



Parliamentary Joint Committee on Corporations and Financial Services

Fairness in Franchising

March 2019

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Executive Summary

Franchising is big business in Australia. In 2016, franchising was estimated to contribute approximately 9 per cent of gross domestic product (GDP). As a business structure, franchising exhibits a substantial disparity in power between franchisors and franchisees. This power imbalance is inherent to the structure, given the franchisor owns the business model and has control over operations and franchisee contracts, as well as their tenancy in many cases.

As a distinct form of business with characteristics that differentiate it from other forms of business, franchising is governed by its own code and legislation. The developers of this regulatory framework promoted it as being designed to address the power disparity that is reinforced in the contract (the franchise agreement) between the franchisor and franchisee, without unduly constraining the market. However, in practice the framework has not achieved that outcome and has in some cases further entrenched the power imbalance.

A franchise agreement is typically a standard form long-term contract between franchisor and franchisee. The franchise agreement is designed by the franchisor. Therefore, it has ordinarily been used to protect the franchisor's interests and place most of the commercial risks, burdens and responsibilities on the franchisee. Even a franchise agreement that may appear fair and reasonable when the franchise is operated to the mutual benefit of the franchisor and franchisee can, if the circumstances change (such as a change of ownership), be abused by the franchisor to the detriment of the franchisee. Indeed, many of the public and confidential submissions received by the committee outlined the significant, and often life-changing, detriment that many franchisees endured as a direct result of being exploited by franchisors.

When this committee inquired into franchising in 2008, it appeared that some franchisors were behaving opportunistically, but that the issues were relatively isolated. By contrast, the evidence to this inquiry indicates that the problems, including exploitation in certain franchise systems, are systemic. Resolving systemic issues requires a much broader and more comprehensive approach. The committee is therefore proposing substantial changes to the Franchising Code of Conduct (Franchising Code), to the sections of the Oil Code of Conduct (Oil Code) that relate to franchising, as well as to the responsibilities and powers of the regulator.

Prior to this inquiry, the principal regulatory response to issues in the franchising sector has been around improving pre-contractual disclosure. During this inquiry, much was made of: firstly, improving the awareness of prospective franchisees and ensuring that they have access to appropriate legal and business advice prior to entering a contract; and secondly, improving the accuracy and meaningfulness of the information provided to prospective franchisees.

The prevailing regulatory response operates on the assumption that if a prospective franchisee is well-informed about the nature of the business and the contractual obligations into which they are entering, the franchisee will be suitably equipped to look after their own interests. Efforts to improve franchisee education and awareness

in tandem with greater transparency are certainly important and necessary. However, they are insufficient because the franchise agreement embeds the power disparity between franchisor and franchisee for the duration of the contract, including the exit arrangements.

The committee received a raft of evidence about how the abuse of contractual power can manifest in a franchise agreement. Further, the committee also received evidence that pointed to shortcomings in the current regulatory responses such as the duty to act in good faith and the unfair contract terms provisions.

Franchising is typically viewed as a relationship between franchisor and franchisee. Even at this relatively straightforward level, there is enormous diversity within the franchising sector in Australia. However, the listing of some franchise operations on the stock exchange and the entry of private equity has added further complexity. The entry of a third party, such as shareholders, may shift the franchisor's focus from its franchisees to its shareholders. For example, if the franchisor cannibalises franchisee territory, increases its fees, reduces its service to franchisees, and introduces costly mandatory training that is unaccredited, the franchisee will find scant relief in the contract and the Franchising Code.

This report recommends an overarching franchising framework that is fair for all participants and which recognises that, in franchising (just like banking and financial services), disclosure alone is an insufficient regulatory response to power imbalances and exploitative behaviour by powerful corporations.

The committee acknowledges that many franchisors have developed franchise systems that operate to the mutual benefit of the franchisor and their franchisees. Indeed, the committee heard from a franchisor whose business model explicitly recognises the mutual importance of the franchisor, franchisees and suppliers. Further, that franchisor has commitment to resolving challenges in collaboration with its franchisees. Therefore, in developing its recommendations, the committee has been mindful to avoid imposing unnecessary burdens on franchisors who treat franchisees fairly. That said, the recommendations are designed to lift standards and conduct across the entire industry because, on the balance of evidence given to the committee in public and in confidence, far too many franchisors are abusing the power imbalance between themselves and their franchisees.

The committee notes that wage theft continues to occur in many franchises: partly due to the business model franchisors operate and partly due to a range of socio-cultural problems. At times, wage theft was occurring as a way for franchisees to extract profits or service payments in order to stay afloat in a financially constrained business model (given wages are one of the greatest costs in the franchisee's control). In some instances wage theft was encouraged by franchisors. Whilst many franchisors cited greed as the primary motivation for wage theft, the committee notes that the issue is far more complex and partly inherent to the business models' structural breakdown of power and the imposition of cost controls. Some of the recommendations contained in this report, if implemented, will go a long way to indirectly rectify this issue by mitigating incentives to engage in wage theft.

Industry views—The Franchise Council of Australia

The Franchise Council of Australia (FCA) is the peak body for Australia's franchise sector. The FCA has been highly influential across all aspects of franchising, including education, research, policy and the development of the regulatory framework. The FCA describes itself as representing 'franchisees, franchisors and suppliers', stating that it 'has a strong track record of working collaboratively with government and regulators to advance the best interests of Australian franchising, and has supported constructive efforts to reform the Franchising Code'.

However, the FCA does not appear to provide a balanced representation of franchisor and franchisee views, and this is likely because of its membership composition. There are almost no franchisee members of the FCA, and membership of the FCA is dominated by franchisors. In effect, the FCA is captive to the interests of franchisors.

A more balanced representation of views would be of benefit to the entire franchise industry. For example, the existence of strong franchisee associations in the United States has enabled the development of Fair Franchise Standards which can be used to assess and accredit franchise systems.

The committee also observes that the FCA opposed almost all the recommendations submitted to this inquiry by the Australian Competition and Consumer Commission (ACCC). The recommendations proposed by the ACCC were designed to address some of the power imbalances in the franchise sector and many of these recommendations are supported in this report.

While the committee received a raft of evidence from disgruntled franchisees as well as some automotive dealer organisations, there was no strong and well-informed franchisee organisation that had an industry-wide view of the franchising sector. The committee is of the view that many of the problems considered in this report, including the unbalanced regulatory framework, are at least partially a result of a lack of effective representation of franchisee views. Therefore, the committee considers it important that the relevant government departments and agencies be keenly aware of the risk that the policy and regulatory debate can be, and has been, easily captured by franchisors and their representatives. The committee also considers it important that franchisees develop a strong national association.

The committee's approach

As noted earlier, the franchising sector is diverse and, as a result, the issues that arise are complex. However, certain themes recurred throughout the inquiry, including the need to develop greater:

- transparency and accountability;
- fairness and protection; and
- education and awareness.

These themes are not necessarily discrete, and many aspects of the inquiry illustrated all these themes to a greater or lesser extent. Nevertheless, the committee considers these themes to be useful to explain its approach to the report and the topics covered in the chapters.

The chapters on disclosure and registration, third line forcing, and supplier rebates all talk to a need for greater transparency and accountability of franchisors.

The chapters on unfair contract terms, the cooling off period, exit arrangements, goodwill, restraints of trade, collective action, dispute resolution, and the industry codes all point to a need for greater fairness and protections for franchisees that require amendments to the Franchising and Oil Codes of Conduct, as well as to primary legislation, to prevent exploitation by franchisors.

The chapters on pre-entry education and access to advice, retail leasing, and financing and lending, illustrate the need to increase the awareness of franchisees in relation to the risks and obligations involved in entering a franchise agreement and to provide franchisees with ready access to independent sources of information and advice.

The remainder of the executive summary sets out the key findings and recommendations of the report.

Franchising taskforce¹

The committee recommends that the Australian Government establish an inter-agency Franchising Taskforce to examine the feasibility and implementation of a number of the committee's recommendations. The Franchising Taskforce should include representatives from the Department of the Treasury, the Department of Jobs and Small Business and, where appropriate, the ACCC.

Industry associations²

As noted above, the FCA does not appear to provide a balanced representation of franchisor and franchisee views. The committee therefore recommends that the relevant government departments and agencies be alert to the risk that franchisors and their representatives can capture the policy and regulatory debate. The committee also urges franchisees to develop a strong national association.

Disclosure and registration³

Disclosure is a vitally important transparency mechanism and comprises both up-front (pre-contractual) disclosure, as well as disclosure during the term of the franchise agreement. Evidence to the inquiry revealed significant concerns about pre-contractual provisions and the accuracy of earnings information, and the abuse of marketing fees and funds by franchisors.

The committee makes significant recommendations around disclosure including:

- a requirement to provide the disclosure document in electronic form;
- requirements around the provision of earnings and financial information when franchises are sold or transferred; and

1 Chapter 1.

2 Chapter 5.

3 Chapter 6.

- greater clarity, consistency and accountability with respect to the use and reporting of marketing funds.

Registration is an important step in achieving market transparency. The committee recommends that the Franchising Taskforce investigate options for a public franchise register with franchisors providing updated disclosure documents and template franchise agreements annually in compliance with the Franchising Code. Civil penalties should apply for non-compliance.

Transparency and accountability on third line forcing and supplier rebates⁴

Consistency of products and services offered to customers across a franchise network is of paramount importance. For this reason, it is common for franchisors to use third line forcing arrangements to require franchisees to use specified suppliers. These arrangements also allow franchisors to use bulk buying power to obtain better deals for their franchisees.

But, an inherent conflict of interest exists when the franchisor uses third line forcing arrangements to mandate that franchisees purchase goods and services from particular suppliers while at the same time receiving a financial incentive in the form of supplier rebates, the amount of which remains hidden. The committee notes that, at times, the goods were priced at a greater cost than what could be sourced in the open market. The committee recommends that the ACCC collect data on the extent to which these conflicts of interest manifest in practice.

It is fundamentally important for prospective franchisees to be able to make an informed appraisal of the true cost of goods in order to assess the profitability of a business, especially when both royalties and rebates are applied simultaneously. The committee recommends mandatory disclosure in percentage terms of all supplier rebates, commissions and other payments in relation to the supply of goods or services to franchisees. The committee also refers a range of related matters to the Franchising Taskforce.

Whistleblower protections⁵

Evidence to the inquiry revealed a substantial amount of intimidatory behaviour and misconduct by franchisors. The Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2018 which passed Parliament on 19 February 2019 implements some of the committee's recommendations from its September 2017 report, *Whistleblower Protections*. The committee recommends that the whistleblower protection regime recommended in its *Whistleblower Protections* report apply to franchisees and their employees, and that breaches of the Franchising and Oil Codes by franchisors be included in the definition of disclosable conduct. The committee recommends the Government respond to its *Whistleblower Protections* report.

4 Chapters 7 and 8.

5 Chapter 3.

Unfair contract terms laws⁶

Given the inherent power imbalance in franchising, many franchisees have suffered as a result of unfair contract terms. The unfair contract terms laws have had limited effect on franchising. The committee considers it unacceptable that franchisors are able to retain unfair contract terms (such as unilateral changes to the business model or setting menu prices below cost) in their franchise agreements without penalty, and therefore have little incentive to remove such terms. The committee therefore recommends that the Franchising Taskforce examine the appropriateness of making unfair contract terms in franchise agreements illegal and for civil penalties to be established.

Cooling off period⁷

A franchisee is currently entitled to a seven day cooling off period after signing the franchise agreement, during which time they may terminate the agreement. However, the timing of the cooling off period and the mechanisms which might trigger it are beset with uncertainty.

In order to ensure that prospective franchisees have access to all necessary documentation before the cooling off period expires, the committee makes several recommendations to clarify the triggering and timing of the cooling off period.

Fair exit rights and goodwill⁸

Appropriate exit arrangements are essential in ensuring that one party is not overly penalised when the business relationship ends. For too long, the Franchising Code has only provided termination rights to franchisors. The committee recommends a significant addition to the Franchising Code to give franchisees the right to exit franchise agreements under certain conditions, which vary according to the situation. These recommendations should bring significant cultural change to franchising and help address the power imbalance. The committee also recommends the Franchising Taskforce consider greater transparency around the allocation (if any) of goodwill in franchise agreements, as well as protections for franchisees when required to undertake significant capital expenditure near the end of the term of a franchising agreement.

Collective action⁹

The committee recommends that the Government implement the ACCC's proposal for a class exemption to make it lawful for all franchisees to collectively bargain with their franchisor regardless of their size or other characteristics. The committee recommends that franchisees be empowered to undertake collective action, such as joint negotiation, mediation and arbitration to resolve problems and disputes. This

6 Chapter 9.

7 Chapter 10.

8 Chapters 11 and 12.

9 Chapter 14.

would provide a significant mechanism to address the power imbalance between franchisees and franchisors and intimidatory behaviour by franchisors.

Dispute resolution and arbitration¹⁰

Evidence to the inquiry included a litany of instances where the franchisee alleged the franchisor failed to engage in good faith in the mediation process, knowing that the only alternative was court action which was prohibitively expensive for the franchisee. Absent good faith, the mediation process fails by design.

If all the issues are unable to be resolved satisfactorily through mediation, a determinative procedure such as arbitration is required. The committee accepts that arbitration is more expensive than mediation because of the time and expertise required. But, it can deliver finality to parties who want to resolve a matter and move on. Arbitration is cheaper and more flexible than pursuing court action and this is important in any attempt to deliver a just outcome in a timely fashion at a reasonable price.

The committee therefore recommends that the dispute resolution scheme under the Franchising Code include binding arbitration with the capacity to award remedies, compensation, interest and costs.

Further, the committee recommends that the Franchising Code be amended to allow a mediator or arbitrator to undertake multi-franchisee resolutions when disputes relating to similar issues arise.

Enhancement and alignment of the Industry codes¹¹

The current Franchising Code has fallen short of its intended aim to strike an appropriate power balance between franchisors and franchisees.

One of the key proposals in this report relates to the penalty regime associated with the Franchising and Oil Codes. For too long, some breaches have either not attracted a penalty, or the penalty amounts have been derisory. The committee is firmly of the view that the lack of consequences for breaching the Franchising and Oil Codes undermines the ACCC's ability to ensure compliance with the codes. Where penalties are manifestly insufficient, franchisors are likely to factor the risk of a penalty into the cost of doing business. Where penalties are unavailable or not applied, there is no incentive for a franchisor to comply with the codes.

Therefore, the committee considers that civil pecuniary penalties and infringement notices should be made available for all breaches of the Franchising and Oil Codes. Further, the penalty amounts should be similar to the penalties currently available under the Australian Consumer Law to ensure meaningful deterrence. Importantly, the penalty amounts must be prescribed in legislation, so that the limit on penalties under industry codes does not apply to franchising. The committee therefore recommends the Franchising Taskforce develop amendments to the *Competition and Consumer Act*

10 Chapter 15.

11 Chapters 16 and 17.

2010 and the Franchising Code to implement the penalty regime recommended by the ACCC.

The committee also notes that the Food and Grocery Code of Conduct has some features that would enhance the Franchising Code, and recommends the inclusion of a ban on unilateral or retrospective variations to terms and conditions in the Franchising Code.

The committee also recommends that the Franchising Taskforce identify reforms that would support the fair handling of capital intensive stock when franchise agreements between car manufacturers and new car dealers are not renewed.

The committee also recommends that the Oil Code be amended to align with the Franchising Code to avoid inconsistencies, and that the Franchising Taskforce consider options to ensure that multiple codes remain aligned over time.

No churning and burning¹²

Churning refers to the repeated sale at a single site of a failed franchise to a new franchisee. Outlets that pass through a corporate store stage in between being operated by franchisees can also be counted as site churning.

Burning refers to continually opening new outlets, some of which are unlikely to be viable, to profit from upfront fees, while leaving existing outlets to struggle and close.

Franchise systems that focus on profit through the sale of new outlets may be tempted to engage in churning and burning complemented by contracts which were shorter in duration than industry standards. While the committee received evidence about churning and burning in other franchise systems, the problem appears to be far greater within Retail Food Group (RFG). The committee is concerned about both the aggregator model of acquiring existing franchising brands used by RFG as part of its growth strategy, as well as the implications of RFG's listing on the stock market.

The committee recommends that the ACCC be given an intervention power to identify and act on the marketing and sales of franchises where a franchisor shows a track record of systemic churning and/or burning. The committee notes that the proposed intervention power should target only the most egregious behaviour by franchisors.

Education and advice¹³

Appropriate education is vital in equipping prospective franchisees with the knowledge and skills to better inform themselves about the risks and responsibilities of becoming a franchisee. Many prospective franchisees do not have ready access to services that can help them understand those risks, and some franchisees have not undertaken sufficient due diligence or sought sufficient and appropriate legal or accounting/business advice.

The committee proposes a range of improvements to the education and advice available for franchisees. In particular, the committee recommends that the ACCC

12 Chapter 4.

13 Chapter 18.

develop a FranchiseSmart website for franchises along the lines of the Australian Securities and Investments Commission (ASIC) MoneySmart service.

The committee also considers that franchisees need to develop far greater awareness around the risks and responsibilities of being a franchisee. This includes pre-entry education and seeking appropriate advice about the franchise agreement, but also extends to financing, and the implications of retail lease arrangements.

Financing and lending¹⁴

Previous parliamentary inquiries and the Royal Commission on Financial Services have exposed misconduct related to small business lending, including in franchising.¹⁵ The committee draws attention to the detrimental consequences of irresponsible lending and borrowing in the franchise sector. The committee also questions franchisor-assisted lending, and whether it risks artificially inflating the value of franchise outlets.

Retail lease arrangements¹⁶

The interaction between shopping centre landlords, franchisors and franchisees is complex and, at times, fraught. Franchisors argue that major shopping centre landlords engage in anti-competitive conduct and impose restrictive lease terms, excessive price increases, and onerous conditions around lease termination.

In some cases, factors external to the franchise relationship cause problems in retail leasing. While the committee recommends that the Franchising Taskforce consider various matters, particularly in relation to the clarity, transparency and timeliness of the disclosure of retail lease agreements to the franchisee, the committee emphasises that franchisees should exercise particular caution around retail lease agreements that involve shopping centres.

Conclusion

Disclosure has been the principal and almost only protection for franchisees. Many franchisors would like to keep it that way. However, the extent and breadth of misconduct and exploitation by franchisors within the franchise sector demonstrates that disclosure and transparency alone, while vitally important, are an insufficient response to power and information asymmetry.

During the inquiry, the poor conduct of a large number of franchisors has been exposed publicly. In spite of that exposure, up until the reporting date the committee continued to receive information from franchisees indicating that intimidatory conduct is continuing.

14 Chapter 19.

15 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, Volume 2: Case Studies, 28 September 2018, pp. 271–293.

16 Chapter 20.

The current regulatory environment has manifestly failed to deter systemic poor conduct and exploitative behaviour and has entrenched the power imbalance. The committee has therefore taken a two-pronged approach to improved regulation.

Firstly, the committee recommends a suite of changes to the Franchising and Oil Codes. This includes a recommendation for civil pecuniary penalties and infringement notices for all breaches of the Franchising and Oil Codes, an increase to the penalty amounts to a level similar to the penalties currently available under the Australian Consumer Law, and prescribed penalty amounts in legislation, so that the limit on penalties under industry codes does not apply to franchising.

