborate on this research because it is often regarded as being ineffective, especially when it is called into some major issue, usually when there is already a full-blown dispute and it is way too late for it to do anything to help. It was interested in finding out what causes conflict in franchising relationships so that perhaps some action can be taken much earlier within the system, without external interference, to prevent it escalating to dispute. That was the context for inviting us to do the research.

Our research is still in progress. It is a two-year project and this is the first year. But I can present some preliminary findings about the unique nature of conflict in franchising. What we have discovered at this stage has drilled down into a lot of the causes of conflict in franchising.

The most common cause appears to be because franchisees' expectations about franchising are mismatched for two main reasons. Sometimes it is the franchisee's own naivety and sometimes it is the result of franchisors making misleading statements in an attempt to recruit the franchisees. There is certainly a gap between what franchisees expect to find and the reality. That leads initially to disappointment, then to blame and often to a breakdown in the relationship. It can result in a dispute or even failure of the business. It affects their health and personal relationships. So it has quite an impact.

Many franchisees persist in blaming someone else when it was their own folly at the start. That has to be recognised. They are not preparing very well. It always surprises me just how little investigation franchisees tend to undertake before embarking on a franchise. They do not seem to know how to go about it or what to look for. Often their heart is set on joining a particular franchise and they have not investigated other opportunities.

Typical expectations are shattered as a result of this expectation gap. A big one is the level and nature of the franchisor support and the attention that they thought they were going to get. Often it is their perception rather than an outright promise that has been made. They thought they were going to get a lot more attention, communication and hand-holding. Another one is the amount of money that they will make. It often causes disappointment when that does not occur. Again, it can be perceptions.

There is also the issue of the quality of lifestyle that they end up having. Very often people join franchising because they are trying to escape paid employment, having a boss and so on. But then they discover that they have to work really hard. They still have a franchisor who is, in many ways, similar to having a boss instructing them. It is not the lifestyle they expected. Instead of going out to play golf, they find that they have to put the golf clubs away.

They are also often disappointed about their lack of independence. If they ran their own small business, they would have it; but in franchising there is less independence. They are also disappointed about the nature of the relationship. They find it more like employment. As I said, it is a bit like having a boss. In fact, franchisees have said to me that it is worse than having a boss, which they had not realised.

The nature of the work often surprises them. They tend to have a bit of a fantasy about what it is like mowing lawns or cutting up and selling chickens. That is fine, and there are certain skills required for that. But what they do not realise is how much of the actual promotion and selling they have to do to find customers, particularly in the service sector. If you are a lawn mower, it is not just mowing lawns; it is knocking on doors and promoting your business. Often they thought that that would happen. It would just a matter of having the 1300 number and the business would come to them. In some cases they find that they are not very well suited to selling. That is a bit of a shock to them. There is also a misunderstanding sometimes on the part of franchisees that they are only leasing the trademark rather than owning the business.

The second cause of conflict relates to franchisor practices and their organisational culture. Examples would be the use of the advertising fund and reports of bullying approaches by franchisors and their representatives, such as field staff. The different types of approaches taken by the field staff have been described to us as either a having-a-coffee visit versus a Gestapo visit. That has a big bearing on how the relationship develops.

Other issues include: infilling—that is, putting company stores in close proximity to franchised stores—which causes tension; forcing franchisees to sell items below cost to increase the sale volume and therefore the royalties for the franchisor and to promote the franchisors' brand; the franchisor making money out of rebates, which often annoys franchisees; and the inexperience of the franchisor, especially in relation to management skills.

A third form of conflict that we have discovered relates to situational influences. These are not deliberate; they just happen because of circumstances. Examples would be increased competition when another coffee shop opens up in the shopping centre; a change of the master franchisee; a change of the area manager and the new manager's style is quite different; forced refurbishments; poor site location; and the landlord increasing the rent. I think we will see more of these situational influences if we end up having some sort of economic downturn, which will affect franchisees' businesses. What effect will that have on the relationship?

Various causes of conflict occur at different times. The expectation mismatch that I started with is recognised in the first six to 12 months. It sets in very early. That disappointment occurs early, so the conflict occurs early. The franchisor's practices obviously occur throughout the life of the agreement, so that can occur at any time. Situational incidents also occur at any time, even perhaps several years into the arrangement. Of course, we have to bear in mind that as franchisees mature in the system they move through predictable stages of development.

I refer to Greg Nathan's work on the stages of the franchisee lifecycle. Initially, franchisees are very dependent on the franchisor and therefore require a high level of support. They also expect a high level of communication. Gradually they become more independent and at the same time a little more demanding. Often they think they know more than the franchisor and that they, rather than the franchisor, are responsible for all the success. They forget how they actually got started in the business in the first place. They would not have been able to do it without the franchisor, but their memories become short.

At this stage some of them become a little non-compliant because they think they know better. They might start selling unauthorised products, for instance, or breaching territorial restrictions. Those who move through that stage often become co-dependent, which is more like the franchising relationship is meant to be. But we find that they may need extra challenges to keep them motivated, especially if the work is quite repetitive. If they are in a car washing franchise, for instance, after a few years they know the business very well and they will get bored with it. That is when they can cause disruption in the system unless the franchisor is able to continue to add value and to motivate them.

I have a few ideas on some resolution strategies that I will share with the committee. We are really only moving into this phase of the research, but my sense at this stage is that the good systems we have seen are those in which the franchisor has a philosophy of being fully committed to resolving a dispute should one arise—that is, they are anticipating it and then have systems in place to deal with it.

Trying to identify the underlying issue is very important, because it is not always what it appears to be. It often appears to be about money, because ultimately the franchisee's business is not doing well and it will present as a financial dispute. But in fact it might be simply a

communication breakdown and the fact that the franchisee does not feel the franchisor has much regard for them.

Franchisors need to train their managers in how to facilitate good conversations and how to handle a difficult conversation with their franchisees. Not all managers are equipped to do this. Therefore, franchisors need to choose managers with good people skills as well as technical skills. That is quite often overlooked. Obviously there needs to be clear dispute resolution processes embedded in the franchisor system. It needs to be a transparent system that franchisees are aware of from the outset, so they know what process they can follow if there is any issue. It would probably be better if these conflicts were addressed earlier and even if mediation were used earlier than it is currently. People wait too long.

As far as some possible reforms for the sector are concerned, I will finish off with a few ideas. These are ideas that have come from our own thinking, but there are also suggestions which have been made by people we have interviewed and which perhaps have been mentioned several times. One of them is that there should be an accreditation process for advisers and brokers. Some of these people do not have the necessary qualifications for what they are trying to do.

Because a lot of franchisees tend to enter franchising without being fully prepared, it would be good if they had an easy-to-read version of the code for prospective franchisees. Even though it is a fairly plain language document, it is still a little daunting and off putting and people tend not to read it. We need better pre-entry education for both franchisees and franchisors. There could be a government publication on franchising that explains all the risks. It should make people think and get away from the fantasy for a while about how everything is going to be great and make them think about what could happen, for example, the risk of franchisor failure—their franchisor may not be there—the possibility of non-renewal and so on. It should be mandatory for franchisors to give it to prospective franchisees. They should get that little reality check a bit earlier.

A lot of people have talked about the appointment of an independent ombudsman. Perhaps that ought to be considered. A lot of discussion has also been had about a centralised filing of disclosure documents or whether such things should be registered. Certainly, centralised filing of them would be suitable. It would be very transparent and would enable people to have access to a lot more information. That includes advisers, researchers and members of the public. I will leave it at that.

CHAIR—Thank you for that extensive introduction and also your past surveys and submission. I know that you are releasing the 2008 survey next Friday. I am not sure whether you have included any of that data. Would it be possible to give us a pre-update on some of the things that might be important or that have changed since 2006?

Prof. Frazer—When does this become public?

CHAIR—It is public now.

Prof. Frazer—Can you wait until next Friday?

CHAIR—We can. I just thought I would lead off with that to see whether there is any new information. But we would certainly appreciate it the day you release it.

Mr ROBERT—We are web streaming you as you speak.

CHAIR—That is right. You have raised a range of issues. I think to start with a very important one is that your survey is the only bit of hard data that gives us any idea of the numbers of people in franchising, what takes place in franchising, and certainly people's views and the relationships. We are very interested in a range of those areas. We had submissions and heard evidence yesterday in Sydney that, for example, there could be up to 3,000 franchise systems in Australia and not 960. There is this issue of defining a franchise. Do you have a particular view on who might be roped into being defined in the broadest terms of a franchise?

Prof. Frazer—I cannot imagine that there would be 3,000 of them because we do a very extensive search and there are a lot of databases. We also look for advertisements in newspapers. Obviously, we could miss some new, smaller franchises. But I would not imagine there would be a lot. I would say that that would be inaccurate.

CHAIR—I know you have alluded to this, but do you believe that you need a proper mechanism, a proper system, to do the research and have really good statistics and data not only in terms of how many systems are franchises but also what takes place within them, and, further to that, who then identifies as being a franchise? Do you think that is something we need do?

Prof. Frazer—As I said, the Australian Bureau of Statistics does the survey on small businesses regularly. It could be combined with that. It is information on franchisees that is missing. Of course, what we do is a survey of franchisors. So it is very limited in that respect. Often when we report things, it is all the franchisors' perspective that we are looking at.

CHAIR—Not everyone identifies themselves as being a franchisee or a franchisor, even though they may be under the act and then have the code apply to them.

Prof. Frazer—We include them in our database. We often have that argument when we approach people about doing the survey. They will say that they are not a franchisor, they are a licensor or something like that. We simply tell them that that information is still useful to us; we are not going to get into an argument with them as to whether they are franchise or not. Some of those organisations will then fill out the survey for us on that basis. But that is an issue; some people claim they are not franchising. I am not a lawyer and it would probably need a lawyer to look at that to see whether they are. But I suspect that is the case.

CHAIR—You also mentioned the need for either centralised filing or some form of registration of the contracts. Why do you think that is important?

Prof. Frazer—There are a few reasons. I have heard Jenny Buchan's comments in previous inquiries where she suggested that advisers who are perhaps not in capital cities and so on and who are out in the country would not have access to that information because they do not often see a franchise agreement and they are trying to advise a client. I thought that was a very useful idea. If there is a central database of this information then it is available to everyone, and it should be available to the public. When it is transparent you can make your own comparisons.

Obviously, a lot of franchisees will not do that, but their advisers will, or should. There is one reason. Obviously it would assist with research. We would not have to go out and gather this data in the way that we do; a lot of it would be available and it would be current. That is another reason.

There is a big difference between just filing documents and registering them. You would have to decide what was the best thing to do, or you could actually accommodate it, because it would be a big process to register them. It would give some sort of idea that they were accredited, especially if registration occurs with the government or the ACCC, for instance. People would lodge their documents and members of the public would think they are accredited. Unless they are going to be audited, and that would be—

CHAIR—Registration of other documents, for example, company prospectuses with the Australian Securities and Investments Commission, does not give anybody the impression that suddenly the government is approving every company that is on the share market. It is just a form of registration. I do not think there is any confusion out there. Certainly, no-one I have ever spoken to believes that because a company prospectus is registered with the Australian Securities and Investments Commission that somehow the government then endorses or gives some authority to that document. It is just a registration process.

Prof. Frazer—You have to be careful, because I know that there are franchisees who have seen, say, the FCA logo on advertising and then assumed that that franchisor has been approved by the FCA when it may merely be a member. The FCA is not claiming anything other than that this is a member. But franchisees are lulled into a sense of security that this is a very ethical operator or a good system that has been endorsed. I see the same thing perhaps happening. But education could be a way around that.

CHAIR—This arises out of the issue that while the standard form contract is called that, contracts are all very different. This is no real standard in terms of what those contracts look like. There could be things that are included, omitted, remain silent or breach the code. But there is no real way of knowing that unless you are an expert in that area. It would be very difficult to see a franchisee who is very enthusiastic about joining any franchise system understanding that. That is why they go to some sort of adviser.

Certainly, the information that I have read and what I have seen in your survey is that that in itself is an issue; that is, that the advisers themselves and the franchisees are not getting good enough information and advice to be able to negotiate through a standard form contract. Can you give us your view about how that works, what is included and what is omitted and so forth?

Prof. Frazer—No, I do not have a view I could share, because I do not study contracts. I do not spend a lot of time doing that, so I do not feel that I have the expertise to talk about it.

CHAIR—I am not asking you about studied contracts. I am asking you what franchisees, franchisors or anybody you have spoken to in your survey work have to say about the original contract, which is often a source of dispute?

Prof. Frazer—They do not often mention the contract. So I tend to think that the contract perhaps is not given a lot of attention by the franchisees, at least, and the franchisor. The

franchisors do sometimes say, 'If we have to get the contract out of the drawer, there is a problem.' That is a just a cliche in franchising meaning that they do not refer to the contract; they refer to the day-to-day relationship. I think that is the practice.

There is a lot of goodwill between parties when they enter into a relationship where they are not relying on the contract. It is only when there is a problem that they might go back and flick through it and say, 'It does not say anything about what the franchisor was going to promise me.' That is an example of where franchisees are disappointed with the amount of support they are getting from the franchisor. But it may not have been specified in the contract anyway. They did not realise it was going to be an issue. People take other people at face value, I think.

CHAIR—That suggests that things can be omitted from contracts that remain silent.

Prof. Frazer—I have no doubt that contracts would be incomplete. We do not always provide full information; we always hide information in a sense.

CHAIR—In terms of that full information—and this is a big issue in the franchising sector—I refer to what actually is and is not disclosed. There are quite stringent disclosure provisions in the code. What is your experience in terms of the survey with what people's views were about what was disclosed or not disclosed?

Prof. Frazer—I do not think a lot of that has come about. It would be interesting to see whether the recent changes to the code—where the franchisors are able to include contact details of former franchisees—actually occurs and whether it has been useful. As I said, a lot of franchisees do not prepare well and do not investigate well before entering the franchise. One of the simplest things you can do is contact people who are currently in the franchise system, but also, more importantly, those who have left.

Now that they will have access to do that, I would be very interested to see whether prospective franchisees will contact franchisees who have left to see what they thought of the system. Was it a good relationship? Did they leave for good reasons? And probably most times it is. Or was there something else? That avenue is there. I do not know how well taken up it is by franchisors and then whether prospective franchisees are going to use it. But that will be a very important aspect.

CHAIR—You make a pretty big point and you spend some time in your surveys talking about the expectation. There are particular franchisees whose expectations are mismatched with what happens in reality. You have made some indication as to how that occurs. Obviously there are communications issues, expectations about income level, lifestyle and a whole range of things you have mentioned. Where do those expectations originate? If someone has an expectation about a certain income level that they will achieve or a certain lifestyle, where does that originate?

Prof. Frazer—In most cases I would say it is the inaccurate perception of the prospective franchisee. They have not explored fully to test it to see whether or not it is correct. There are definitely some cases where the franchisors are overenthusiastic in the claims or promises they make in an attempt to recruit franchisees. There would probably be some examples of where franchisors have outright lied about what they are going to offer. I would think it is more the lack

of preparation of the prospective franchisees; that is, that they have not sat down and thought about it properly. They are just so excited about it all that they are not willing to look at what is really there.

CHAIR—It amazes me that, even if those expectations are very high and you are enthusiastic and want to get into a franchise and you see this wonderful system, by the time you have gone through the selection process and before you have signed on the dotted line, the franchisor, through the education and disclosure provisions, has not hosed down those expectations and said, 'Look, here is the expected income you will make. It is in this range. Here is worst case and best and the sort of hours we need you to work for our system to be functional. Here is a typical franchise system of ours in your region, this is how it works and this is the ballpark income.' People go, 'Wow!' and it is better, worse or about where they thought it was. It puzzles me that through all this people still have very high or unmatched expectations. By the time a franchisor has gone through that selection process they should ensure they have the right people in the first place and have educated them. I would like your comments on that.

Prof. Frazer—That is an ideal world. It would be great if franchisors did that. Franchisees do not spend a lot of time looking around before they commit. Perhaps there is not a lot of time for the franchisor to dampen down that enthusiasm. But that would be the responsibility of a franchisor and it would be good practice if they did that. It is going to be hard to make franchisors do that if they do not have that personal philosophy.

I know that most franchisors will tell you that in their early days, when they were more desperate for franchisees, say, they made bad recruitment decisions and chose the wrong people because they just wanted someone who had money and they were happy to get them in. Boy, do they pay for it later on. Usually they learn not to do that and they get better at it. Franchisee recruitment is more of an art than a science. It is very hard to know; it is only hindsight that shows you that the person was not the right one.

The responsibility is on both parties. In the research we have done on franchisees who have failed, in virtually every case, after time has passed—say, one or two years—that ex-franchisee is able to say, 'I was not really the right person for franchising. I did not have the right mindset. I am better off being employed.' It is hard to know until you have done it. But pre-education is really important. However, people do not realise they need it.

Why single out franchising when small business operators would be in a similar boat? They are not well prepared either. That brings me to another point. You are probably aware of the high exit rate in small business. It is hard to measure in that area and hard to measure in franchising, so we do not have accurate statistics that I could quote. But we do know the rate of exits in franchising, which is reported in disclosure documents. It is very low.

CHAIR—Do we know the reasons for those exits?

Prof. Frazer—You will get a sense of that in the 2008 survey. We did ask about whether they were positive or negative reasons: Did they leave because they had fulfilled their goals or was it because there was conflict, the business was not making money or they are were personally unsuitable? We have a little bit of information on that.

CHAIR—It could also be that that statistic is distorted by the fact some people cannot exit no matter what. They have put in money that they have to recoup over time and they will bear whatever it takes to get through it. But they cannot exit because that means bankruptcy.

Prof. Frazer—If that is the case, eventually you will exit. Eventually it would be a closure. You would see a pattern of that.

Mr ROBERT—My view of government regulation is that it should be enough to establish a level playing field, but whether people succeed or fail is entirely up to them. We are in a free country and people should be free to make money or, indeed, to lose it. In the current market, I am sure some people are feeling that.

With respect to the level playing field, can I get your view on the drop-dead clause? Most franchise contracts involve a 10-year agreement. Considering it is the tenth anniversary of the code, that may well impact a number of people in the next 12 months. Most of them have a 10-year agreement and an option for a further 10 years and, after that, nothing. Is that effective? Is it working?

Prof. Frazer—Firstly, have you got some data on the 10-year thing? Our survey shows that the most common is a five-year agreement.

Mr ROBERT—Okay, good.

Prof. Frazer—This is a real area of concern for prospective franchisees, because people I have spoken to who have gone into franchising do not often realise the implications of the five-year term—that they are really renting the business for the five years. At the end of the five years it could all be over. It is a five-year term. Often when they are told that they have a five, plus five, plus five they have the idea that it is a 15-year agreement. Of course, it is saying that it can be renewed after five years and so on. That is an area where prospective franchisees really do not get it. It is not made clear to them.

I gave a seminar to prospective franchisees in a new system once. When I mentioned the issue of renewal, it was clear that it had not crossed their minds at all. They did not realise that the franchise had a possible life of five years. If they are entering thinking it is forever and that perhaps they can sell when they want to, they are going to be very disillusioned, because it is not actually that way.

Mr ROBERT—In your experience and having looked at agreements, if the common agreement is for five years—and there is no common, set agreement in law—do most of them have an option or do some have an option? How do most of them deal with the end of the contractual year? How do they deal with the end of the five years or 10 years?

Prof. Frazer—Most of them do have an option. I can see from the franchisors' point of view why they would do this. They are entering into a business relationship with someone for five years. At the end of that time, if it has proved successful, they would be mad not to renew it and allow them to stay. However, if they have not been a good operator, it gives them that chance to exit them.

Mr ROBERT—Granted. But at the end of the five years, what is to stop a franchisor saying to a very successful franchisee, 'Thanks very much, but it is over. We are not going to exercise the option'?

Prof. Frazer—I believe that is the case. We are getting into the legal area, and I do not have expertise in that. But I believe that is the case.

Mr ROBERT—I refer to the issue of churning. Your submission indicates that about nine per cent of franchise units experience a change of ownership. You say:

> ... 6% were due to franchisees selling their business, fewer than 2% of units were terminated, and 2% ceased operating. This evidence provides some support that franchising failure rates are low across the sector. Note that if the incidence of 'churning' of units was widespread in the sector, the above figures could be expected to be larger.

If there were instances of churning—that is, a franchisor deliberately not extending an agreement so that they can on sell or turn it into a company store—what sort of figures would you expect?

Prof. Frazer—More than that. We are looking here at six per cent selling their businesses. It would not be included in there.

Mr ROBERT—I will hold you there for a second. I refer to 'Franchising Conflict: Towards greater understanding and effective resolution', an article you co-authored with Giddings, Weaven and Grace. Are you aware of that?

Prof. Frazer—Yes.

Mr ROBERT—In the second last paragraph on page 4, it says:

> The importance of good faith—Calls have been made for the introduction of a statutory duty of good faith as part of a clear framework for the conduct of franchisees and franchisors. The SA inquiry received 'numerous accounts where a threat of termination was apparently employed to force the under-value sale of a franchise outlet by a franchisee back to the franchisor' (SA Inquiry, P58) Such accounts provide support for additional protections to safeguard the interests …

Your figures would simply show that as a sale; it would not show that as a churn. The South Australian evidence clearly points to that. In fact, the article you co-authored points to the fact that that is churning.

Prof. Frazer—I am not saying that I have evidence on churning or not. I am just saying that I would have expected it to be higher. I know that there are allegations about churning. The ACCC has even said that churning exists. So I am sure it does in some cases. But, that would be a rogue operator. It does not make business sense to churn. It would be much easier to keep a good franchisee in the system. Normal practice would be to do that. There would be instances of it, but it would not be good practice to do it, nor would it make sense.

Mr ROBERT—I will get your comments on the Rockingham issue with Yum! Restaurants International and KFC, where in November 2007, at the end of 20 years, they simply closed the store. They gave the proprietor at the time notice that they were no longer extending.

Competitive Foods then just closed the store. On the surface, that would appear to be a specific case of churning a profitable store they wanted to take over. You said there is no business sense in doing it. Could you give any reason why a company like Yum! would do such a thing?

Prof. Frazer—I might have a different view of churning. I would see churning as when you put a franchisee into a store that you know will fail—it is in a bad location or whatever—and it does fail and then you move them out and get another person in. You keep doing that because you are obtaining the initial fee.

It is a different matter if the franchisee has come to the end of the agreement and they knew they had that agreement. It may not be fair, but I think legally that is the situation. If the franchisor takes over that unit, probably because it has been a good operation, then you need to look at whether that is fair and whether anything can be done to stop it happening.

Mr ROBERT—Great. That is where we started. What would you recommend with regard to dealing with that? Let us apply the pub test and work on the premise that, on the surface, most Australians would say that would be unfair. What should we be looking at?

Prof. Frazer—I do not know. I do not have the expertise to be able to comment on it. You can look at a really good example of franchising like McDonald's. It has 20-year agreements. Compare that with the average of five years. Investors need to be careful that they are not paying too much to enter a five-year agreement, because they have only five years to see that investment through and to recoup their investment. McDonald's 20-year agreements are obviously meant to be long term and you would expect to pay a premium for that. Investors need to think about that. As I said, they do not realise the implications of a five-year term.

Mr ROBERT—Government's role is not to save people from themselves. That is not the role of government; people should be free to enter agreements and free to exit them. What is your view of the proposed good faith bargaining that came out of the South Australian inquiry?

Prof. Frazer—I find it difficult. Again, I think you have to be a lawyer to understand all of that stuff. To me, it is commonsense. How do you legislate the definition of good faith? All those sorts of things would be difficult for me to comment on. It is beyond my expertise.

Mr ROBERT—Let us take the pub test of the average Australian again. If an agreement came to an end, at a pub test level, is it reasonable to assume that a franchisor would negotiate in good faith to allow a continuation?

Prof. Frazer—Do you want my personal opinion on that?

Mr ROBERT—Absolutely.

Prof. Frazer—Personally, because I know a little bit about franchising, I would say that is reasonable, because you entered a five-year agreement or whatever it is.

Mr ROBERT—Thank you.

CHAIR—Thank you very much.

[10.16 am]

BLACK, Mr Gary David, Executive Director, National Retail Association Ltd

CHAIR—I invite you to make a brief opening statement.

Mr Black—I can assist the committee in terms of its time schedule. I do not need to say much by way of opening. The National Retail Association is a very diverse organisation, but included in its constituency are some significant franchisor and franchisee interests. The franchisors include Yum!, Subway, Eagle Boys and Boost Juice. Some of these organisations have elected to file submissions and some have not. In the formulation of the association's view, we have taken into account the views of these organisations. However, I do not want to purport to specifically represent their interests other than to say the general view is that we oppose any addition to the regulatory burden on franchisors and generally, therefore, we support the view that there is no need to change the code.

To remove any confusion, we do not purport to make any representations on behalf of our franchisee members. It would be too difficult for us to try to represent the franchisor and franchisee interests in a proceeding such as this. In respect to the third paragraph of our submission, I think we make what is not a factually correct statement. We say that since the code was introduced in 1998—

CHAIR—Which page?

Mr Black—The first page in response to the question, 'Do we need an inquiry?' We say that that since the code was introduced in 1998 a number of reviews have been conducted. I do not think that is factually correct. I think the correct proposition is that there have been over time a number of reviews into the franchising sector. But, since the code itself was introduced, I think there may have been only the Matthews review, which resulted in the amendments which had effect earlier this year. I think that is the factual case, but I do not purport to have the expertise. I simply want to make that correction for the benefit of the committee.

The final matter I want to allude to is the reference to section 51AC of the Trade Practices Act. We omitted to make mention of that in our submission. In that regard I indicate that I have had the opportunity to look at the submission of the Shopping Centre Council. That organisation deals with this issue on the first two pages of its submission. We support its position, which is basically that there is no need to make amendments to section 51AC. In particular, we note and support what they say. That is, that if the committee felt otherwise disposed—that is, if the committee wanted to recommend some amendment to section 51AC—the council expressed the view that this should be the subject of wider consultation since it has business ramifications that extent well beyond the franchisor-franchisee relationship. We endorse that proposition. I do not wish to add anything further.

CHAIR—Thank you very much. I will go through your submission and work through a number of issues that you have raised. First, I will deal with your request to present at a public hearing and that if there are any oral submissions from individual organisations that the NRA

should be afforded the same opportunity and respectfully makes that request. There is no specific provision for that to happen. This is actually your opportunity and you are being afforded that opportunity the same as everybody else. Everybody will be treated equally in that process. If an adverse comment is made by you about another organisation, that organisation will be informed of that adverse comment and then given the opportunity to respond to it, as would you be given that opportunity if somebody else were to make an adverse comment about your organisation.

You spend quite some time on the next point: 'Do we need an inquiry?' It is the independent body and the parliament itself that makes that determination, not representative bodies or anyone else. No-one else in the marketplace determines the need for an inquiry. The inquiry is going ahead and obviously that is why we are here. The whole question of whether we need an inquiry is obsolete. Yes, we do need an inquiry, and we believe that based on quite a number of grounds, and they are stipulated in the five terms of reference which are part of the inquiry process.

You also made reference to a number of other inquiries. I note that, and you have made some corrections in your opening remarks. That deals with a number of other inquiries. But this is specifically a different inquiry from, for example, the Western Australian and the South Australian inquiries, which are state-based inquiries. This is a commonwealth inquiry being conducted by an independent committee of the parliament rather than by the government itself.

Your submission states, and you have well established it in terms of what you say, that there is no need for much change at all, of anything. I hope we might be able to explore some areas today and treat this as an opportunity to say where we can improve the sector on behalf of all of the parties in it—franchisors, franchisees and the sector as a whole. This inquiry is that opportunity. It is an opportunity for continual improvement. It is not just a case of saying, 'It's fine. Let's just not deal with it at all.'

I will give you some time to think about that, but I will go through a number of other points. In particular, you state that frequent inquiries into the code of conduct inevitably cause uncertainty and contribute to a destabilising effect on the franchising sector. I am interested in those comments and what that destabilising effect is, what cost it might have, what uncertainty is caused and so forth.

Mr Black—The response to most of that is articulated on page nine. What we are reflecting here is the frustration within the sector as we see it about the number of inquiries. This year there have been three general inquiries into the code. Two of those inquiries have been state-based inquiries. Notwithstanding that, I think there is generally acknowledgment and endorsement for the view that this is an area which should continue to be federally regulated.

Despite that, already this year there have been two state inquiries and now the third inquiry, this federal inquiry. There is significant frustration within the sector that all of these inquiries are happening. They generate some instability. In the context of the state-based inquiries, we do not know that this process has run its course. I think that in some cases the state-based inquiries have said that they want these matters dealt with by the federal inquiry, even though they made those comments in advance. There is some possibility that if they are not satisfied with the recommendations of this inquiry or any subsequent legislative proposal there may be more inquiries into the franchise sector at the state level.

We think that this is incredibly destabilising. It generates uncertainty and people do not know what the regulatory framework will be. Are we going to have a sector that is regulated by a federal code or by both federal and state instruments? They are also a considerable distraction for organisations like ours and the franchisors, who either get involved in these inquiries, review them, try to read submissions, give advice to their constituents, form views, bring people together and so on. It is a very frustrating time.

In no way are we saying that the parliament does not have the right to institute these inquiries. But, at the same time, if you were sitting in our chair you would understand the frustration that this is the third inquiry in one year. Ironically, it is the same year in which the most recent amendments to the code came into effect. It is a difficult period

You raised the matter of change. The view of the franchisor sector is that the code has worked effectively and efficiently. There are parts of the code that they do not favour or would like to see differently expressed. Generally speaking, the view is that we will deal with what we have and move on. The problem for us is the continuous uncertainty that arises from proposals to change the code.

In terms of the most recent amendments, the most regular comment that franchisors make to me about the disclosure sections of the code is that the disclosure documents handed to franchisees are now so large that there is a risk that they are becoming counterproductive. I think the previous witness alluded to the fact that franchisees have considerable difficulty absorbing and assimilating the range of material they are given. As the disclosure documents increase, it is becoming a large burden and it is perhaps contributing to the fact that franchisees may not examine these documents in the depth that they should.

CHAIR—I will follow up particularly on the disclosure document issues. This is very important. Before getting to that, I will perhaps put your mind at ease. We are not related to the state-based inquiries. To ensure you understand, what we do is independent of those as well. I expected or at least hoped that this was an opportunity for the franchising sector to deal with a range of outstanding issues, such as the concerns you have just clearly articulated about other inquiries and that they might continue into the future. The opportunity in this process is to deal with all of those matters at a commonwealth level, giving us all perhaps the capacity to work through these matters and not have the need for further state-based inquiries if we have some constructive change at the federal level.

With regard to the disclosure documents being too large, I agree with you. I think they are too large. A witness yesterday showed us one document under the current regulation that was probably a good 14 inches thick. Other documents are substantially smaller. That in itself poses a problem. Franchisors can write a document as large as they like under the current code. It could be three feet off the floor. In fact, often the more information is provided the less meaningful it is. How do you propose we could actually provide better disclosure? It is not about more or less; it is about more efficient, better, real information that serves the purposes of what the code intends.

Mr Black—I do not think I can help the committee. To the extent that we have discussed this review with our constituents, there is probably a view that as the disclosure section has been most recently reviewed and despite the sort of complaints that are articulated, the pragmatic

view is to live with what we have and get on with it. I apologise to the committee to the extent that I am not providing these constructive suggestions.

CHAIR—I am not suggesting that we live with what is perhaps an inefficient, non-best-case-scenario-type disclosure instrument. I am looking for a pathway to finding what works for both franchisors and franchisees to say, 'You do not need to be burdened with the extra costs of living with what you have, because living with what you have got may not be the best way forward.'

I am saying that perhaps this is an opportunity to pare down those disclosure documents and make them smaller, cheaper and more easily understood so that we can actually provide the right information. In the end, disclosure is not so much about what is easily and readily available to everybody but what is very difficult and very expensive to obtain. That is what disclosure is about. Does the NRA have a view about that particular type of information that the code is trying to address?

Mr Black—Not in particular terms, no.

CHAIR—Okay. The NRA submission focuses quite a bit on committee activities, particularly in terms of whether we are pro-regulation or whatever it might be. It makes particular references to Competitive Foods Australia Pty Ltd. While a question has been asked about that today, I again make the statement that this inquiry is not about any one particular franchisor or franchisee. It is clearly about the whole sector. I think we have made that clear enough. Certainly, our terms of reference are broad enough. Your submission comments about just how broad it is. It perhaps does not drill to one area. However, under term of reference No. 5, it gives us the ability to look at any related matters.

I refer to goodwill, which has been the subject of a lot of discussion. Your submission states that the concept of goodwill is already dealt with adequately in law. That is pretty well right; it is dealt with in law. In fact, businesses and franchisees every day sell their going concern for a market value, which is goodwill. It has a market price; it has a value. That occurs on a daily and weekly basis when franchisees decide that they no longer want to be in the business or for whatever reason decide to sell up. They place their business on the market with the agreement of the franchisor and sell that business for a market value price. The problems and disputes seem to arise as you get closer to the end of a term, where there would be a diminution of that price as we got closer and closer to not having an agreement to renew, or at the point where the contract was no longer renewed and the market value would then effectively be zero—you would have nothing to sell. What is the NRA's view on the goodwill in those terms?

Mr Black—If goodwill is to be a factor, we think it should be something dealt with up front in the franchise agreement. As we generally understand it, that is the way it should be happening now. This issue should be dealt with and both parties should be aware of their rights or obligations when they enter into the agreement. The proposition that we are most keen to articulate is that the concept of goodwill is not as easily translated as we generally understand it to be in the franchise sector. The franchise sector survives on what I regard as very high and stringent forms of replication.

I know that these are very general propositions and there may be exceptions. We are not talking in the submission about people who through their own innovation and creativity develop

a new product, establish a niche in the market, create a new business and grow that business and then are entitled to claim the benefit of goodwill. These are operations that survive on their replication, their sameness. It is not easy, if you want to make a judgement about goodwill, to determine what goodwill is attributable to the contribution of the franchisor, the system or the brand and what portion is attributable to the franchisee.

We also warn that one of the greatest dangers for the franchising system is underperformance by individual franchisees. In that circumstance, there is a risk of adverse or negative goodwill, if you like, which will impact across the entire system. It is a very complicated subject. Our view is that if it is to be dealt with at all in terms of the code, it should be dealt with only to the extent of saying that it is something that ought to be specifically provided for in the agreement up front.

CHAIR—It is your view that it should be provided in the agreement up front. What prevents that happening now?

Mr Black—To some extent it might, but I am not sure. I thought in some of the discussions I had that this might occur. I think one of the reviews in the mid 1980s discussed that to some extent. I am not sure whether that is dealt with. The 1986 review said:

… it is not desirable (even possible) to make provision by legislation for an apportionment of goodwill on termination of the franchise agreement … and the franchisee should be cognizant from entering an agreement of the possibility/likelihood that they will not be compensated upon termination for goodwill built up by them …

I do not know to what extent it is currently in agreements. But it would seem to us—

CHAIR—I want to continue on this theme of goodwill. It seems to be well established and we have heard lots of evidence and received close to 150 submissions pointing out that, while goodwill may be difficult, it certainly does exist. We have the survey from 2006 and other surveys that state that the key to the success a franchise business and system is a good quality franchisee who needs to understand that you have to work really hard and build this thing up. Customers are not walking through the door because they ring a 1300 number. The franchisees actually have to contribute a fair bit, quite substantially, to ensure the success of the business, otherwise it fails. I think that that is commonly understood.

That establishes the broad concept of goodwill. How do you see beyond that? I think you have at least proposed a way forward there by saying it should be up front. How would you see a way forward in terms of saying that we have now established that goodwill does exist, because you can sell a business at any point and attract the market value and, therefore, the goodwill? Perhaps we need to hear some advice from the NRA about how you then begin that process of saying that we have established it so how do we now include it in standard contracts?

Mr Black—Having established it does not necessarily mean it is any easier to measure or apportion the respective contributions.

CHAIR—Do some have it now or does no-one have it now?

Mr Black—I thought some franchisors said to me that it may be a feature of the franchise agreement that goodwill is factored into the agreement as made.

CHAIR—Broadly speaking, no-one really includes goodwill; they do not black letter it or write it into a contract that there is goodwill and that they will do something at the end, or that there is no goodwill and the franchisee will get nothing.

Mr Black—I think some would dispute that. When you speak direct to the franchisors, some would say that it is a factor in the negotiation of the original franchise agreement. But I do not want to purport to have any expertise there. The difficulty is that if there is to be provision for goodwill, there then has to be some mechanism that enables the goodwill to be measured.

CHAIR—Would the goodwill not simply be part of what is the sale price and what is the turnover of the store? That is part of the everyday business-to-business transaction. If it can be sold six months prior to expiry for a certain amount of money and the person knows the contract will not be renewed, is that not already well established in law, common law and case law?

Mr Black—No, I do not think so. As I said, we are dealing with how you translate the concept in the franchise sector. You could have an exceptionally successful franchise business. But most of that success might be attributable to the brand. It might be a fantastic brand, the systems might be fantastic and the training procedures might be equally as good. The actual franchisee influence over the success of the franchise may not be as high as what would otherwise be the case.

CHAIR—Is that not all the more positive that the better the brand, the better the goodwill and the better the value and flow on? I will move on. I am very interested in your view because of your special relationship as the National Retail Association and having quite a number of members who are franchisors and who use your logo for their own operations. I am particularly interested in the way standard form contracts are used and their content. As has been stated before, sometimes people will then use the authority, as it were, as a stamp or a mark on their contract to say that this is a credible, authorised contract because we are members of the NRA. Does the NRA actually take on board looking at contracts and determining whether they breach the code?

Mr Black—No.

CHAIR—Not at all?

Mr Black—No.

CHAIR—In that case, do you think there needs to be some sort of central filing mechanism that gives people the ability perhaps to compare contracts and ask what they are getting if they are looking to buy into a franchise system? What are they going to get in one versus another? It could be for the simplest reason of ensuring that standard form contracts or contracts meet the standard and the code. Should that be dealt with?

Mr Black—I think if you look at the operation of reputable franchisors, that would be a case of over-regulation.

CHAIR—There are plenty of good franchisors, and they are doing the right thing. What do we do about the disreputable franchisors?

Mr Black—It is a difficulty for the committee. As we say in the submission, if there are 60,000-odd franchise units, inevitably there will be some levels of disaffection and dissatisfaction. But that in itself should not lead to adjustments to the code. You would think that there would have to be a pervasive or a fundamentally—

CHAIR—If there were abuses of power—that is, franchisors who have abused their position or not adhered to the codes—is it okay because many people do follow the code that we let the ones who do not get away with it because, as you say, that would be over-regulation of the existing franchise systems? I made it clear at the start that this committee is not about more or less regulation. We are talking about better, more efficient and perhaps less regulation or less onerous requirements with regard to disclosure, but better disclosure. This is not about making life more difficult for the good, reputable franchisors; it is about making life simpler and removing from them the burden of those who do the sector damage.

Mr Black—We would say that the current remedies should address those sorts of circumstances. If you are talking about the unconscionable conduct provisions, the standard remedies that are currently available ought to operate in those cases. I am not sure what the evidence is given that the franchise sector is pretty well regulated now. I am not sure what the evidence is about any such abuse. If it involves a breach of the code then adding more regulations will not change that because it will simply be a beach of the new code.

CHAIR—Would not registration ensuring that contracts to begin with are not in breach of the code solve that problem and make life easier for everybody involved? It is as simple as that.

Mr Black—I do not know how it would work. If there were such a register, would there be a delay in monitoring the instruments?

CHAIR—I am looking at your submission and at the wonderful opportunity that is presented to everybody through this inquiry to look at those issues. That is what this is about. Let us look at those issues. This is a key and central part of this inquiry. Through the terms of reference we are trying to hear from all the parties. We want to hear from everybody. We want to hear what are the ways forward on some of these difficult matters. They are difficult matters and they are in the marketplace. How do we know this?

There is a lot of law evidence, cases and disputes and a range of other indicators telling us that this is an issue. That is apart from the fact that every person we meet with and submissions tell us the exactly the same thing. Whether they are for or against, they tell us the same thing. It is the same issue: whether you want goodwill or do not want it, you still mention goodwill, because it is an issue. Whether or not you believe in good faith, it is still raised in your submission because it is an issue. That is what I am trying to deal with and hopefully resolve.

Mr Black—All the franchisors we deal with make it absolutely clear to us that they are intimately aware of their obligations under the code and they comply with them. So, for us there is no need for such a register. If the register were there, I do not know how it would work or whether it would delay the entry of franchisees if there had to be some approval for a contract before the business commenced operation.

The previous witness was generally supportive of the fact that one of the difficulties for small businesses is that they do not take the precautions they should be taking, they do not get legal advice when they should get it or they do not get the appropriate advice. So, if you say to them, 'In addition to the very lengthy disclosure documents, we are going to give you these opportunities to review contracts', I am not sure it would help.

Mr ROBERT—I believe in very small government and minimal regulation, just enough to get a level playing field. Therefore, what regulation can we dispense with?

Mr Black—For better or worse, as I said to the chairman, I think the franchisors we deal with have pragmatically taken the view that they will live with the code as it stands. We made our views known about the disclosure section when the review was conducted. There have been changes and they have made the adjustments. They have reservations about effectiveness of the disclosure documents. But, essentially, in my contact with the franchisors that I have named—apart from Eagle Boys, who are appearing before the committee this afternoon and proposing change—they have said that they do not think there is any need for change.

Mr ROBERT—So you are saying that you are happy for the committee to say that the NRA does not want to see any regulations dispensed with; you are happy for it all to stay exactly as it is?

Mr Black—We do not want see more regulation of the sector and we are not advocating any change to the code.

Mr ROBERT—So you do not want to see any less either? You are happy with how it all operates; you believe it is all as efficient as it could possibly be?

Mr Black—We would acknowledge, to the extent that we have not advocated to you in precise terms a change that would reduce regulations, that we are not entitled to claim that as an outcome.

Mr ROBERT—Say that again.

Mr Black—We would acknowledge that as we have not put before you a specific proposal recommending how you might go about reducing the regulatory burden, we are not entitled then to argue or to criticise the committee at any point because it did not reduce regulation.

Mr ROBERT—I understand that.

Mr Black—We accept responsibility for that.

Mr ROBERT—So you do not want to recommend to the committee that any regulation to be dispensed with?

Mr Black—We are not making any such submission, no.

Mr ROBERT—Thank you.

CHAIR—I want to pursue the idea of getting proper advice. I think that is a substantial issue. We have talked a lot about education—and I know that your organisation and others have referred it—and particularly pre-contractual education. That is a really important area. Yesterday we were presented with a standard form contract. As I mentioned before, it was almost a foot high. A very experienced franchise lawyer was asked if they would read that and interpret that document under the current regulation. The fee was $10,000 to read that document. Not to advise or to comment, just to read it. A problem exists in terms of its size. I am looking for answers.

You have mentioned lengthy documents and people not getting proper advice. How do we fix that? Should the franchisors do more; should the franchisees do more? I am very conscious of the fact of the diversity of franchising from the simplest operation—for example, a dog washing or lawn mowing franchise, which does not require a lot of business acumen—to the most complex arrangements. How do we deal with that diversity?

Mr Black—I imagine what we have now in terms of contracts and other documentation is a product of the regulatory environment or the cautious nature of franchisors in ensuring beyond doubt that they are complying with the regulatory environment. All I can say is that all the franchisors will say to you that their success is inextricably related to the success of their franchisees. They have no interest in implementing systems or contracts, which in some way or other might contribute adversely or be inimical to the interests of the franchisee. Their focus is on ensuring a successful relationship. I have not seen those contract documents, so it would be inappropriate of me to try to comment.

CHAIR—Finally, the NRA specifically asks in the submission whether it can put a view or make other recommendations before the committee makes its final determination. In other words, when we have a draft report, the NRA would like to be able to make a further submission. No, that is simply not how any parliamentary committee works. The process is very clear, up front and transparent. We have terms of reference and an inquiry. We invite submissions, which everybody is entitled to make. We then have a public process, which is why you are here today. The committee then independently deliberates and hands down a report to the parliament.

Mr Black—Thank you.

Proceedings suspended from 10.53 am to 11.03 am

BEDDALL, the Hon. David, President, Franchisees Association of Australia Inc.

CHAIR—I welcome everybody back to the committee hearing. I invite the next witness, from the Franchisees Association of Australia Incorporated, the Hon. David Beddall, to come forward and make a brief opening statement.

Mr Beddall—Thank you very much. I will make a brief opening statement because I am sure, having listened to the previous speakers, there will be lots of questions. I will premise my remarks by giving a bit of background.

In my time in federal parliament—from 1983 to 1998—I was Minister for Small Business, Construction and Customs between 1990 and 1993 in both the Hawke and Keating governments. Prior to that I chaired the House of Representatives Standing Committee on Industry, Science and Technology, which conducted the first overall inquiry into small business, which became known as the Beddall report. Prior to losing office as a government in 1996, I was deputy chairman of that committee. I note there were a number of references to the Reid committee. I was deputy chairman of that committee. On a number of occasions when Mr Charles, who was the original chairman of that committee, was not available, I actually chaired some hearings. So I have some knowledge of that.

I want to give an overview of where we think there is need for change and, like the committee, we think there needs to be better regulation rather than more. We think that in many instances with franchisees the true content of the relationship is not understood. It is often referred to as a business-to-business relationship, but in many instances it is a master-servant relationship. All the power vests with one party—the franchisor. The powerless, in many instances, are franchisees.

We do think there is some need for some sensible regulation. One of the dangers of not having sensible regulation is what is already starting to happen. It is something that I was very concerned about when I started the process. I set up the first working group to look at franchising and a code way back during my term as a minister. On that committee was the late Charlie Bell from McDonald's and Motor Traders' Michael Delaney, who thankfully is still with us. There were also four representatives of franchisees and franchisors and advisers to franchisors—lawyers et cetera.

One of the concerns I raised was that if we did not have a working commonwealth framework we would end up with six state jurisdictions and two territory jurisdictions. I think you are starting to see the genesis of that through the inquiries in South Australian and Western Australia. When I ceased being the Minister for Small Business and moved on to other pastures, Senator Schacht took over from me and he was responsible for bringing to fruition the voluntary code that has since become the mandated code.

We have a view that significant reform is needed. That is detailed in our submission. The Franchisees Association of Australia is a voluntary organisation where all parties work pro bono. We have some legal advisers, people who basically want to see franchising in Australia become what we think is fair franchising; that is, it works for all parties—franchisors and franchisees.

We believe good franchising is a very good system and we support the franchise model very strongly. The vast majority of my board members are either current or past franchisees. Some of the board members are representatives of organisations that have franchisees as members.

Our organisation is a collective organisation similar to the model of COSBOA. We have a number of affiliated organisations and we represent their views on franchising. That is my opening statement. I am happy to work through the submission. If there are areas in the submission that are technical because they have been drafted by people with expertise much greater than mine, I am happy to take questions, as you say in the parliament, on notice and I will ensure you get a full response.

CHAIR—Thank you, Mr Beddall, and thank you for your very detailed submission. For the record, you have covered seven specific areas and made a number of other comments, specifically looking at the Australian Securities and Investment Commission's vetting of franchising agreements. You have heard some comments from previous witnesses about a franchising ombudsman, having a franchising code that includes the principles of good faith, the revision of the unconscionable conduct provisions of the Trade Practices Act; an enforced as well as enforceable franchising code covering a number of areas, including penalties for breaches and variable and sensible terms of contract and tenure; and, finally, the use of the unfair contracts provision of the Independent Contractors Act as part of your submission. It is a very extensive submission and I do not think we will have time today to go through every part of it in detail. There are some areas I want to explore, and I am sure Mr Robert wants to explore it as well.

I refer to the first point on your list, which deals with the Australian Securities and Investments Commission's vetting of franchise agreements. We have heard differing views, and I think we know the central arguments. Principally, if we had a central registry or registration with the Australian Securities and Investments Commission or some sort of vetting to determine that they meet the code that would prevent a lot of disputes and it would not cause confusion because there would be no stamp of authority as a result of simply registering, as is the case with securities investments and other companies that are required to register. I would like your comments on that area first.