Secondly, the committee proposes to give the ACCC more responsibilities, and in certain instances, greater enforcement powers. The committee therefore expects the ACCC to undertake a series of investigations to root out misconduct and exploitative behaviour in the franchise sector.

However, the ACCC is not the only regulator with responsibility for franchising because part of ASIC's remit includes overseeing corporate governance in Australia. Recent parliamentary inquiries and the Financial Services Royal Commission have identified serious failures of corporate governance in the financial services sector. The evidence presented to the committee during this inquiry indicates that the extent of poor corporate governance in some areas of franchising is comparable to that in the financial services sector. There are deeply rooted cultural problems that will not be resolved by a franchisor replacing a few senior executives. ASIC must take a much more proactive role in monitoring franchisor corporate governance and taking enforcement action where necessary.

The actions of certain franchisors have caused enormous reputational damage to the sector. This needs to be rectified for the benefit of the entire franchising industry. The proposed reforms outlined by the committee in this report are substantial, and many elements are interdependent. For example, the new features proposed for the Franchising Code would be ineffective if mandatory arbitration is not included in the dispute resolution arrangements, and if the recommended penalty regime is not implemented in full. The committee has sought to strike an appropriate balance between the legitimate business interests of both franchisors and franchisees. The committee has taken a holistic approach to address the systemic problems presented to it, and therefore recommends that the government avoid cherry picking, and instead implement all the recommendations in this report as soon as possible.

The committee thanks the many franchisees who came forward to provide evidence despite the bullying and intimidation used to silence and influence franchisees in the franchising sector.

Recommendations

Franchising Taskforce

Recommendation 1.1

1.23 The committee recommends that the Australian Government establish an inter-agency Franchising Taskforce to examine the feasibility and implementation of a number of the committee's recommendations. The Franchising Taskforce should include representatives from the Department of the Treasury, the Department of Jobs and Small Business and, where appropriate, the Australian Competition and Consumer Commission.

Whistleblower protections

Recommendation 3.1

3.46 The committee recommends that the whistleblower protection regime recommended in its September 2017 report, *Whistleblower Protections*, apply to franchisees, their employees and that breaches of the Franchising and Oil Codes of Conduct by franchisors be included in the definition of disclosable conduct. The committee also recommends the Australian Government respond to its *Whistleblower Protections* report.

Intervention power and investigations

Recommendation 4.1

4.73 The committee recommends that the Australian Competition and Consumer Commission be given power to intervene and prevent the marketing and sales of franchises where a franchisor shows a track record of churning and/or burning.

Recommendation 4.2

4.76 The committee recommends that the Australian Competition and Consumer Commission, the Australian Securities and Investments Commission and the Australian Tax Office, conduct investigations into the operations and dealings of Retail Food Group, its former and current directors and senior executives and companies and trusts they own, direct, manage or hold a beneficial interest in, with regard to matters including, but not limited to, the Australian Consumer Law, the Franchising Code of Conduct, insider trading, short selling, market disclosure obligations (including related party obligations), compliance with directors' duties, audit quality, valuation of assets (including goodwill), and tax avoidance.

Industry associations

Recommendation 5.1

5.21 The committee recommends that, until a suitable body exists to adequately represent the interests of franchisees, the Franchising Taskforce examine how consultation processes associated with franchising policy, regulation and legislation can achieve an appropriate level of input from franchisees, including whether it is appropriate for a franchisee representative to be a voting member of the franchisor's board.

Recommendation 5.2

5.22 The committee recommends that the Franchising Taskforce examine how the Australian Government could be provided with regular reports and updates on the effectiveness of regulatory settings for franchising, including the extent to which industry participants are seeking to circumvent the regulatory arrangements.

Disclosure and registration

Up-front and pre-contractual disclosure

Recommendation 6.1

6.107 The committee recommends that the Australian Government amend the Franchising Code of Conduct to provide that the disclosure document and franchise agreement must be made available in both electronic and hardcopy form.

Recommendation 6.2

6.108 The committee recommends that the Australian Government amend the Franchising Code of Conduct to provide that franchisors must provide the information statement set out in Annexure 2 to franchisees as a separate document that is also subject to the disclosure and cooling off provisions, and not as an attachment to the Franchising Code of Conduct.

Provision and accuracy of earnings information

Recommendation 6.3

6.116 The committee recommends that the Australian Government amend the Franchising Code of Conduct to provide that:

- the vendor franchisee or franchisor must provide the prior two years' Business Activity Statements, a profit and loss (income) statement and balance sheets (statement of financial position) and an assessment of labour costs for that particular franchise business to the prospective franchisee, or franchisor if the vendor franchisee is closing or selling back to the franchisor, in the disclosure document or attached to the disclosure document; or

- if the franchise is a greenfield franchise, then the franchisor must provide the prospective franchisee the Business Activity Statements, profit and loss statements and balance sheets for the two year period of a comparable franchise to the prospective franchisee in the disclosure document or attached to the disclosure document.

Recommendation 6.4

6.117 The committee recommends that the Australian Government amend the Franchising Code of Conduct to provide that all financial information relating to the franchise business must not be provided to the franchisee separately to the disclosure document (that is, it must be provided in or attached to the disclosure document).

Recommendation 6.5

6.118 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require the franchisor to include the following statement in the franchise disclosure document concerning financial statements it provides:

"To the best of the franchisor's knowledge, the earnings and other financial information provided in this disclosure document are:

- a) accurate, correct and compliant with the Franchising Code of Conduct and relevant Australian Accounting Standards Board standards at the time of signing;
- b) except where discrepancies have been identified in writing at the time of signing."

Franchise agreement brokers

Recommendation 6.6

6.121 The committee recommends that the Franchise Taskforce review the use of third party brokers in selling franchise businesses and the continued appropriateness of the use of 'no agent' and 'entire agreement' terms in franchise agreements, and if so, whether additional disclosure on the meaning and effect of such clauses should be mandated in the Franchising Code of Conduct.

Marketing fees and marketing funds

Recommendation 6.7

6.132 The committee recommends that the Australian Government amend clauses 15 and 31 of the Franchising Code of Conduct to provide that both clauses apply where a franchisee is required to make regular payments to the franchisor to cover advertising and marketing activities. The language used in clauses 15 and 31 needs to be consistent.

Recommendation 6.8

6.133 The committee recommends that the Australian Government amend clause 31 of the Franchising Code of Conduct to provide for civil pecuniary penalties for a breach of the clause.

Recommendation 6.9

6.134 The committee recommends that the Australian Government amend clause 15 of the Franchising Code of Conduct to provide that the actual financial statements for the marketing fund account be provided to franchisees within 30 days of the end of each quarter with sufficient detail as to be prescribed in the Franchising Code of Conduct and relevant standards set by the Australian Accounting Standards Board.

Recommendation 6.10

6.135 The committee recommends that the Australian Government amend clause 12 of the Franchising Code of Conduct to provide that a master franchisor must comply with clauses 15 and 31 where the subfranchisee is directly or indirectly required to contribute to a marketing or cooperative fund controlled or administered by the master franchisor.

Recommendation 6.11

6.136 The committee recommends that the Auditing and Assurance Standards Board prepare and issue an audit guidance and Chart of Accounts for marketing and cooperative fund audits in order to:

- assist accountants and franchisors in the preparation of financial statements for a marketing or cooperative fund; and
- assist auditors to prepare audit reports for marketing or cooperative funds.

Recommendation 6.12

6.137 The committee recommends that the Australian Government clarify, through legislation, the distribution of unused marketing funds in the event of the franchisor winding up.

Recommendation 6.13

6.138 The committee recommends that, subject to the other recommendations in this report in relation to marketing funds and fees in the Franchising Code of Conduct, the Oil Code of Conduct should be amended so that it contains the same provisions as the Franchising Code of Conduct in relation to marketing funds and fees.

Franchise registration

Recommendation 6.14

6.143 The committee recommends that the Franchising Taskforce investigate options for a public franchise register with franchisors providing updated disclosure documents and template franchise agreements annually in compliance with the Franchising Code of Conduct and Oil Code of Conduct. The Franchising Taskforce should examine:

- the appropriateness of the Australian Competition and Consumer Commission (ACCC), or another agency, operating the register;
- the information being made publicly available online with a disclaimer that the ACCC (or another agency) does not endorse the franchise systems listed; and
- the application of civil penalties for non-compliance.

Recommendation 6.15

6.144 The committee recommends that the Australian Government amend section 51ADD of the *Competition and Consumer Act 2010* to provide civil pecuniary penalties for non-compliance with a section 51ADD notice.

Additional Disclosure

Recommendation 6.16

6.146 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require, as part of mandatory disclosure, guidance on employment matters, especially Awards, minimum wages, and overseas workforce issues to be developed by the Fair Work Ombudsman.

Third line forcing

Recommendation 7.1

7.52 The committee recommends that the Franchising Taskforce examine how to amend the Franchising Code of Conduct to provide that franchisors are required to include within the disclosure document to franchisees for the two year period prior to the franchisee entering the franchise:

- where the maximum resale price of each item has been below the cost price of the product purchased by the franchisee including, but not limited to, the cost of the product inclusive of any fees associated with the purchase of the product, royalties, other fees and fixed and variable costs in relation to the purchase and sale of the product have been added; and
- the margin between the purchase price paid by the franchisee and the maximum price or recommended resale price of the top five by volume of goods and services sold by the franchisee; and
- if data is not available for that particular franchise, then data for a comparable franchise needs to be provided.

Recommendation 7.2

7.53 The committee recommends that the Franchising Taskforce consider whether the Australian Competition and Consumer Commission should conduct an inquiry into all terms in franchise agreements relating to the discretion of the franchisor to decide the volume and frequency of supply orders for goods and services to be sold in the franchised business to prevent exploitative behaviour around over-ordering.

Supplier rebates

Recommendation 8.1

8.84 The committee recommends that the Australian Government amend the Franchising Code of Conduct so that all supplier rebates, commissions and other payments in relation to the supply of goods or services to franchisees by the franchisor or suppliers mandated by the franchisor be disclosed as a percentage of the full purchase price on each transaction.

Recommendation 8.2

8.85 The committee recommends that the Franchising Taskforce consider amendments to item 10 of the Franchising Code of Conduct to require the franchisor to detail in percentage terms what proportion of the supplier rebate will be:

- retained by the franchisor; and
- directed to franchisees, including indirectly, through:
 - direct payment to franchisees;
 - free or subsidised training; or
 - advertising and marketing; or
 - subsidised goods and services; or
 - administration expenses.

Recommendation 8.3

8.86 The committee recommends that the Franchising Taskforce conduct an investigation to examine conflicts of interest associated with supplier rebates and third line forcing, including:

- the extent to which tender processes for suppliers conducted by franchisors are influenced by rebates or other benefits provided back to franchisors;
- the nature and extent of rebates or benefits that flow from suppliers to franchisors;
- the extent to which those rebates or benefits coincide with the use of third line forcing;

- the extent to which such rebates or benefits may be conflicted remuneration;
- the extent of the detriment suffered by franchisees as a result of such rebates or benefits;
- whether any of the rebates or benefits (including any associated third line forcing) are in breach of the Franchising Code of Conduct or competition laws;
- whether, and if so, the extent to which rebates or benefits are passed through to and provide a benefit to franchisees; and
- making recommendations for policy or regulatory change to address any problems that are identified.

Recommendation 8.4

8.89 The committee recommends that the Franchising Taskforce consider amendments to items 7 and 10 of the Franchising Code of Conduct to provide that if the master franchisor controls and/or receives rebates from suppliers, this is disclosed in the franchise disclosure document.

Unfair contract terms

Recommendation 9.1

9.57 The committee recommends that the Franchising Taskforce examine the appropriateness of amending section 23 of Schedule 2 of the Australian Consumer Law to provide that:

- unfair contract terms contained in small business contracts and franchise agreements are prohibited; and
- civil pecuniary penalties and infringement notices apply where the provision of a standard form contract (franchise agreement) to a small business contains an unfair contract term.

Recommendation 9.2

9.58 The committee recommends that the Franchising Taskforce consider amendments to the *Competition and Consumer Act 2010* to ensure section 155 notices are available to allow the Australian Competition and Consumer Commission to obtain evidence about whether a standard form contract contains an unfair contract term.

Recommendation 9.3

9.61 The committee recommends that the Australian Government resource the Australian Competition and Consumer Commission to enable it to appropriately investigate all complaints or whistleblower reports about illegal unfair contract terms.

Recommendation 9.4

9.64 The committee recommends that the Franchising Taskforce examine the appropriateness of amending the Franchising Code of Conduct to require compliance with unfair contract terms legislation.

Recommendation 9.5

9.68 The committee recommends that the Franchising Taskforce examine how to amend section 23 of Schedule 2 of the Australian Consumer Law to provide that unfair contract terms provisions apply to all franchise agreements notwithstanding any other term in the franchise agreement or other agreements.

Recommendation 9.6

9.71 The committee recommends that the Franchising Taskforce consider options to address the existence of unfair contract terms in perpetual franchise agreements.

Recommendation 9.7

9.75 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require that where any franchise agreement provides for what would otherwise be unilateral variation to the terms of the agreement, that such amendment can only be made with the agreement of the majority of franchisees within the same franchise system or representatives elected by a majority of franchisees within the same franchise system.

Recommendation 9.8

9.79 The committee recommends that the Franchising Taskforce consider whether the Franchising Code of Conduct should place restrictions (including whether such amendments can only be made with the agreement of the majority of franchisees, or representatives elected by a majority of franchisees, within the same franchise system) on franchise agreements providing for what would otherwise be unilateral variation to subsidiary requirements to franchise agreements, such as franchise manuals or policies.

Cooling off period

Recommendation 10.1

10.32 The committee recommends that the Australian Government amend the cooling off period in the Franchising Code of Conduct to clarify that the cooling off and disclosure periods are measured in calendar days.

Recommendation 10.2

10.33 The committee recommends that the Australian Government amend the cooling off period in the Franchising Code of Conduct to clarify in clause 26 of the Franchising Code of Conduct that a franchisee may exercise their right to exit any and all arrangements associated with a franchise (including leases) at any time up until 14 days after the last of the following have occurred:

- a franchise agreement has been signed;
- a payment to the franchisor has been made;
- the required disclosure documents set out in the recommendations in chapter 6 have been received by the franchisee (within the required disclosure period); and
- a copy of the lease has been received by the franchisee.

Recommendation 10.3

10.34 The committee recommends that the Australian Government amend the cooling off period in the Franchising Code of Conduct to clarify in clause 9 of the Franchising Code of Conduct that the 14 day disclosure period must begin at least 14 days before the signing of a franchise agreement.

Recommendation 10.4

10.35 The committee recommends that the Australian Government amend the cooling off period in the Franchising Code of Conduct to apply to transfers, renewals and extensions (including decisions to renew or not to renew), together with longer notice periods for renewals and extensions (including decisions to renew or not to renew).

Recommendation 10.5

10.36 The committee recommends that the Australian Government amend the cooling off provisions contained in the Oil Code of Conduct to make them consistent with the Franchising Code of Conduct.

Recommendation 10.6

10.37 The committee recommends that the Australian Government amend the Oil Code of Conduct to make the disclosure provisions consistent with the Franchising Code of Conduct, and that it be made explicit that the disclosure provisions also apply to transfers.

Exit arrangements

Recommendation 11.1

11.63 The committee recommends that the Australian Government amend the Franchising Code of Conduct to include provisions for franchisee triggered exit from franchise agreements as set out in scenarios 2, 3 and 4 in this chapter.

Recommendation 11.2

11.65 The committee recommends that the Franchising Taskforce consider how to amend the Franchising Code of Conduct to include provision for a franchisee to have a right to terminate the franchise agreement in special circumstances (similar to clause 29), for example, if a liquidator is appointed to the franchisor (or where the franchisor is a natural person, becomes bankrupt).

Recommendation 11.3

11.67 The committee recommends that the Australian Government amend clause 36 of the Oil Code of Conduct for termination in special circumstances to align with clause 29 of the Franchising Code of Conduct, and to include a note that such clauses do not give rise to a statutory right to termination and that such a right must be in the franchise agreement itself.

Recommendation 11.4

11.69 The committee recommends that for termination in special circumstances under both the Franchising Code of Conduct and Oil Code of Conduct, the franchisor must provide seven days' notice and if the franchisee lodges a notice of dispute with a mediator, arbitrator or court during the seven days, the termination process must be suspended until the dispute is resolved. Action by a franchisor in furtherance of a non-compliant notice (with insufficient notice) should attract a civil penalty of a similar amount to other penalties associated with such further action or termination.

Recommendation 11.5

11.71 The committee recommends that the Australian Government amend the termination in special circumstances provisions in both the Franchising Code of Conduct and Oil Code of Conduct such that:

- termination in relation to fraud can only occur if the franchisee is convicted of fraud in connection with the operation of the franchise; and
- termination in relation to public health and safety can only occur if the franchisee is served with a 'permanent closure direction' for the franchise by a relevant government body, or failure to remedy WHS orders or notices.

Goodwill

Recommendation 12.1

12.56 The committee recommends that the Franchising Taskforce examine whether the Franchising Code of Conduct should be amended to include a requirement for franchise agreements and transfer contracts to set out the end-of-term arrangements for franchisee goodwill, including:

- what financial consideration the franchisee is entitled to (if any) when a franchise agreement expires and the agreement is not renewed, including:
 - if the franchise is closed down; or
 - if the franchise becomes a corporate store; or
 - if the franchise is sold by the franchisor to another party;
- what financial consideration the franchisee is entitled to (if any) when a lease between a franchisor and the landlord upon which the franchise is dependent is not renewed; and
- how the franchisee goodwill is calculated and determined separately from the site and brand goodwill.

Recommendation 12.2

12.57 The committee recommends that the Franchising Taskforce examine how to implement the collection and analysis of data on franchise transfers to determine how common it is for franchisee goodwill to be included in transfer contracts and whether or not the corresponding franchise agreements attribute goodwill to franchisees. The Franchising Taskforce should then re-examine whether the policy and regulatory settings are appropriate, particularly if it is common for transfer contracts to include goodwill, but franchise agreements do not.

Restraint of trade

Recommendation 13.1

13.51 The committee recommends that the Australian Government, through the Australian Competition and Consumer Commission (or another agency as appropriate) commission a review of clause 23 of the Franchising Code of Conduct to determine whether it is fit for purpose and whether any changes are required.

Recommendation 13.2

13.52 The committee recommends that the Australian Government amend the Franchising Code of Conduct to incorporate into the disclosure document an explanation that clauses (or part thereof) of a franchise agreement that are not in compliance with clause 23 of the Franchising Code are of no effect and not enforceable by the franchisor.

Recommendation 13.3

13.53 The committee recommends that the Australian Government amend the Franchising Code of Conduct to:

- clarify what constitutes a 'breach' for the purposes of paragraph 23(1)(b) with particular regard to the concept of a 'related agreement' within the clause; and
- insert "at the time of expiry" at the beginning of paragraph 23(1)(b).