Mr Beddall—We have thought long and hard about this. In another part of my non-parliamentary life I am now the chairman of a publicly listed company. That company floated on the stock exchange and it had to prepare a prospectus. It was vetted by the Australian Securities and Investments Commission to ensure that it met the standards. There were changes made to ensure that it met those standards.

We strongly believe that one of the great myths of franchising is that if you get good advice from a lawyer/accountant then everything will be all right. The problem is that for one particular franchise, each individual franchisee will get advice from a different lawyer. Many of them are suburban solicitors who do not have expertise in the area. We think there should be a basic vetting by the Australian Securities and Investments Commission that the premise of the agreement should at least meet the franchising code of conduct.

Many franchises are sold in Australia that do not comply with the franchising code of conduct. I just do not understand how that can happen. That would then reduce a whole range of

paperwork and the foot high stacks of paper you are talking about because people would say that this complies with the Australian Securities and Investments Commission's requirements.

The counter argument is that that is an endorsement. Let me tell you, the Australian Securities and Investments Commission does not endorse my company on the stock exchange. If it did, perhaps the share price would not crash like everybody else's. We think the reality is that simple vetting by a division of the Australian Securities and Investments Commission would ensure that every franchisee had the understanding from day one that the franchise they were going to buy complied with the code.

Mr ROBERT—Franchises comprise five per cent of small businesses. We do that for the other 95 per cent. They simply get out there with a risk-reward point of view, do their analysis, get their advice and take a risk. If they earn a reward, fabulous. We are not responsible as a parliament to ensure outcomes for people, just that there is a level playing field. Why would we do this for franchisees and not a small business?

Mr Beddall—Quite simply because you are buying the right to operate someone else's business. They are making a statement that that business is of a certain character.

Mr ROBERT—How is that different from buying a fish and chip shop? I am buying a business with an established reputation and on the basis that the figures and everything else is correct. How is that different?

Mr Beddall—It is different. You are not buying David Beddall's fish shop; you are buying the fish shop on the corner of Smith Street and you are doing that business. People buy franchises because there is a clear perception in the community that buying a franchise is a safe way to invest. Starting your own business is much more risky and people understand that. Although the rewards are greater, the risk of failure is also greater. But when you buy a franchise, you are buying what is supposed to be a recognised brand in the marketplace. We are saying that there should be a basic protection that the franchise you are buying complies with the code of conduct. It is as simple as that, and I do not know why anyone would object to that.

Mr ROBERT—I acknowledge that there is a perception. But why should government be forced to regulate because there is a perception? At the end of the day, people have to face up to the fact that there is a certain degree of risk in buying anything.

Mr Beddall—Absolutely.

Mr ROBERT—We believe in the right to succeed and the right to fail. Why should government take responsibility away from the individual? The individual should say, 'Does this agreement comply with the code of conduct or does it not?', just like they would investigate any other risk in purchasing any other business.

Mr Beddall—Why does a company listing on the stock exchange have to get approval from the Australian Securities and Investments Commission? Why cannot the stock exchange say, 'Okay, you can list'? People would than take their chances with your stock and see if it goes up or down.

We say that this is much more important for franchisees because if I go out and buy shares in a public company, I might spend part of my superannuation or part of my savings. When you are buying a franchise, nine times out of 10 you are putting your house and all your savings on the line. We think there is a role for government in that. It does not have to be too intrusive, but there is a role for government to ensure that a government code is complied with. At the moment, there is a government code—and no-one is asking for the code to be taken away. But there is no enforceability, except through the courts.

Mr ROBERT—Yet we do not do that with any other contract to see whether it complies with the Corporations Act, for example.

Mr Beddall—We do it with a whole range of things. There is an oil industry code and many other areas where government says that there is a public interest in protecting this sector. Governments, past and present, have said there is an interest in protecting the franchise sector through a code of conduct. We are saying we should make that better for the franchisors and franchisees and ensure that the rogue operators do not ride on the back of the good franchisors. The rogue operators do exist and I can give the committee a list. You have probably had a lot of submissions from people about them.

Mr ROBERT—Thank you.

CHAIR—Following on with that important area, does the Australian Securities and Investments Commission have the resources, power or ability to do that task?

Mr Beddall—I think it would.

CHAIR—Currently?

Mr Beddall—I am not sure. I think it is very quiet at the moment. There are certainly not many initial public offerings out there, so they probably have spare capacity. There would be a fiat associated with that which would then help to fund it. I think it could be self-funding. It would not be anywhere near as detailed as an initial public offering for a share float. We are saying that the Australian Securities and Investments Commission would look at it and there would be an opportunity for it to say whether it complies with the code or does not, as happens now with prospectuses.

If your prospectus does not comply with the requirements to list on the stock exchange, you are told why and where and you make adjustments. I think it would help not only franchisees, but also franchisors.

CHAIR—There is a code, and I think it is quite stringent in relation to disclosure. A fair bit is required. Some submissions have said that it is onerous, although I would not agree. Many of the standard form contracts vary in the amount of information they contain, some from as little as the very bare minimum requirement and others that are very extensive documents that require legal experts to spend countless days, if not weeks, just to read them. Where can we make an improvement in terms of trying to get something that is manageable, affordable and not burdensome for franchisors but, at the same time, works for the whole sector—that is, something that works for franchisees as well?

Mr Beddall—I think that with our suggestion about the Australian Securities and Investments Commission-type regulatory regime, you would peel a way a lot of that. I am not a lawyer, but I know from English history law books that those with the most pages of evidence won. In many instances in Australia, if your franchise agreement is a foot thick then perhaps there is something wrong with it. It is more likely to be burying something than exposing it.

Our view is that if you put in place a fundamental requirement then the code would help franchisors by having a registered, prospectus-type document. There would be less need to go into all the various details. This is particularly important for rural and regional areas, where franchising is growing substantially. There are not enough lawyers there trained in franchising law. As I said at the start, you get a number of lawyers looking at the same document, so the cost to franchisors is enormous. If the document were able to be standardised, that would be fine. It would always be up to the individual franchisor how thick the documents were.

We made a submission to the previous inquiry—I think it was the Matthews inquiry put out by Fran Bailey. We were very happy with the outcome, and we said so in our submission. We thought it went just far enough and picked up most of the points. So we think disclosure is about right.

CHAIR—Do you think the pre-contractual arrangements in terms of education, information and managing that expectation level are satisfactory? There is no problem until one exists, but all disputes in the end come out of people having a different view and different expectations, and it comes back to the contract in the first place.

Mr Beddall—I think that is it. If the code is right—and we have not heard a lot of people saying it is not right; they might think it is a bit onerous here and there—and if a franchise complies in the code, you are a fair way down the track. I know a number of people have given evidence to the committee that they have had a situation where the franchise agreement has never complied with the code. They are in a very difficult situation. Even when they go to a lawyer, nine times out of 10 when the legal advice is not to sign the contract, people still sign. You cannot protect people from that. As I said from the start, if every franchise in Australia complied with a code, you would be halfway there.

CHAIR—How do we get people to comply with the code? I think you are right; you made very solid points. All the submissions we have received point to the fact that the code is working in principle and that the franchise sector as a whole is a very good, solid sector that employs a whole heap of people and contributes massively to GDP. This is always about the rogues, those few people. How do we get them to comply? What mechanisms are available to get them to comply?

Mr Beddall—I think the code has to be enforceable. Currently the only way you can enforce the code is through legal action. I think it has to have penalties. We have expressed that view in our submission. Like any of these issues where you have to comply with government regulation, there should be some penalty for breaching. We have a simple view that that would get rid of the vast majority of the rogues.

I know of a number of instances and I know that some of the people involved have made submissions to the committee. They start off in a franchise with one franchisor and they go on

for a number of years extremely well. Then, all of a sudden, the franchisor changes ownership. Then the problems start.

There is a view that if it is good for the franchisor it is good for the franchisee. That is not necessarily the case. A franchisor is primarily in the business of selling franchises. They can be very profitable but the franchisees are not profitable. There are a number of instances where it is evident that the business model does not work, except that they sell franchises. They also have in their agreements that you have to buy from particular suppliers, the third line forcing. Apart from the illegal kickbacks that might be happening in some rogue areas, it means that the franchisor will always make money out of selling to the franchisee. It does not mean the franchisee is profitable. The good franchisors ensure the profitability of their franchisees.

Someone mentioned McDonald's. I have a lot of time for the McDonald's model. I am pretty au fait with it, because one of my directors has just sold his two McDonald's franchises for a substantial capital gain, which is the McDonald's model. His franchises had terminated, but he was able to sell at the end of his franchise, take the capital gain and retire.

CHAIR—Who did he sell to? Back to the company or just in the open market?

Mr Beddall—In the open market. McDonald's has a very good model. You would have to ask them for the full details, because I certainly do not have them. My understanding is that McDonald's always owns the real estate and the business—that is the equipment and the goodwill—is owned by the franchisee, and he has the right to sell.

CHAIR—So they have a formula—

Mr Beddall—Absolutely.

CHAIR—which works for them?

Mr Beddall—Yes. They have a formula. McDonald's is not called 'McDonald's Hamburgers', it is called 'McDonald's Systems'. They have a model that says if you are turning over $2 million you should make X dollars profit. If you are not, their regional people come in and help you get that profit up.

Mr ROBERT—I refer to the code of conduct. Do the contracts you are aware of contain a statement or something ancillary that says that this contract complies with the code?

Mr Beddall—Not that I am aware of, no.

Mr ROBERT—Would there be any value having such a statement, for example, in the first line of a contract or in a document attached to it?

Mr Beddall—Yes. Obviously it is better than what is there now. But that is their assessment of it. The franchisor could say, 'Oops, sorry. We thought it complied with the code.' What is the penalty? The franchisee has to sue them in a court of law. That costs $250,000.

Mr ROBERT—The penalty would be that if a contract from the company says this complies with a code and it does not, it is misleading behaviour and the contract will be null and void.

Mr Beddall—The only way you can pursue it is through the courts.

Mr ROBERT—Correct. Which is, for example, the same situation that applies to a not-for-profit organisation. In Queensland, if there is an issue, it is all designed for the Supreme Court to address.

Mr Beddall—But you have to understand the nature of franchisees. All their life savings are tied up. If they are under duress and the reason they are under duress is that they have signed a franchise agreement that does not comply with the code and it has disadvantaged them, their access to the court is nil.

Mr ROBERT—If there was a franchising ombudsman—where it sits is a little irrelevant in the question—would that have any benefit?

Mr Beddall—Yes. We are a firm supporter and, as you know, we have recommended that. A lot of people have said that will not work. I was around the parliament when the banking ombudsman came in and people said that the banks would just ignore it. We know that that is not the case. I was the Minister for Communications when the telecommunications ombudsman's position was established. We appointed Warwick Smith as the first ombudsman.

Mr ROBERT—The banking ombudsman finds against the banks eight out of 10 times.

Mr Beddall—Yes.

Mr ROBERT—So it is actually very effective.

Mr Beddall—Very effective.

Mr ROBERT—If, for example, contracts had a statement saying that they complied with the code and there was a franchising ombudsman in place, what power would you see the ombudsman having in areas where a franchisor had knowingly put that statement in when indeed it was not complying? How would you see that franchising ombudsman working?

Mr Beddall—I am not au fait with the current situation. I have been out of the parliamentary system for 10 years, so I am not current with the penalty regimes.

Mr ROBERT—It has not changed a lot.

Mr Beddall—I do not think it has. Only the faces change. I think the power of persuasion is the only power that the banking ombudsman has. You have a sector that is very sensitive to public scrutiny. Current affairs shows love to punish banks, particularly in recent times, if not always. We started to see the bad franchisor of the week on A Current Affair or Today Tonight. I think that will continue, because it is good fodder. It is a bit like parliamentary perks—every three weeks there is a story. If the ombudsman is not in place and if we do not have the vetting of the code then there should be powers for the ombudsman to pursue on behalf of franchisees.

CHAIR—You mention in your submission not only the enforceability but also the code actually being enforced. You mentioned criminal sanctions for breaches of the code, co-extensive liability for directors, managers and other employees, civil consequences and disclosure documents which work as a statutory warranty. Can you give us examples of where that works in other industries or elsewhere?

Mr Beddall—I can give my own example. I am the director of a public company. I have all the responsibilities of ensuring that that public company complies with the Australian Securities and Investments Commission requirements and the stock exchange requirements. If it does not, I am open to very severe civil penalties as a public officer in a public company. We think that should also apply to franchisors. It applies to a vast number of Australian businesses now—some 3,000.

CHAIR—Is that an onerous task? Is that too much to ask?

Mr Beddall—I am still chairman of a public company. You take that risk and you have directors and officers liability insurance, which I hope covers it. The same would apply. One of the disclosure requirements under the Matthews committee was that the senior people had to disclose their history of franchising. A large number of people move around the franchise sector as employees who are not directors and who do not have stellular reputations. When you are looking at a franchise, it is always very important that you know whom you are dealing with. Not just that it is XYZ franchise, but the personnel involved.

CHAIR—How much respect do you think there exists for the code if it is not generally enforced or if it is very difficult to enforce?

Mr Beddall—I think currently franchisors by and large think it is a nuisance, an inconvenience. There is no sanction in it. As I have said before, and I think it is worth restating: The only sanction that a franchisee has is to take action in the courts. By the time they are in dispute they have lost their house and they have no capacity. We have also recommended that the Australian Securities and Investments Commission be given the power, as was suggested way back in the 1990, if not the 1980s, to take up test cases on behalf of franchisees.

Mr ROBERT—Cognisant of the subjective nature of the question, would you have a guess as to what percentage of current franchisor contracts would not comply with the code of conduct?

Mr Beddall—We have done some rough work. I cannot say it is quantitative or qualitative. We think that it is about 15 per cent. The Franchise Council of Australia in the High Court case said that 10 per cent of contracts were at risk. That was their own admission. We think that 10 per cent to 15 per cent of contracts may not be complying with the code. It may be more or less. But it is a significant number when you look at the number of franchisees.

CHAIR—Let us say that 85 per cent to 90 per cent comply with the code. Do they strictly comply with the code, letter for letter, and diligently go about meeting those requirements?

Mr Beddall—It is what we would say under our fair franchising: they comply in spirit. They actually want to comply. They may not technically comply, but they want to comply with the

spirit of the code. We think the vast majority of franchisors do that. Anything we recommend here would not impact on those franchisors.

CHAIR—I agree that most would want to comply and would go out of their way to ensure that they do. Again with this whole idea of standard form contracts, there is a massive difference for a whole range of reasons in the size, volume and amounts of information in disclosure in those contracts. Some people are over-complying quite deliberately and providing a lot of information that is not necessary. What are your comments on that?

Mr Beddall—There are two questions franchisees should ask themselves before they enter into a franchise. First, does it comply with the code? That is, is it fair and reasonable under the code that has been established by government? Second, is it a commercial success? The rest of it is important, but they are the two important questions. I do not think any amount of education will change that.

Having chaired a few inquiries in my past life, the easy answer is to say that we need better education. You are never going to get that properly. One of the Reid inquiries was into retail tenancies. It was a very difficult area and it is much the same as franchising. The issue is that if you do not sign this lease the owner has 10 people sitting in the waiting room who will sign it.

Mr ROBERT—As a private citizen, let us say that I am in that situation and you say that there are 10 people out there. That is my risk. I can say, 'Great, I am out of here. You get one of the 10 people to sign.'

Mr Beddall—People do not. You only have to go back to the tenancy disputes and all of those other things. Remember, as I said, this is a master-servant relationship. All the economic power is with one party, and it is not the franchisee. The economic power is with the franchisor.

Mr ROBERT—But is it government's role to save that person from themselves?.

Mr Beddall—It is government's role to ensure they are not treated unfairly.

Mr ROBERT—Correct.

Mr Beddall—That is why the code needs to be enforceable. You will find that the FCA logo is on the franchise and most of the franchisors are members.

Mr ROBERT—They are a member of the FCA?

Mr Beddall—Yes, but it is seen as an endorsement.

Mr ROBERT—But that is like me going and buying something that has the Heart Foundation symbol on it and thinking that it will be good for me.

Mr Beddall—And the Heart Foundations says that you should be able to trust its logo.

Mr ROBERT—I think the Heart Foundation would say that that logo goes on because the producer is a member has paid to put it on. The Heart Foundation has not actually tested something to say that it is good for you.

Mr Beddall—That is not what they say when they put the Heart Foundation logo on McDonald's food. They said that it has to meet their standards. If I see a Heart Foundation logo, I think it meets the foundation's requirements. If it does not, it is misleading advertising.

We never bash the FCA because it represents franchisors and we think it does an excellent job. That is a legitimate and necessary function for someone to do in this community. But, we are saying that there are a lot of rogues out there and they come and go. You can go back through a whole history of them and I can name them, one after the other, where they take advantage of franchisees. Sure, it is buyer beware. But we have consumer laws so you do not buy a dangerous toy for your child. There is a role for government to play in making sure it is a level playing field. We think in this case it is tilted too far one way.

CHAIR—A complicated area is the issue of good faith, fairness and contract. It is easy to argue and say that a contract could well and truly meet the code, because of what needs to be in that contract. There is a clause in a substantial contract—this was presented to us yesterday by a witness—in which the opening line of the contract states, 'This is the agreement and these are the things that we will do', and the second part of the clause states, 'We can change it at will at any time and we can change it to any form we like for any reason. There is no limitation to what we can do. The moment after you have signed we can completely change everything.' That may not be fair but it certainly is not in bad faith if all parties then sign it because they agree to those terms. There is this difficulty of the fairness issue and the good faith issue in what people are saying. Can I have your view on how that might work?

Mr Beddall—I think that would now be in breach of the code. However, that is only from memory, as I have not read Matthews for some time. One of the things in Matthews was that there could be no unilateral change to the terms and conditions. If there were changes to the terms and conditions of the original contract they had to be agreed by all parties. If that was not what the outcome was in parliament that is what it should be.

I can give you instances of large multinational franchises that have unilateral power. People invest not hundreds of thousands of dollars but tens of millions of dollars in their franchises. Once you are in there is not much that you can do. The lawyers always tell them never to sign the renewals or the contracts, but when you have $25 million exposed and there is a no compete clause in the original agreement, there is not much you can do except sign. That is what happens.

Mr ROBERT—The first witness who spoke who did work on the surveys—which is probably the only real source of industry-wide data we have—indicated that the majority of franchise contract terms were for five years. Some had options and some did not. How do you think industry should deal with renewals? If there are five-year or 10-year contracts, or an option for five-year contracts, do you believe it is fair at the end for a company to take over a successful business and that is it?

Mr Beddall—No, I do not at all. That is not international best practice. One particular franchise rang an American counterpart because he had a five-year term and he was told that the

United States would not sign anything. That same franchise, which sold a five-year term here, had an open-ended term with the United States franchisees. I think five years is crazy, not for a lawn mowing franchise or whatever, but for anything with a large capital injection where you will add value to the franchisor because you would be selling their product and, if you do it well, you will sell more. We have made some suggestions but my view is that it should not be renewed in the breach rather than a drop-dead date.

I know a bit about the economic market, but if you ask franchisees whether they have amortised the cost of the franchise over the five years they will inevitably tell you that they have not. With a $250,000 franchise you have to make $50,000 after tax just to get back your capital. Most franchisees have never done that. That is where you can have some input with an education program. In many instances you can talk to franchisees—and no doubt you will—and you will find that they are told with a nudge and a wink, not in the document, 'Of course we will renew', and people believe it. In most instances a lot of franchisors renew, but some do not.

Mr ROBERT—How would you recommend that the issue of renewals should be dealt with?

Mr Beddall—We think that, by and large, a fixed-term renewal is too restrictive. We note, in particular, in the case of Yum foods—and I have read its submission—that that was a 20-year term, which is a substantial one. It made a strong argument that that was not sufficient because it had built the brand. McDonald's is a 10 by 10. We think those are closer to where they should be for major capital expenditures. In our view there should always be the right to sell, even if it is the end of the franchise.

Mr ROBERT—I was just looking at the McDonald's contract. I appreciate that you might know it but you are saying it is 10 plus 10 years. At the end of the first 10 years there is an option if the franchisor wishes to extend it.

Mr Beddall—My understanding is that perhaps they will appear. It was difficult to get them to appear before me when I was the chair, but they did. It is only under exceptional circumstances that they do not renew, and that is when the performance is bad, or whatever. You have to understand that the other missing equation in all this is franchisee betting. In many instances the two requirements for a franchisee to get a franchise are a pulse and a chequebook, and you can buy your franchise. McDonald's and other major franchises pre-qualify. You have to work for nine months for no money to learn the system and they then have the right to say yes or no. If more franchisors vetted their franchisees and saw that they were the appropriate people to build the brand you would have fewer disputes.

Mr ROBERT—Do you know what McDonald's does at the end of the second year? Does its contract state, 'You will be entitled to sell at market value?'

Mr Beddall—I think at that stage you can sell at market value; I am not sure. I understand that its model is different to most.

Mr ROBERT—Granted, but you can only sell the franchise if the franchisor agrees to it.

Mr Beddall—Absolutely.

Mr ROBERT—One could argue that, if you were dealing with an unscrupulous franchisor—I am not saying that McDonald's is by virtue of the fact that our last discussion was about McDonald's—and you were approaching the end of the period and wanted to sell and it said no, where would you go? You cannot sell it.

Mr Beddall—No.

Mr ROBERT—You have no ability to roll something over. You are approaching the end of an agreement. You went into the contract in good faith. A contract is a contract. At the end of 10 years or five years the contract states you have no rights. You signed it and you need to take responsibility for it. But the question is: Is that right?

Mr Beddall—I have a view that unless you breach you should virtually have a perpetual franchise. That is not necessarily the view of my association; that is my personal view. If together you have built a successful brand you have to take into account the fact that you can have two separate stores from the same franchise and they trade very differently. Much of it is to do with the hard work and effort of one person building the goodwill of that business. Does that goodwill belong to the franchisee or to the franchisor? I think it is a joint thing. How you determine that is a Solomon solution, but there has to be some requirement.

We think there should be a formula in the code based on the amount of capital invested at the start to ensure that you return that capital over a period and there is such an opportunity. However, it is difficult to put that into the code. If I am a franchisor and I say, 'The chairman is not the right person'—he may be the perfect person—'but I have someone else to whom I want to sell that franchise', currently there is nothing that I can do.

Mr ROBERT—There seems to be something inherently unreasonable about putting a five-year, 10-year, or a longer period in place to jointly build a business and, at the end of that period, one party has all the rights and the other has none when it has been a joint exercise the whole time.

Mr Beddall—I could not agree more. I think good franchisees recognise that. You will see it often when they are allowed to sell. They will bring a potential buyer to the franchisor. The franchisor must have the right to vet those people to make sure that they are appropriate. If they are and they are knocked back I think that has to be a breach of the good faith provisions of the code.

Mr ROBERT—I note your earlier comment about one of your director colleagues who reached the end of his time with McDonald's and it gave him every opportunity to sell, which he did quite profitably. Obviously that is to its credit.

Mr Beddall—This is one of the cases that you will hear about. At one stage he took them to court. Over the time he had not been a completely compliant franchisee, but he had been a superb franchisee for them in relation to the business. Even with someone who was considered a bit of a pest because he had taken that person to court, and unfortunately for him he lost, they did not change any requirements that they had about him being able to on-sell his business.

CHAIR—Mr Beddall, we have received a number of submissions that deal with goodwill and that state that goodwill rests with the brand. There probably is an even wider view that that is the case—that it rests with the brand. Today we heard evidence from Professor Lorelle Frazer that a large number of franchise systems hit the market before they ever established a business.

So they have the business, the franchise system and the whole lot hitting the market at the same time and that is all within a 12-month period, therefore leading to the prospect that the brand and the business are built at the same time.

Mr Beddall—I do not think that is the case. There is an old rule in American franchising that if it does not have 100 outlets do not buy it. I would have a very jaundiced view of any franchise that was opening up a new franchise that did not already have operating company stores. When you are buying a franchise you should be able to get a comparative analysis of what your business would be able to do compared to a company store or another franchise. It is good if they have a great business plan. It is a bit like the dot.com boom. There are 10 billion people around, so if you sell one to every billion people you will sell 10 million.