Collective action

Recommendation 14.1

14.39 The committee recommends that the Australian Government implement the Australian Competition and Consumer Commission's proposal for a class exemption to make it lawful for all franchisees to collectively bargain with their franchisor regardless of their size or other characteristics. The committee recommends that the following additions be made to the reform:

- the proposal be extended to also cover collective action regarding franchise business models, dispute resolution, and sharing of information;
- the fees for the notification and authorisation process should be reduced so that they are not an impediment to franchisees and other small businesses; and
- any contract terms that seek to supersede or restrict the effect of the class exemption for collective bargaining be declared illegal under Unfair Contract Terms laws.

Recommendation 14.2

14.40 The committee recommends that the Australian Competition and Consumer Commission conduct an investigation into whether franchisors have taken action to impede franchisees who have attempted to pursue issues collectively, and to take action based on the findings of this investigation, as appropriate.

Dispute resolution

Recommendation 15.1

15.72 The committee recommends that the Franchising Taskforce consider the appropriateness of:

- **merging the Office of the Franchising Mediation Adviser with the Australian Small Business and Family Enterprise Ombudsman, and that franchising be included in the name of any combined body;**
- **funding any combined small business and franchising ombudsman through an industry levy based on numbers of complaints;**
- **all franchisees under the Franchising Code of Conduct falling within the jurisdiction of the combined body if established;**
- **enhancing the powers of any combined body so that it may refer and direct parties to binding arbitration under the Franchising Code of Conduct; and;**
- **the appointment of a combined small business and franchising ombudsman as an independent assessor with the ability to review handling of disputes and the capacity to refer systemic or serious matters to regulators.**

Recommendation 15.2

15.73 The committee recommends that the dispute resolution scheme under the Franchising Code of Conduct remain mandatory and be enhanced to include:

- **the option of binding arbitration with the capacity to award remedies, compensation, interest and costs, if mediation is unsuccessful (does not exclude court action);**
- **require that mediation and then arbitration commence within a specified time period once a mediator or arbitrator has been appointed;**
- **restrictions on taking legal action until alternative dispute resolution is complete (along similar lines to those used by the Australian Financial Complaints Authority);**
- **immunity from liability for the dispute resolution body;**
- **to include a requirement that if a franchisor takes a matter straight to court, the franchisor must demonstrate to the court's satisfaction that the matter cannot be resolved through mediation, and if not the court should order the parties to mediation;**
- **the capacity for a mediator or arbitrator to undertake multi-franchisee resolutions when disputes relating to similar issues arise (as determined by the mediator or arbitrator).**

Comparison of industry codes

Recommendation 16.1

16.34 The committee recommends that the Franchising Taskforce consider amendments to the *Competition and Consumer Act 2010* and the Franchising Code of Conduct to implement the penalty regime recommended by the Australian Competition and Consumer Commission, including:

- civil pecuniary penalties (and, thereby, infringement notices) be made available for all breaches of the Franchising Code of Conduct and Oil Code of Conduct;
- the quantum of penalties available for breach of the Franchising Code of Conduct and Oil Code of Conduct be significantly increased to ensure that penalties are a meaningful deterrent, such as to at least reflect the penalties currently available under the Australian Consumer Law; and
- ensuring that the penalties for a breach of the Franchising Code of Conduct are prescribed in legislation, so that the limit on penalties under industry codes in subsection 51AE(2) does not apply to franchising.

Recommendation 16.2

16.35 The committee recommends that the Australian Government amend the Franchising Code of Conduct to include the following provisions:

- except where already incorporated into a joining fee, a prohibition on passing on to the prospective franchisee the legal costs of preparing, negotiating and executing documents, including a civil penalty for any franchisor found to be deliberately attempting to increase franchise fees to circumvent a regulation to prevent the passing on of legal costs;
- a ban on unilateral variations to terms and conditions;
- a ban on retrospective variations to terms and conditions;
- a ban on franchisors charging wastage and shrinkage payments; and
- a duty on franchisors to provide franchisees with training on the requirements of the Code.

Recommendation 16.3

16.36 The committee recommends that, subject to any recommendations for reform of the Franchising Code made in this report, the Australian Government amend the Oil Code of Conduct to align with the Franchising Code of Conduct.

Automotive industry code

Recommendation 17.1

17.32 The committee recommends that the Department of the Treasury and the Department of Jobs and Small Business give further consideration to identifying reforms that would support the fair handling of capital intensive stock when franchise agreements between car manufacturers and new car dealers are not renewed, including, but not limited to:

- manufacturers being required to provide at least 12 months' notice when not renewing a dealer agreement;
- dealers not being compelled to upgrade the dealership after notice of non-renewal or termination has been given to the dealer; and
- in the event of the non-renewal of a lease, mandating that the franchisor buy back at cost price all vehicle parts up to three years old, with the cost of any independent valuation of stock to be split evenly between the franchisor and franchisee.

Recommendation 17.2

17.37 The committee recommends that the Department of the Treasury and the Department of Jobs and Small Business ensure that multiple codes remain aligned over time, noting that options may include establishing a core franchising code that applies generally, with industry-specific aspects in schedules or sub-codes that apply in addition to the core franchising code for relevant industries.

Pre-entry education and access to advice

Recommendation 18.1

18.41 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require the franchisor to provide a prospective franchisee with the Australian Competition and Consumer Commission franchisee manual at the time the franchisor first provides the disclosure document to the prospective franchisee.

Recommendation 18.2

18.42 The committee recommends that the Australian Competition and Consumer Commission develop a FranchiseSmart type website with a similar design and purpose to the Australian Securities and Investments Commission MoneySmart website to address issues that franchisees may encounter within the franchise sector, including examples of detrimental outcomes experienced by franchisees, information on Australian Fair Work rights, minimum wage laws and Awards, and provisions that apply to migrant workers.

Recommendation 18.3

18.44 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require, as part of mandatory disclosure, a reasonable estimate of the personal workload to be undertaken by the franchisee (or their nominee or manager) in running and operating the franchise business).

Retail lease arrangements

Recommendation 20.1

20.95 The committee recommends that the Franchising Taskforce examine the appropriateness of amending clause 13 of the Franchising Code of Conduct to:

- remove the word 'or' after subparagraph 13(3)(a)(ii) and replace it with the word 'and';
- require that a copy of the head lessor disclosure statement and final lease agreement be provided to the franchisee or prospective franchisee no less than 14 days prior to the franchisee entering into the franchise agreement;
- remove any references to 'a copy of the agreement to lease' within clause 13;
- require that the franchisor must, upon request by a franchisee or prospective franchisee, provide the head lessor disclosure statement that is currently in effect within 7 days of the request;
- remove any inconsistencies in subclause 13(4) with respect to the above;
- provide that, notwithstanding any terms of a franchise agreement or related documents including the lease agreement or other agreements or documents providing the franchisee with the right to occupy a premise, a franchisee may terminate without penalty the franchise agreement and any agreement to the sub-lease of a premises by providing written notice to the franchisor within six months of the franchisee occupying the premises if:
 - the franchisor does not comply with the obligation to provide the head lessor disclosure statement; or
 - a head lessor disclosure statement when given to a franchisee is:
 - materially incomplete; or
 - omits information, including key financial information; or
 - contains false or misleading information;
 - and the franchisee is in a substantially worse position than the franchisee would be if the head lessor disclosure document were not subject to the above.

Recommendation 20.2

20.97 The committee recommends that the Franchising Taskforce examine the appropriateness of amending Annexure 1 of the Franchising Code of Conduct to insert a new item 9.3 in Annexure 1 of the Code to read as follows:

- whether the site to be occupied for the purposes of the franchised business is to be occupied by the franchisee:
 - as owner of the site; or
 - as lessee under a lease or agreement to lease granted by the franchisor, an associate of the franchisor or a third party; or
 - as sublessee under a sublease granted by the franchisor, an associate of the franchisor or a third party; or
 - as licensee under a licence granted by the franchisor, an associate of the franchisor or a third party; or
 - pursuant to any other occupancy right and, if so, the details of the conditions of such occupancy right; and
- whether the term of the relevant lease or licence aligns with the term or period of the franchise agreement.

Recommendation 20.3

20.99 The committee recommends that the Franchising Taskforce examine the appropriateness of amending the Franchising Code of Conduct to provide that, notwithstanding any terms of a franchise agreement, when the franchisor holds the head lease and the franchisee is the licensee, money paid by the franchisee to the franchisor for the purposes of paying rent to a landlord must be held in trust and only used to pay the franchisee's rental expenses, with franchisors being liable. Further, in the event of the franchisor winding up, the money held in trust must be used to pay the rent owed to the landlord.

Capital expenditure

Recommendation 21.1

21.31 The committee recommends that the Franchising Taskforce examine how clause 30 of the Franchising Code of Conduct should be amended:

- to include a clear definition of 'significant capital expenditure'; and
- so that there are appropriate constraints on the ability of franchisors to impose capital expenditure requirements on franchisees to ensure that franchisees:
- are able to make an appropriate return on investment within the remaining franchise agreement, lease or licence terms; or
- only have to pay for a pro-rata portion of the capital expenditure that would allow an appropriate return on investment within the franchise, lease or licence terms, with the franchisor to fund the rest of the capital expenditure; or
- are paid appropriate compensation by the franchisor if the franchisor subsequently terminates the franchise agreement.

Recommendation 21.2

21.32 The committee recommends that the Franchising Taskforce consider updating Item 18 of Annexure 1 of the Franchising Code of Conduct to reflect any changes made to clause 30 of the Franchising Code of Conduct.

Recommendation 21.3

21.33 The committee recommends that the Australian Government amend Schedule 2 of the Franchising Code of Conduct to explain the effect of an amended clause 30 and any interaction with the law of unconscionability and unfair contract terms.

Franchisees as a potential source of capital for franchisors

Recommendation 22.1

22.14 The committee recommends that the Franchising Taskforce examine the extent to which franchise systems and their agreements involve sufficient co-investment and risk sharing in an enterprise such that they should be regulated in a similar nature to financial products under the *Corporations Act 2001*.

Abbreviations

AADA	Australian Automotive Dealers Association
ABA	Australian Banking Association
ACCC	Australian Competition and Consumer Commission
ACL	Australian Consumer Law
AFCA	Australian Financial Complaints Authority
ASBFEO	Australian Small Business and Family Enterprise Ombudsman
ALNA	Australian Lottery and Newsagents Association
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
ATO	Australian Taxation Office
Bakers Delight	Bakers Delight Holdings
CAC	Code Administration Committee
CCA	Competition and Consumer Act 2010
CPI	Consumer Price Index
Cth	Commonwealth
Dymocks	Dymocks Franchise Systems (NSW) Pty Ltd
EBITDA	Earnings before interest, tax, depreciation and amortization
EM	Explanatory memorandum
FCA	Franchise Council of Australia
FCAI	Federal Chamber of Automotive Industries
FFA	Franchisee Federation Australia
Foodco	Foodco Group Pty Ltd
Franchising Code	Franchising Code of Conduct
GDP	Gross Domestic Product
IHG	Independent Hardware Group Pty Ltd
IT	Information Technology
Law Council	Law Council of Australia
LRA	Lottery Retailers Association
McDonald's	McDonald's Australia
MTAA	Motor Trades Association of Australia
NCCP Act	National Consumer Credit Protection Act 2009

NPAT	Net profit after tax
NRA	National Retail Association
NSW	New South Wales
OFMA	Office of the Franchising Mediator
Oil Code	Oil Code of Conduct
PwC	PricewaterhouseCoopers
RFG	Retail Food Group
SBDC	Small Business Development Corporation
The Coffee Club	The Coffee Club Franchising Company Pty Ltd
UCT	Unfair contract terms
VACC	Victorian Automobile Chamber of Commerce
VSBC	Victorian Small Business Commission
QLD	Queensland
Yum!	Yum! Restaurants Pty Ltd

Chapter 1

Introduction

Duties of the committee

1.1 The Parliamentary Joint Committee on Corporations and Financial Services (the committee) is established by Part 14 of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act). Section 243 of the ASIC Act sets out the committee's duties as follows:

- (a) to inquire into, and report to both Houses on:
 - (i) activities of ASIC or the Takeovers Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or
 - (ii) the operation of the corporations legislation (other than the excluded provisions); or
 - (iii) the operation of any other law of the Commonwealth, or any law of a State or Territory, that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); or
 - (iv) the operation of any foreign business law, or of any other law of a foreign country, that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and
- (b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and
- (c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.¹

1 *Australian Securities and Investments Commission Act 2001*, s. 243.

Terms of reference

1.2 On 22 March 2018, the Senate referred an inquiry into the operation and effectiveness of the Franchising Code of Conduct for report by 30 September 2018. The terms of reference are as follows:

- (a) the operation and effectiveness of the Franchising Code of Conduct, including the disclosure document and information statement, and the Oil Code of Conduct, in ensuring full disclosure to potential franchisees of all information necessary to make a fully-informed decision when assessing whether to enter a franchise agreement, including information on:
 - (i) likely financial performance of a franchise and worse-case scenarios,
 - (ii) the contractual rights and obligations of all parties, including termination rights and geographical exclusivity,
 - (iii) the leasing arrangements and any limitations of the franchisee's ability to enforce tenants' rights, and
 - (iv) the expected running costs, including cost of goods required to be purchased through prescribed suppliers;
- (b) the effectiveness of dispute resolution under the Franchising Code of Conduct and the Oil Code of Conduct;
- (c) the impact of the Australian consumer law unfair contract provisions on new, renewed and terminated franchise agreements entered into since 12 November 2016, including whether changes to standard franchise agreements have resulted;
- (d) whether the provisions of other mandatory industry codes of conduct, such as the Oil Code, contain advantages or disadvantages relevant to franchising relationships in comparison with terms of the Franchising Code of Conduct;
- (e) the adequacy and operation of termination provisions in the Franchising Code of Conduct and the Oil Code of Conduct;
- (f) the imposition of restraints of trade on former franchisees following the termination of a franchise agreement;
- (g) the enforcement of breaches of the Franchising Code of Conduct and the Oil Code of Conduct and other applicable laws, such as the *Competition and Consumer Act 2010*, and franchisors; and
- (h) any related matter.²

2 *Journals of the Senate*, No. 91, 22 March 2018, pp. 2886–2887.

Conduct of the inquiry

1.3 The committee advertised the inquiry on its webpage and invited submissions from a range of relevant stakeholders. The committee set a closing date for submissions of 4 May 2018.

1.4 On 22 March 2018 the committee resolved to inform submitters that:

The committee welcomes individual stories that may identify widespread issues and recommendations for reform. The committee's powers allow it to report to Parliament with recommendations for changes to legislation, regulation and government policy. The committee is not able to investigate or resolve individual disputes.

If you do wish to inform the committee about a franchising dispute, please identify in your submission whether your dispute has been or may be considered by:

- any of the following bodies or a mediation adviser appointed or referred by:
 - the Office of the Franchising Mediation Adviser; or
 - the Australian Small Business and Family Enterprise Ombudsman; or
 - a local, state or territory Small Business Commissioner; or
- the Dispute Resolution Adviser if the matter relates to the Oil Code of Conduct;
- the Australian Competition & Consumer Commission; or
- a court; or
- any other dispute resolution body.³

Submissions

1.5 The committee received 406 submissions, of which 190 were confidential. Public submissions and public supplementary submissions are detailed in Appendix 1. The committee also received additional information, including answers to questions taken on notice, as listed in Appendix 1.

Hearings

1.6 The committee held the following public hearings:

- 8 June 2018 in Brisbane;
- 22 June 2018 in Melbourne;
- 29 June 2018 in Sydney;
- 24 August 2018 in Canberra;
- 11 September 2018 in Canberra;
- 14 September 2018 in Canberra;

3 Parliamentary Joint Committee on Corporations and Financial Services, resolution, 22 March 2018.

- 21 September 2018 in Canberra;
- 16 October 2018 in Canberra; and
- 26 November 2018 in Canberra.

1.7 Some confidential *in-camera* hearings were also held.

1.8 A list of witnesses who gave evidence at the public hearings is at Appendix 2.

Extension of the inquiry

1.9 On 19 June 2018, the Senate agreed to extend the inquiry reporting date to 6 December 2018.⁴

1.10 On 4 December 2018, the Senate agreed to extend the inquiry reporting date to 14 February 2019.⁵

1.11 On 13 February 2019, the Senate agreed to extend the inquiry reporting date to 14 March 2019.⁶

Structure of this report

The committee's approach

1.12 The franchising sector is diverse and, as a result, the issues that arise are complex. However, certain themes recurred throughout the inquiry, including the need to develop greater:

- transparency and accountability;
- fairness and protection; and
- education and awareness.

1.13 These themes are not necessarily discrete, and many aspects of the inquiry illustrated all these themes to a greater or lesser extent. Nevertheless, the committee considers these themes to be useful to explain its approach to the report and the topics covered in the chapters.

1.14 The chapters on disclosure and registration, third line forcing, and supplier rebates all talk to a need for greater transparency and accountability of franchisors.

1.15 The chapters on unfair contract terms, the cooling off period, exit arrangements, goodwill, restraints of trade, collective action, dispute resolution, the industry codes, and capital expenditure all illustrate a need for greater fairness and protections for franchisees that require amendments to the Franchising Code of Conduct (Franchising Code), and the sections of the Oil Code of Conduct (Oil Code) that relate to franchising, to prevent exploitation by franchisors.

1.16 The chapters on pre-entry education and access to advice, retail leasing, and financing point to a need to increase the awareness of franchisees in relation to the

4 *Journals of the Senate*, No. 99, 19 June 2018, p. 3183.

5 *Journals of the Senate*, No. 135, 4 December 2018, p. 4397.

6 *Journals of the Senate*, No. 139, 13 February 2019, p. 4635.

risks and obligations involved in entering a franchise agreement and to provide franchisees with ready access to independent sources of information and advice.

1.17 The structure of this report is as follows:

- The Executive Summary summarises the key issues in franchising and the committee's proposals for addressing the issues dealt with in each of the following chapters.
- Chapter 2 provides **contextual background information** on franchising in Australia.
- Chapter 3 summarises the **broad themes and issues** raised by submitters to the inquiry. This chapter also covers the **parliamentary privilege** matters that arose during the inquiry.
- Chapter 4 presents a **case study of Retail Food Group (RFG)**. Based on evidence received during the inquiry, the committee decided to use RFG as a case study because the operations of RFG illuminate many of the issues identified in franchising in Australia.
- Chapter 5 considers the current status of **industry associations** in the franchise sector.
- Chapter 6 discusses **disclosure and registration arrangements** for franchising in Australia.
- Chapter 7 examines the rules around **third line forcing** and its use by franchisors in the provision of supplies to franchisees.
- Chapter 8 considers the potential conflicts of interest involved with, and the adequacy of regulatory controls for, **supplier rebates** in franchising.
- Chapter 9 considers the impact of the **unfair contract terms** laws on the franchise sector.
- Chapter 10 examines evidence to the inquiry regarding the **cooling off period** provisions of the Franchising Code.
- Chapter 11 examines the adequacy of regulatory settings for **exit arrangements** for franchisees and franchisors.
- Chapter 12 discusses the long-standing problems associated with the treatment of **goodwill** under franchising agreements.
- Chapter 13 focusses on the appropriateness of provisions under the Franchising Code in relation to **restraints of trade**.
- Chapter 14 considers regulatory arrangements for **collective action** in franchising.
- Chapter 15 provides a comparison of the **dispute resolution arrangements** for franchising with small business generally, the food and grocery supply sector, and the financial services sector.
- Chapter 16 provides a comparison of **industry codes of conduct** and identifies a range of enhancements for the Franchising and Oil Codes.

- Chapter 17 considers proposals put to the committee for a separate **automotive code of conduct**.
- Chapter 18 focuses on the role of **education and specialist advice** for franchisees.
- Chapter 19 focuses on the **lending practices** of banks and other financial intermediaries providing finance to franchisees.
- Chapter 20 discusses the adequacy of **retail leasing arrangements** for franchisees.
- Chapter 21 considers the nature and scope of **capital expenditure** that a franchisor can require a franchisee to undertake.
- Finally, chapter 22 considers the extent to which franchisees may be used as a **source of capital** by franchisors.

Acknowledgements

1.18 During the course of the inquiry, the committee has benefitted greatly from the participation of many individuals and organisations located throughout Australia. The committee thanks all those who assisted with the inquiry, especially the witnesses who put in extra time and effort to answer written questions on notice and provide further valuable feedback to the committee as it gathered evidence.

1.19 In particular, the committee acknowledges the many franchisees that appeared before the committee to recount their experiences. The committee recognises that many of these individuals were motivated by a desire to see positive changes in Australia's franchising sector that would be beneficial for both franchisors and franchisees.

Notes on references

1.20 References and page numbers for the committee *Hansard* are to the proof *Hansard*. Please note that page numbers may vary between the proof and official transcripts.

Franchising taskforce

1.21 The committee acknowledges that several of the recommendations made throughout this report will require detailed consideration before they are implemented to ensure that they operate effectively.

1.22 To this end, the committee recommends that the government establish an inter-agency Franchising Taskforce to examine the feasibility and implementation of the committee's recommendations. Each recommendation directed towards the Franchising Taskforce is identified as such. Other recommendations are directed to relevant departments and agencies.

Recommendation 1.1

1.23 The committee recommends that the Australian Government establish an inter-agency Franchising Taskforce to examine the feasibility and implementation of a number of the committee's recommendations. The Franchising Taskforce should include representatives from the Department of the Treasury, the Department of Jobs and Small Business and, where appropriate, the Australian Competition and Consumer Commission.

Chapter 2

Background

Introduction

2.1 This chapter provides contextual background information to current franchising arrangements in Australia. It begins by explaining the nature of franchising in Australia, and then sets out the legislation under which franchising operates. Some of the more recent reviews and reforms are then summarised, followed by several recent legislative changes.

2.2 Franchising is a distinct form of business with particular characteristics that differentiate it from other forms of business. Franchising refers to a number of business models characterised by a business relationship where one party, the franchisor, provides another party, the franchisee, with the right to market and distribute the franchisor's goods or services.¹

2.3 The franchise sector is a substantial part of the Australian economy. It is governed by its own code of conduct and various pieces of legislation. These regulations are intended to address the power asymmetry between franchisor and franchisee, which often arises through the franchise agreement contract.

2.4 Franchising is a dynamic sector. Over several decades, franchising has been subject to numerous reviews and regulatory reforms that have aimed to address various issues in franchising. Many of the issues raised in this inquiry are not new and have been considered, but not fully resolved, by earlier parliamentary inquiries and independent reviews. As this report documents, a level of exploitation has occurred in certain franchise systems that warrants a thorough consideration of the adequacy of regulatory settings.

Franchising in Australia

2.5 The Franchise Council of Australia lists the various business models that are dependent on franchise relationships:

- manufacturer—retailer: Where the retailer as franchisee sells the franchisor's product directly to the public (for example, new motor vehicle dealerships);
- manufacturer—wholesaler: Where the franchisee under license manufactures and distributes the franchisor's product (for example, soft drink bottling arrangements);
- wholesaler—retailer: Where the retailer as franchisee purchases products for retail sale from a franchisor wholesaler (frequently a cooperative of the franchisee retailers who have formed a wholesaling company through which they are contractually obliged to purchase (for example, hardware and automotive product stores)); and

1 Franchise Council of Australia, *What is franchising?*, www.franchise.org.au/what-is-franchising-.html (accessed 31 January 2019).

- retailer—retailer: Where the franchisor markets a service, or a product, under a common name and standardised system, through a network of franchisees. This is the classic business format franchise.²

2.6 The manufacturer—retailer and manufacturer—wholesaler categories are generally referred to as product or tradename franchises. In a product or tradename franchise, the franchisee is a distributor of the product. Franchisees in a product or tradename franchise may operate under their own name and may advertise using the trademarks representing the product range. The franchisee may also sell competing or complementary products. Franchisees operate using their own business systems and do not require the franchisor to supply training or support. Franchisees are only required to be familiar with the product range, its capabilities and follow-up services.³

2.7 By contrast, business format franchises, such as the retailer—retailer category, require franchisees to use the franchisor's established business concept. This generally comprises a comprehensive system for conducting the business including:

- trading under the franchisor's brand name;
- selling only the ranges of products associated with the franchisor's business; and
- using the franchisor's management and operation systems and methods.⁴

2.8 Business format franchisees also follow prescribed marketing strategies and would expect to receive more training and ongoing support. Under this format, the responsibilities and obligations of the franchisor and franchisee are stipulated in a highly detailed franchise agreement.⁵

2.9 A study illustrating the importance of the franchising industry was presented by Griffith University's *Franchising Australia 2016* report. The study concluded that there are approximately 79 000 units (individual franchise outlets) in Australia, and annual sales turnover for the sector estimated to be \$146 billion. Many of these franchises are small businesses, and approximately four per cent of small businesses in Australia are franchises. The franchising sector was estimated to make up almost 8.9 per cent of gross domestic product (GDP) for 2016. Ninety per cent of franchise brands in Australia originated domestically, and one third of those brands had

2 Franchise Council of Australia, *What is franchising?*, www.franchise.org.au/what-is-franchising-.html (accessed 31 January 2019).

3 Shelley Nadler, *What Franchise, What's the difference between product/trade name franchising and business format franchising?*, www.what-franchise.com/questions/whats-the-difference-between-product-trade-name-franchising-and-busine (accessed 1 February 2019).

4 Franchise Council of Australia, *What is franchising?*, www.franchise.org.au/what-is-franchising-.html (accessed 31 January 2019).

5 Franchise Council of Australia, *What is franchising?*, www.franchise.org.au/what-is-franchising-.html (accessed 31 January 2019).

expanded into international markets. The sector was estimated to have directly employed 472 000 individuals.⁶

2.10 Franchising has expanded across several industries, including:

- non-food retailing;
- food retailing;
- administration and support services;
- rental and hire services;
- education and training services;
- finance and insurance services;
- construction and trade services;
- healthcare and social services; and
- information media and telecommunication services.⁷

2.11 The Department of Jobs and Small Business noted that franchising is a common business model in Australia, and is delivered in a variety of modes, including one, or a combination, of:

- bricks and mortar outlets;
- online businesses;
- home-based enterprises; and
- mobile businesses.⁸

2.12 As noted above, franchising is a dynamic sector. The entry of venture capital and the listing of franchise companies on the stock exchange has altered franchisors' responsibilities and changed the nature of the relationship between the franchisor and its franchisees in those companies.⁹ These issues are examined in greater detail in chapter 4 of this report, which considers Retail Food Group (RFG), a company that listed on the Australian Stock Exchange and subsequently acquired a range of existing franchise brands.

6 Griffith University, Asia-Pacific Centre for Franchising Excellence, *Franchising Australia 2016*, pp. 4–6.

7 IBISWorld, *Franchising—Australia Market Research Report*, January 2018, www.ibisworld.com.au/industry-trends/market-research-reports/thematic-reports/franchising.html (accessed 31 January 2019).

8 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 2.

9 Dr Jenny Buchan, *Submission 16*, pp. 2–3.

Key legislative requirements

2.13 The regulation of the Australian franchising sector is the policy responsibility of the Department of Jobs and Small Business. Prior to 20 December 2017, the sector was the responsibility of the Department of the Treasury.¹⁰

2.14 The franchising sector is subject to a number of codes of conduct and various pieces of legislation. These are administered and enforced by the Australian Competition and Consumer Commission (ACCC) and other agencies. They include:

- the Franchising Code of Conduct (Franchising Code);
- the Oil Code of Conduct (Oil Code);
- the *Competition and Consumer Act 2010* (CCA);
- the Australian Consumer Law (ACL);
- the *Australian Securities and Investments Commission Act 2001*; and
- the *Corporations Act 2001*.

2.15 Franchise outlets that contain a fuel outlet are regulated by the Oil Code. This is because the Franchising Code does not apply to franchise agreements for which another mandatory industry code that has been prescribed under section 51AE of the CCA applies.¹¹

2.16 Various elements of franchising are also subject to the common law.

Franchising Code of Conduct

2.17 The Franchising Code is the key instrument regulating the conduct of franchising in Australia. As noted in the introduction, the Franchising Code was introduced to regulate the conduct between franchisors and franchisees with the objective of alleviating problems arising from the power imbalance in the franchise relationship and to give franchisees a consistent framework of protection to enable well-informed decision-making.¹²

2.18 The Franchising Code defines a franchisee, franchisor, master franchise and subfranchisor as set out below.

2.19 A franchisee includes the following:

- a person to whom a franchise is granted;
- a person who otherwise participates in a franchise as a franchisee;
- a subfranchisor in its relationship with a franchisor;

10 Administrative Arrangements Order—amendment made 20 December 2017, pp. 3–4.

11 Department of Jobs and Small Business, *Supplementary Submission 20.2*, p. 6; Australian Competition and Consumer Commission, *Submission 45*, p. 23; Australian Competition and Consumer Commission, Industry Codes, www.accc.gov.au/business/industry-codes (accessed 31 October 2018).

12 Trade Practices (Industry Codes—Franchising) Regulations 1998, cl. 2.

- a subfranchisee in its relationship with a subfranchisor.

2.20 A franchisor includes the following:

- a person who grants a franchise;
- a person who otherwise participates in a franchise as a franchisor;
- a subfranchisor in its relationship with a subfranchisee;
- a subfranchisor in a master franchise system;
- a subfranchisor in its relationship with a franchisee.

2.21 A master franchise means a franchise in which the franchisor grants to a subfranchisor the right:

- to grant a subfranchise; or
- to participate in a subfranchise.

2.22 A subfranchisor means a person who is:

- a franchisee in relation to a master franchise; and
- a franchisor in relation to a subfranchise granted under the master franchise.¹³

2.23 The Franchising Code is a mandatory code that has been in operation since 1 October 1998 and is an instrument made under the CCA. Amongst other things, it prescribes:

(1) a franchise agreement as an agreement:

- (a) that takes the form, in whole or part, of any of the following:
 - (i) a written agreement;
 - (ii) an oral agreement;
 - (iii) an implied agreement; and
- (b) in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and
- (c) under which the operation of the business will be substantially or materially associated with a trade mark, advertising or a commercial symbol:
 - (i) owned, used or licensed by the franchisor or an associate of the franchisor; or
 - (ii) specified by the franchisor or an associate of the franchisor; and

13 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, cl. 4.

- (d) under which, before starting or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including, for example:
- (i) an initial capital investment fee; or
 - (ii) a payment for goods or services; or
 - (iii) a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or
 - (iv) a training fee or training school fee.¹⁴

2.24 The most recent version of the Franchising Code came into effect on 1 January 2015. It required all franchise agreements entered into, varied, renewed, extended or transferred on or after 1 October 1998 to comply with the Franchising Code.¹⁵

2.25 The new Franchising Code contained a number of key requirements, including that franchisors provide additional information, disclosure and greater transparency to prospective and established franchisees. Franchisors were provided with a transitional period ending on 31 October 2015 to review and update their disclosure documents. Franchisors were also required to prepare a marketing fund statement if franchisees were required to pay into a marketing fund, and to have a marketing fund statement audited by 31 October each year.¹⁶

2.26 The Franchising Code regulates the conduct of franchisors and franchisees. It specifically deals with:

- an obligation to act in good faith;
- disclosure requirements before entry into a franchise agreement;
- franchise agreements including franchisor obligations, and transfer or termination of an agreement.¹⁷

2.27 The Franchising Code also provides for dispute resolution. Currently there are two methods through which a dispute between parties to a franchise agreement can be resolved: mediation or litigation.¹⁸ A large number of submissions referred to the inadequacy of the limited dispute resolution mechanisms available under the Franchising Code. This evidence and the related issues are covered in detail in chapter 15 of this report.

14 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, cl. 4.

15 See Competition and Consumer (Industry Codes—Franchising) Regulation 2014, cl. 5. There were a small number of exemption provisions, such as subclauses 21(2), clauses 22 and 23, paragraph 20(1)(b), subclause 21(2).

16 Australian Competition and Consumer Commission, *ACCC reminds franchisors of 31 October deadline for updating of documents*, www.accc.gov.au/update/accc-reminds-franchisors-of-31-october-deadline-for-updating-of-documents (accessed 31 January 2019).

17 Competition and Consumer (Industry Codes—Franchising) Regulation 2014.

18 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, cls. 34–37.

Oil Code of Conduct

2.28 An Oil Code was first established in 2006 to address the potential for market power to be abused by fuel suppliers in their dealings with fuel retailers.¹⁹

2.29 In January 2016, the Department of Industry, Innovation and Science undertook a review of the Oil Code to examine the ongoing need for the Oil Code, which was due to sunset on 1 April 2017. The review recommended retaining the Oil Code with minor amendments.²⁰

2.30 The most recent version of the Oil Code came into effect on 1 April 2017.

2.31 The purpose of the Oil Code is to:

- improve transparency in wholesale pricing and access to declared petroleum products at a published terminal gate price;
- set minimum standards in relation to contract requirements and tenure;
- assist participants to make informed decisions when managing fuel re-selling agreements through the disclosure of specific information; and
- provide for access to a cost-effective and timely dispute resolution scheme as an alternative to litigation.²¹

Competition and Consumer Act 2010

2.32 In addition to the Franchising and Oil Codes of Conduct, franchisors and franchisees must comply with obligations and protections under the CCA, including the Australian Consumer Law. The CCA provides additional protections beyond those in the Franchising and Oil Codes of Conduct, including:

- prohibiting false representations and misleading or deceptive conduct (sections 18 and 29);
- prohibiting unconscionable conduct (section 21); and
- providing a means of challenging unfair contract terms in standard form small business contracts (section 23), which can include franchise agreements.²²

2.33 Except where authorised by the ACCC, the CCA also imposes other obligations on the franchisors and franchisees as it:

- prohibits the franchisor from requiring the franchisee to acquire goods and services from particular suppliers if doing so has the purpose, effect or likely effect of substantially lessening competition (section 47);
- prohibits the franchisor from providing the franchisee with an exclusive territory if doing so has the purpose, effect or likely effect of substantially lessening competition (section 45); and

19 Department of Environment and Energy, *Submission 61*, p. 2.

20 Department of Industry, Innovation and Science, *The Oilcode Review—Final Report*, p. 23.

21 Department of Environment and Energy, *Submission 61*, pp. 2–3.

22 Australian Competition and Consumer Commission, *Submission 45*, p. 33.

- prohibits the franchisor and franchisee from agreeing to minimum prices for the sale of the franchisee's goods or services (section 48).²³

Previous inquiries, reviews and reforms

2.34 The franchising sector has undergone a substantial number of reviews at both the Commonwealth and state levels since specific franchising regulation was first conceptualised in 1976. A timeline and summary of some of the earlier inquiries, reviews, guidelines and legislative change between 1976 and 2011 is provided in Appendix 3. More recent reviews and legislative changes are covered later in this chapter.

2.35 The early reviews in 1976, 1979 and 1990 considered matters including goodwill, disclosure, termination conditions, transferring franchises to another person, the cooling off period and conditions for altering a franchise agreement.²⁴

2.36 In 1993, the Voluntary Franchising Code of Practice was introduced.²⁵ It contained provisions on disclosure, the cooling off period, standards of conduct based on unconscionability, and dispute resolution procedures.²⁶

2.37 In 1994, a review of the Voluntary Franchising Code of Practice by Mr Robert Gardini found it lacked coverage, with only 40 to 50 per cent of franchises registered. The Gardini review recommended a system of mandatory self-regulation or co-regulation to provide universal coverage for franchise systems.²⁷

2.38 In 1997, the House of Representatives Standing Committee on Industry, Science and Technology (the Reid Committee) report concluded that self-regulation did not work due to the lack of a viable regulatory strategy to account for the disparity in power between parties. The Reid committee recommended specific legislation providing compulsory registration of franchisors and compliance with the code.²⁸ The first mandatory Franchising Code was introduced in July 1998, as a regulation under the then *Trade Practices Act 1974*.

23 Australian Competition and Consumer Commission, *Submission 45*, p. 33.

24 See, for example, Trade Practices Act Review Committee (the Swanson Committee), *Report to the Minister for Business and Consumer Affairs*, August 1976; Trade Practices Consultative Committee, *Small business and the Trade Practices Act* (the Blunt Review), Volume 1, December 1979; House of Representatives Standing Committee on Industry, Science and Technology (the Beddall Committee), *Small business in Australia: Challenges, problems and opportunities*, January 1990.

25 Department of Jobs and Small Business, *Submission 20*, p. 22.

26 See Franchising Code of Practice, 1 February 1993, in Robert Gardini, *Review of the Franchising Code of Practice: Report to Senator the Hon Chris Schacht, Minister for Small Business, Customs and Construction*, Australian Government Publishing Service, Canberra, pp. 45–66.

27 Robert Gardini, *Review of the Franchising Code of Practice: Report to Senator the Hon Chris Schacht, Minister for Small Business, Customs and Construction*, Australian Government Publishing Service, Canberra, p. v.

28 House of Representatives Standing Committee on Industry, Science and Technology (the Reid Committee), *Finding a balance: Towards fair trading in Australia*, May 1997.

Parliamentary Joint Committee report—December 2008

2.39 In December 2008, the committee released its inquiry report, *Opportunity not opportunism: improving conduct in Australian franchising*.²⁹

2.40 The committee's recommendations and the government response are categorised as follows:

- Compliance and enforcement: the Franchising Code of Conduct and the Trade Practices Act (Recommendations 2, 9, 10 and 11);
- Measures to better balance the rights between franchisees and franchisors (Recommendations 5 and 8);
- Mediation (Recommendation 6);
- Franchising statistics (Recommendation 7);
- Franchise failure (Recommendations 1 and 4); and
- Future review of the franchising sector (Recommendation 3).³⁰

Wein review—April 2013

2.41 The independent review into the Franchising Code of Conduct conducted by Mr Alan Wein, commissioned by the Commonwealth government, resulted in 18 recommendations focusing on changes to:

- disclosure provisions, including an information statement that is to be provided to a prospective franchisee at the first point of contact with a franchisor;
- the transparency of financial information;
- the introduction of an express obligation to act in good faith;
- franchisee rights during the transfer, renewal or end of a franchise agreement;
- dispute resolution, including a prohibition on franchisors attributing the costs of dispute resolution to a franchisee without a court order; and
- penalties of up to \$50 000 for breaches of the Franchising Code.³¹

Current Franchising Code of Conduct

2.42 As a result of the Wein review, the 1998 Code was replaced by the current Franchising Code on 1 January 2015, which was prescribed under section 51AE of the CCA. The current Franchising Code applies to all conduct occurring on or after

29 Parliamentary Joint Committee on Corporations and Financial Services, *Opportunity not opportunism: Improving conduct in Australian franchising*, 1 December 2008.