A lot of that is about. It must be a flashing warning sign for any franchisee that is buying into a franchise that is not established and that does not have business behind it. Any number of franchises have been established primarily to inject capital into the franchisor's business. Again, that is the wrong reason for franchising. When there is an education program there is one also for franchisors. It is not just a capital raising exercise. Rather than going to the bank get someone else to fund your franchise business by selling franchises.

CHAIR—The education issue has been raised a fair bit. Who do you think should do the educating, and who should pay for it? You have already alluded to some of those areas but who should pay, who should do it and should it be compulsory?

Mr Beddall—That is a difficult question because franchising has such a broad range—from $20,000 businesses to businesses worth millions of dollars. I think that any substantial franchise should do what McDonald's does—there should be in-house training before you take up the franchise. That does not mean that the area manager turns up three days a week for a couple of months and gives you half an hour's training or, in some instances, says, 'Here are the keys. Open the franchise.' Substantial training should be embedded in the franchise model, and that should be from the franchisor. The Government cannot train people how to run a franchise.

Mr ROBERT—And nor should it.

Mr Beddall—No. If it could, the whole public service would be out there making businesses, but they are not.

CHAIR—I refer you to the mediation issue. Currently, a mediation process exists. For want of a better system, it seems to work. Could we have your views on that?

Mr Beddall—I will use the words used by one of the mediators who said, 'The reason it seems to work is that we give a figure that reflects that 90 per cent of cases are settled.' In 90 per cent of those cases it is because the franchisee walks away. So they are only settled; in fact, there is a resolution. The resolution is that the franchisee goes broke and walks away. We do not think

it works. There are some serious flaws in it and a particular flaw is that it is one-on-one mediation. If groups of franchisees are disgruntled they cannot appear collectively to the mediation.

One case that is quoted in our submission—or if not in our submission you will receive it from someone who has been associated with us—was where the franchisor did not turn up to the mediation. He ignored it and, therefore, there was no mediation. The franchisor decided that he was not going to participate and that was it. Within the mediation system it is better rolled into the Ombudsman's office.

CHAIR—The issue of unconscionable conduct has also been the subject of many submissions. Given that unconscionable conduct is already contained in the Trade Practices Act and there are differing views as to how you would manage that if it were to be put specifically in the code, perhaps we could get your view on that. To preface your response, the Senate economics committee now has an inquiry specifically into what the statutory definition of unconscionable conduct is, and it will be reporting to the parliament on 3 December.

Mr Beddall—Good luck. I have to make a confession. I am responsible for that being in the TPC. One of the recommendations from my inquiry in 1988 was that the unconscionable conduct provisions be put into the Trade Practices Commission.

Mr ROBERT—How would you define it?

Mr Beddall—We could not. We thought it had to be tested and tried in the court. From memory, our recommendation—and this is a long time ago now—was that the ACCC would be empowered to take the test case all the way through, so you could define it by tort law.

CHAIR—Does it need to be defined in the code or in the Trade Practices Act? Is there a necessity for that for it to be useable?

Mr Beddall—No, because each time it goes to court a judge will interpret it in a different way.

CHAIR—So it is market share verses market priorities in 46 (1) of the Trade Practices Act and the Birdsville amendment last year. It needs to have time for the courts to play it out.

Mr Beddall—Yes, but unconscionable conduct has been around since about 1990 and it has not been resolved in 18 years.

CHAIR—Is it your view that it should be specifically contained in the code?

Mr Beddall—Absolutely. Parliamentary draughtsmen are charged with getting the wording right. The difficulty is that what to you and I and to the pub test is clearly unconscionable is often deemed by a court not to be. The Senate committee should concentrate on getting a clear definition of 'unconscionable'. That is a difficult task, but if it can do it should get a Nobel Prize.

CHAIR—Are there any final comments that you would like to make?

Mr Beddall—I welcome the inquiry. We have been calling for this inquiry for years and we are pleased to see that it has come to fruition. I reiterate that my association is fully supportive of the franchising industry. We think it has done well under a system of fair franchising. It is a terrific business model for Australians, it gives people financial security, and it helps to grow our society.

CHAIR—Mr Beddall, thank you very much.

Mr Beddall—It was my pleasure.

[11.51 am]

SPENCER, Dr Elizabeth, Private capacity

CHAIR—Would you like to make a brief opening remark or a statement in support of your submission?

Dr Spencer—Thank you for asking me to participate today. I have been researching in the area of franchising law and regulations since 2001. In 2007 I completed my dissertation in the area of the regulation of franchising, in particular, franchise contracts and how that relates to the regulation of franchising. I have written papers on dispute resolution and on disclosure in franchising. Currently I am involved in work based on a grant to look into the roles of trade associations in the regulation of franchising, and I am also writing a book called Understanding the Regulation of Franchising, which is an international comparative analysis on which I am getting started.

I am not very good at prepared talks but I would like to make a few observations about my research. What I have noted, some of which is very obvious and which I am sure has been stated many times, is the imbalance of power in the franchising relationship between franchisors and franchisees. This happens on the market level for a variety of reasons. An imbalance of power also happens at the level of the contract and this leads to a high level of uncertainty for franchisees at the level of the contract.

There is a problem of opportunism in the relationship—a problem that franchisors generally can control with respect to franchisee opportunism, usually through the mechanisms of the contract. But franchisees do not have the same opportunity to control franchisor opportunism in this way. My observations about governance at the level of court interpretation indicate that court interpretation is inconsistent and consistently fails to comprehend the context of franchising.

So far as governance through legislation is concerned I note that in Australia the legislation, through the franchising code of conduct, relies primarily on three principal types of tools. One is disclosure, a self-regulatory tool; the other is mediation, also a self-regulatory tool, the deficiencies of which I have outlined in my submission; and, finally, a few substantive provisions. In my view, the main problem that remains unchecked in franchising is opportunism, particularly on the part of franchisors, which can lead to an adversarial rather than a cooperative relationship between franchisors and franchisees. I believe that this is damaging to the sector as a whole.

Fundamentally, there are two approaches to dealing with this, which legislation has begun to address. The first approach is to constrain, or restrain, the behaviour of franchisors and the second is to empower franchisees. We have started to do this and I do not believe that legislation is entirely deficient. We have made inroads, but I think there are some missing pieces. The missing pieces with respect to constraining or restraining the behaviour of franchisors where it may be necessary involves, first, the potential for a statutory duty of good faith. The reasons I think that good faith is appropriate in Australia for the franchising sector are that it is a low

intervention regulatory tool; it has been described and observed to be critical, perhaps essential, in dealing with relational contracting; it reinforces trust in a relationship; and it is also appropriate for use in the regulation of standard form contracts.

Another mechanism or tool might be the use of unfair terms legislation in a limited way. I also believe that the registration of disclosure is a worthwhile option. The second option, empowering franchisees, involves better education—which I see you have already discussed—some collective action and help for franchisees in collectively acting, and also better dispute resolution mechanisms and alternatives in dispute resolution. I think this is the most important aspect; it is the most positive intervention to empower franchisees to protect themselves. Another important way to do this is to bring franchisees themselves into the regulatory process. Regulatory theory calls for democratic, participative and transparent process, inclusive of all stakeholders.

I would like to see us using that kind of a process together to generate information, identify the problems and generate solutions. I understand that this is a major undertaking that requires a commitment from all participants in the sector. An interesting case study is the experience of the British Franchise Association, which is currently undertaking a strategic review. It is looking at ways of representing the sector better as a whole rather than only one part of the sector. It feels that that will offer industry as a whole a competitive advantage going forward.

To finish up, I am not an advocate of more regulation, but we all know that good regulation is competitive advantage. Yesterday on the ABC finance Minister Tanner observed that Australia may be better positioned to weather this current global financial crisis, in part because we have different financial and banking regulations than the ones that existed in the United States. We would not be in that advantageous position if we just followed what the United States regulations had done. I note that Australia is not exceptional in the extent of its regulation of franchising. The United States, Italy, Indonesia, Spain, Malaysia and South Korea all have a fairly extensive significant franchise regulation. To me it is not really a question of more or less regulation; it is really about getting it right for the conditions in the sector in Australia, and for moving forward to the future that we want.

CHAIR—Thank you very much, Dr Spencer. We thank you also for your submission. I lead off by asking you to give us a bit more information on your view about that relationship between franchisee opportunism—basically riding on the back of a brand and coasting, and franchisor opportunism may be abusing the power of relationship. How does that work in practice? From your research what do you understand that to be?

Dr Spencer—I think you have said it well. You asked whether there were opportunities for franchisees free riding on the brand, on the work of others. Franchisees can appropriate the intellectual property of franchisors. Franchisees may not accurately report income figures, so there are definitely ways franchisees may underperform. There are lots of ways that franchisees can fail to perform and can act opportunistically. They can leave the system and set up their own business and not continue to pay royalties.

These mechanisms generally are protected against in the contract that, as I have mentioned in my submission, is a standard form contract that is drafted by the franchisor, the franchisor's attorneys, and is presented to franchisees generally on the basis of, 'This is not negotiable.'

There are good reasons for that. Franchisors have a legitimate reason to want to control the situation or the relationship. It is their responsibility to protect the brand. We have great franchisors that behave beautifully and that never behave opportunistically, but there is an opportunity for franchisors to behave opportunistically.

We see many examples of this—I am sure you have in your submissions—in the areas of encroachment, in the areas of supply, kickbacks, advertising, churning, non-renewal, transfer, termination, and unilateral amendments. Those are the areas where franchisors can behave opportunistically. Sometimes it seems that there may be a need to constrain that behaviour.

CHAIR—You may have heard the discussion we had with the previous witnesses about standard form contracts. We have received a number of submissions that highlight to us that there is a great variety of them and a great difference between some bare minimum disclosure standard form contracts, which may or may not meet the requirements of the code, and others that are hugely onerous documents for anyone wanting to read them. The problem that arises is that often the more information that is provided the less meaningful it is. Could you give us your view and your experience about how important that standard form contract is in getting the relationship right and getting the success model right?

Dr Spencer—I think that most businesspeople do not spend a lot of time reading contracts. I would say that the contract is important when problems arise. Having code compliant contracts is an interesting concept to me, and one about which I do not often think. Essentially the code is disclosure. Disclosure often requires people to say what is in their contracts. If you have a compliant contract you have to put in some provisions about mediation and you have to put in a provision that states there is no general indemnity of a franchisor by franchisees. There has to be a cooling-off period. To say you have a code compliant contract does not mean a lot to me.

Disclosure is basically ensuring that you as a franchisor need to tell your franchisees what is in the contract. For the most part the code does not tell us what should be in the contract, so you can still put things in the contract. I wanted to mention that I noticed you said that the right to unilateral revision might be prohibited after March 2008. That is not really the case. Since March 2008 I believe it is only a factor that the courts may consider in determining unconscionable conduct. You can still have a contract that states that a franchisor has a unilateral right to amend the contract. You do not even need to tell franchisees that you have that in the contract.

Frankly, I think all franchisees should read the contract. In many ways you wonder what is the point of disclosure if many of the aspects of disclosure, or the provisions of disclosure, simply state that you have to tell franchisees what is in your contract. Why are the franchisees not reading the contract? That is a good question. I do not know. I also have a comparison here. I know you are interested in what could be left out of disclosure. I have a comparison here between the franchise code of conduct and the UFOC.

CHAIR—Just to clarify that point, I was not asking what could be left out of disclosure; I was asking what could be left out of a contract rather than disclosure or the code. I think the code specifies it and it is quite stringent. It is more a case now of how it applies to what is in a standard form contract. Some standard form contracts are bare minimum documents with a limited number of pages and others contain thousands of pages. We have examples of them. If they both claim or do not claim to be in compliance with the code, how can there be so much

difference and what impact would that have? I am asking you what is your view or opinion, or whether you have any thoughts on those differences?

Dr Spencer—If I have an opinion on the difference between a long contract and a short contract?

CHAIR—Yes. One does not have more legal fees. Let me rephrase my question very simply.

Mr ROBERT—Are there any lawyers in the room?

CHAIR—Often in a contract the more pages, the more information and the more words that are in the contract the more difficult it is to comprehend and the less likely you may be to read that document. On the other hand, if you are presented with something that complies with the code and that gives you the bare minimum information that is required that meets the standard, meets the code and gives you everything you need, that could be provided in a shorter form—a simple English short form type of contract. In your experience and because of the work that you have done have you seen problems arising as a result of people presenting you with a document and saying, 'We are about to sign a contract for the franchise. Here it is', and it happens to be 10,500 pages long and you need to have that reviewed et cetera, compared to a document that might be quite simple to read and understand?

Dr Spencer—I do not practice in franchising law. I have reviewed documents for my research but I have ethical clearance to talk about only 20 of them. There are another 50 or so but I do not have ethical clearance to deal with them. There is no requirement at all that there has to be any written agreement. You do not have to have a contract at all. You must provide for disclosure and you must state those items in disclosure. If you want to baffle your franchisees with a 1,000-page contract, or you feel it is important, that is fine. I do not think I can address that question. Some franchisors do not have very well developed systems, or they are just starting out, their contracts are shorter and the extent of what they can do in the contract is much more limited.

Mr ROBERT—I am interested to know what we can leave out of disclosure. You started before down that line. If there is any regulation we can dispense with that has to be a good thing.

Dr Spencer—Yes. To that extent I have not thought in great detail about what can be left out. I do not think being more detailed about what information needs to be provided and being prescriptive at this point is a good idea. If there is a strong reason in a particular context for providing for an item of disclosure, for example, with respect to earnings claimed, and if there is a repeated area where there is a problem then we need to put in more disclosure.

The main point I was trying to make here is that the franchising code of conduct is not as lengthy and detailed as the American UFOC—the FTC rule. I do not think we have gone down the road where we have so much disclosure that people cannot understand it. On the other hand, I think there are a lot of reasons why franchisees do not understand the documents that they have in front of them when they are getting into a franchise business. I do not think it will help to give them more disclosure or to give them verbiage, in particular, when they have a hard time securing experienced legal counsel to advise them on franchising.

CHAIR—You mentioned in your submission the prospect of franchisees being better educated. Better education certainly has been the focus of many a submission. Could you give us some practical sense of how you see that having an effective impact, given that, as you say and as other surveys have said, people tend not to understand or fully read contracts and documents? How do we better educate people before they get into a franchise agreement?

Dr Spencer—The main problems with disclosure are largely to do with the fact that franchisees cannot process that information, they do not understand that information, and they cannot get good legal and accounting advice about that information. Even if they were to have all that, they cannot act on the information because there are not enough perceived alternatives in the market. There are no alternatives for contract terms because the contract is a standard form and not negotiated. They cannot find alternatives either in the market or for contract terms. The other way that disclosure is supposed to help parties who receive disclosed information is by helping them to negotiate. As we just said, these contracts are not negotiated.

I think those are the problems. We need to educate franchisees about the nature of the risks involved in franchising and also enable them collectively to negotiate. I know that franchisors feel that that is anathema; it is not an attractive option for them to think about franchisees acting collectively. But it has worked in the United States, for example, in the case of the Culligan's Franchise System where franchisees got together and collectively said, 'We want to have these terms in the contract' and the franchisor changed the terms of the contract in favour of some of the franchisees' interests. As has also been pointed out to you, very often franchisors and franchisees interests are not shared interests.

Mr ROBERT—Dr Spencer, what is stopping franchisees from doing that now in Australia?

Dr Spencer—For one thing franchisees are notoriously hard to organise.

Mr ROBERT—Granted. Despite the fact that it is hard to herd cats legislatively, what is stopping franchisees getting together and rolling up to a franchisor and saying, 'We will collectively look at your contract because we do not like it?'

Dr Spencer—Threats of defamation. Franchisees have also been found not to have behaved in good faith when they have contacted other franchisees to discuss their concerns with respect to franchisors. In the Dymocks case in New Zealand the franchisor said to the franchisee, 'I do not care. Go ahead. Send the other franchisees a fax.' But then the court found that terms of the operations manual said, 'This is an all for one and one for all kind of proposition. You, as the Dymocks franchisee in Auckland, sent out faxes to other franchisees saying that there were problems. That was a failure to act in good faith and, therefore, you are in breach.'

Mr ROBERT—Is it the same under Australian law?

Dr Spencer—The NSW law was supposed to be the law that governed in that case. It is a problem. Franchisees feel the threat of defamation and they feel the threat of not behaving in good faith, even if they were not so busy and they were inclined to get together. I honestly feel that this is an area where help should be given to franchisees to function collectively. For example, in the United States there have been several attempts at effective franchisee organisations, and there have been several attempts at effective franchisee organisations here in

Australia. They do not work. I do not know whether it is like women in business organisations where you are just empowering people who inherently do not have power.

Mr ROBERT—They need a good union.

Dr Spencer—I do not know whether they need a union. I know that the word 'union' is not an attractive word for a lot of people.

Mr ROBERT—I could not agree more, Dr Spencer.

Dr Spencer—I refer to the approach that has been taken in the United Kingdom at the moment. The British Franchise Association, an association that for years has been an association of franchisors, is now saying, 'Times have changed. We are in a new competitive era in franchising. We need to show a unified front.' I ask myself why franchisors in Australia do not see it similarly. I would think that, after the fourth government inquiry in a few years, franchisors would say, 'We need a unified front here. We need everyone involved. If we are going to market franchising as the wonderful business opportunity that it can be we need to be doing it collectively. We need everyone.' We need franchisees and franchisors together saying, 'This is a great business model.'

Mr ROBERT—Could we move on to good faith? In the executive summary of your submission you state that good faith has been implemented in several United States jurisdictions. I believe that a number of Canadian provinces have also gone down that path. Do you have any information as to how effective those good faith provisions have been within United States jurisdictions in the Canadian provinces?

Dr Spencer—I do not have a study of case law, but good faith is pervasive; it is in about 50 UCC, or uniform commercial code, provisions. It is very pervasive in Europe in civil law jurisdictions. I can send you but I cannot give you the names of a couple of cases in Germany where good faith has been extremely effective, perhaps some would say too effective in protecting franchisees' interests. In Canada, it applies to all commercial contracts in Quebec. It is in the code in Ontario and Alberta, so it is widespread. I cited a paper in my submission—Ronaldo Macedo talking about good faith, its importance, and its increasing importance in contract law in South America. I think it is the trend. We are seeing a trend towards good faith as opposed to unconscionable conduct worldwide.

Mr ROBERT—You made the point that you thought the good faith provisions in German law may have been too effective. What did you mean by that?

Dr Spencer—I suppose it again depends on your point of view. But there have been some situations where, for example, I believe a franchisor tried to terminate a contract because the franchisee failed to make payments. It was found not to be a breach but instead the franchisor was directed to use debt collection methods to get back the money, which I do not think was particularly satisfactory from a franchisor's point of view.

Mr ROBERT—Dr Spencer, I refer to the dispute resolution issue. There is an inherent risk in any business relationship, or in any relationship. Franchising is often referred to as a business marriage of some sort. We are not trying to legislate for failure or success; the capacity for that is

completely up to the individual. Is the current process of dispute resolution effective enough? If it is not, what are the original sources of those disputes whatever types of disputes might they be? What is their origin and from where do they stem?

CHAIR—There are two questions relating to the process of dispute resolution and from where the disputes stem.

Dr Spencer—I have looked at the different reports of the ACCC, OMA and the FCA on the sources of disputes, but not recently. You would be better off asking someone else exactly what are the sources of disputes. In relation to their effectiveness I think that the mediation process is very effective when disputes get that far. When I did my research—it was up until about 2004—between the start of OMA and 2004, OMA had received about 1,100 inquiries, in fact, 1,078 inquiries. Of those about one-third, or about 300, went on to have a mediator appointed. Of those 10 per cent settled before mediation and roughly 62 per cent settled after mediation.

What you have is a high settlement rate of 72 per cent for mediation. The problem is that there were 300 of those, but there were another 770 inquiries and no-one knows what happened to them. No-one has any idea. Somebody had a big enough problem to call the Office of the Mediation Adviser and ask for help, and we have no idea what happened to them. We have very little idea but franchisors know what happens in the case of the disposition of mediator disputes. They can go on and use that information with their other franchisees. But individual franchisees, because of the confidentiality of the process, do not share that information.

Sometimes mediation reinforces an imbalance of power in the franchisor-franchisee relationship. There are couple of other reasons for that. The terms of the contract are written so that franchisors have a high level of discretion. It is very hard to hold a franchisor's feet to the fire and say, 'You are in breach', and also because of the flexibility of the mediation process. Because franchisors tend to be in control of the franchisor-franchisee relationship, often that control also persists in the mediation process.

CHAIR—A number of submissions talk about the issue of non-renewal of agreements. That has certainly been the subject of a lot of discussion. What is your view on non-renewal? Do you support a good cause-type arrangement about the renewal process?

Dr Spencer—I am not exactly sure of the number. I think about 20 states in the United States have a good cause requirement with respect to termination. Based on our experience in Australia and based on the nature of the relationship as it exists now, I think that a good cause requirement in renewal and in termination is something that ought to be considered.

CHAIR—Should the ACCC play a bigger role, or should it be more active in pursuing breaches of the code, pursuing test cases, or being more active in the area of franchising?

Dr Spencer—I am not an expert on the role that the ACCC plays, and I do not want to be critical of it. On the positive side I would like to see franchisees better able to enforce their own issues in the franchising relationship. David French at the International Franchise Association in Washington may have lodged a submission with your committee. They certainly posted an opinion on the Internet about ongoing inquiries in Australia.

David French observed that the reason disclosure works in the United States is that it has an active plaintiff's bar. I think that is a huge issue here. Because we have lawyers who do not work on a contingency fee basis, because we have loser pays, and because franchisees have a hard time finding franchise lawyers or solicitors who really understand franchising, who are not working for franchisors and who are not committed to franchisors, franchisees have a difficult time in considering litigation in Australia.

CHAIR—I am probably on the record in a number of places as not wanting to give extra work to lawyers in the possible view of offending some people here. Is there a way to avert that before things fall apart, before the relationship breaks down and you require a court? Is there a better way? Is it in the way we deal with standard form contracts or is it in the way we deal with fairness or good faith principles in the agreement? In the initial arrangements do we require better relationships for franchisees and franchisors?

Dr Spencer—Yes. I think it is important to empower franchisees through education, to allow them to function collectively, to bring them into franchise trade associations, to make them part of that and part of the regulatory process. It is difficult, but I think franchisees should no longer be marginalised. They should be encouraged and they should be given every avenue to participate. I think that really is the best way.

So far as dispute resolution is concerned, there should possibly be an Ombudsman, certainly a convening clause, and a greater role for the Office of the Mediation Adviser, or whatever organisation is responsible for dispute resolution in franchising. A few years ago one report suggested that registration could fund dispute resolution for franchising but that was rejected at that time. Franchisees needs more help and they need to be more involved. I think that is the way forward out of the adversarial relationship and into something that is more cooperative. I would hope for that.

CHAIR—Dr Spencer, thank you very much.

Proceedings suspended from 12.23 pm to 1.29 pm

CONAGHAN, Mr Anthony James, Partner, Co-chair Franchise Group, DLA Phillips Fox

CHAIR—I welcome everybody back to the committee hearing. Mr Conaghan, would you like to make an opening statement?

Mr Conaghan—Thank you for inviting me to appear before the committee today. I appreciate that you have received a significant number of written submissions, and those submissions range across a number of interests involved in the franchising sector. They include representative bodies, franchisors, franchisees, dissertations from learned academics and submissions from other industry bodies. Before accepting your invitation to make some additional oral submissions, I thought I should establish some credentials in being able to make some comments relevant to your inquiry.

I commenced work in a law firm in 1976 and in 1978 I was admitted as a solicitor. So far as I can recall, my first experience in franchising was in the early 1980s. The experience during and since that time was in advising franchisors, both local and international, and also advising franchisees. Our firm has always held the view that in order to provide expert but balanced legal advice to our clients it was important that we were able to consider perspective from the point of view of franchisors, master franchisees, area developers and franchisees.