30 Commonwealth Government Response to the report of the Parliamentary Joint Committee on Corporations and Financial Services—*Opportunity not opportunism: Improving conduct in Australian franchising*, 2009, p. 7.

31 Mr Alan Wein, *Review of the Franchising Code of Conduct*, 30 April 2013, pp. viii–xi.

1 January 2015 in relation to a franchise agreement entered into on or after 1 October 1998.³²

2.43 The 2015 Franchising Code was intended to place a stronger focus on regulating the conduct between participants in franchising. In particular, the government intended that the Code would:

- address the imbalance of power between franchisors and franchisees;
- raise the standards of conduct in the franchising sector without endangering the vitality and growth of franchising;
- reduce the cost of resolving disputes in the sector, and
- reduce risk and generate growth in the sector by increasing the level of certainty for all participants.³³

Recent legislative changes

Unfair contract terms

2.44 Unfair contract terms protections were extended to small business contracts by the *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015*. The new provisions apply to a standard form contract entered into or renewed on or after 12 November 2016. For contracts that are varied after this date, the law only applies to the varied terms, not the contract as a whole.³⁴ Matters relating to unfair contracts terms are covered in detail in chapter 9.

Amendment to the Fair Work Act

2.45 In response to several high-profile examples of employee exploitation within franchise systems, in September 2017, the Commonwealth Government introduced changes to the *Fair Work Act 2009* to improve protections for vulnerable workers. The changes increased the responsibility of franchisors, who are now required to take reasonable steps to prevent contraventions of workplace laws by franchisees in their networks.³⁵ Franchisors may be subject to civil penalties for failing to meet the new requirements, and courts can order franchisors to pay underpaid employees in their network. Franchisors may recover amounts paid from franchisees that are responsible for the underpayment using the judicial mechanisms provided.³⁶

32 Department of Jobs and Small Business, *Supplementary Submission 20.2*, pp. 5–6.

33 Department of Jobs and Small Business, *Supplementary Submission 20.2*, pp. 5–6; Competition and Consumer (Industry Codes—Franchising) Regulation 2014, *Explanatory Statement*, 2014, pp. 68–69.

34 Australian Competition and Consumer Commission, *ACCC advises franchising industry to consider its agreements ahead of new unfair contracts law*, 10 October 2016, www.accc.gov.au/media-release/accc-advises-franchising-industry-to-consider-its-agreements-ahead-of-new-unfair-contracts-law (accessed 31 January 2019).

35 *Fair Work Amendment (Protecting Vulnerable Workers) Act 2017*, s. 558B.

36 *Fair Work Amendment (Protecting Vulnerable Workers) Act 2017*, s. 558C.

Chapter 3

Submissions and privilege matters

Introduction

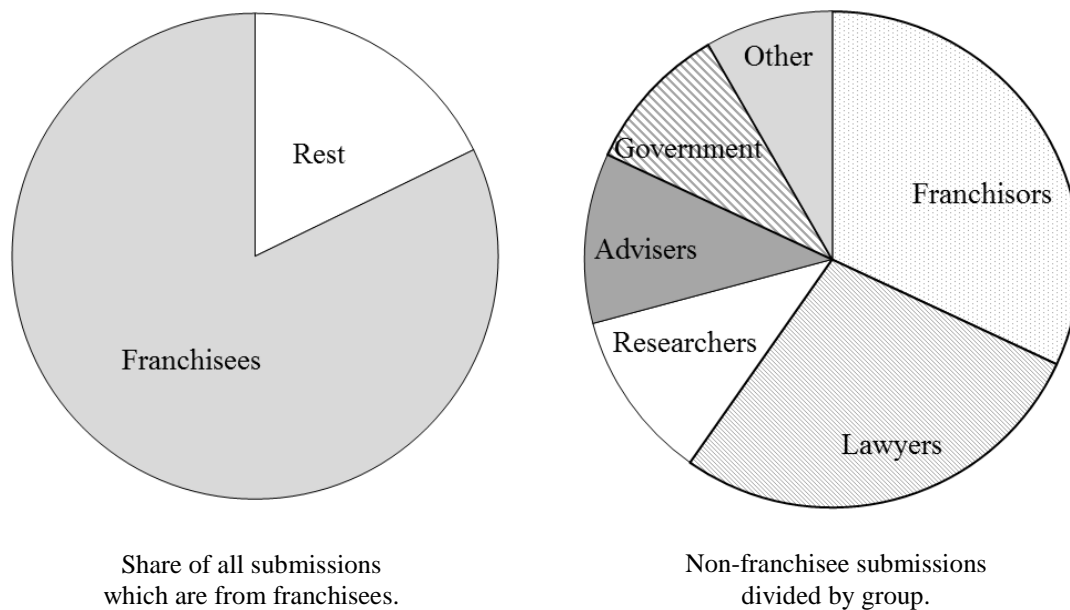
3.1 This chapter summarises the broad themes and issues raised by submitters to the inquiry. The first section provides statistics in relation to submissions received. It also identifies the franchise systems (and issues) most frequently raised in submissions (including the high volume of confidential submissions received). The second section summarises the privilege matters that were raised with the committee, including franchisors' alleged interference with submitters and witnesses. The chapter concludes with the committee's view and recommendations.

Summary of submissions

Who made submissions

3.2 The committee received over 400 submissions. Over 80 per cent of these were provided by franchisees. The remaining submissions were provided by franchisors, lawyers, researchers, advisers and government agencies as shown in Figure 3.1.

Figure 3.1: Share of submissions by group

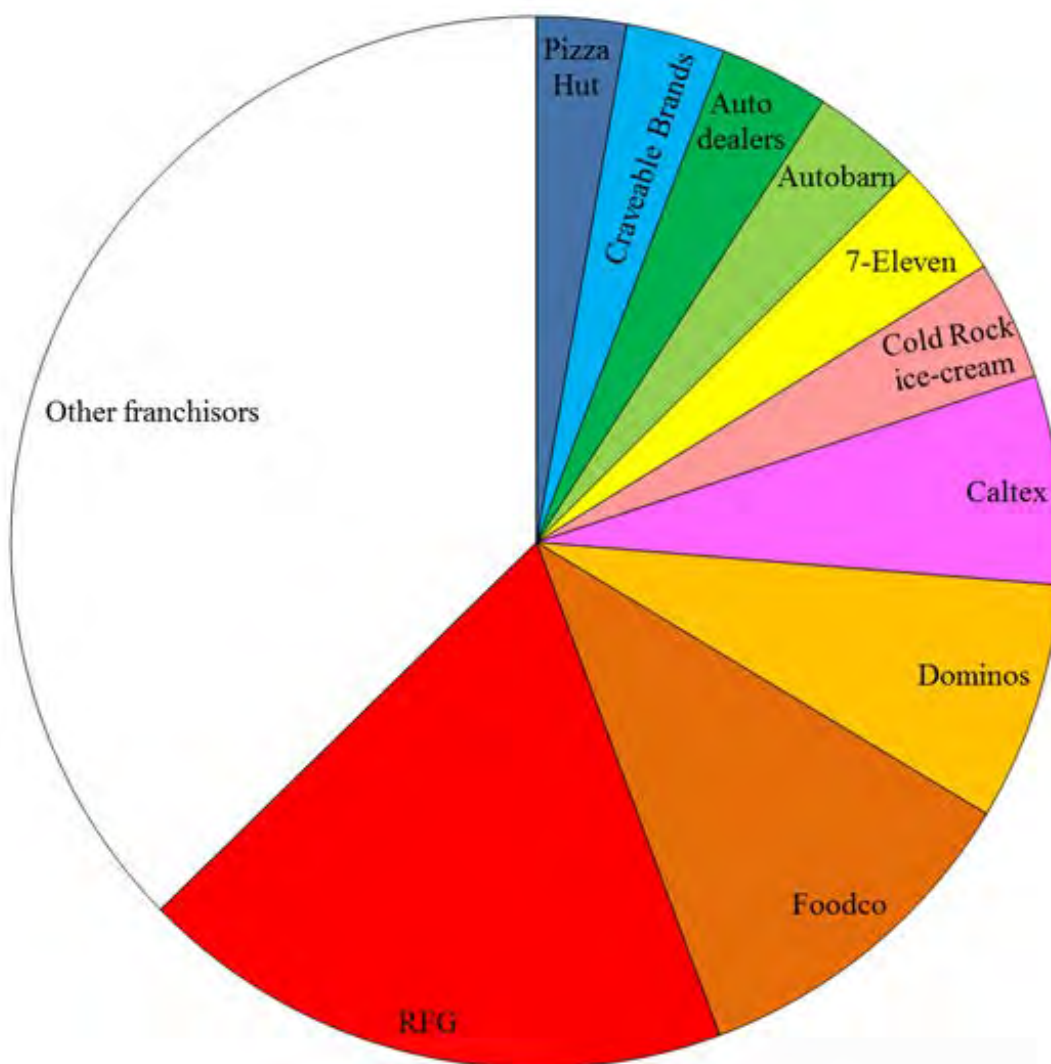


Franchisors identified in submissions

3.3 The committee received a large number of submissions in relation to large franchise corporations and systems. Of those who identified a particular franchise system, over 40 per cent of submissions related to Retail Food Group (RFG), Foodco, Domino's and Caltex (Figure 3.2). An additional five franchise systems were commonly identified by submitters: Cold Rock ice-cream, 7-Eleven, Autobarn, Craveable Brands and Pizza Hut.

3.4 The committee considers it important to note that there are some very large franchise systems in Australia that rival RFG, Foodco, Dominos and Caltex in terms of franchise outlet numbers, for example McDonald's. However, very few submissions were received about those systems.

Figure 3.2: Franchise systems mentioned in franchisees' submissions



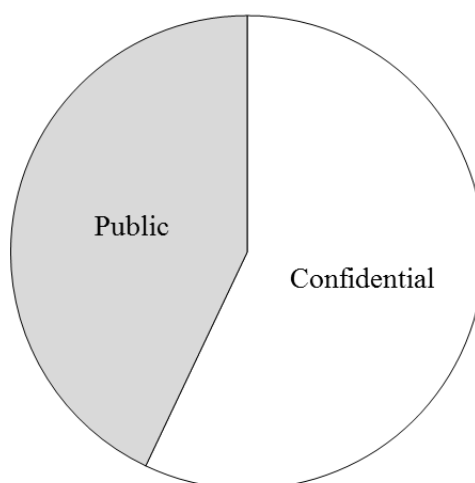
Confidential submissions

3.5 Of the submissions provided by franchisees, over half were confidential, as shown in Figure 3.3. While the committee decided to accept a few submissions as confidential because of the sensitive nature of the evidence, the vast majority were accepted as confidential due to franchisee requests. In many cases, franchisees stated that they feared retaliation from franchisors, in spite of the protections available under parliamentary privilege. Similarly, the committee also accepted over 40 public submissions from franchisees on a name withheld basis: that is, the committee published the submission, but withheld the name. It is noted that a number of people who made public submissions have since contacted the committee with concerns about retaliation from franchisors. These concerns are considered further in a later section.

3.6 The committee's decision to accept specific submissions as confidential enabled these franchisees to raise concerns in a way with which they were comfortable. The committee also held *in-camera* (confidential) hearings for those franchisees who did not want to give public evidence because they feared retribution from their franchisors.

3.7 A majority of the submissions received were provided by submitters with postcodes in NSW, Queensland and Victoria, as shown in Figure 3.3. A smaller percentage of submissions were received from Western Australia and the other states and territories. Postcodes were not available for all submissions.

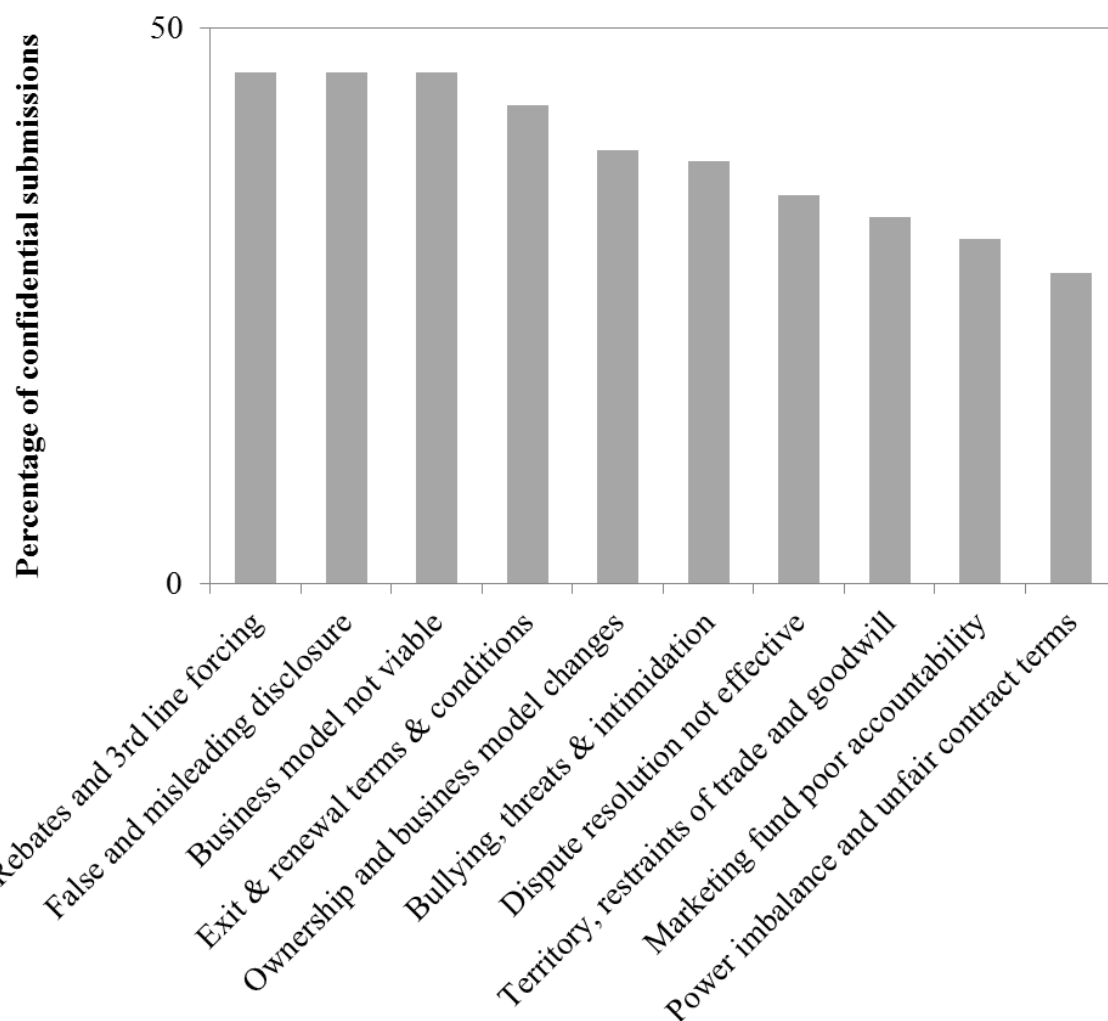
Figure 3.3: Share of franchisee submissions that were public or confidential



Issues identified by confidential submissions

3.8 The committee examined the issues raised in confidential submissions and has summarised the frequency of these issues in Figure 3.4. The committee used this information to identify areas of focus for the inquiry report, which are set out in the remaining chapters. The committee notes that many of these issues were also raised in public submissions. Where appropriate, the committee has referenced these public submissions throughout the report.

Figure 3.4: Top ten issues raised in confidential submissions



Parliamentary privilege

3.9 The term 'parliamentary privilege' refers to the privileges or immunities of the Houses of the Parliament and the powers of the Houses, including the power to call for witnesses and documents, and punish contempts. Parliamentary privilege, the protections that it offers, and the powers that it confers, are essential in enabling the Parliament and its committees to carry out their functions without being subject to outside interference or control. These powers, privileges and immunities were inherited under section 49 of the Constitution and, to some extent, have been codified in the *Parliamentary Privileges Act 1987*. This section explains certain aspects of parliamentary privilege, and the remainder of the chapter sets out some of the privilege matters that arose during the inquiry.

3.10 As a joint statutory committee, the committee operates under the Senate Standing Orders and Privilege Resolutions. These standing orders and resolutions inform the way the committee conducts its duties, including its treatment of witnesses. Therefore, the sections of this report referring to parliamentary privilege refer to the Senate and its committees, rather than the Parliament as a whole. To be clear, however, the relevant law is the same for both Houses of Parliament and parliamentary joint committees.

3.11 One of the principal means by which the Senate informs itself is by referring matters to its committees, which conduct inquiries and report on their findings. Inquiries assist the Senate to obtain information, not just to legislate effectively, but also to ensure that legislative regimes are achieving the stated outcome. Inquiries are conducted principally by seeking information and opinions from persons and organisations who possess relevant information and/or expertise and whose views are likely to be relevant to the terms of reference. The methods by which this information-gathering is conducted is through written submissions addressing the terms of reference and hearings of evidence at which witnesses attend and provide information by answering questions.¹

3.12 So that this information-gathering process is effective, the Senate and its committees have the power to require persons to attend hearings, provide evidence, and produce documents. Failure to comply with an order of a committee or the Senate may be found to be a contempt of the Senate. Ordinarily, the power to compel the attendance of witnesses and order the production of documents is not used in the conduct of inquiries. Inquiries generally proceed on a voluntary basis, with witnesses invited to make submissions, to produce documents, and appear at hearings to provide oral evidence. Witnesses are normally very willing to place their views and the information they possess before the Senate to assist its understanding of the issues and the framing of legislation.²

3.13 The corollary of the power to compel the attendance of witnesses is the protection afforded to witnesses in respect of their cooperation with Senate inquiries. Moreover, to ensure that its powers are not used oppressively, the Senate observes

1 See *Odgers' Australian Senate Practice*, 14th edn, 2016, p. 547.

2 See *Odgers' Australian Senate Practice*, 14th edn, 2016, pp. 547–548.

significant procedural protections of the rights of witnesses.³ The Senate and its Privileges Committee (the investigator) have always taken very seriously, and investigated thoroughly, any suggestion that witnesses have been interfered with in any way in respect of their evidence.⁴ The Senate's Privileges Committee, in undertaking its investigations, is guided by the Privilege Resolutions establishing the criteria to be taken into account when determining matters relating to contempt (Privilege Resolution 3).⁵

3.14 The committee dealt with a substantial number of privilege and related matters during the course of the inquiry, including:

- allegations of interference with witnesses;
- witnesses refusing to appear at a public hearing when ordered to do so, and taking the committee to the High Court in an attempt to have the committee's summons set aside;
- a franchisor declining to provide information requested by the committee; and
- allegations of misleading evidence.

Allegations of interference with witnesses

3.15 The Senate has long regarded interference with witnesses as the most serious of all possible contempts. Interference encompasses intimidation of witnesses, as well as situations where a person imposes a penalty, or threatens or seeks to impose a penalty upon a person for giving evidence to a committee.⁶ The rationale is clear: committees are fundamentally reliant on the accuracy and integrity of the evidence presented to them. Therefore, conduct that deters, discourages or prevents witnesses from giving evidence, or penalises them for doing so, compromises the inquiry process. This, in turn, has the potential to divert the committee's attention away from the inquiry process or interfere with its ability to perform its functions.

3.16 As noted earlier, many franchisees indicated that they were reluctant to make submissions to the inquiry (or appear as witnesses) because they feared that they may be disadvantaged or sued by franchisors. More seriously, however, the committee received allegations of franchisors interfering with submitters and witnesses.

3.17 This section summarises how these matters were dealt with during the inquiry. The committee notes that it engaged with the Franchise Council of Australia (FCA) to ensure that its member franchisors were aware of their obligations. The committee also investigated, to the extent it was able, instances of alleged interference with submitters and witnesses.

3 See *Odgers' Australian Senate Practice*, 14th edn, 2016, p. 549.

4 See *Odgers' Australian Senate Practice*, 14th edn, 2016, p. 550.

5 The Senate, *Standing orders and other orders of the Senate*, August 2018, Privilege Resolution 3 (Resolutions agreed to by the Senate on 25 February 1988).

6 Senate, Privilege Resolution 6.

Engagement with the Franchise Council of Australia

3.18 In the early stages of the inquiry, the committee wrote to the FCA and asked it to provide information to its member franchisors about the appropriate way to respond to submitters and witnesses to parliamentary inquiries. The committee provided information on parliamentary resolutions for the protection of submitters and witness, and sought information from the FCA about:

- the measures the FCA have in place to ensure its members are aware of parliamentary resolutions for the protection of submitters and witness; and
- what action the FCA may take against members that sought to interfere with witnesses and submitters.⁷

3.19 The initial response from the FCA was perfunctory and indicated that the FCA did not recognise the seriousness of the committee's concerns.⁸

3.20 The committee wrote to the FCA a second time, indicating that its first response was inadequate and reasserting the original request.⁹ The committee welcomed the FCA's second response which indicated that the FCA was taking the committee's concerns seriously. The FCA noted that:

- it was not aware of any examples of franchisors influencing submitters and witnesses;
- if a franchisor had inappropriately influenced submitters and witnesses, the FCA would review its membership rights (with the option reserved to suspend or terminate membership); and
- a copy of the committee's first letter had been provided to all its members.¹⁰

Privilege case 1

3.21 Soon after the start of the inquiry, a large multi-brand franchisor wrote to its franchisees about a number of matters, including allegations made against the franchisor. In its letter to franchisees, the franchisor stated:

Many of you have contacted us, concerned by a small percentage of former franchisees who have made unsubstantiated allegations against us. We are aware of this activity and with your assistance, we now have the evidence to support the misleading and false statements being made. I assure you we will be taking the appropriate legal action against any person who has made unsubstantiated defamatory claims against us. We will protect our

7 Parliamentary Joint Committee on Corporations and Financial Services, *Correspondence to the Franchise Council of Australia*, 17 May 2018.

8 Franchise Council of Australia, *Correspondence to the Parliamentary Joint Committee on Corporations and Financial Services*, 23 May 2018.

9 Parliamentary Joint Committee on Corporations and Financial Services, *Correspondence to the Franchise Council of Australia*, 5 June 2018.

10 Franchise Council of Australia, *Correspondence to the Parliamentary Joint Committee on Corporations and Financial Services*, 11 June 2018. The committee notes that some franchisors, for example, Retail Food Group, are not members of the FCA.

reputation at all costs and in doing so, protect our brands and the businesses you have all worked so hard to establish.¹¹

3.22 The committee wrote to the franchisor to provide information about the protections available to submitters and witnesses, and asked the franchisor to:

- confirm that it would not be taking any action against submitters and witnesses to the franchising inquiry;
- indicate what measures it was implementing to ensure that staff within the company are aware of parliamentary privilege in relation to submitters and witnesses to parliamentary inquiries; and
- detail what action it would take to clarify with current and former franchisees that it would not take action against submitters and witnesses to the franchising inquiry.

3.23 The franchisor complied with the committee's request.

Privilege cases 2 and 3

3.24 A number of submitters, from two separate franchise systems, raised concerns about intimidation and retaliatory action by their franchisors as a result of their participation in the inquiry. The committee wrote to the franchisors in the same way as privilege case 1. One of the franchisors largely complied with the committee's request in a timely fashion. The other franchisor also eventually complied (after initial unsatisfactory responses and the committee's continued pursuit of the matter).

Privilege case 4

3.25 Franchisees raised concerns about intimidation and retaliatory action from another franchisor, Waves Detail Pro.¹² This franchisor failed to respond to four written requests from the committee about the matter. The committee notes that the alleged poor treatment of franchisees by this franchisor has been given a degree of media coverage and public exposure. While the committee does not rule out further investigations and taking action in relation to interference with submitters, it notes that the franchisor is now subject to public scrutiny for its actions (in relation to current and former franchisees).

Witnesses refusing to appear at a public hearing when ordered to do so

3.26 Franchising in Australia is multi-faceted. In order to understand the bigger picture, the committee inquired into the operations of Retail Food Group (RFG), a publicly listed company that has acquired and continues to operate multiple franchise systems. A substantial proportion of franchisee submissions were in relation to RFG (see Figure 3.2). These matters are covered in greater detail in chapter 4, which presents a case study of RFG.

3.27 As part of its inquiry, the committee sought to secure the appearance of three former RFG executives—Mr Tony Alford, Ms Alicia Atkinson, and Mr Andre Nell—

11 Correspondence from the franchisor obtained by the committee.

12 The committee has named this franchisor because it failed to respond to the committee.

at a public hearing. The committee first wrote to Mr Alford, Ms Atkinson and Mr Nell in July 2018, inviting them to attend a public hearing in September. In all, the committee wrote to the three former executives on four occasions, setting out the reasons why the committee sought their input into the inquiry. All three repeatedly declined to attend a hearing.

3.28 At the time, the committee noted that serious questions were being raised about the strategies and conduct of RFG during the tenure of Mr Alford, Ms Atkinson and Mr Nell, and that their refusal to attend could impede important aspects of the committee's inquiry.

3.29 On 18 October 2018, the committee therefore decided to issue summonses to Mr Alford, Ms Atkinson and Mr Nell, ordering them to attend a public hearing on 26 November 2018.

3.30 In response, Mr Alford and Ms Atkinson disputed the committee's power to compel their attendance. On 19 November 2018, Mr Alford and Ms Atkinson (the plaintiffs) lodged documents with the High Court of Australia challenging the committee's power to summon them and seeking relief.

3.31 On 21 November 2018, the committee was summoned to appear in the High Court (*Alford & Atkinson v Parliamentary Joint Committee on Corporations and Financial Services*). The Attorney-General acted on the committee's behalf as contradictor. The committee also instructed the Australian Government Solicitor to act for the committee.

3.32 On 22 November 2018, Justice Gordon dismissed the plaintiffs' application to stay the committee's order that Mr Alford and Ms Atkinson appear before the committee at a public hearing on 26 November 2018:

Given the lack of merit in the plaintiffs' substantive application for certiorari and declaratory relief and, further, given that the issues raised by the plaintiffs should generally be resolved by the Parliament, not the courts, the plaintiffs have failed to establish a prima facie case for relief.¹³

3.33 Further, Justice Gordon found no issue with the committee's power to direct witnesses to attend a public hearing:

The Corporations and Financial Services Committee exists. It has a power to direct witnesses to attend before it. It has exercised that power and directed the plaintiffs to appear before it. The plaintiffs have not identified any reason why such an exercise of power by the Committee should be reviewed by this Court or any basis for this Court to find the exercise of that power invalid.¹⁴

3.34 Justice Gordon also noted that the Senate's Privilege Resolutions are extensive and deal with the protection of witnesses, and that there was 'nothing to suggest that

13 *Alford v Parliamentary Joint Committee on Corporations and Financial Services* [2018] HCA 57, p. 2.

14 *Alford v Parliamentary Joint Committee on Corporations and Financial Services* [2018] HCA 57, p. 16.

the Corporations and Financial Services Committee would not comply with its own procedures'.¹⁵

3.35 Subsequently, Mr Alford, Ms Atkinson and Mr Nell appeared before the committee on 26 November 2018.¹⁶

Refusal to provide information requested by the committee

3.36 As noted earlier, the power to require information is essential to a committee effectively fulfilling its inquiry function. The committee made five formal requests of RFG to provide information that would allow the committee to ascertain the veracity of allegations (made by submitters and witnesses) that RFG had 'churned' certain franchise outlets in particular locations. RFG repeatedly declined to provide the requested information.

3.37 Ultimately, the committee did not order RFG to produce the information, and therefore the issue of privilege did not arise. However, the committee draws its own conclusions on RFG's refusal to provide the requested information in chapter 4.

Allegations of misleading evidence

3.38 During the inquiry, the committee received a substantial amount of correspondence alleging that a number of witnesses had provided false and misleading evidence to the committee. The majority of these allegations were made by franchisees against particular franchisors. However, the committee also received evidence from a franchisor, alleging the evidence provided by a number of franchisees was inaccurate and potentially misleading.

3.39 The committee's response to these allegations is covered at the end of the committee view.

Committee view

3.40 The committee acknowledges that there are some excellent franchise systems operating in Australia. However, the committee is deeply concerned about the apparent level of bullying and intimidation used to silence and influence franchisees in the franchising sector, as indicated by:

- the large number of confidential submissions raising such matters, and the fact that more than half the submissions provided by franchisees were accompanied by a request for confidentiality;
- the frequency that such matters were raised in public submissions and hearings; and
- the privilege matters raised with the committee, including the allegations of interference with submitters and witnesses.

15 *Alford v Parliamentary Joint Committee on Corporations and Financial Services* [2018] HCA 57, p. 16.

16 Parliamentary Joint Committee on Corporations and Financial Services, *Committee Hansard*, 26 November 2018.

Allegations of interference with witnesses

3.41 The committee notes that an FCA board member was involved in a serious matter of privilege during the committee's 2008 inquiry into franchising. The matter was described in detail in an appendix to that report. The person involved was an FCA board member at the time of the 2008 incident, and remains an FCA board member.¹⁷ It is unclear whether the FCA reconsidered that person's membership and role as a board member following the incident. The committee hopes that the FCA's second response (see paragraph 3.19) to the committee's correspondence is indicative of a cultural change within the FCA.

3.42 As noted earlier, the protections offered by parliamentary privilege are not well known by those who do not engage with committee processes on a regular basis. For this reason, the committee considers it appropriate, on this occasion, to take an educative approach in relation to privilege matters. Pleasingly, most participants in the inquiry have responded to this approach as the committee had hoped and expected. However, a small number have threatened to take adverse action against witnesses and submitters. This is not acceptable.

Whistleblower protections

3.43 Bullying, threats and intimidation by franchisors was one of the top ten issues raised in confidential submissions (see Figure 3.4). Franchisees identified many instances in which they were threatened and intimidated after attempting to bring issues to the attention of franchisors.

3.44 The committee considers it entirely appropriate for franchisees to be able to bring issues, including breaches of the Franchising Code and other laws, to the attention of their franchisor without fear of retaliation. If such issues are not adequately dealt with through complaint handling or dispute resolution systems, a franchisee should be able to 'blow the whistle' on franchisor misconduct and have protection from retaliation. Further, a franchisee should be able to report an allegation of retaliation to a regulator and the regulator should be required to investigate.

3.45 The committee notes that the inquiry it completed in 2017 in relation to whistleblower protections included recommendations for protections in the corporate sector. The Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2018 which passed Parliament on 19 February 2019 implements some of the committee's recommendations from its September 2017 report, *Whistleblower Protections*.¹⁸ The committee considers that all the protections in the committee's recommendations from its *Whistleblower Protections* report must apply to franchisees and their employees and that breaches of the Franchising and Oil Codes of Conduct by franchisors should be included in the definition of disclosable conduct for whistleblower protection. The committee also considers that the Australian

17 Franchise Council of Australia, *Board of directors*, www.franchise.org.au/board-of-directors.html (accessed 16 January 2019).

18 Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2018.

Government should provide a formal response to the *Whistleblower Protections* report.

Recommendation 3.1

3.46 The committee recommends that the whistleblower protection regime recommended in its September 2017 report, *Whistleblower Protections*, apply to franchisees, their employees and that breaches of the Franchising and Oil Codes of Conduct by franchisors be included in the definition of disclosable conduct. The committee also recommends the Australian Government respond to its *Whistleblower Protections* report.

Committee's power to issue a summons and High Court judgment

3.47 It is rare for a committee to exercise its power to compel a witness to attend a hearing. Witnesses are typically willing to assist committees in the conduct of their inquiries.

3.48 Further, the committee is not aware of a precedent in which the powers of a parliamentary committee to require a person or persons to appear before it has been challenged in the High Court of Australia.

3.49 The committee is grateful for the Attorney-General's actions on this matter and the assistance of the Australian Government Solicitor. The committee also notes the clarity of the High Court judgment in confirming the jurisdiction of the Parliament and the powers of the committee to summons witnesses.

Appearance of Mr Alford and Ms Atkinson

3.50 While further matters arising from the appearance of Mr Alford, Ms Atkinson and Mr Nell are covered in chapter 4, at this juncture the committee draws attention to two privilege-related issues.

3.51 Firstly, proceedings in Parliament, including public hearings, are covered by parliamentary privilege. Witnesses before parliamentary committees are protected by a legal immunity, commonly known as freedom of speech in parliament. This immunity means that participants in committee proceedings—whether members of parliament or witnesses—are immune from legal liability for things said or done in the course of those proceedings. The Chair's opening statement drew attention to the protections of parliamentary privilege. Nevertheless, Mr Alford and Ms Atkinson insisted on uttering the word 'privilege' at the beginning of almost every response they made to the committee, despite further explanation from the committee that this action was unnecessary.

3.52 Secondly, the committee did not find Mr Alford to be a reliable or credible witness. Mr Alford was evasive, inconsistent and generally uncooperative. The committee was struck by Mr Alford's professed, repeated ignorance about a range of matters which one would ordinarily expect a Chief Executive Officer to be acutely aware. The committee considers that this reflects poorly on Mr Alford and his tenure as Chief Executive Officer of RFG.

Refusal to provide information requested by the committee

3.53 As noted above, RFG repeatedly declined to provide the committee with important information about its operations. The lack of cooperation by both current and former RFG officers is striking, and indicative of a poor corporate culture at the company. While the committee did not pursue the refusal to provide information further, the committee draws its own conclusions on the matter in chapter 4.

Allegations of misleading evidence

3.54 The committee considers that the prevalence of allegations regarding misleading evidence indicates problems between the franchisor and franchisees within certain franchise chains. Having weighed both the evidence and the allegations, the committee considers that the evidence alleged to be misleading did not tend to substantially obstruct the work of the committee. However, the committee reminds all submitters and witnesses of the need to ensure, on reasonable grounds, that any evidence given to a committee is true or substantially true in every material particular.¹⁹

19 See the Senate, *Standing orders and other orders of the Senate*, August 2018, Privilege Resolution 6(12)(c).

Chapter 4

Case study—Retail Food Group

Introduction

4.1 This chapter presents a case study of Retail Food Group (RFG). The committee decided to use RFG as a case study because the operations of RFG illuminate many of the problems identified in franchising in Australia. In addition, RFG is different from many franchise operations due to its acquisition of a large number of brands. The case study is set out as a series of perspectives derived from RFG itself, franchisee submissions and witness testimony, the stock market, RFG's lenders, RFG's auditors, and regulators.

4.2 RFG is a large multi-brand retail food franchise owner with franchising operations in Australia and overseas. RFG also has coffee roasting and supply businesses.¹ As at 11 December 2018, RFG owned and operated the following franchise brands: Brumby's Bakery, Michel's Patisserie, Donut King, Crust Gourmet Pizza, Pizza Capers, Gloria Jean's, Cafe2U, The Coffee Guy, BB's Café, Big Dad's Pies and Esquires Coffee.²

4.3 In its May 2006 prospectus, RFG outlined its strategic intent which included the accumulation of multiple brand systems.³ RFG was listed on the Australian Stock Exchange (ASX) in June 2006. The timeline set out in Table 4.1 below summarises RFG's acquisitions and growth, and the subsequent challenges that became apparent in late 2017.

RFG's view of itself

4.4 RFG submitted that it seeks to strike a balance between providing support and guidance to its franchisees and preserving franchisee independence:

RFG is a passionate supporter of business format franchising, and considers it a commercially beneficial and rewarding model by which risk and reward is appropriately shared amongst franchisor and franchisee, providing a mutual support structure not emulated amongst the wider small business sector.⁴

1 Retail Food Group Limited, *Welcome to RFG*, www.rfg.com.au/about/ (accessed 11 December 2018.)

2 Retail Food Group, www.rfg.com.au/ (accessed 11 December 2018); Correspondence to the committee.

3 Retail Food Group Limited, *Managing Director & CEO's Address*, 30 November 2012, p. 1.

4 Retail Food Group Limited, *Submission 32*, p. 2.

Table 4.1: Major events in RFG's history

2000	Mr Tony Alford becomes CEO and Managing Director of RFG ⁵
Jun 2006	RFG listed on the ASX
Jul 2007	Brumby's Bakery acquired
Oct 2007	Michel's Patisserie acquired
Jan 2010	DCM Donuts and Big Dad's Pies acquired
Feb 2011	Esquires Coffee Houses acquired, Pizza Capers acquired
Oct 2012	Crust Gourmet Pizzas acquired
Nov 2012	The Coffee Guy acquired, La Porchetta acquisition terminated
Dec 2014	Gloria Jean's acquired
Jun 2015	Mr Andre Nell succeeds Mr Alford as CEO
Jul 2016	Mr Nell succeeds Mr Alford as Managing director
Dec 2017	Media articles on RFG franchise issues ⁶
Dec 2017	RFG share price collapses ⁷
Jan 2018	Mr Richard Hinson joins RFG as Chief Executive Australia, then promoted to RFG Group CEO in May 2018 ⁸
Nov 2018	Mr Peter George succeeds Mr Colin Archer as Chairman
Dec 2018	Mr Hinson resigns as CEO, Executive Chair Mr George takes over ⁹

Source: except where footnoted, Financial Review, *RFG*, www.afr.com/research-tools/RFG/company-profile/operational-history?year=2018 (accessed 11 December 2018).

5 Mr Tony Alford, Private Capacity, *Committee Hansard*, 26 November 2018, p. 2.

6 Adele Ferguson and Sarah Danckert. Cup of sorrow: the brutal reality of Australia's franchise king, *The Sydney Morning Herald*, 8 December 2018; Adele Ferguson and Sarah Danckert, 'It's like 7-Eleven': claims underpayment is rife at RFG, *The Sydney Morning Herald*, 18 December 2018.