Over that period we have represented all these types of parties, both in their commercial aspects and in their disputes. Additionally, in 1989 I did a mediation course and in 1990 my first mediation in franchise. When the Office of the Mediation Adviser was established under the franchising code of conduct I was one of the original mediators appointed by the OMA. My recollection is that that was about 1996 or so, but I stand to be corrected. I have been involved in probably over 100 mediations, some as a lawyer advising a franchisor or a franchisee, and others as the mediator retained by the parties or appointed by the OMA.

Additionally, I have made previous submissions to earlier inquiries, including the 1996 inquiry into fair trading by the House of Representatives Standing Committee on Industry, Science and Technology. At that time I gave a personal submission and I appeared before the inquiry. I have drafted and advised on most types of franchises, documents and agreements, and I have been involved in the litigation process, mediations and court hearings. Neither my firm nor I have any financial or other interests in either a franchisor or a franchisee. We provide legal advice on an objective basis for fees and we have no legal or commercial conflict of interest as such.

The submission before you was prepared with the assistance of my partner, Peter Buberis, Judith Miller, Ben Coogan, and our special counsel, Fred Potgieter, who drafted the franchising code for South Africa and advised that government in relation to the implementation of that code. Additionally, our firm has an exclusive alliance with DLA Piper, which is the leading law firm in franchising in the United States of America. Consequently, a benefit of that exclusive alliance is having up-to-date knowledge and experience of development in the United States of America and other jurisdictions.

If you have any other questions regarding my experience and knowledge base I will be pleased to answer them so far as I am able to do so. Unless you wish to do so I do not propose to

address any particular case or client event. The bounds of client confidentiality would restrict me from doing so and my comments would be limited to those matters that are in the public domain, or I could share with you on a generic basis. Nevertheless, in our written submissions we have addressed what we believe to be the key aspects to which we want to draw your attention. I do not propose to read those submissions but just to make a couple of observations if I may.

Firstly, I refer to the operation of the franchising code of conduct and your obligation. In respect of the inquiry into the operation of the code and improvements, you have many submissions from people experienced in industry itself, so we have not commented on that. I draw attention to the submission of the Franchise Council of Australia, which provides a lot of valuable information about the sector, and there are also submissions and annexures, including those of Jason Gehrke and other academics, who have done surveys and conducted inquiries for your assistance.

I want to make a couple of observations about the legal aspects in the relationship. I do that because they will be relevant to the issues on which I will touch relating to good faith, renewals, termination and aspects of goodwill. Just to reiterate briefly, we have a definition of a franchise being an agreement and then the grant of the right to carry on the business offering or supplying goods or services but under a system or marketing plans substantially determined, controlled or suggested by a franchisor, a branding aspect, the use of a trade mark and hence a payment.

Consequently, a franchise arrangement is quite different from that of an agency, a distribution, or other licensing arrangements, or indeed those who might buy and acquire or carry on a small business such as your local corner store, a hairdressing salon, a butcher shop, a fish and chip shop, which are not part of any chain, corporation or franchise. For instance, whilst an agent or a distributor has access to products or services they still have to provide their own systems and processes in respect of how they deliver those goods and services to their customer base. Inevitably, the business control required is absent in most other forms of business arrangements, which distinguishes franchising from other forms of doing business in small and medium-size enterprises.

Consequently, whilst there is limited legislation or regulation in respect of SMEs, the vast majority of which are carried on outside franchising per se, this is in contrast to the extent of legislation and regulations covering franchising, which puts the Australian franchise sector as one of the most regulated in the world, irrespective of what this inquiry may choose to do. There are also many factors distinguishing franchising from a master-servant or employer-employee relationship. I understand that there has been some analogy in the submissions taking you there. Indeed, in my experience, many franchisees would not like that analogy applied to them, as they are proud of the fact that they are an independent small business, albeit part of a franchise system.

Critically, the franchisor and franchisee are free to contract. There is a choice, and we will talk about education and knowledge and what they are contracting into. But there is no compulsion in this pre-relationship aspect or entering into it. In my experience, franchisors additionally are putting much more weight on securing the right franchisee and having some extensive processes to support this because of their experience that it is better to get the right person in rather than to have to deal with an issue, contentious or otherwise.

The characteristics that distinguish franchising are important because they will bear upon your consideration of the issues relating to the good faith and fair dealing aspects, and what happens in relation to renewal and termination in the proposal for payment of goodwill. These aspects are covered in our submission. Suffice to say that an essence of the franchise system is that it does not mean a small business enterprise has to do or create the business, the branding, the systems, or the processes themselves.

A true entrepreneur may choose not to become a franchisee because of those limitations but to start their own business. That is because they understand that whilst entering into a franchise constitutes less risk, which is attractive, it also has other limitations in the ownership of the intellectual property, the brand, the systems and the processes. It lies elsewhere—it lies with the franchisor—but obviously commercial benefits need to be weighed in doing that. A phrase has also been coined to describe the characteristics of a person who might be a franchisee: which is 'intrapreneur'—someone who values the fact that they have their own business but at the same time is part of a system. There is less risk but they still have that capacity.

I wish to comment on some of the submissions—and you have many—but I wish in particular to comment on some of those that create quite rightly strongly emotive responses. Indeed, they are genuine sad stories from former franchisees describing their experiences. An observation with several of those is that there were adequate legal remedies or recourse available. However, they made the point that legal costs and access to justice were an issue. I recognise that that is an issue. It is a serious issue for the community and is not just relevant to franchising, but I do not think it is something this inquiry can resolve, although I will make a point about that later in relation to mediation.

As to the pre-entry issues, the issue of education and knowledge and understanding of the agreement is something I want to touch on. In relation to pre-entry, in about 1995 I advised our prospective franchisee and franchisor clients to obtain legal advice—this was well before the code and before it was mandatory—and for franchisees, in particular, to get accounting, financial and business advice. There were three reasons for doing so. The first was to ensure that franchisees had realistic expectations, they did their due diligence, and they were able to make an informed decision.

What was the benefit of that? By introducing them to an experienced accountant and/or business adviser, frankly, that increased the prospect of the franchisee being successful, because the franchisors were interested in having a successful franchisee. We thought something was missing even back then. Getting legal advice and understanding the terms of the agreement was one thing, but the issues arising from my mediation experience from 1990 were issues about representation, of turnover, profit—net profit and gross profit—and site selection.

These were not legal issues; these were issues about the business system, about getting good advice, about what was the potential, making their own inquiries, doing the worst case scenario on what money you needed to survive, what was the level of borrowing, debt equity ratios, and those sorts of things. At that time that was adopted by our first client and it was very successful. Later on it became something that was more attractive because it is very commonsense and it has a lot of benefits. Thirdly, from a legal aspect, it reduced the risk to a franchisor of being sued.

I make a further comment about these relationships. Even though they want the independence associated with running their own business, at the same time the franchisee does not have to create that brand, the system processes, marketing, finance, et cetera. That is why the goodwill rests with the franchisor and not the franchisee, and that is why those agreements say so. There is an excellent dissertation about goodwill in the submission from the Shopping Centres Association, which takes you through three legal types of goodwill and how that pans out. I commend that to you rather than going over it. In finishing, as to ensuring a franchisee is well informed, my recommendation would be that we move to it being a prerequisite for a potential franchisee to get that independent accounting and financial advice.

In my experience so many of the issues that have come before me for mediation have been from franchisees who elected not to get that independent advice or to sign waiver certificates. It is not just getting that advice; it is having someone independently sit down with a person who obviously is interested in the concept and excited about it. Sometimes they have made the decision that this is for them, and there are examples where some franchisees have pestered franchisor clients for two years because they want to be in the system, they want the site, they got knocked back, and finally a franchisor has let them in.

But if you are getting independent advice it covers all those aspects that you are talking about—knowledge, knowing what you are getting into, going off and talking to other franchisees, asking why former franchisees are not there and what happened to them—whether it was a good news or bad news story—and working in the system for a while. That all depends on the extent of your investment, the return you are looking at, the cost, and if it is a smaller investment, how much time you need to do that. You have to go and get advice so you know what you are getting into. You need that knowledge to manage the expectation.

People need to know what is going to happen and they need to have a free choice about that. A particular issue has arisen in the area of mediation. When an issue arises and there is a dispute it goes to the OMA, the OMA appoints me and I then contact the parties to get mediation. Sometimes parties are not completely cooperative and it is difficult to get one or the other—it may be the franchisor or the franchisee—to the mediation. We spend a lot of time trying to work that out one way or another. It might seem strange but there are many reasons why a franchisor might be reluctant to come.

They might be bad faith reasons or good faith reasons, or they might simply be that people do like confrontation. A franchisee might be running a business. If it is a husband and wife team or just a sole person, they do not want to leave the business because they do not have other people to come in and help them run it. There are also timeframes and costs associated with that. For all those reasons it is more difficult to get franchisors to the table. Our recommendation is that they should be given a time—in our submission we said two months—within which mediation must occur.

Wearing my mediator hat, if you can get the two parties in a room the mediation process is effective in working towards some sort of resolution. I could go on but I expect the inquiry will have questions for me or you might want to me to expand on a number of issues.

CHAIR—Mr Conaghan, you raised a number of points. I will start with good faith. You obviously believe that in business transactions there is principle of good faith and that people should apply a good faith type principle approach to their dealings?

Mr Conaghan—Certainly in the course of the franchise relationship I do not think there is any doubt under Australian law that an obligation to act in good faith and fair dealing applies.

CHAIR—One of the things that comes through in witness submissions is that problems and disputes that arise out of matters of good faith and disputation are mismatched expectations, misunderstandings, miscommunication, or things of such matter. Obviously that refers back to the contract, given that all contracts are extended form contracts, open to no negotiation. Is it a take it or leave it?

Mr Conaghan—I do not necessarily accept that.

CHAIR—You do not accept that there are standard form contracts where franchisees go in and negotiate their own contracts?

Mr Conaghan—I acted for a group of over 100 franchisees in renegotiating a contract that was not satisfactory. I also acted for another group of 35 very sophisticated commercial operators. Another one involved small business operators who got together, sought our advice, and we represented them in renegotiating their agreement. We were able to address a whole range of issues.

CHAIR—I am not challenging that; I accept it completely.

Mr ROBERT—You are saying that you represented them collectively?

Mr Conaghan—Yes.

Mr ROBERT—Were there any issues? We heard evidence this morning that perhaps the representation of a collective group of franchisees would not work in this country because there may be issues of tort law with respect to defamation and those types of things with one franchisee speaking to another. What is your experience in representing collective franchisees?

Mr Conaghan—That it has happened. We have negotiated very successful outcomes for groups of franchisees.

Mr ROBERT—Does the committee need to make any recommendations to change any part of the law to allow that to happen?

Mr Conaghan—There are careful issues about section 45 of the Trade Practices Act, collective bargaining and what have you. Referring to a situation where franchisees approach the franchisor there are legitimate commercial serious issues to resolve in the system because there was confrontation, negotiation occurred and there was a successful outcome. That is all I can say.

CHAIR—I draw you back to my question. What I asked you specifically and what I am seeking an answer in relation to does not involve renegotiations.

Mr Conaghan—In my view there is no standard form contract. Clients have asked us for a range of agreements. Some clients did not want the plain English version; they wanted a legal one because that is what they were paying us for. On the other hand, we would say 'All the systems are different and there are different issues in them.' At the end of the day it goes back to a situation where you have to have—

CHAIR—We are talking about two separate things, Mr Conaghan. I am not asking you about different systems. If you believe there are no standard form contracts I will take that as your interpretation. But everyone else to whom we have talked and every submission we have received from everybody refers in some way to standard form contracts.

Mr Conaghan—For a franchise agreement? That is not my experience. In the past two years I have probably seen 20 different franchise agreements. Whilst there are a lot of common terms—

CHAIR—I think you might have misunderstood the question. I am not talking about different agreements; I am talking about a standard form of contract. For example, McDonald's pretty much has a standard form contract. I thought I made that clear. I am talking about a standard form contract. I expect there to be a different type in every franchise system because there are different businesses.

Mr Conaghan—Yes, sorry. I beg your pardon. Systems do not want to change those.

CHAIR—Going back to the issue of standard form contracts and the good faith that is inherent in contracts, the good faith and fairness principle applies where there is an agreement in that contract. Basically, both parties sign up to a contract. The fairness principle applies but, given that those contracts are standard form, and we have heard from everybody that there is no negotiation, you do not get to negotiate when you roll up to buy into a franchise system—it is a take it or leave it contract. You do not get to suit your own conditions.

Mr Conaghan—I would not accept that.

CHAIR—You might say not necessarily but I say that, in principle, you do not get to change the brand or anything else.

Mr Conaghan—No.

CHAIR—The principle of a franchise system is that you buy what is being sold to you, and you either accept the agreement or you do not. We are trying to understand better—and perhaps you can help us—whether something is contained in that contract that might or might not be unfair but that might become the point of disputation later. That might not necessarily have been in bad faith because it was signed. We have examples of those. From your experience rather than from your legal point of view how does one deal with any of those contracts—they are all standard form contracts? How do we deal with a contract when there is an inbuilt imbalance or unfairness, or something that may or may not be unconscionable, or may or may not be in bad faith, but it still forms part of a contract that people have signed?

Mr Conaghan—It is very difficult for me to answer in generalities. It would really depend on specific issues and legal examples. I am not trying to be evasive about it.

CHAIR—I asked you that question—

Mr Conaghan—My mind goes to any number of issues.

CHAIR—I asked you that specific question, which is a difficult one to answer, because of your statements. Your statements talk about your experiences, processes, courts and cases. You said that this had not been a problem. I am saying to you that it might not have been a problem because you cannot say that something is not in good faith if they have at least met parts of the code or, in principle, done everything that they could. Even if it is unfair and it creates a dispute later it does not necessarily breach that. I used as an example earlier where there is a clause that states, 'This contract binds the parties to do a whole range of things', but the next clause states, 'We can then change our view on anything, at any time, and in any manner we like', thereby creating the problem or dispute. In cases of law, in cases of the code and in cases of the Trade Practices Act how do we deal with a situation where a contract contains within it contradictory clauses, for example?

Mr Conaghan—In our submission I take you to what Justice Byrne said:

'There is to be implied in a franchise agreement a term of good faith and fair dealing which obliges each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and not capriciously or for some extraneous purpose.'

My answer to your question is: Where those clauses have existed and franchisors try to enforce something that has been an issue of contention, the test we put to the client is: Is it acting reasonably? Will a court find that it has been acting reasonably and not capriciously or for some extraneous purpose? Case law has given examples where the courts have said, 'No. What you are trying to do and how you are behaving as a franchisor is not acting in good faith and in fair dealing.'

CHAIR—Even if both parties have agreed to go down that path?

Mr Conaghan—Indeed.

CHAIR—That is fine. You talked in your submission about prior disclosure. Obviously that is something that is important. How do you define or see disclosure? What is disclosure about?

Mr Conaghan—Let me contrast it to buying a small enterprise, a vendor purchaser contract. There is very limited disclosure as to what you are buying and that depends on those negotiations. Here the obligations upon a vendor or a franchisor result in quite extensive disclosure. I take you to a particular aspect about it that I think has made quite a difference. In the early 1990s before the code and disclosure obligations came in, churning was perceived as a problem in the industry. In our experience, since the disclosure obligations have came in, and even more so since the 1 March changes came in, in our experience there was a significant lessening of the churning element because of the disclosure aspects and particularly because of the contacts of former franchisees.

CHAIR—So improved regulation in that area had a significant impact on the sector?

Mr Conaghan—I believe that it has and it is more informed. It enables a franchisee to get that information and that forms a benchmark for further questions and inquiry.

CHAIR—I have a follow-up question about disclosure. I am interested in your view because obviously you have had a lot of experience. On this issue of disclosure what is important about the disclosure parts and which bits of disclosure? Are we talking strictly about meeting the black letter law requirement? Are we saying, 'Here are the bits of disclosure' and that is it? Is it the voluminous, let us say, overabundant disclosure that some provide? What is it about disclosure that makes it important to the sector?

Mr Conaghan—My recollection of comments made by former inquiries was that it was against the background of having quite extensive legal agreements and the recognition that many people did not really read them. Disclosure, identifying the essential elements of what you were getting into, was a commonsense approach to that. People have taken different approaches. In some of the cases the courts have said, 'What you have disclosed in a disclosure document was not comprehensive enough. It did not disclose a particular element.' A risk adverse way of doing that is making sure that you put it in your disclosure document, and most of those things are in the franchise agreement. Years ago disclosure documents were more limited. We have seen them grow and become more concise, but the danger is that disclosure documents start to mirror franchise agreements because people say, 'We have a legal obligation here.'

CHAIR—I am asking you: Why is it important?

Mr Conaghan—The point is that it is important because people will read the disclosure document but they will not necessarily read the full franchise agreement or the terms that are disclosed. At the moment our clients are content with the disclosure document, subject to what we say in the submissions. There have been a number of aspects of that about which we are not quite clear.

It is part of the process of enabling potential franchisees to become much more informed about what they are getting into, and the risk elements relating to that.

CHAIR—You are referring to your clients.

Mr Conaghan—To franchisors.

CHAIR—I wanted to understand your perspective.

Mr Conaghan—Franchisees appreciate that but obviously more commercial questions arise out of those documents.

CHAIR—How do you see continuous disclosure fitting into that arrangement?

Mr Conaghan—As it is provided for at the moment necessarily, and where there are material changes they have to be disclosed. Bringing that back we do not propose any changes in that. I am not sitting here before you as a lawyer saying that there should be more changes because,

frankly, if there is any change the franchisors and franchisees have to go and find out what is the meaning of that change. The level of regulation and legislation that we have at the moment is sufficient. Subject to clarifying a couple of issues we believe that only limited change is necessary.

CHAIR—You said that if there were any changes now franchisors and franchisees would have to go out and inform themselves of those changes. By implication, do franchisors and franchisees currently understand the code, the Trade Practices Act and the other bits relating to them?

Mr Conaghan—I am not necessarily going that far.

CHAIR—I did not think you were, but I just thought I would clarify it. I would hazard a guess that if I walked down the road—there were plenty of franchises along the road when I went to lunch today—and I asked those franchises they would say, 'What code?' That might be the more common response that you would get. They might know that it exists, what is in it and how it applies.

Mr Conaghan—It depends on what election they made when they got into it—whether they decided to get any advice from anyone about it or waive that.

CHAIR—How important is it for people not only to read the code but also to understand it? Do franchisees and franchisors have an understanding of what all that means?

Mr Conaghan—I could say that it was essential, but that is self-protection.

CHAIR—Referring to the pre-education issue that I have raised on a number of occasions, when most people make a decision or there is a likelihood that they will make a decision to get into a franchise they are quite enthusiastic about it. They want to be a part of it but there is already an inherent ability for the franchisor and the franchisee to go ahead and sign an agreement and have some sort of a bargain together, which I would say is probably reflective of the way that this is done. How important is it to have a code and a regulation or to place some rules on the table that are adhered to? How do we achieve that? How do we get that compliance? I think the expectation from everybody in the sector is that we provide adherence to those codes rather than them just being there in name and in principle. People must follow through on what is contained in them.

Mr Conaghan—Obviously there is a cooling off period and protective mechanisms are in place at the moment. There are cooling off periods, the 14-day scenario and the agreement being allowed for two weeks so they can see all that. I am sorry, but I am not quite sure what you are getting at.

CHAIR—Do you believe that all contracts meet the code?

Mr Conaghan—I think there is evidence in the submissions before you that not all of them do.

CHAIR—Is that an issue? We have a code. You are saying to me that if there is to be a change people ought to be informed of that change. Let me take you one step back and ask: Do they know now?

Mr Conaghan—I think it is an issue. We already have a couple of existing authorities in place. We have the OMA and the ACCC. Clearly I think the ACCC should have an increased monitoring role. They are subject to a franchise when making a complaint or when they are doing some rolling type investigations.

CHAIR—Do you think the ACCC has a stronger role to play? How might it do that?

Mr Conaghan—As an existing body by compliance audits, for instance. They field a number of inquiries or they get information. Obviously that is the first source. In addition, they could have a random compliance role. I think that an increased presence from the ACCC could only be beneficial.

Mr ROBERT—With respect to goodwill in section 2.14 you state:

It is suggested that the current state of our common and statutory law provide adequate protection and any attempt to introduce an explicit good faith obligation into the Code may not only be unnecessary but an unfortunate legislative indication that '*good faith*' has a different meaning as currently understood, applied and continually further developed by our Courts.

You could not possibly be indicating that the courts would determine a better definition of good faith than the Parliament, could you? You could not possibly be inferring that we should leave such things for the courts, unelected, to decide as opposed to the nation's elected officials, who are accountable to the people?

Mr Conaghan—Where should I start—in relation to the Constitution or otherwise? You are the lawmakers.

Mr ROBERT—I think we will keep the Constitution as read. That aside, you raised a concern that if the Parliament were to enact legislation to define good faith within the Trade Practices Act or the compulsory code of conduct, you have a fear that it may put a degree of ambiguity in the law.

Mr Conaghan—No matter whether we are talking about franchising or whatever, where there is an existing body of case law we have had cases involving franchise laws where there has been aberrant behaviour. There are examples of what they have done and everyone has a pretty clear understanding that when advising a franchisor or a franchisee they cannot do those sorts of things. Franchisors cannot do those sorts of things and you have remedies along these grounds. We now have some reasonable case law. As soon as we change that in some way—we might have a legislative definition about it and there is a slight change—depending how thorough, how wide or how close it is to what is understood, there is room for uncertainty to occur.

Mr ROBERT—A few months ago we had an argument in parliament regarding section 46 (1 (a) of the Trade Practices Act, which was the Birdsville amendment—moving away from market power to market share. The argument was that the now government wanted to get rid of it, the

opposition were icy and said that the courts had not had enough time to define market share because the Boral case had widened the concept of market power. Legislation, by its very definition, contains a requirement for the courts to refine it over time. Is there not an argument that the courts have already begun? You mentioned Justice Byrne and his judgment, in which he has already begun to define good faith. Therefore there is a good basis for good faith to be inserted into the relevant act without the need to overly define it because the courts have already done so. It simply makes it explicit within the legislation without interfering in the courts—heaven forbid!

Mr Conaghan—Mr Robert, I am only a lawyer. If you and the inquiry form the view that that is the way to go, so be it. Our cautionary note from experience is that where we have something that is working well and it is well understood, making further change could introduce some uncertainty.

Mr ROBERT—You made a statement in your opening remarks that goodwill rests with the franchisor and not with the franchisee. On the surface that might appear to be at odds with some of the evidence. Let us take Blogs mowing service—I am not too sure whether there is a firm called Blogs mowing service. If there is a 1300 number many franchisees have come to realise that calls do not flood in; that they have to get out there and market and advertise and build up a whole range of goodwill. If they have done that—if they have built up a basis of goodwill and a basis of service—and they are cognisant of the fact that systems and processes rest with the franchisor how could goodwill then still rest with the franchisor and not with the franchisee?

Mr Conaghan—That would be the personal goodwill. This topic is dealt with in the submission of the Shopping Centre Council of Australia. Clause 7.2 deals with personal goodwill. The response to those issues is dealt with in two pages. I could talk to those but that might delay the situation. Perhaps I could highlight it:

"In legal terms there are three types of goodwill: business goodwill, site goodwill and personal goodwill. The franchisee pays for business goodwill and possibly site goodwill when buying into a franchise system. Personal goodwill is added by the franchisee."

When a franchisee sells the franchise business, inevitably in the business purchase contract will be a description of goodwill. It has a particular meaning for revenue and tax consequences in that business purchase agreement. In relation to a franchisor and the goodwill that it has, that term goodwill is used in a different context. There is a lot of confusion about goodwill and what it means in a particular circumstance.

Mr ROBERT—Let us hold that to be true. Let us now move to previous evidence where it was said that the average contract for franchisors to franchisees is five years in duration.

Mr Conaghan—I will accept that.

Mr ROBERT—Whether it is five or 10 it is largely irrelevant for the example. At the end of the five-year or 10-year period, if there is no option to extend, the franchisor could simply exercise his contractual obligations and say, 'Thanks very much. The time is up. I know you built a cracker of a business, or we have together, but we are taking it over with no recompense to you', which would be allowable if indeed the contract allowed it and both parties entered into

it with absolute knowledge that that would happen. There is no argument about that. The question is: Is it right? Is it reasonable under the pub test? Does the average bloke sit in the pub and say, 'That is a fair thing?