7 ASX Prices and Research, www.asx.com.au/asx/share-price-research/company/RFG (accessed 11 December 2018).

8 Mr Richard Hinson, Director of Franchisor and Chief Executive Officer, Retail Food Group Limited, *Committee Hansard*, 11 September 2018, p. 1.

9 Sue Mitchell, 'Retail Food Group CEO resigns, executive chairman takes control', *Australian Financial Review*, 3 December 2018.

4.5 RFG submitted that it is implementing various measures to improve franchisee profitability and support, including appointing a new senior executive, some fee reductions for establishing franchises, and new field officer roles to support outlet performance and mentor business owners.¹⁰

4.6 The committee received a substantial numbers of submissions regarding RFG (including a number of confidential submissions). These submissions raised a number of concerns and prompted the committee to ask RFG to provide information on all instances in which RFG may have acted towards franchisees in a way that fell short of community standards. RFG responded that:

The concept of behaviour which is legal but 'falls short of community standards' seems quite vague. RFG is aware of this concept being the subject of discussion in terms of the current Royal Commission into the banking sector, but it seems outside the Terms of Reference of the Inquiry and difficult for RFG to answer objectively.¹¹

4.7 In his opening statement to the committee on 11 September 2018, the then CEO, Mr Richard Hinson, blamed external market pressures, shopping centre leases and competition from supermarkets for RFG's poor performance. Mr Hinson claimed that media reports about franchisees being in difficulty solely due to the actions of RFG were inaccurate.¹² However, Mr Hinson was willing to admit that RFG was complex and it lacked some systems and processes for oversight of its network:

When I arrived in January this year [2018], I found the business with a strong foundation which had delivered strong growth over a number of years. It was also a business which had expanded rapidly through acquisitions, which led to complexity...the acquired businesses could have been more effectively integrated and the transition could have been better managed.¹³

4.8 However, Mr Tony Alford, the former long term CEO of RFG, disagreed with Mr Hinson. In his appearance before the committee on 26 November 2018, Mr Alford indicated that in his view, RFG had all the necessary systems in place to deal with the expanding network. When questioned about allegations that franchise systems, such as Brumby's, suffered downturns after they were acquired by RFG, Mr Alford refuted those allegations.¹⁴

10 Retail Food Group Limited, *Submission 32*, p. 2.

11 Retail Food Group Limited, *Correspondence to the committee*, 15 August 2018.

12 Mr Richard Hinson, Director of Franchisor and Chief Executive Officer, Retail Food Group Limited, *Committee Hansard*, 11 September 2018, p. 2.

13 Mr Richard Hinson, Director of Franchisor and Chief Executive Officer, Retail Food Group Limited, *Committee Hansard*, 11 September 2018, pp. 1–2.

14 Mr Tony Alford, Private capacity, *Committee Hansard*, 26 November 2018, pp. 2, 6, 10.

4.9 Mr Alford also disagreed with Mr Hinson's view that RFG had grown rapidly.¹⁵ By contrast, Mr Alford claimed that 'the growth was programmed, it was steady and it was as required and as the opportunities arose'.¹⁶

4.10 And yet, during an eight year period between 2007 and 2014, RFG grew its outlet numbers by over 2000 outlets through the following acquisitions:

- 2007: Over 600 outlets acquired with Brumby's and Michel's;
- 2010: 37 Big Dad's Pies outlets and 23 DCM Donuts outlets acquired;
- 2011: 46 Esquires coffee outlets acquired;
- 2012: 110 Pizza Capers outlets acquired;
- 2012: 119 Pizza Crust outlets acquired;
- 2013: 56 The Coffee Guy outlets acquired;
- 2014: 236 Cafe2u outlets acquired; and
- 2014: 800 Gloria Jean's outlets acquired.¹⁷

4.11 The addition of 2000 outlets during an eight year period represents a significant portion of the total outlet population of around 2500 outlets in 2015–16, indicating that the growth in outlets was rapid.¹⁸

4.12 Mr Alford was questioned about Mr Hinson's evidence that RFG booked a \$427 million impairment in assets and costs in financial year 2017–18 associated with closing as many as 250 franchise outlets. Mr Alford stated that he had left RFG and therefore had no insight into the events that may have caused those outlets to be closed or the assets to be impaired.¹⁹

15 See Mr Richard Hinson, Director of Franchisor and Chief Executive Officer, Retail Food Group Limited, *Committee Hansard*, 11 September 2018, pp. 1–2.

16 Mr Tony Alford, Private capacity, *Committee Hansard*, 26 November 2018, p. 2.

17 Retail Food Group Limited, *Annual report*, 2014, Director's report, p. 1; *FY10 Results Presentation*, 2010, p. 4; *IH11 Results presentation*, February 2011, p. 3; *FY12 Results Presentation*, 2012, pp. 14, 17; *Results Presentations – Financial Year 2013*, p. 9; *FY14 Results Presentations*, 2014, p. 19; *Annual Report*, 2014–15, pp. 9, 12.

18 Retail Food Group Limited, *Annual Report*, 2015–16, p. 10.

19 Mr Tony Alford, Private capacity, *Committee Hansard*, 26 November 2018, p. 3.

Submitters' and witnesses' view of RFG

4.13 This section summarises the views submitters and witnesses put to the committee about RFG.

4.14 Mr Michael Sherlock, a former franchisee and CEO of Brumby's Bakeries before RFG acquired it, suggested that some simple changes are needed to existing regulations to expose the franchisors who choose to exploit the franchisor-franchisee relationship as seen with 7-Eleven, Domino's and RFG. The changes that Mr Sherlock proposed included:

- requiring marketing funds to be spent on marketing (Mr Sherlock, suggested that RFG only spent 18 per cent of the marketing funds that it collected from its franchisees on actual marketing);
- ensuring the transparency of rebates on supplies;
- requiring disclosure documents to include a schedule of all fees; and
- establishing a register of franchise documents and disclosure agreements.²⁰

4.15 Ms Elke Meyer, a former RFG credit controller, made a submission to the committee with serious concerns about the RFG business model, franchisee issues, and staff retention, morale and training:

...the business model could not possibly be sustainable long term. When a Company's staff and Franchisees are consistently disgruntled, stressed, and volatile; and your staff retention rate is incredibly low so you constantly have inexperienced staff dealing with issues the Franchisees have; it appeared doomed to fail in my opinion. The companies' motto was 'Cash is King'...it was creating a false economy as it was not sustainable long term if the Franchisees and staff were constantly unhappy and struggling.²¹

4.16 Ms Meyer also raised concerns about the accuracy of disclosure to new franchisees regarding the profitability of outlets:

I spoke with Franchisees daily who would tell me they believed they were lied to regarding the alleged profit the store they purchased was making prior to purchase. Many of them had not done their due diligence because they believed the company had credibility. Many of the Franchisees had purchased company stores and there were allegations made that the profit/loss paperwork was altered prior to sale.²²

4.17 Ms Meyer commented on the way RFG changed business models, increasing the profitability of the franchisor at the expense of franchisees:

The Franchisees were also expected to pay for an increasing number of services and products allegedly provided to them by RFG. This was a bone of contention due to the common opinion that they were slowly, but surely,

20 Mr Michael Sherlock, *Submission 3*, pp. 2–3.

21 Ms Elke Meyer, *Submission 4*, pp. 1–2.

22 Ms Elke Meyer, *Submission 4*, p. 3.

being bled dry by RFG. Franchisees overwhelmingly were working for no profit at all, and were losing money hand over fist.²³

4.18 Another concern identified by Ms Meyer was RFG opening outlets in close proximity to existing RFG franchises:

There were also numerous instances of RFG breaching their agreements with Franchisees regarding competition stores being permitted to open within the distance the original Franchisees had been advised competition stores could be. This in turn meant their profits were severely affected, and stores ended up closing. This was particularly the case with Pizza Capers and Crust stores.²⁴

4.19 Concerns were raised about clusters of corporate outlets with poor profitability being managed by other entities, with special fee arrangements between RFG and the entities.²⁵

4.20 Other submitters raised a range of issues, including:

- poor disclosure of various matters including outlet viability;²⁶
- franchisees being compelled to buy from suppliers who provided secret commissions (rebates) to RFG;²⁷
- ownership and business model changes that affected product quality and shifted costs from RFG to franchisees;²⁸
- lack of accountability for marketing fees;²⁹

23 Ms Elke Meyer, *Submission 4*, p. 3.

24 Ms Elke Meyer, *Submission 4*, p. 3.

25 Mr Baden Burke, *Submission 148*, pp 1–4; Mr Baden Burke, Private capacity, *Committee Hansard*, pp. 20–37; Mr Steven Mason; Private capacity, *Committee Hansard*, pp. 20–37; Ms Alicia Atkinson, Private capacity, *Committee Hansard*, 26 November 2018, pp. 8–33.

26 Mr John & Mrs Julia Banks, *Submission 100*, p. 1; Mr Bryan Kelly, *Submission 6*, pp. 1–2; Name withheld, *Submission 160*, p. 1; Name withheld, *Submission 161*, p. 1; Name withheld, *Submission 180*, p. 2; Name withheld, *Submission 182*, p. 1.

27 Mr Bryan Kelly, *Submission 6*, p. 4; Mr Robert Verni, *Submission 102*, p. 1; Mrs Xiaoyan Lu, *Submission 151*, p. 1; Name withheld, *Submission 167*, p. 3; Name withheld, *Submission 180*, pp. 3–4; Name withheld, *Submission 188*, p. 2.

28 Ms Danuta Dwornik, *Submission 99*, p. 1; Mr Robert Verni, *Submission 102*, p. 1; Mr Vincent Lee, *Submission 105*, p. 1; Ms Devi Trimuryani, *Submission 116*, p. 1; Mr Wayne Hong, *Submission 125*, p. 1; Mr Rob & Mrs Fiona Bellian, *Submission 128*, p. 1; Mrs Xiaoyan Lu, *Submission 151*, p. 1; Name withheld, *Submission 166*, p. 1; Name withheld, *Submission 185*, p. 1; Name withheld, *Submission 186*, p. 1; Name withheld, *Submission 188*, p. 1; Name withheld, *Submission 190*, p. 1; Name withheld, *Submission 194*, p. 1; Name withheld, *Submission 196*, p. 1.

29 Ms Danuta Dwornik, *Submission 99*, p. 1; Mr Robert Verni, *Submission 102*, p. 1; Mr Santoshkumar Rajput, *Submission 106*, p. 1; Name withheld, *Submission 161*, p. 2; Name withheld, *Submission 180*, pp. 2–3; Name withheld, *Submission 184*, p. 1; Name withheld, *Submission 185*, p. 1; Name withheld, *Submission 188*, p. 1; Name withheld, *Submission 196*, p. 1.

- churning of outlets, including through corporate outlet stages;³⁰
- lack of business development managers;³¹
- overpriced fitout or refurbishment costs;³² and
- franchise businesses that were unviable, unsellable, and that ended up destroying franchisees' financial assets because the franchisees were unable to escape the harsh termination conditions.³³

What RFG's own data show

4.21 A key feature of the allegations made against RFG is that a significant number of outlets were not financially viable. The allegations summarised above make reference to high numbers of outlet closures, churn through transfers, and outlets being taken back by RFG and operated as corporate outlets (that is, operated by the franchisor, RFG).

4.22 This section attempts to quantify the extent of outlet closures and transfers at RFG since 2011–12. Some of the data has been gleaned from RFG's annual reports. However, the annual reports do not necessarily distinguish between domestic and international outlet openings and closures. Based on evidence received from RFG at the hearing on 11 September 2018, the committee understands that the RFG network at the time of the hearing included about 2200 outlets worldwide, of which about 1500 were in Australia.³⁴

4.23 The committee was hampered in its attempts to understand the nature of outlet transfers and closures. RFG refused to provide the committee with appropriate data to enable the committee to assess the allegations of churning made by RFG franchisees. On four occasions between 26 July 2018 and 8 November 2018, the committee asked RFG for list of all sites in the RFG networks for which there have been two or more

30 Ms Elke Meyer, *Submission 4*, p. 3; Mr Robert Verni, *Submission 102*, p. 1; Name withheld, *Submission 161*, p. 1; Name withheld, *Submission 180*, pp. 5–6; Name withheld, *Submission 194*, p. 1.

31 Mr Santoshkumar Rajput, *Submission 106*, p. 1; Name withheld, *Submission 185*, p. 1; Name withheld, *Submission 188*, p. 2; Name withheld, *Submission 196*, p. 1.

32 Mr Robert Verni, *Submission 102*, p. 1; Name withheld, *Submission 166*, p. 2; Name withheld, *Submission 180*, p. 6; Name withheld, *Submission 194*, p. 1.

33 Mr John & Mrs Julia Banks, *Submission 100*, p. 3; Ms Danuta Dwornik, *Submission 99*, p. 1; Mr Robert Verni, *Submission 102*, p. 1; Ms Devi Trimuryani, *Submission 116*, p. 1; Mr Jaresh Bhatt, *Submission 122*, p. 2; Mr Rob & Mrs Fiona Bellian, *Submission 128*, p. 1; Mrs Xiaoyan Lu, *Submission 151*, p. 1; Name withheld, *Submission 160*, p. 1; Name withheld, *Submission 166*, p. 1; Name withheld, *Submission 184*, p. 1; Name withheld, *Submission 185*, p. 2; Name withheld, *Submission 194*, p. 1; Name withheld, *Submission 167*, p. 1; Name withheld, *Submission 180*, p. 1; Name withheld, *Submission 182*, p. 1.

34 Mr Richard Hinson, Director of Franchisor and Chief Executive Officer, Retail Food Group Limited, *Committee Hansard*, 11 September 2018, p. 3.

franchisees during the last 10 years, and how many franchisees there have been per site.³⁵

4.24 On 15 August 2018, RFG advised that because of the costs associated with recruiting, selecting and training new franchisees, there is no financial incentive to encourage franchisee turnover. On 20 August 2018, RFG provided some details on outlet closures and transfers for Financial Years 2014–15, 2015–16 and 2016–17, but withheld information on locations that would allow churn to be identified. On 10 October 2018, RFG advised that it does not hold consolidated records of the requested data.³⁶

4.25 On 30 November 2018, the committee modified its request to five of the 11 brands operated by RFG, namely Brumby's, Gloria Jean's, Donut King, Michel's Patisserie, and Pizza Capers.³⁷ On 5 December 2018, RFG again advised that it did not hold the data in a readily accessible format and that it would take considerable time and resources to collate it. Instead, RFG provided a series of tables which included statistics in relation to franchise transfers and closures.³⁸

4.26 Data collated from RFG's annual reports shown in Figure 4.1 provide a comparison of the rates that outlets were opened and closed at RFG. Prior to 2017–18, the rates of opening and closing outlets were broadly similar. Both rates were around 200 per year between 2014–15 and 2016–17. However, in 2017–18, the rate of new outlet openings fell sharply, with just 8 new outlets in Australia (the remaining 93 were international).³⁹ In contrast, the rate of outlet closures continued to rise, with 305 closures in just one year, 2017–18.⁴⁰

4.27 In addition to the trends shown in Figure 4.1, in a seven year period from 2011–12 to 2017–18, over 1000 new outlets were opened and over 1100 outlets were closed. With a peak outlet population of around 2500 outlets in 2015–16,⁴¹ the closure of 1100 outlets raises questions about the viability of the business model.

35 Parliamentary Joint Committee on Corporations and Financial Services, *Correspondence to Retail Food Group Limited*.

36 Retail Food Group Limited, *Correspondence to the committee*, dates as listed in the text of the report.

37 Parliamentary Joint Committee on Corporations and Financial Services, *Correspondence to Retail Food Group*, 30 November 2018.

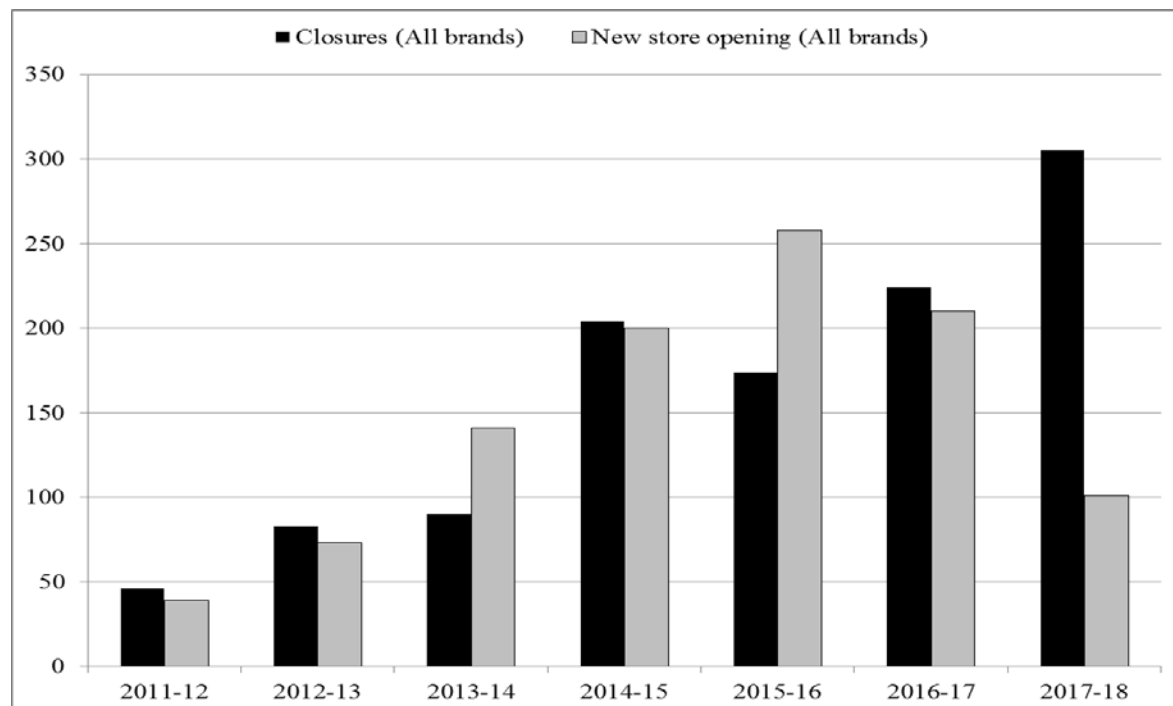
38 Retail Food Group Limited, *Correspondence to the committee*, dates as listed in the text of the report.