Mr Conaghan—In my experience the vast majority of the franchise agreements provide a term. That term used to be 10 by 10. In many franchises it has come down either to five by five or five by five plus five. When we say that it is a term, it is an initial term with an option for renewal. In the vast majority of systems that option for renewal is at the election of the franchisee, provided that he is not in breach.

Mr ROBERT—I fully accept that.

Mr Conaghan—So our terms are either 10-year, 15-year or 20-year terms. We talked previously about the model of a franchise. It is very clear that you are buying an income stream. Good advisers will make it clear to someone considering this type of business acquisition or environment that he is buying an income stream. It is very clear what happens at the end. Having said that, the vast majority of circumstances reveal that if it is working well there is automatic renewal beyond that term. Let us take the example of, say, a 10 by 10 term. Somewhere into that second term, and relatively fairly easily, either the franchisor or the franchisee will be raising the issue about what happens at the end.

In most circumstances, if it is working well, some renegotiation occurs and there is an extension or, alternatively, a franchisee will move to sell the business to take out the capital benefit in an existing business when someone is buying cash flow business. A franchisor, in considering usual provisions about identifying a suitable franchisee coming in, will then enter into a new agreement for a new term—10 by 10 or whatever—with the new franchisee. There are those provisions. It also goes back to the fact that when you enter into that type of transaction you are acquiring an income stream.

Mr ROBERT—The other option is that franchisors would simply say, 'No you cannot sell it', and, 'No we are not allowing you after the end of the term. We will just take it over.'

Mr Conaghan—In most franchise agreements there has to be a reasonable basis for a franchisor to refuse a sale in the franchise agreement.

CHAIR—Where is it held to be done in that way? You said it is in the franchise agreement, which is the standard form contract. But where is it compulsory?

Mr Conaghan—There has to be a sound basis for that. It cannot simply be that, if you come along with a franchisee who is adequately capital financed and who fulfils all the other criteria and the franchisors have all the criteria, you will fulfil that criterion. The franchisor might say, 'No, that is not a reasonable basis on which to accept an incoming purchaser.'

Mr ROBERT—That seems to be reasonable. What happens at the end of the five, 10 or 20 years if the franchisee wants to keep it and the franchisor says, 'No. You have not breached anything. Our contract is for 10 plus 10, which has been fulfilled. It has been great. We have made lots of money but we are taking over.' The question comes down to reasonableness—what I call the pub test.

Mr Conaghan—That depends. Very many successful franchisees have made a considerable amount of money during that period, and they have become wealthy as a result.

Mr ROBERT—Without a doubt. However, it does not answer the question. Is it reasonable that a franchisor can do that? Clearly, it is lawful; there is no question about that within the current contract.

Mr Conaghan—That depends on the circumstances. At the same time you have someone who has elected to go into that sort of business in environment knowing that he could start his own brand and develop his own system.

Mr ROBERT—With full disclosure.

Mr Conaghan—That is an entrepreneurial type of approach instead of a less risk approach, in which there are fewer limitations and benefits. One of the limitations is you are buying an income stream. It is less risk averse, but that is the balanced equation. People can make a decision about whether or not they enter into it. It is not a common circumstance by any means that that is the result. To have a new franchisee or a company owned situation coming in is fraught with a whole lot of internal costs. It does not happen very much because it is not necessarily a cost-efficient way of doing business. There may be all sorts of reasons after 10 or 20 years. In 1980 the agreements for 10 by 10 did not address any issues relating to computers, websites, wireless, telecommunications and the whole way of doing business. For legitimate reasons franchisors often say, 'We will reassess where we are' over that period.

CHAIR—You raised a couple of points that I think need more exploration. You referred to the issue of getting financial advice in that pre-educational period and making sure that, before you enter into the agreement, you have all that advice. I think there is much agreement that the better informed they are obviously the better decisions they will make. One of the issues that have been raised is the difficulty in getting that proper advice, because so many different people look at the standard form contracts.

Mr Conaghan—It is essential for them to get advice from experienced accountants or business advisers. There are lots of franchise advisers or lawyers around. I think it is essential when you are buying a business for you to understand all the business and the financial concepts.

CHAIR—I agree with you that it is essential. The problem is that it may not happen in practice.

Mr Conaghan—The law societies now have various accreditation standards. The FCA is strongly in favour of more education. There could be some form of registration system through the FCA of those who satisfy relevant criteria. They must have experience to be able to advise potential franchisees across the board.

CHAIR—Do you think it would be an appropriate mechanism to have, for example, the Franchise Council of Australia to accredit—

Mr Conaghan—It could be the ACCC, or it could be the Office of the Mediation Adviser giving independent advice.

CHAIR—But you believe that somebody needs to sit down and look at each of those agreements and say, 'Yes they meet the standards of the code'?

Mr Conaghan—I was thinking in relation to advisers and an accreditation process for advisers for registration of agreements or otherwise.

CHAIR—So it would just be for registration of advisers?

Mr Conaghan—Registration of advisers, yes. I do not see the utility because of the vast number of different documents. At the moment there are ASIC-like prospectuses. You go and register the thing but they do not vet it. The danger is that a franchisee might think that if there is some registration system of agreements, it gives some validity or credibility to the document relating to compliance whereas before they just filed the thing. It adds another layer of compliance and complexity without necessarily giving any benefit to a franchisee.

CHAIR—You spoke also about people's expectations, about profit and about site selection. You mentioned a range of things about what people expect when they enter into the bargain.

Mr Conaghan—Depending upon representations and what has been held out in relation to that.

CHAIR—That was my next question. Often there seems to be a mismatch. It seems to be widely acknowledged that there is a mismatch of expectations between what franchisees will do to gain or derive an income.

Mr Conaghan—Certainly that comes about.

CHAIR—Let me finish Mr Conaghan; it might be helpful to understanding the question. Obviously everyone shares some responsibility in that mismatch. But is there an issue in making sure that claims made by franchisors about what a franchise system will produce in reality is based on some form of fact? How do we deal with that difficult situation?

Mr Conaghan—In my experience it is a very minor issue. What you are seeing are the complaints that have failed. That represents less than one per cent of people involved in the franchising industry. You have the statistics about the low level of disputation so far as that is concerned.

Mr ROBERT—By and large?

Mr Conaghan—By and large the issue is that they have chosen to get that independent advice. They understand what they are getting into. In the vast majority of circumstances there is not an imbalance of representation about what they are getting into.

CHAIR—I think you have misunderstood my question. We are not talking about risk. It is understood that people take a risk. We are not trying in any way to legislate or regulate for people to succeed or fail. There is freedom of contract as you mentioned. We are talking about the expectation, the mismatch, or what somebody might have when they are signing up to what potentially will be the biggest economic decision they will make in their lives by sinking all their

life savings, et cetera, into a system, in the expectation that that system will deliver an outcome for them.

Mr Conaghan—I do not believe that—

CHAIR—You do not believe that is the case?

Mr Conaghan—Not in the vast majority of successful franchise operations.

CHAIR—I asked that question because you raised the issue earlier.

Mr Conaghan—They do not want that to occur. That is why complaints have come about. I made the point that, by and large, in my experience as a mediator they were from those franchisees who elected not to get any independent advice before entering into an agreement. For the other 99 per cent of franchises I assume that issue would not have arisen.

CHAIR—You raised the issue of mediation in your submission, you have played a role in mediation processes, and you also have some experience in that area.

Mr Conaghan—Over 100 in mediation since 1990.

CHAIR—I thought I heard that figure earlier.

Mr Conaghan—We started that process well before the code, because it is a sensible and cost-effective way of resolving issues before people go off to court. By and large it has been very successful.

CHAIR—Is there an issue of non-compulsion to derive an outcome? Is there a need to attend, or attend in principle, but not to derive an outcome? There is no penalty. In a while the mediation process might be successful in what it has to deal with. The process itself is a matter of good faith. Unless you enter the mediation process with good faith and the will to resolve, if you decide in the end that you do not want to achieve anything out of it and you just go through the motions everyone walks away. The only recourse open to you is a tribunal, a court process, or some sort of penalty for breach, et cetera.

Mr Conaghan—I have a lot of faith in the mediation process. It has produced lots of successful results. Once you get the people there the mediation process is the way to work through that process. There have been many successful mediations even though there was a lack of good faith on the part of one or other of the parties not wanting to be there.

CHAIR—Can you define good faith? There are two ways to look at this. I would say that they are successful, but people say that it is too hard.

Mr Conaghan—I heard some comments that it is because they are out of the system. There have been a number of mediations where the franchisee has stayed in the system or there has been a change to the commercial relationship.

CHAIR—Has there been a measure of success as a result of staying in the system?

Mr Conaghan—If that is the choice that they have made.

CHAIR—The way I am seeing it is that you do not have a choice other than to stay in the system. I do not see how that is a measure of success. If you are a franchisee you cannot get out of the system; you have to recoup your sunken costs or your investment. If I had a dispute I would want to try to resolve that dispute, not necessarily leave the system. I understand that it is successful and I have read the submissions. I am seeking your experience as a result of having dealt with so many mediations. Can you give this committee some insight?

Mr Conaghan—If I had a couple of days I would be happy to take you through it.

CHAIR—How about I give you an opportunity right now to give us some insight?

Mr Conaghan—They are so varied. Both parties want to continue the existing relationship. We have had a situation where a master franchisee and a franchisor have had issues. They have parked them aside, we have dealt with the issues and the relationship has continued. When there is a confrontation process you are able to do it.

CHAIR—There is no real outcome. We are not dealing with those that are successful; we are trying to deal with those that are not.

Mr Conaghan—If there is a breach they will be walking away. They are able to deal with those issues and they are able to continue. That applies similarly to franchisees. Often you get them in the same room and you are able to get the communication process up and running and you are able to work out the real agendas of these people. Those agendas come out, for example, they want to leave the system or they want to stay in the system, but on a different basis.

CHAIR—Is it about a franchisee wanting to stay in the system or leave it? Can disputes be both sided?

Mr Conaghan—Absolutely. There is a range of franchisor and franchisee issues. When we talk about success we talk about the outcomes that people have wanted. They will not get an agreement unless both sides compromise, otherwise they stick to their positions and you have other outcomes. At the same time you are able to test that. If you do not reach an agreement it continues as it is or people have other legal rights—they go to court or they do other things. There are lots of potential outcomes. You will not be able to legislate for someone to reach an agreement.

However, you can assist people in participating in that mediation process. That has proved difficult. Some parties will say, 'We can come but we cannot come next week or next month', and the process gets a life of its own because a dispute has arisen. If you can get to it quickly or early in its life you have a much better prospect of working out some sort of resolution. If someone wants to leave the system they are given a certain time within which to sell their business and exit, getting back capital and those sorts of things rather than terminating, otherwise you will have a problem.

If you have a problem with a franchisee and they have issues with conduct or otherwise, there are lots of commercial solutions as a result of mediation that cannot occur in a court. In a court

you are talking about breaches and damages. A court cannot remedy other aspects of a relationship.

CHAIR—Is that only for a breach?

Mr Conaghan—If you are in a court a court is limited. A court cannot say cannot, 'We will rewrite the agreement.'

CHAIR—If a matter goes to court, okay.

Mr Conaghan—In mediation there are lots of avenues to adjust commercial relationships and to enable parties to continue.

CHAIR—Thank you, Mr Conaghan. As a matter of interest I picked up the fact that you used the words 'emotive submissions' in your evidence.

Mr Conaghan—They are genuine and it is sad. It is terribly unfortunate that those circumstances occur but, at the same time, the question is: Is there some deficiency in the law at present in respect of those circumstances? When I read those submissions I established that they had legal redress and they had legal rights, but the costs of pursuing them was a problem. That was the point that I made. It is a serious issue for society. I do not walk away from that, but I do not know where this inquiry can take it.

CHAIR—Thank you Mr Conaghan; we appreciate your time.

Mr Conaghan—Thank you.

[2.29 pm]

STEWART, Mr Murray John, General Manager Corporate, Eagle Boys Dial-A-Pizza Australia Pty Ltd

VINE, Ms Shirley Jane, In-house Lawyer, Eagle Boys Dial-A-Pizza Australia Pty Ltd

CHAIR—Thank you for attending. You are welcome to make any opening remarks you wish to make.

Mr Stewart—In my opening statement, I will cover some of the key components of our submission. As a franchisor, I will talk about the impact of the code and some of the practicalities from a franchisor's point of view. The code exists to regulate the franchise system in its totality, but the essence of the franchise relationship is the franchisor, and franchisors always need to work together for a system to succeed. The existence of a code helps to regulate that relationship. I also see franchising as an important area of the small business sector. The franchising sector needs to continue to grow to aid the growth of small business within Australia.

Within the scope of the materials and the committee's terms of reference, I read that there is some talk of increased regulation. We are not averse to regulation, but it really needs to be sensible from a franchisor's point of view.

CHAIR—May I ask if you have read the increased regulation bit so I know where to refer it to?

Mr Stewart—The terms of reference talks about explicit inclusion of duty of good faith within the code.

CHAIR—Okay, thank you.

Mr Stewart—That represents additional obligations for both franchisors and franchisees. From our point of view we see the code in its current format as something that works. Since it was introduced, it has reduced the level of dispute between franchisees and franchisors, but we would like to see the level of regulation being sensible. In relation to the issue of explicitly including the issue of good faith in the franchise code of conduct, we do not see any reason to change because the code really governs the franchise relationship. The issue of good faith generally goes further than just franchising.

In relation to dispute resolution, we see the process that is set out in the code as working well. In terms of the way we manage it in the Eagle Boys system, we are proactive. You could say disputes between franchisors and franchisees occur on a daily basis; it is just a matter of how you manage them. Disputes are managed internally. If they are not able to be resolved, they escalate through the system. We use all commercial avenues to resolve disputes before needing to get to the mediation point. But it is there for a reason. It works well. Disputes can be resolved through that process. I am sure you have heard that through other people who have presented information to you.

Generally we find franchisees are scared of the mediation process. That is something that potentially can be taken on board. They see it as a situation in which the big bad franchisor can take an opportunity to sit in a room and get the outcome that the franchisor wants, but it should not been seen like that. In terms of disputes within a franchise system, I suppose sometimes within business and within franchising businesses fail. You have read some submissions that reflect that. The dispute resolution process within the franchising code of conduct is there to assist businesses in not failing. I guess from the point of view of businesses that are non-franchised as opposed to franchised, the nature of franchising is there to reduce the level of business failure. That is why businesses would enter into a franchise as opposed to entering into a business that is not associated with a franchise system.

I have already spoken about a sensible level of regulation. Some of the changes that took place in relation to the code in March this year seemed to increase the level of regulation. We find that particularly we are having to disclose on more than one occasion to franchisees, so we are sending the disclosure document to them twice.

CHAIR—Just to clarify that—that is the same information or continuous disclosure.

Mr Stewart—It is the same information. If you want me to elaborate on that now, I can.

CHAIR—No, continue. That is fine.

Mr Stewart—The disclosure document and the franchise agreement are provided to franchisees to assist them in their due diligence process. That is just a practical application of some changes that we have made, which potentially presents an opportunity to review right now as part of this process. I would also ask that some clarification be given because we do not believe the code is entirely clear in relation to how often franchisors are to update their disclosure document as the business changes over the course of a 12-month period, and businesses do change over time. We seek some more definitive clarification or more definitive wording in the code to state when updates are required to disclosure documents, or whether it is the intention that a disclosure document is updated annually once and then remains a static document for that period, apart from certain significant changes. For example, if we add another trade mark to the system, does the disclosure document have to be updated at that time? That is really all I have to say in my opening statement.

CHAIR—Ms Vine, did you have anything to add?

Ms Vine—No.

CHAIR—We will ask some questions.

Mr ROBERT—Honest.

CHAIR—That is right. First, I must say it is refreshing to hear somebody say the words that the code is there to help franchisees and franchisors work together. That is certainly a perspective we are coming from in terms of this inquiry. It is nice to hear you say that. In terms of the code, in your own experience you are running a franchise system. In the current code, some changes were made, as you have acknowledged, in March. How do you find the code

working for you as a franchisor? What is your own view of how it works for your franchisees as well?

Mr Stewart—To be honest, the code is a legal document. Our interpretation of the code translates into our disclosure document, and it is a big fat document. The mere size of that document as well as our franchise agreement and putting that in front of a franchisee is a pretty daunting issue for a franchisee. The code has been in place for 12 or 13 years, and a lot has changed over that period. For example, there is a lot more information in the public domain. Our website and many franchise systems websites would include all the information that you are required to put into the disclosure document from the point of view of franchisee names and addresses, and contact numbers, et cetera. So maybe there is an opportunity here to take a view on what has changed over a period of time. Certainly if there is information in the public domain that we can pull out of a disclosure document—

CHAIR—You have raised a really good point. It is something I have been pursuing with other witnesses. I have been asking them about that in terms of the size of the document. I am certainly not necessarily of the view that the bigger the document the better it is. Perhaps reducing the size would be more efficient, particularly when a lot of information currently exists in the public domain. I would be interested in your views on the whole disclosure principle is really about providing information that is difficult or expensive to get to rather than what is freely available and is just two or three mouse clicks away.

Mr Stewart—That is exactly right.

CHAIR—Could I have your view on that in terms of bringing down the volume of the document and the daunting task faced by franchisees.

Mr Stewart—Certainly there are critical areas of information that will differ from one system to another, such as what fees do you pay, how much does it cost to get in, what are our site selection criteria—those sorts of things. I think it is important to disclose to franchisees the processes that are in place or the or the level of disclosure that is required in relation to specific areas. In some other areas, it is not as important. If I talk about some of the other things that we put in our disclosure document, we are restating a whole bunch of stuff that is in our franchise agreement. We are bulking up our disclosure document.

CHAIR—That is the information that you are required to disclose under the code.

Mr Stewart—Under the code, yes. The code says you have to list a whole chain of events, and that is all within: What are the franchisee obligations? What are the franchisor obligations? That is all in our disclosure document and in our franchise agreement.

CHAIR—We are actually getting to a nub of one of the issues. When you go through the process of selecting someone to take on your system, do you go through those documents with them and explain to them, 'Look, this means this, and this means that', and you, let us say, measure their expectations in terms of what your system does and what it delivers?

Mr Stewart—We give them a whole bunch of information early in the process. When we know they are a serious applicant, they are disclosing, they are getting the franchise agreement

and they are getting the code, at that point we are encouraging them to start their due diligence. They talk to other franchisees. We have our sales guys talking to them as well. But, really, we are encouraging them to talk to other franchisees, do their own research and basically take the information out of the disclosure document.

If we can make that disclosure more concise, so they really know what they have to focus on, that process can potentially become more efficient for a franchisee. Whether they are going to wade through a document and really pick up the critical issues as the document sits right now is questionable. But we are only providing them with limited information and virtually no advice. We encourage them to do their own research, visit stores, talk to other franchisees and actually go and spend time in a store. Pizzas are not Jim's Mowing; it is a more complex system. You have to be the right sort of person to want to enter into it. Getting them involved and encouraging them to really understand what they are getting into is an important part of the process.

CHAIR—You are absolutely right. One of the issues before us is not so much dealing with, let us say, the ones who are successful at what they are doing, who go through those processes and, as you have described, take their franchisees through, for want of a better term, a comprehensive educational process before they step on board. We are trying to define the failures in that when people deliberately try to step around it. We are trying to identify those failings.

Mr Stewart—Sure.

CHAIR—The reason there is a code and, I would contend, the reason that franchising has been so successful in the past decade and more has been because there has been a very strong regulatory regime and a code. Certainly as the requirements have been increased, as you said earlier the systems are working very well. That is the context.

Ms Vine—We need to have a very strong panel process in-house so that the potential franchisee comes into our office and they go through a very rigorous panel process. All the different departments sit with them and they can ask questions, although things are not explained to them to the extent that their lawyer would explain it to them because it is the role of their solicitor to explain the legal document. But we do have a process, and not all franchisees are passed or approved either in our system. Like Murray was saying, they may not be suitable to be a franchisee to start with.

CHAIR—It is probably a very different system to what we have heard in other evidence. For example, there are some franchise systems that begin their very first shop operation with the beginning of the franchise brand and it all happens on the same day. There is nowhere and no-one for people who are buying in to go to because there is no history, so your setup is probably a very different case. I have a number of other questions, but I am happy to defer for the moment.

Mr ROBERT—Mr Stewart, your submission states you do not recommend that good faith bargaining be implemented within the franchise code or Trade Practices Act, but you do not explain why not.

Mr Stewart—I see the code as it works right now as working for our system, so it is my view that there is no need to change it.

Ms Vine—When we discussed that, we looked at some of the other submissions that you had.

Mr ROBERT—This is why you have legal counsel assisting you.

Ms Vine—That is right. I had to do all the reading.

Mr Stewart—I am not a lawyer.

CHAIR—You do not need to be a lawyer to present in front of us.

Ms Vine—I agree. I am not sure which submission it came from, but there is no definition as such of good faith. We also have that in our franchise agreement—that both parties have to act in good faith.

Mr ROBERT—The interesting thing, Ms Vine, is that of those who either are a franchisor or represent the franchisors across the 160-odd submissions, all do not want good faith; but everyone who represents franchisees does. Do you have any comment upon the apparently two camps that seem to be building up with nothing in the middle?

Ms Vine—Apparently you guys were talking before about the logistics of what happens in parliament and the lawyers.

CHAIR—No, I was just letting the lawyer know that the legislators make the law, the judges interpret it, and it is not the way round.

Ms Vine—I understood what you said there, but I think the courts from time to time in all the cases are showing by the facts scenario what someone has done and whether that is considered to come under the definition. So it is not hard and fast and it is not black and white. Perhaps that is why it is not going to be in the code. We have the mechanism in the Trade Practice Act, but we put it in our franchise agreement so that we are aware that we have to be professional.

Mr ROBERT—With the old way of arguing, if I took this to the pub to run the Stu Robert pub test and said that there is nothing that exists in legislation, but the judiciary more and more are starting to define it because they see a need, is there therefore a requirement coming through from the people that perhaps we should be legislating on this, I think the average person in the pub would say, 'Well, yeah, absolutely.' If various justices like Justice Byrne are feeling a need to say, 'Well, it's implied within the agreements and it's an implied part of business', why would parliament not make it explicit rather than implied?

Ms Vine—I totally agree with you, but from a franchisor's perspective I think we have enough in the code that we have to contend with. Changing it again when it is really not settled or defined is just adding more complexity.

Mr ROBERT—But if it is already implied, what difference will it make to you if parliament makes it explicit?

Ms Vine—I am sorry?

Mr ROBERT—If parliament was to amend the code of conduct to say that you are to negotiate in good faith, especially with respect to renewals and breaches and so on, what difference would it make to how you operate, cognisant that the law already implies it?

Mr Stewart—I suppose what needs to be clear is that good faith is not just a franchisor obligation.

Mr ROBERT—Correct. That would be in there and across all parties.

Mr Stewart—From our point of view, we already have good faith in our franchise agreement. We have franchisees who allow their agreements to expire and just do not renew them and do not talk to us about them, so there is an element of a lack of good faith on the part of the franchisee as well.

Mr ROBERT—Unquestionably, but if you already had good faith built into your agreements, why does your submission say that you do not support getting good faith from the code of conduct?

Mr Stewart—I see additional requirements in the code such as that as additional regulation and additional paperwork for a franchisor, and that is why I do not support it.

Mr ROBERT—Granted, but it is already implied in the law. You have already got it within your own agreements anyway, which have to be a reflection of the code of conduct—and you might want to look at your attorney at this stage—so therefore why would you not support it going into the code of conduct? You already have it in your agreements.

Mr Stewart—That is a voluntary thing for us to put it in our agreements.

Mr ROBERT—And you are to be commended, sir.

CHAIR—Absolutely.

Mr ROBERT—You can talk about it outside. With respect to your end of agreements, could I ask how long your agreements are normally for? Are they five plus five plus five?

Mr Stewart—Just five plus five.

Mr ROBERT—When the first five years are up, how does Eagle Boys generally deal with the option to extend? I am just trying to get a bit of a feel for how franchisors deal with options and then at the end of a term.

Mr Stewart—We look at whether the franchisee has been a complying franchisee in terms of doing the right thing, submission of required information and also doing the right thing by the overall system and the brand. In my cases our franchisees comply to that level. If that is the case, then we just automatically offer them renewal. We do not even make it their obligation. The agreement says they have to come to us, but we actually write to them and tell them. At the end

of the 10 years, more often than not franchisees renew. In three years, there are no franchisees who have not wanted to renew at the end of their term. We offer them a further five-year period.

Mr ROBERT—Have you had any who want to go over the 15 years?

Mr Stewart—Yes. We have had franchisees over 15 years. The system has been going for over 20 years, so we have some very long-serving franchisees.

Mr ROBERT—Am I correct in saying that there are some franchisees who hit the 10 years and you have extended by five years, and they have hit the 15 and you have extended again?

Mr Stewart—Yes.

CHAIR—At least within your organisation—I will not ask you to comment on others—and within your own system, your expectation and perhaps those of your franchisees is that you do have a long-term relationship that really does go beyond, 'Look, I know we are signing for five years.' That is the initial period, and everyone may want to pull out at some point, but if things are going well and they are making money and you are making money, the expectation is, for want of a better reason, you just continue.

Mr Stewart—Yes, that is exactly right. At the end of the day we are building a business in partnership with our franchisees, so over many years we want that business to continue to grow. We are only going to grow it by retaining our existing franchisees.

CHAIR—In support of that, we heard from a previous witness who said that in her many years of research, you would be mad not to want to continue into perpetuity, given that it is achieving the goals of both.

Mr Stewart—Yes.

CHAIR—We have also had some evidence through submission and the process that there is a number of franchisees that are 'ripe for the picking', as the comment was, the more successful they are towards the end of their contract because the corporation wants to take them over. I am not saying that that is what your business does, but certainly that exists out in the marketplace. Do you have any view or opinions to express?

Mr Stewart—I guess that is a philosophical issue for a franchisor in terms of 'What is their business?' For us, we are a franchise system so we have a very small number of corporate stores. Out of our 235 stores, we have three corporate stores. They are all geographically close to our head office and they are there for a reason—for us to do product testing, et cetera. For us, we are a franchise system. I would imagine there are other systems that are not just franchisors; they are actually running company stores themselves, so they may have a different view and a different attitude towards when agreements renew.

Mr ROBERT—Are you saying you do not run any company stores?

Mr Stewart—We run three company stores.

CHAIR—Does the option exist for your franchisees to sell at any time or thereabouts if they want to exit the system and just sell. You obviously would approve the people coming in, but that does exist?

Mr Stewart—Yes.

CHAIR—And that can happen at any time during those contracts by agreement, I assume?

Mr Stewart—That is right, yes. I listened to a conversation when you talked about good will earlier. We have many franchisees that sell their business after a number of years for well in excess of what they paid to get into it because they built up what the previous speaker spoke about as the personal good will component. Obviously we are retaining the good will component associated with the brand and what they have helped us build. What they have built their business into over that period of time helps us as well, so there is shared good will there.

CHAIR—There is no situation, at least within your franchise system, whereby at the end of a contract, there is zero value in that franchisee business because the contract has expired and there is nothing to sell. You do not have that situation in your system where the value diminishes over time, the closer it gets to expiry date, because if it is not renewed, it has no value because there is no business.

Mr Stewart—No.

Ms Vine—There would be, in certain circumstances. If you abandon a store, the situation is a little different.

CHAIR—But in the normal course of events—

Mr Stewart—Under a normal renewal, more often than not or in virtually every case, we are going to renew because, when you think about it from a business value point of view, business value is a multiple of profits. The revenue from your store network gives you the profits that build your business value. If you let your revenues go away, your business value is going to fall. It does not make logical sense for franchisors to want to let franchisees go away, if they operate under the type of system that we operate whereby we are purely a franchise model.

CHAIR—Unless there is a good cause—

Mr Stewart—Yes, unless there is a good cause—

CHAIR—There is no reason to go down that path.

Mr Stewart—And there could be significant dispute. That may happen from time to time and you do not renew. We have had situations in the past where we have had significant disputes with franchisees and put them on notice that we are not going to renew prior to renewal. That is the exception rather than the norm.

Mr ROBERT—You indicated there are some franchisees who just do not speak to you.

Mr Stewart—Yes.

Mr ROBERT—Odd. How do you deal with that? Is there a mediation process? How does Eagle Boys approach that?

Mr Stewart—It is an interesting question. What we find franchisees really struggle with is the fact that we are a business and they are a business. They can tend to get very caught up in the emotion of the relationship between the two parties when it is really just an arrangement between our company and their company. Most of the situations, if we talk about disputes and franchisees not talking to us, relate to personal issues rather than pure business disputes.

Mr ROBERT—They do not like you.

Mr Stewart—Or may not like a particular person in our organisation. It is an issue of managing the process.

CHAIR—Do you say that is common, though, or not common. Is it common?

Mr Stewart—It is in some cases. At other times, there are genuine disputes so they may just decide not to talk to us or ignore our phone calls.

Mr ROBERT—Ms Vine, with respect to mediation, does Eagle Boys use mediation as a process?

Ms Vine—We do, yes.

Mr ROBERT—How effective have you found it?

Ms Vine—Very effective.

Mr ROBERT—Have you ever not turned up to mediation?

Ms Vine—No, not us, and we have never had a party not turn up.

Mr ROBERT—Phillips Fox recommended in its submission that mediation be compulsory, with penalties for not turning up. Do you have a view on that course of action?

Ms Vine—Because I have worked in private practice for franchisees and now I am working in-house for a franchisor, I have seen both sides of the story. A lot of franchisees may not want to go to mediation because of the cost to get a lawyer involved.

Mr ROBERT—My understanding of mediation is that you do not need legal representation.

Ms Vine—You always need legal representation.

Mr ROBERT—Spoken like a true lawyer.

CHAIR—Well done!

Ms Vine—You do. They are in the business of franchising and selling pizzas. They are not in the business of knowing how to interpret the law correctly and how to present their arguments in the best way that they can. I am not sure if you made it compulsory and there were fines involved whether that would enhance the negotiation process and encourage people to make it to mediation. It is compulsory through the code. If you cannot resolve your dispute, you cannot go straight to court; you have to go to mediation, which I think works. I do not think that needs to be changed. But there are lots of factors. It is not just one factor scaring franchisees.

They do sometimes have the mentality that there is a them and us type of thing whereas Murray was saying before that it is business. It is no different having your franchisor to deal with than having, say, a distributor or customers or employees. You have lots of relationships within the business that you have to make work. We find that some franchisees are just not emotionally intelligent. They bring lots of emotion into it. Instead of saying, 'Okay, what is the issue here? How do we resolve this? Step one, two and three', they just get all funny.

Mr ROBERT—And you always need a lawyer.

Ms Vine—Yes. It does not help when you are the lawyer.

CHAIR—I am interested in the emotion concept. I am just thinking of it from the perspective that I would approach it. If all of my life savings were invested, my home was mortgaged and I faced bankruptcy and potentially there is no way out, I would be emotional too. In fact, I think I would be very emotional.

Ms Vine—But there is no—

CHAIR—I know it is not helpful, but I would find it very difficult to not be emotional. I am just wondering what the emotion has to do with it.

Ms Vine—It is not just if they are in absolute strife, they are at the end, and they are going bankrupt. Sometimes it is just day to day. That is how they deal with you. I do not know if they are just ocker or whether they have no manners or what, but they say some ridiculously rude things. I have been experiencing that recently. It is not helpful.

CHAIR—Unfortunately there are rude people on all sides. It is something for which we cannot legislate, nor for stupidity. I know the questions has been raised in a number of submissions and I have seen a number of comments made about emotion. I look at the side of when there is a dispute in place and what potentially people are facing. If you are the franchisee, you are up against what is a much larger organisation and you do not see yourself as having a lot of power in that circumstance in what you potentially face. Depending on what the dispute is about, if it is a simple dispute of 'Look, you need to put a bit more cheese on your pizza', or a bit less, or whatever it might be. I am sure that can be resolved.

Mr ROBERT—You have some views about cheese on pizza?

Mr Stewart—Sometimes you do.

Ms Vine—Yes, the wrong cheese.

CHAIR—I am sure that happens. My point is that I am sure you can never remove emotion when people's lives, livelihood and other factors are involved. It is a fact of life that in disputes, the nature of a dispute is that people have a different view and may take all different forms of approach.

Mr Stewart—I would just make one further comment there: from a franchisor's perspective, when the situation is such as you have described and emotion does get involved, it tends to impact on the way they are performing in the business, the way they are serving the customers, and the way they are operating. As a franchisor, we have a responsibility to our other franchisees to make sure that we can supply a system and a brand. When franchisees get into that state of mind, we are typically seen as picking on them because we have to act fairly promptly because there is risk that they will cause some significant damage to the brand. We have an obligation to other franchisees to make sure that does not happen.

CHAIR—There are a number of comments you have made about the system, the brand and your selling of franchises, obviously, and things like that, so do you see yourself, as a franchisor organisation like Eagle Boys, as being in the business of selling pizzas as the franchisor, or in the business of selling franchises?

Mr Stewart—We are in the business of both selling franchises and marketing a system to enable our franchisees to make as much money as they can out of selling pizzas. That is what we see our business is.

CHAIR—Sure. Given that you have only got three company stores, as you said earlier, their real purpose is to market test and perhaps do some training, I assume, and a range of other things, which would be very sensible, but the corporation itself is not in the business of directly selling pizzas. You are not in your own business, as it were, of your own product; your product tends more to be the franchise and to make sure you have a successful model, obviously.

Mr Stewart—That is right. Our corporate stores operate as franchise businesses.

CHAIR—Yes.

Mr Stewart—It is just that they are our staff. That is the only difference.

CHAIR—Is there a particular philosophy behind that approach?

Mr Stewart—To having a small number of corporate stores?

CHAIR—Yes, a very small number. Is there a corporate philosophy behind the decision to franchise out rather than have any other?

Mr Stewart—Yes. What we do well is we franchise well. We will focus on what we do well and keep a small portfolio of corporate stores just to enable us to have information in relation to how we can run our stores to benchmark our stores against our franchisees as well as train and do product testing and research and development.

CHAIR—Thank you, Mr Stewart, and thanks Ms Vine.

Proceedings suspended from 3.03 pm to 3.20 pm

FISHER, Mr Greg, Secretary, IndCorp Franchisees Association of Australasia

STEGGALL, Ms Zali, Barrister, IndCorp Franchisees Association of Australasia

CHAIR—I welcome everybody back to the committee hearing and I call on the IndCorp Franchisees Association of Australasia representatives to come forward. If you would like to make a brief opening statement, you are most welcome to do so.

Ms Steggall—Franchising is an opportunity for entry into business ownership for many Australians. As the committee has heard and knows from many submissions, the use in franchising is traditionally of standard form contracts. IndCorp is not arguing the use of standard form contracts. Its members are the Franchisees Association of Australia for Kentucky Fried Chicken franchises. It has been in operation since May 1997 and represents the small independent as well as the big corporate franchises, which is approximately 408 of the 562 KFC stores in Australia.

As I said, its primary role is to represent its member in its collective business dealings with Yum! Restaurants International, the franchisor for Kentucky Fried Chicken, and its role is in the ongoing relationship with the franchisor. It is not involved in the bargaining period with the organisation at the time of entry into contracts or at the signing of initial franchise agreements. IndCorp really comes into play when franchisees are faced with the ongoing changes or the business dealings with the franchisor.

IndCorp accepts and recognises the importance of a strong brand and the need for the franchisor to have the power to establish the strong guidelines and the criteria by which prospective and existing franchisees can operate a store. Where the issues arise for IndCorp's members are, to use a slight sporting pun, when the goalposts keep shifting. An operations manual sets out the standard by which franchisees must operate the franchises. Compliance with the operations manual is a mandatory term of the franchise agreement. There is a level of acceptance and knowledge and acknowledgement that the operations manual is an intrinsic part of a franchise agreement and the way franchises work. The issue is when a franchisor reserves the right to change it at any time and with very little negotiating or communication with the franchisees.

IndCorp's role is in representing all the individual and corporate franchisors in their dealings with the franchisor in relation to changes to the operations manual that occur on a frequent basis. The main point that we would like to make to the committee today is on the basis of those changes to the operations manual that have occurred over the period of franchise agreements that IndCorp has been dealing with. We have copies of the materials we would like to refer to, but we request they be marked confidential.

CHAIR—Perhaps the best way to deal with it is to state that the committee can, and will, accept your documents in confidence, but you need to understand that the committee may at some later date publish some parts of those documents, if it chooses to, but would consult and inform you before that took place. I mention that just so that you know that that is a possible process.

Ms Steggall—We have been made aware of that.

CHAIR—Thank you. You may give those to the committee secretary. I have just one question and then I will hand over to Mr Robert. Can you explain in more detail the operations manual to which you refer?

Ms Steggall—Yes. The operations manual is provided on entering into a franchise agreement to a franchisee by the franchisors.

CHAIR—That is right across the board and applies to everybody. Every franchisee has an operations manual?

Mr Fisher—Yes.

Ms Steggall—The one being handed up is the current operations manual as at July 2006. For example, this one is December 2001, and the point we make is that it is remarkably thinner compared to the one after five years had gone by. That was provided to a prospective franchisee entering into a franchise agreement. While we understand that we are not here to argue against a standard form of contract or that a prospective franchisee gets legal advice and understands the commitment they are going into, weighs up the risks and understands the terms under which they agree to enter into the contract, the point is that one of the terms of a franchise agreement is that they must comply at all times with the operations manual. The problem is that the operations manual is not set in time. The franchisor has reserved the right to change it at any point in time. As I would like to show today, it has changed significantly over time, as is clear from the two examples you have. From 2001 to 2006, it has nearly doubled in size.

After the 2001 manual was distributed, a further document was provided to franchisees outlining some further changes to the operations manual. Essentially changes are effected to that manual at quarterly meetings. The franchisor informs IndCorp and the association members of the changes it requires to be done to franchises and the time frame within which it expects them. The franchise agreement makes it compulsory to be in compliance with it. If a franchisee cannot comply with the changes required or requested, there is very limited scope for franchisees to negotiate or refuse to make the requested changes. Even though IndCorp as the association has the collective bargaining, it has generally been incapable of effecting the changes that are required by the franchisor.

Our submission is that the good faith requirements would be needed to stop a franchisor from being able to completely alter the very nature of the initial agreement into which a franchisee has entered. I will draw to your attention the significant changes, beginning with the green tab of the thicker operations manual. It is the edition with the lease and the deed of re-entry for franchisees. A franchisee cannot operate a new franchise without providing a lease or a deed of re-entry. Even though a franchisee may hold the main lease to a location, they must also obtain a deed between the franchisor and the landlord allowing the franchisor to take over that lease with the landlord in the event of the termination of the franchise. Therefore a franchisee holding a lease has no power to keep a hold on the premises within which they have developed a successful business.

The next change has been at the blue tab, which is the inclusion of 5.11, the IS helpdesk; 5.12, the customer service hot line; 5.13, OH&S accident and incident reporting hot line. All of these are at the cost of the franchisee but are not in the initial operations manual that a franchisee will receive when initially entering into a franchise agreement. This comes at a significant cost to the franchisees. Whereas they have already contracted in their initial franchise agreement to the advertising—

Mr Fisher—Adco.

Ms Steggall—Adco and the royalties percentage, they are then faced with an increasing percentage being added on top of that. IndCorp would argue that that is not part of the initial contract that the franchisees agree to enter into. But because all this is tied to any future approval or development, or any future renewal, they have no real power to object to any of the changes that are imposed.

Behind the yellow tab at 3 is 6.5, the renewal criteria and requirements. You will note at 6.5.1 that a franchisee must comply fully and timely with the relevant provisions of the agreement, the conditions for renewal and the renewal criteria of the franchise agreement, which includes complying with the operations manual. Renewal and any ongoing relationship with the franchisor is dependent on compliance with this operational manual, which keeps on changing.

Mr ROBERT—Just on renewal, Ms Steggall, currently terms for franchise contracts are five or 10 years, with certain provisions to roll over. What has been your experience in when the five or 10 years has come up or an option has expired? What have franchisors sought to do?

Ms Steggall—In IndCorp's situation, initially it is 10 years—10 years plus the 10-year option. At the end of that 10 years, to get the renewal full compliance with the operations manual is required and mandatory to get the renewal period. It is generally at that time that increased requirements are put into the operations manual.

Mr ROBERT—Let us say you deal with all that, and you get the extra 10 years. What happens at the end of the next 10 years?

Ms Steggall—You have no renewal in the first place. At the next 10 years, it starts from scratch. If you want to continue the business, it is a completely new contract.

Mr ROBERT—You deal with KFC exclusively, I believe.

Ms Steggall—Yes.

Mr ROBERT—So Yum is the parent organisation. What have they done when the 20 years has come to an end? Have they allowed organisations to restart contracts again?

Ms Steggall—At this point, one of IndCorp's association members is Competitive Foods Australia, which also has submitted to the committee that that is one of the very real problems; that, no, they have not renewed, or if renewal has happened, it has been under very harsh and reasonably oppressive terms.

Mr ROBERT—In the Competitive Foods case, I assume you are referring to the Rockingham case, there was no option to renew. Have Yum renewed any past 20 years?

Mr Fisher—There has been one renewed, one store.

Mr ROBERT—I understand the question is subjective, but why would they seek to renew one store and not renew another?

Mr Fisher—The store that was renewed was in Cessnock in New South Wales and arguably that would be too remote for Yum to operate itself.

Mr ROBERT—As opposed to the Rockingham one, which you believe Yum could operate itself.

Mr Fisher—Yes, operate and staff itself. It is part of the CBD essentially, or it is part of the growth area of Western Australia, down at the southern coast. I think they would be able to operate that, the same as they could, if you use the New South Wales parlance, on the Central Coast, or whatever the case may be, or going down to Geelong in Melbourne. It is all a growth area. The staff and supply chain, et cetera, is not hard to access, but Cessnock is a bit remote. That is the only one to our knowledge that has been renewed at the end of 20 years, and again that had to be upgraded to brand standard at considerable cost to the franchisee in order for that to be renewed.

Mr ROBERT—In previous evidence, Phillips Fox's Mr Conaghan, when questioned about the end of a period, such as five, 10 or 20 years, and if a franchisor chose to exercise its contractual right and just take a store away, my question was: Is it reasonable for no compensation to be paid? Mr Conaghan was reasonably philosophical, making the point that you are buying an income stream, and it depended upon a whole range of factors as to whether it was reasonable; that is to say, it had to pass the pub test. What is your view of what is reasonable or not at the end of a period of time? Is it reasonable that someone should be able to renegotiate or at least be paid for their individual good will?

Ms Steggall—Yes because, if you think about it, in the light of the operations manual changing on a constant basis, not only does the franchisee enter into an initial agreement and invest initial capital expenditure in their investment and develop the business, the argument is that the ongoing income stream then is the payment for that capital investment. When you get to the end of the 20 years, you have got your return from that initial investment. But the problem is that there is a continuing requirement to continually reinvest in the franchise through the changes to the operations manual. As the franchisee gets closer to the end of the term, there is less and less chance for any kind of return on the continuing requests for investment in the franchise. It is a completely one-sided situation where a franchisee has no choice but to continue investing in their franchise, which is their business, but they face absolutely no security at the end of the term.

Mr ROBERT—I have just one final question on this issue of good faith bargaining. Before when I was speaking to Eagle Boys I noted that it would seem, looking at all the submissions, that those who are franchisees or who are representing franchisees, such as yourself, would seem in general terms to be in favour of putting a good faith bargaining position into the code or

indeed into the Trade Practices Act, but that those who are franchisors or seek to represent them would not. It would seem to be wholly polarised, which would seem odd. Do you have any comment as to why that polarisation would appear on the surface to exist?

Ms Steggall—In what I believe probably would be a vast majority of cases of franchisors that are acting the best interests of their brand, their foremost concern is to have happy franchisees developing strong businesses that develops a strong brand, and that obviously creates a much better business for the franchisor. They would probably recognise that there is an implied duty of good faith and are quite happy to comply with that. There are many franchisors that do. The issue is there are the minority that do not. At the moment, there is no protection against the extent to which that minority of franchisors can abuse the system, per se.

Mr ROBERT—But if the concept of good faith is implied—and Mr Conaghan from Phillips Fox went through a range of case law, including the most recent judgement from Justice Byrne in the New South Wales court, I think—and he went through the statement from the justice with respect to the proposition that good faith exists. If it is implied in the law, what is the issue with making it explicit in the law?

Ms Steggall—That would be the submission on behalf of franchisees—that it is not a great step to be asking the committee to accept and make the changes in making it explicit.

Mr ROBERT—Do you see any issue in making what is implicit explicit? The unintended consequence that Mr Conaghan raised was that perhaps we might confuse the courts, heaven forbid.

Mr Fisher—But you can see the issue we have spoken about if we go back to what we would commonly refer to as the drop dead clause at the end of the 20 years of the franchise agreement. We have spoken just now of two examples. One is the way the franchisor, at their discretion, has chosen to renew and act in good faith and where the franchisor on the other hand, as in the Rockingham case, not to renew. It is the same situation, the same system, the same adherence to systems policies and training manuals, et cetera, but in that case they chose not to do, and in the first case in Cessnock, they chose to do it.

Mr ROBERT—If we take it as read that in the Rockingham and Cessnock cases all areas of your voluminous ever-growing manuals were complied with, and that is an assumption because I do not know the cases, yet one got a renewal and one did not, that would seem to me to indicate poor faith. Is that a fair conclusion, if all those things held to be true?

Ms Steggall—Yes, and the problem is that whereas there is an argument for the implied good faith, there is no way of enforcing it. A franchisor has a discretion or choice to apply it or not. That is why the submission for the proposed amendments would provide some level of safety or some level of pressure on franchisors to consider the level to which they can take the opportunism in situations of non-renewal and the drop dead clauses. Where it is very important I guess is also that, as a franchisee gets towards the end of its term and the requirements for reinvestment into the store come up, a franchisee has absolutely no recourse but to agree.

We are not talking always about the big corporate franchises that have the funds and the resources to upgrade it and keep all their stores to that standard; you are often talking about

individually family-owned franchises who have heavily borrowed to open the store in the first place and who have gradually, over the five to 10 years, managed to pay it off, and are gradually getting a return out of the investment.

If they have managed to renew and get the option of the second 10 years, at 15 years they can be asked to do a refurbishment and a complete upgrade of their premises to the extent of $300,000 or $400,000, which is a significant investment. Frequently the banks will not allow such a business loan purely on the value of the franchise because it no longer has the original value; it has only five years to run on its agreement. Then you are looking at the franchisees having to put their personal assets on the line. The operations manual has introduced changes where family members and associated people within a franchise have to put on personal guarantees towards the operation of the franchise.

The franchisees are having to confine themselves at the end of a 20-year term, having put the family house on the line for the upgrades that they were required anywhere from two years or three years or five years before, and have absolutely no bargaining power to ensure any return for that investment. They can lose personal assets on top of a business that they have developed for 20 years and have no ownership in.

CHAIR—Ms Steggall, I draw your attention to two points and I will explore each separately. There is the concept of trying to either minimise disputes or avoid disputes completely, let us say, and, that having failed, deal with dispute resolution, and how that is dealt with. We are trying to minimise and avoid disputes. What do you think is missing or lacking in the code or the Trade Practices Act at the moment which relates to franchising that could minimise or prevent current disputes?

Ms Steggall—The problem is a minimum requirement of good faith on behalf of the franchisors. IndCorp, as the association for both the corporate and the independents, is obviously frequently in negotiations with the franchisor, Yum, over all the changes that occur, the future of the brand and where it is heading. But its problem is it has nowhere to go in the discussion; there is no negotiation process. Even though it represents such a significant number, it cannot prevent Yum from ultimately requiring the changes, or you are in default of the operations manual and thus your franchise agreement. Mediation or dispute resolution, while an attractive form and theoretically is a good situation where you can bargain and negotiate, unless it is legally enforceable it cannot really resolve the situation.

CHAIR—Is good faith enough, though, in the sense that if you freely enter into a contract, which contains within it the possibility for the outcome you are describing to occur, and it can later be said that whether it is fair or not may be a separate issue, but certainly the parties have acted in good faith. That was the contract; that was the bargain. How does good faith deal with that situation, or is there a need for some other mechanism to say that that is not a fair contract because it either (a) does not comply with the code or (b) is inherently not in good faith because it breaches other principles.

Ms Steggall—I understand that, but the fact is that we are not saying the initial agreement was not in good faith. Our issue is the changes. We are not arguing against standard form contracts. We totally recognise that the franchisees go into it having obtained legal advice and have to understand what they are going into. The problem is the contract where the essential terms are

constantly changing. If you are looking over 10 or 20 years, those changes become quite significant, and as it stands at the moment there is no limit on what the changes can be. They can continue growing.

CHAIR—If we use the same principle as the original contract, can those changes also not be in good faith, but not necessarily fair, and therefore still creating the problem: Does good faith solve the issue? Is good faith the solution to the central problem?

Ms Steggall—Looking at the proposed amendments, for example to the franchising code of conduct put forward by Competitive Foods, within the definition of good faith there is—do you have a copy?

CHAIR—I do. It is in front of me right now.

Ms Steggall—I have copies of everything. For example, one of the circumstances, I would have to say, begins at point (e):

> (e) the respective financial and non-financial contributions made by each of the parties to the establishment and conduct of the franchised business; the risks taken by each of the parties in the establishment and conduct of the franchised business; the alternative courses of action available …

These are all parameters which ensure, when talking about for example the changes to the operations manual, that a franchisor requiring a $300,000 upgrade one year cannot, within the parameters of a legitimate business interest of the parties, just require another investment of $150,000 or $200,000 the next year without good reasons. If not, provisions such as the obligations I have referred to—to act in good faith, requiring a franchisor to act within legitimate business interests, a reasonable contract taking into account 'respective financial and non-financial contributions'—would allow for changes to the operations manual to stay within the realm that is manageable by the franchisees.

The problem that IndCorp members are encountering is that the changes are becoming greater and are frequently unreasonable. KFC, or Yum, I should say—the franchisor—unlike other franchisors does not have a policy whereby changes can be limited to selected stores only, for example. When a change is introduced it has to be introduced across the board to all franchisors, regardless of whether that one individual may not have a store located in an area where such a change is really a valid commercial investment, or a store may have just done a major refurbishment the year before and is now faced with another lot. There is no room for that kind of evaluation on a priority scale.

CHAIR—Can that not be challenged through the Office of the Mediation Adviser?

Ms Steggall—Without an underpinning legal right, we can attempt to mediate it, but the franchisor does not have to respect that.

CHAIR—Can I take you down a slightly different path. I am interested in the principle or the view that the corporation—for example, Yum—decides that it wants to now go down a new path. It decides that over a period of time it wants to no longer have franchisees but wants to corporately own all the stores as company stores. Does it in principle have a right to do that in

any circumstances? If it does, what sort of process should that take? What sort of process should that look like?

Ms Steggall—In principle, it does have the right to do that, but you have to look maybe at the five years or the 10 years leading into such a policy change. You cannot have a right to take over all the stores and have the company all owned, but the year before, without a franchisee being aware that they are about to lose their store in a year's time, require them to do the major refurbishment and refit, put the capital investment into it, and then take over the store. At this point, there is nothing stopping a franchisor, or Yum, at 19 years, from requiring a major refurbishment while a franchisee, believing they will get a renewal, undertakes that capital investment and at the 20 years experiences termination of the agreement, with the franchisor taking over that store and receiving the benefit of the capital investment, the refurbishment and the upgrade. There are no provisions for that franchisee to be compensated for the investment.

CHAIR—Not compensated in any way at all? So it is the drop dead clause, as I think you referred to it, that at the expiry of the contract.

Ms Steggall—'That's it!'

CHAIR—Everything ceases to exist, and the corporation and the franchisor, Yum in this case, takes over all that exists.

Ms Steggall—The franchisor can offer to purchase the fittings which, considering they are brand specific, have very limited value. They have the opportunity to take over the store location because of the deed of re-entry.

CHAIR—You say they 'can offer', but they are not compelled to?

Mr Fisher—I do not know that they can.

Ms Steggall—Well, they can. If their intention is to continue operating the store as a company-owned franchise, it would be in their best interests to at least purchase the fittings.

CHAIR—I was looking at the extremes of both and what they may do, rather than what they could do. They could technically invoke the drop dead clause again and just require the franchisee to give up everything at the expiry, and the corporate entity could come in the following day—or not? No. They would have to pay something. They would have to pay some form of compensation.

Ms Steggall—The deed of re-entry allows them to re-use or take over the property, so basically a franchisee does not even have the opportunity to stay in that location and do a different kind of business—for example, in our situation, a different type of restaurant. They have already lost the location in which they may have invested a significant amount of good will and business appeal over a 20-year period. The fittings are the only thing a franchisee owns.

Mr Fisher—And they are specific to the brand.

Ms Steggall—So it is up to a franchisee to decide whether they would be willing to sell those to a franchisor, but again, being so brand specific, they are of very limited use or value, apart from being for a KFC franchise. So if a franchisee is facing the loss of their business and essentially is being kicked out of their premises, they have no choice but to take whatever is offered for the fittings to minimise the loss. There is no provision for them to sell it as a going concern, which essentially it is. The good will accumulated is not saleable.

In our submission we put in the way the calculation is made for franchisees who intend to sell the franchise during the course of a franchise agreement. The closer you get to the end of the term of the agreement, the less is the value it essentially has in the way it is calculated. That is essentially passive termination of the contract. A franchisor takes over the store and decides to apply a new 10-year franchise agreement to it and then can either sell it on to a new franchisee or operate it as a company-run store.

The good faith provisions basically would prevent that. There would have to be some very valid financial and commercial reasons why preventing a franchisor offering a successful operating store to an independent person.

CHAIR—Given that the principle of good faith already exists and given that unconscionable conduct is already contained in the Trade Practices Act but not in the code, how do you see that the explicit reference to good faith in the code itself would make a difference not just in the principle of the regulation but in the outcome? How do you see the outcome changing? Is that because, along with the good faith being the code, it gives people more avenues to a legal right in a court, which means there is a different understanding from those who would otherwise exploit or abuse the code?

Ms Steggall—The problem is that in the courts, the two main cases, Berbatis and Ketchell, have shown that it is not sufficient.

CHAIR—It is not sufficient?

Ms Steggall—The court has ultimately said it is a superior bargaining position, and bad luck.

CHAIR—That is fine. We have heard a bit already about dispute resolution and how meaningful it is. I am just hearing your evidence and questioning now whether there might be a difference in terms of how dispute resolution takes place, currently with the Office of the Mediation Adviser. Is there a difference in, say, normal course of operation disputes whereby somebody might, for example, argue over a type of cheese on a pizza in a pizza outlet to a much more serious dispute, which might be an end of contract renewal when this is an all-or-nothing dispute? But that is a very different type of dispute that may not have any meaning within what currently exists under dispute resolutions within the Office of the Mediation Adviser, where obviously you are not compelled to attend or meaningfully or even in good faith find an outcome.

Ms Steggall—That is quite correct. There are two very different areas that would come up for dispute, whether we are talking operational issues as to the content of a menu and colours or the other.

CHAIR—Arguably, if the franchisor is looking to go down that path, the franchisor has to look at it as a franchisor. Their job essentially is to take that brand and expand that brand. If, to use your example, it is putting a new style of cheese or whatever the case is on a pizza, you could arguably say that that is expanding the product or expanding the brand. It would be hard to say that invoking a drop dead clause at the end of 20 years would be expanding the product or expanding the brand, or good for the brand. It again comes down to the decision-making process of the franchisor at their discretion.

Ms Steggall—A proposal where mediation over breaches or issues—which are essential or mandatory terms within the operations manual and the franchise agreement and which result in a breach of the franchise, or non-compliance with elements of the operations manual that result in a default under the franchise agreement—would include those areas that need to be compulsory for mediation or for a franchisor to attend mediation on. Also there should be some requirement or some legal power behind that mediation when you are talking about issues that essentially mean the loss of a business.

CHAIR—I will get you to expand on that a little. Are there circumstances where a dispute is no longer meaningful in the current operations of trying to get people to mediate or to find a resolution, which you would expect is beneficial to all parties? In what circumstances would you define that a mediation process in any form is no longer relevant because it is of a nature that might end the agreement or where it needs to be strengthened through either more or different or better regulation, or more legal ramification? Can you give me an indication of where you believe that that line is drawn where a mediation process, no matter how enhanced, no longer applies because you are talking about a special circumstance?

Mr Fisher—I would think that there are two examples: one would be at the end of a term of a franchise agreement, whether that is the end of the 10 or the end of the 20 years and where mediation at the end of the day is when the term of the agreement is about to end, or secondly when the franchisee is called upon to make an investment in the store that would make the store financially non-viable. If the store is at break even, for instance, and the company is asking for you to invest $250,000, and the $250,000 is going to force the store to be unviable, yet the franchisor insists that that happens, I do not know that any mediation is really going to resolve it.

CHAIR—The issue of education has been raised almost invariably by everybody who has made a submission or has come to speak to us. Obviously it is important; there is no question that people need to be well informed, well educated and get good advice and so forth when they are entering into the original contract to make sure they are making the right decisions. How relevant and how important would that pre-contractual education process be in terms of the change of a contract after a 10-year period or at that renewal point in terms of what happens after that?

Mr Fisher—Speaking personally, I am a franchisee, so I am not a paid secretary or whatever the case is. I am a franchisee of the group of franchisees, so I have first-hand experience, I guess. If we go through the chronology of it, we enter into the franchise agreement. We have the franchising code of conduct which gives us full disclosure. We have our local solicitor go through and explain it to us. Truthfully we go into it with open eyes. If there is something that we do not understand, under the franchising code of conduct we have the opportunity to explore

it. Once you go into that and you have signed the franchise agreement, you essentially go into it assuming that the franchise agreement is the franchise agreement.

As you go along the process, you find that the franchise agreement is really reliant upon what we call the operations manual. The operations manual keeps growing. Costs for the franchisor are continually deferred from the franchisor to the franchisee by way of the operations manual. As we then go further along, let us say you are five years into the agreement. You are asked to bring a store up to brand standard. Brand standard also is not something that the franchisee has any input into. Brand standard is what the franchisor deems is brand standard: 'We don't like that sign anymore. We think it should be this one.'

If we use the example of Colonel Sanders, he is Colonel Sanders. He did not get a facelift or anything. It is pretty much the same or in essence the same, but we appreciate as franchisees, I think, that we need to continually push the brand in order to be refreshed and to look smart, I guess, for the customers. But you could at the five year mark be asked to spend $250,000 to $500,000 on the store. If you have gone into the franchise agreement, having spent $1 million to get in, you think, 'Okay, that's fine. I'll pay that off over the seven years', thinking that I will have three years profit at the end. I am saying that seven years is the standard payback period.

We have gone in with $1 million and we have paid it off over seven years and we think that we will have three years at the end as profit. At the five-year mark, you have to spend, let us say, $250,000, so at that point in time, on that payback model you have six months of profit at the end. But then you get to the point where in year nine, you have to refresh the brand standard again. It seems at the moment that you are continually chasing to reinvest and reinvest and reinvest. Do not get me wrong: we as the franchisees have a good relationship with KFC. We are not here under any kind of specific grievance that is happening this week, or whatever the case is. Day to day we have a pretty good relationship with our franchisor. It is just that, especially with an American-based company, this is where we probably need to look at the two different models.

Earlier you spoke about Pizza Haven being in here. That is an Australian-based model on Australian-based conditions. Remembering that with McDonald's and KFC, et cetera, are American-based franchise systems and that essentially the outpost here is enforcing the corporate line from overseas, we get to the point at which we have spent $250,000, let us say, every five years and we cannot recoup; we just simply cannot recoup that initial investment. Then as we move forward, we continually have fees that are coming through the operations manual as well, whether they are for helpdesk, secret shopper programs, software updates, or whatever the case may be, and they are costs that are deferred from the franchisor to the franchisee. We get to the point at which we are another $10,000 down per year for costs that have been deferred to us.

We get to the end of the 10 years and we are fortunate enough to get a re-write, so we have probably just broken even at the end of 10 years. We get into years 11 and 12 and we go through, and probably after year 13 or 14 again we are in the same position where the signs need to be done, the menu needs to be done, the front counter needs to be done and the dining room needs to be done, and we are into it for another $250,000. We then get to the point at year 15 whereby after 15, KFC or McDonald's—think about a Bakers Delight, which might be sold on a two

multiple, or two times annual profit—sell by five times the annual profit, which is the same formula on which your buying in was calculated in the first place.

But after year 15, it really becomes a depreciating asset because what you have to see at the end of the 20 years gets less and less as the 20 years gets closer. The problem that I think we have with the good faith, especially with a company that is an American-based company, is that good faith is determined by whoever seems to be captaining the ship at the time; that is, whoever the US or the UK, or whichever the case is, has sent out at the time to run the show out here. As you know with these big corporations, a marketing director might come along for three years or a managing director might come along for three years. These people are rotating through the system. If I think about the eight years that I have been involved with KFC, we have had three different managing directors, so good faith is determined at the time by whatever that person determines is good faith, not by any set guidelines as to what good faith should entail.

CHAIR—Going back to the educational issue, what you are saying to me by what you have just explained is that no matter how much pre-educational or pre-contractual information you have available to you, no matter what advice you get, or whatever eyes wide open approach you take when you are entering the contract, all of that will be relatively meaningless the next day, if the manual changes and if other requirements are placed upon you. It is too late; you are in, based on the original agreement. But the original agreement, as it were, no longer really applies. The manual and other methods apply.

Mr Fisher—You can see from the thickness of the operations manual how much it has changed in the last five years, and that is just in the last five years.

Ms Steggall—Interestingly enough on the issue of education, one would think that a corporation or a franchisee that has multiple stores has maybe a greater level of education and understanding as to what they are getting into and may be in a better bargaining position to come into a contract that is going to be fairer, if we are looking at an education or an understanding of the terms leading to a franchisee understanding better what they get into. But in actual fact, probably the best level of understanding is actually the single, independent very first store you enter into. Once a decision is made to enter into a specific type of franchise, a franchisee is very locked into that system. There are many restraints of trade. Once you have committed the investment and the capital to that one brand, essentially, no matter what level of education, you are locked into that system. The financial commitment is such that you cannot, as your level of education changes, opt out or change to a different franchise system.

Mr Fisher—When you have your house on the line, you are educated towards a new one and the franchising code of conduct tells you essentially what you are going for. That in essence changes and is continually changing throughout. As Zali said, there is continual shifting of the goalposts. You have signed at, this is where you are at, but the goalposts continually move. You have the family house on the line. Every franchisee has the family house on the line, and you get no closer to paying that off because of the continual reinvestment. I do not know that the education in year one when you are coming in really counts. While as you say the franchising code of conduct probably looks and talks to that, I do not know that the education level coming in is the issue. It is the ongoing changes.

Ms Steggall—The changes have been successful in terms of the franchisees entering into it are better prepared, understand the business model better. The disclosure requirements and understanding the system are important. It is probably the very reason why it is such a successful industry and why people are keen to buy into franchises. Once they are educated and understand the system, in the vast majority of cases it is very successful. It is a successful business model and offers opportunity for growth and opening further stores. The problem is when, in the minority of cases, there is a level of opportunism and taking advantage of that changing operations manual without any requirements or parameters within which those changes need to stay reasonable, maintain business reality or be proportional to the stores to which they are applying.

For example, with Yum, for IndCorp members, the same changes can be imposed on someone with a very thriving business in Sydney or in one of the major cities and the same requirement is made on a franchisee with a store in the Northern Territory or Western Australia—somewhere where the market is quite different—and the same things may not be as profitable or as commercially viable from an investment point of view.

CHAIR—A lot of issue has been made about good will and whether it exists or not, and if it does exist, who contributes to what parts of it. Maybe on a broader consensus, it maybe comes in three forms: the branding, the site and the operator or the good will of the franchisee. Some have referred to getting into a franchise agreement as merely leasing or renting for a period of time an income stream. Can you give us your view in terms of whether you think it is just merely leasing an income stream for a strict period of time and then it is all over, or whether there is a contribution from the business operator to contribute to that good will?

Ms Steggall—I think there are both. There is the aspect of an income stream, and that is where a franchisee recognises that they are going into a brand, that it is an established product, and that they are benefiting from the investment, the recognition and the status of that brand from before they enter into it, but at the same time it is through the payment of the royalties that the franchisor gains a return. If you take the argument that the franchisee's ownership or benefit from involvement is only an ongoing income stream but there is no long-term ownership of good will, at what point when a franchisor is getting ongoing royalties along the way and the franchisee is also investing into the advertising fund which is growing the brand name to the benefit of both franchisor and franchisee, it is very one-sided if there is no ultimate ownership of some of that good will.

CHAIR—Typically, what is the risk investment component of the franchisor who has the brand compared to the franchisee who is buying into the system? What is the risk investment component?

Mr Fisher—If we go through it, I guess the franchisor would attract an initial franchise fee. The franchisee would pay for the building of the store, the staffing of the store, the fit-out of the store, the compliance with all the manuals and training of the store, the equipment within the store, and obviously the foodstuffs and the stock within the store. To that point in time, really there has been no franchisor input other than affording the franchisee the use of the logo or the brand.

CHAIR—There is no capital risk—zero.

Mr Fisher—None at all.

CHAIR—All the financial risk and economic risk is being taken by the franchisee. Is this the most common circumstance?

Mr Fisher—To the point now where in the current operations manual, the franchisor has made the franchisee insure for royalty and advertising if the store burns down during the period when the store is burnt down. If the store burns down and it takes six months for the store to be rebuilt, the franchisee's personal insurance has to cover ongoing payment of royalties and advertising for that period to the franchisor, so they lose nothing. While the franchisee would lose income stream, potentially good will from being closed for six months, the franchisor loses nothing.

CHAIR—The agreement is much more than a passive investment purchase of an income stream where you basically make an investment, sit at home and watch the income come in.

Mr Fisher—Yes.

CHAIR—This is a very much involved, proactive, capital investment risk.

Mr Fisher—Day in, day out, every night, every weekend. You are in it. Your family is in it. It would be playing it down just to say you are just leasing an income. There is a lot more goes into it than that with every franchising model.

CHAIR—One of the other issues that has been raised with the committee around good will has been the concept that if it does exist, it is just too hard to determine which component is which, so let us just not deal with it. How would you apply some sort of formula to determining what the good will is in a business? What approach would you take?

Ms Steggall—There are formulas in place. If you are at five years of a 10 years plus another 10 years is coming down the track, there are formulas in place for selling a franchise agreement. A value is put on the good will and it is possible. The issue is just that when you are coming to the end of a franchise agreement, all of a sudden that good will, even though it is a perfectly well operating business seemingly has no more value. The very next day after that agreement has expired, if a franchisor chooses to apply a new term or a new agreement to that store, and offer it to a new person, it all of a sudden has renewed value. That good will exists again. That is where good will is not something that is non-existent; it very definitely exists.

Mr Fisher—Were you saying how do you calculate good will, or how do you quantify good will?

CHAIR—Either. I am happy to hear from you as to what your view is, so either how you quantify it, how do you calculate it, and how do you view it?

Mr Fisher—I would point to the market at the moment, with franchising making up over 50 per cent of retail at present in Australia and it has been a growing number through everything from service stations to bakery shops. Pretty much everything that is within Westfield is predominantly a franchise. I would think that the markets determine it at the moment. If you pick

a bakery, or whatever the case is, that might be a two multiple profit right through to a five or five and a half multiple profit in the larger scale ones like KFC and McDonald's. But, again, that would indicate the amount of investment, equipment and staffing involved. It is just a larger model.

I chance to say that if you are looking for a way to quantify a formula you could probably say, 'Okay, let's take the last dozen stores nationally. Let's average whatever the multiple was', or whatever the case is. So you pick the last 12 Bakers Delight stores and they sold on average for two point two times the annual profit or whatever the case is, so great—that can be the rule of thumb. If it was a service station, for instance, which might be a four, or a pub which might be a seven, there are market indicators there. Obviously there are only four major funders.

This week there are four banks that will fund franchising. We had better be quick.

CHAIR—I will be very careful to restrict my views on any of those issues.

Mr Fisher—That information would be easy to access. For instance, we use Westpac as a rule of thumb to determine the current multiple that these stores are being sold at. Westpac knows that because they are calculating in order to provide financing for the incoming franchisee. This leads to another point while I digress. The thing about good will at present is that in the current economic climate, and obviously we have all witnessed what happened over the last two weeks, funding has tightened up so much. Going to a bank four weeks ago and saying, 'I need $100,000 for XYZ', was not such a hurdle if you have a good business model and a reasonably functioning store or stores. Going to the bank this week is a whole different proposition.

But nothing has changed in the relationship between the franchisee and the franchisor, or the ability for the franchisor to direct the franchisee to spend money. But from the franchisee's point of view, the access to funding has changed. Firstly, the franchisee cannot get the funding, or needs to put the house back on the line to satisfy the franchisor's request.

CHAIR—It is probably fair to say that the majority of our conversations and our deliberations up to date have been about well established, well understood, well known brands and systems as well as people who have a history in the franchising sector. We have also heard evidence about the situation that there is a whole new sector emerging, which is the franchise systems that franchise for the first time on the day they open their first store. They therefore have no history and no experience and are they are entering into this field as a result of somebody having an idea, deciding to franchise it, and opening the first store with the brand, the name and so forth. How do all these principles then apply down? There is very little good will attached to something that has not begun yet, either in the brand or anything else.

I ask that as a general concept. I am not trying drill down into all the minute detail of this, but everything we are talking about is about well known, well understood, well established brands. People can quickly identify KFC and other brands across Australia, but there are dozens and more others that no-one has every heard of. How do you see the code of conduct, dispute and other matters being addressed? How do you see the parliament dealing in a regulatory manner with systems? If it is already difficult with ones that are well established and well understood, what about with ones that have no history at all?

Ms Steggall—On the issue of good will, those very small or new upstart franchise systems, the argument that you are buying into that stream of income is even less valid if you are talking about a franchise that really is beginning in the sense that someone is buying into a franchise that has very little brand recognition or brand name. It will be all up to the franchisee to develop that recognition. Then that ownership of the good will, or the correct recognition that the good will is developed and that a significant percentage of that development is due to the franchisee, not the franchisor's investment of time, money and commitment, becomes even more important in those new, smaller situations with very unrecognisable brands to have something in place that protects a fairer equation and accounting of who has developed the brand and the good will within those franchise businesses.

CHAIR—But in terms of the code and the application of the code, all I am doing here is exploring what I see is just another branch, if you like, of the application and understanding of the code in systems which are completely new and have no experience or history. I am wondering how a strengthening of the code will work and whether we need strengthening of the code to deal with those particular circumstances.

Ms Steggall—Not being truly versed in those situations, it is really hard. What it is interesting to ascertain is where the franchising model goes wrong or digresses from its initial purpose, which is to provide commercial success to franchisors and commercial success to franchisees when everyone works together to create a strong brand name. Whether we are talking about established brands or new upstart brands, the situation is probably that with new franchise brands, it is very much in everyone's interests for the franchisor to be keen to get franchisees on board and working hard to develop a profitable brand that they can then make attractive to more franchisees to get into. It is once it is a big profitable brand that the balance of power really shifts. That is when ultimately the franchisor does not need the franchisees anymore. They have a strong successful brand and they no longer need the good will and the contribution and enthusiasm of the franchisees because they will be able to find others to replace them.

CHAIR—You are really saying in that that the dependency within the model is much more in the very early days of the establishment period when there is much more co-dependence between franchisees and franchisors, rather than a much more mature brand or, let us say, a very successful where that balance actually grows wider rather than narrower.

Ms Steggall—Yes. As it grows wider, that is where there is the stronger requirement for some legislative changes to protect or realign the balance.

CHAIR—Thank you very much, Ms Steggall and Mr Fisher. That concludes today's hearing.

Subcommittee adjourned at 4.22 pm