39 Retail Food Group Limited, *Annual Report*, 2017–18, p. 10.

40 Retail Food Group Limited, *Annual Report*, 2017–18, p. 10.

41 Retail Food Group Limited, *Annual Report*, 2015–16, p.10.

Figure 4.1: Rates of opening new outlets and closing outlets at Retail Food Group (Worldwide)



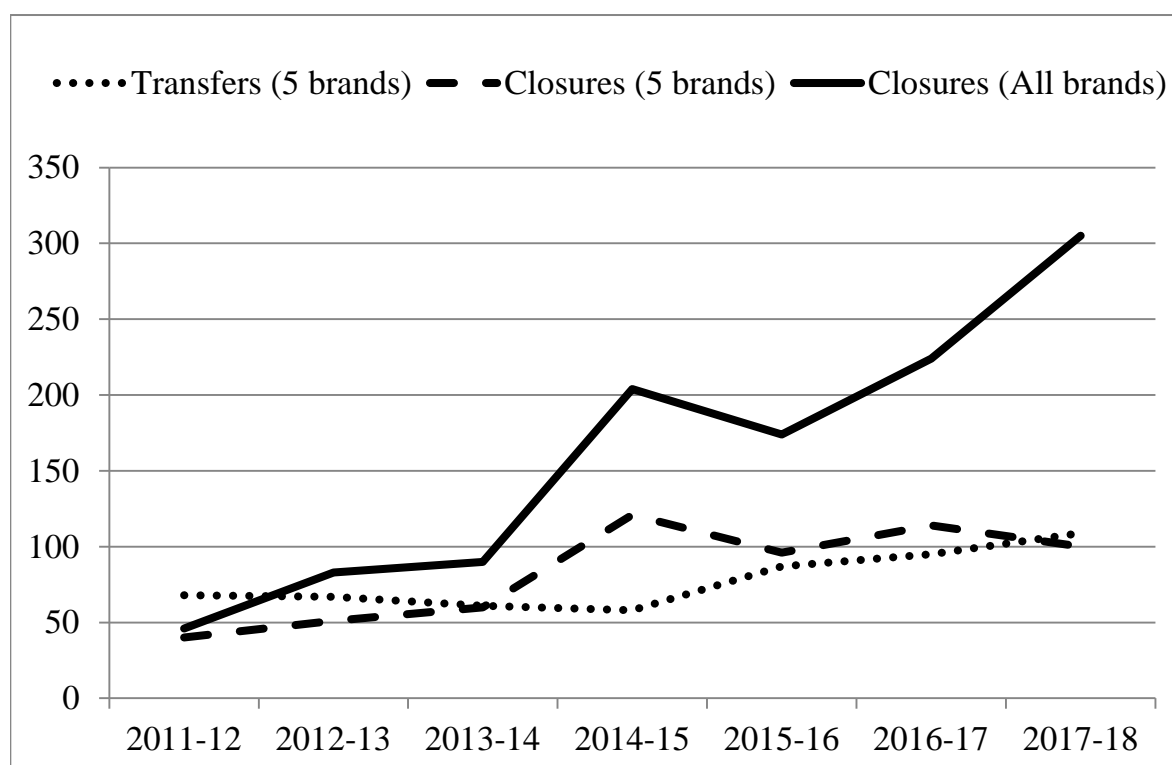
Note: These figures do not include increases in outlet through acquisitions of brand systems, the number of new outlets opened are through organic growth.

Source: Retail Food Group Limited *Annual Reports*, 2011–12, pp. 19–20; 2012–13, pp. 19–20; 2013–14, p. 20; 2014–15, p. 7; 2015–16, p. 7; 2016–17, p. 7; 2017–18, p. 10.

4.28 Another indicator of outlet failure and potential churning is a high rate of transfers. RFG annual reports do not disclose the annual rates of outlet transfer. As noted above, the committee obtained some information from RFG on the transfer and closure rates for five of its brands.

4.29 In Figure 4.2 below, the committee has taken the statistics provided by RFG and aggregated the closure rates and transfer rates for five brands: Brumby's, Gloria Jean's, Donut King, Michel's Patisserie, and Pizza Capers. The hashed line shows the annual closure totals across the five brands. The dotted line shows the annual transfer totals across the five brands. The solid line shows the closures of all brands between 2011–12 and 2017–18 drawn from figures in RFG's annual reports.

4.30 Figure 4.2 indicates that the total number of closures and transfers across the five brands over a seven year period was roughly equivalent at almost 600 outlet closures and approximately 500 outlet transfers. While the committee is wary of drawing any firm conclusions, it notes that if the closure and transfer rates for all brands were similar to the five brands, the overall number of transfers for RFG outlets across all brands over the seven year period may also be over 1000.

Figure 4.2: Retail Food Group: Transfers and closures of RFG outlets

Source: Correspondence from RFG, 5 December 2018; RFG Annual Reports, 2011–12, pp. 19, 21; 2012–13, p. 19; 2013–14, p. 20; 2014–15, p. 7; 2015–16, p. 7; 2016–17, p. 7; 2017–18, p. 10.

4.31 Given the total number of outlets in the RFG franchise network in 2015–16 was approximately 2500 outlets,⁴² the number of transfers is a substantial proportion of the total number of outlets.

The market's view of RFG

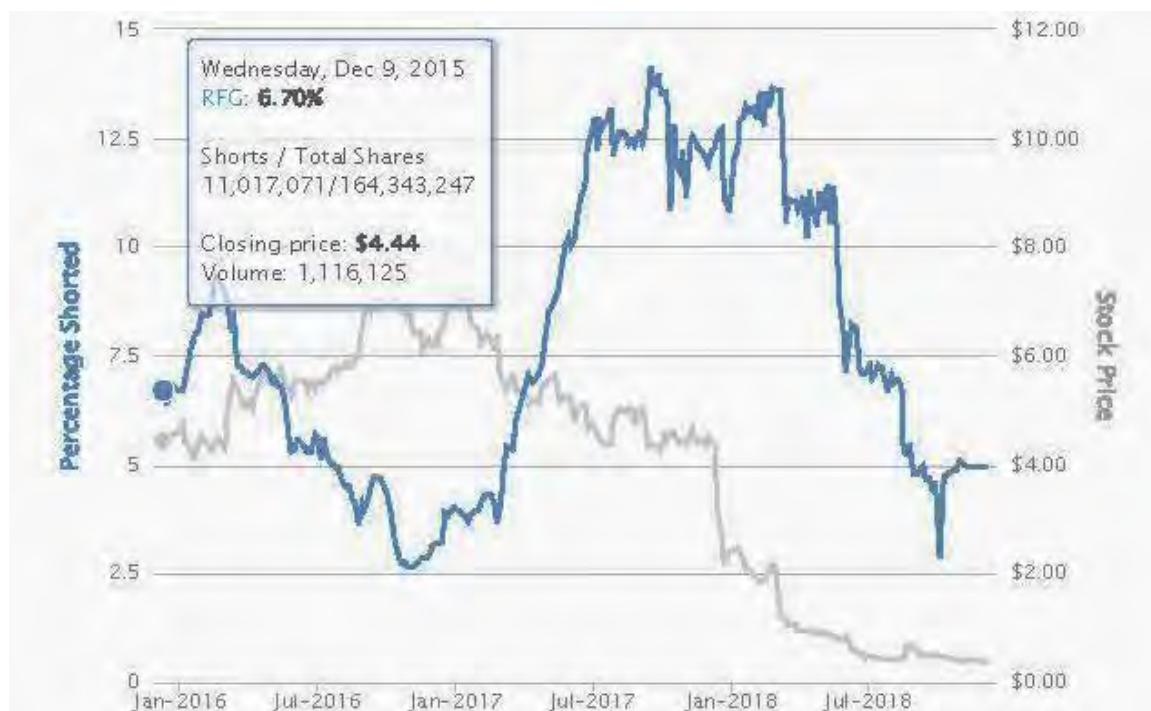
4.32 RFG released its first half results (for 2016–17) on 23 February 2017. The results indicated that revenue, earnings before interest, tax, depreciation and amortization (EBITDA), net profit after tax (NPAT), earnings per share, half year dividends and net operating cash flow had all increased.⁴³

42 Retail Food Group Limited, *Annual Report*, 2015–16, p. 10.

43 Retail Food Group Limited, *1H17 Results*, 23 February 2017, p. 4.

4.33 However, in the first half of 2017, RFG's share price began falling (as shown by the grey line in Figure 4.3). A significant increase in the short selling of RFG shares also began in the first half of 2017 (as shown by the blue line in Figure 4.3).

Figure 4.3: Retail Food Group share price and percentage of shares shorted



Source: www.shortman.com.au/stock?q=RFG (accessed 12 December 2018).

4.34 On 2 June 2017, UBS issued two trading reports that included a share price target downgrade from \$5.70 to \$4.70, based on the introduction of new accounting standards (IFRS 16) for leases issued in January 2016, which will take effect from July 2019. On 6 June 2017, RFG argued that the UBS reports on the potential impact on RFG's financial statement, lending covenants or other debt arrangements were 'premature, precipitous and with respect an exercise in speculative guesswork'.⁴⁴

4.35 At the RFG annual general meeting on 30 November 2017, RFG Chairman, Mr Colin Archer, discussed the downward pressure on RFG's share price from short sellers. Mr Archer stated that short selling was 'undermining perceptions regarding RFG's credentials, performance and future prospects'.⁴⁵

4.36 In December 2017, RFG's share price fell dramatically and prompted a query from the ASX. RFG responded to the market stating that it was not aware of any information that had led to the decline in the share price that it had not disclosed to shareholders.⁴⁶ As at mid-March 2019, RFG's share price had not recovered.

44 Retail Food Group Limited, Media release, *Trading in RFG Shares*, 6 June 2017.

45 Mr Colin Archer, Chairman, RFG, *Chairman's Address*, 2017 AGM, 30 November 2017.

46 Retail Food Group Limited, *Response to price query*, 21 December 2017.

Lenders' views of RFG

4.37 This section summarises RFG's current financial position and RFG's dependence on ongoing support from its lenders in order to remain in business. RFG received a waiver from its lenders for a breach of covenant testing in June 2018. RFG needed to take urgent action to address its gross debt as the maturity date for its \$285 million loan facility was brought forward to 31 October 2019. The following excerpt from the RFG Chairman's report indicates a considerable degree of concern about RFG's financial position:

The program to restructure the Company's business and build confidence in the franchise brands is progressing, however, the risk that the Group may breach financial covenant thresholds within the next 12 months remains, which could result in the Company's syndicated debt becoming due and payable.

RFG's continuing viability is, therefore, dependent upon the continuing support of its syndicated lenders, and managing the terms of its renegotiated debt facilities.⁴⁷

4.38 The RFG directors' report went further and highlighted actions that RFG will have to undertake to maintain the confidence of its lenders:

The continuing viability of the Group and its ability to continue as a going concern is dependent upon the Group maintaining the continuing support of the syndicated lenders, and managing the covenants and the terms of the renegotiated facility.

Achieving this outcome also depends upon:

- (1) The Group's ability to implement successfully an asset sales program over the next twelve months to realise funds to assist in paying down the syndicated debt;
- (2) The Group's ability to obtain additional funding (by way, for example, of a capital raising or accessing alternative sources of finance);
- (3) The Group's ability to execute successfully the restructuring initiatives previously referred to.⁴⁸

4.39 Taken together, the Chairman's report and the directors' report indicate that RFG's lenders have imposed stringent terms and conditions on RFG in order to maintain the confidence of its lenders.

Auditor's views of RFG

4.40 Following its audit of RFG's financial position as at 30 June 2018, RFG's independent auditor, PwC, reported a material uncertainty about RFG's ability to continue as a going concern:

We draw attention to Note 35(d) in the financial report, which indicates that the Group incurred a net loss before tax of \$380m for the year ended

47 Retail Food Group Limited, *Annual Report*, 2017–18, pp. III, 8.

48 Retail Food Group Limited, *Annual Report*, 2017–18, p. 8.

30 June 2018 and, as of that date, the Group's current liabilities exceeded its current assets by \$231m, inclusive of syndicated secured borrowings of \$265m.

The Group's ability to continue as a going concern is dependent on the Group having a continued appropriate level of funding from its existing lenders and/or other sources for at least the next twelve months from the date of this report. These conditions, as well as successfully executing the assets sales program and other Group restructuring initiatives as set forth in Note 35(d), indicate that a material uncertainty exists that may cast significant doubt on the Group's ability to continue as a going concern. Our opinion is not modified in respect of this matter.⁴⁹

4.41 The above audit report indicates that, as a result of its substantial losses and liabilities and its consequent reliance on ongoing support from lenders, RFG's continued existence is precarious.

The regulators' interactions with RFG

ACCC action on unfair contract terms

4.42 In its submission, RFG noted that it had reviewed its franchise agreements in light of the introduction of unfair contract law provisions that came into effect in November 2016.⁵⁰ The committee asked RFG to provide a copy of RFG's and the ACCC's review of RFG's unfair contract terms and to identify which unfair contract terms had been removed from contracts both pre- and post-November 2016. RFG refused multiple requests from the committee for this information.⁵¹

4.43 In November 2017, a year after unfair contract terms provisions came into effect, the ACCC contacted RFG to raise concerns about potentially unfair contract terms in RFG franchise agreements. In May 2018, RFG provided the ACCC with revised clauses.⁵² In other words, it took 18 months and action from the regulator to prompt RFG to address unfair contract terms in new and renewed franchise agreements that RFG should have removed from its contracts by November 2016. This conduct adds weight to the ACCC argument for unfair contract terms to be illegal and for penalties to apply to corporations that fail to comply with unfair contract terms laws.⁵³ Unfair contract terms laws are discussed in more detail in chapter 9.

4.44 In November 2018, the ACCC provided the committee with information on clauses in RFG contracts that it considered 'may be unfair contract terms'. The types of clause identified by the ACCC were:

49 PwC, *Independent Auditor's Report*, RFG Annual Report, 2018, p. 91.

50 Retail Food Group Limited, *Submission 32*, p. 4.

51 Retail Food Group Limited, *correspondence to the committee*, 15 August 2018, 5 December 2018.

52 Australian Competition and Consumer Commission, answers to questions on notice, 8 November 2018 (received 22 November 2018).

53 Australian Competition and Consumer Commission, *Submission 45*, p. 6.

- unilateral variation clauses which allow a franchisor to vary franchise manuals without notice;
- clauses which indemnify the franchisor for actions of third parties even if the franchisor, and not the franchisee, engaged the third party or the franchisee engaged a third party selected by the franchisor;
- clauses which seek to waive a franchisor's liability for representations it makes to franchisees;
- clauses which seek to shift liability to the franchisee for work that is being carried out by the franchisor;
- clauses which broadly indemnify the franchisor from any costs it incurs in connection with the franchise agreement;
- clauses which seek to classify events or circumstances in the lives of franchisees, or possibly guarantors, that are not related to the operation to the franchise, as an 'event of default' under a franchise agreement;
- clauses which allow a franchisor to terminate a franchise agreement, even if the franchisee is not in breach, and then recover damages for franchise fees or marketing contributions that would have been paid over the remainder of the term of the franchise agreement;
- clauses which create a very broad definition of 'event of default' under a franchise agreement whereby even minor infringements such as late payments may be considered a default event;
- clauses which indemnify the franchisor from any loss, cost or expense when acting as attorney appointed by the franchisee in certain circumstances; and
- clauses which contain broad restraint of trade terms which restrict the rights of a franchisee at the end of a franchise agreement and protect a franchisor from competition beyond their legitimate commercial interests.⁵⁴

4.45 The ACCC indicated that it is continuing to investigate how RFG historically dealt with its franchisees with respect to unfair contract terms in its franchise agreements.⁵⁵

Other investigations

4.46 The committee sought information from the ACCC, the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO) on what, if any, investigations they had undertaken into RFG and its current and former directors and executives.

4.47 ASIC informed the committee that its specialist teams had reviewed RFG, but no issues were identified that required further review or action. ASIC also noted that

54 Australian Competition and Consumer Commission, answers to questions on notice, 8 November 2018 (received 22 November 2018).

55 Australian Competition and Consumer Commission, answers to questions on notice, 8 November 2018 (received 22 November 2018).

as RFG is a listed entity, ASIC does not make any comment that may affect the market.⁵⁶

4.48 The ATO claimed that 'due to taxpayer confidentiality laws', it was 'unable to disclose this information'.⁵⁷

4.49 The ACCC indicated that it is investigating RFG's conduct in relation to the Australian Consumer Law and Franchising Code of Conduct.

Committee view

4.50 Evidence to the committee revealed serious problems with the sustainability of the franchise model operated by RFG. These problems included changes to the business model that had the effect of increasing the profitability of RFG at the expense of franchisees.

4.51 The committee heard that RFG engaged in raising fees at the same time as it stripped away the services that were previously provided to franchisees, impacting the viability of businesses. However, the committee also heard that after a franchisee walked away, many of those businesses were simply reacquired by RFG, run as a corporate outlet for a brief period, and then resold to the next prospective franchisee without revealing the full picture on the outlet's financial history.

4.52 The committee notes that RFG listed on the ASX in June 2006. Subsequent to that listing, RFG went on a rapid acquisition spree acquiring ten franchise brands over a seven year period. Evidence to the committee raises concerns that RFG's growth model was based both on acquiring new brands and the rapid organic expansion within those brands at the expense of the existing franchisees.

4.53 However, the listing of a franchisor on the stock market, or the acquisition of a major stake in a franchise system by a third party (such as private equity), may signal a fundamental shift in the franchisor / franchisee relationship. The traditional view of franchising, and one that appears to exist in all successful franchise operations, is that franchising is a mutually beneficial relationship between franchisor and franchisee, and that the relationship that a franchisor has with their franchisees, and franchisee profitability, is of fundamental importance to the health of the overall business.

4.54 Listing on a stock market introduces another key element into the business model, namely the relationship between the franchisor and its shareholders or stakeholders. As the duty of maximizing shareholder value can come at the expense of franchisees financial wellbeing, given the unique cost breakdowns and royalty structure of the franchising model. The evidence on RFG indicates that a franchisor may prioritise the expectations of shareholders to the detriment of franchisees. This may include rapid expansion and saturating certain markets by continually opening competing outlets, expecting franchisees to work copious hours in-store as a means of

56 Australian Securities and Investments Commission, answers to questions on notice, 19 October 2018 (received 3 December 2018).

57 Australian Tax Office, answers to questions on notice, 6 December 2018 (received 19 December 2018).

free labour, as well as charging increased fees, reducing the services previously provided to franchisees, and extracting excessive rebates from the suppliers that are ultimately paid for by higher cost of goods to franchisees. In order to satisfy shareholders, the focus shifts from long-term sustainability to short-term profitability. In short, there is a risk that listed or private equity may try to extract too much value from the franchise system, namely shifting profit from the franchisees to the shareholders.

4.55 In stating the above, the committee acknowledges that several major franchisors have spoken of the harsh realities of the current retail environment, and the particular difficulties involved in operating in shopping centres. Nevertheless, it appears that RFG has operated a particularly unjust business model in which shareholders and senior executives have profited at the expense of franchisees.

Churning and burning of franchise outlets

4.56 The committee is under no illusions as to the scale of the problems at RFG. The evidence from submitters and witnesses points to an extraordinary increase in the number of outlet closures and franchisees walking away from the RFG system.

4.57 Churning refers to the repeated sale at a single site of a failed franchise to a new franchisee. Outlets that pass through a corporate outlet stage in between being operated by franchisees can also be counted as site churning.

4.58 Burning refers to continually opening new outlets, some of which are unlikely to be viable, to profit from upfront fees, while leaving existing outlets to struggle and close.

4.59 Given that the allegations of churning are particularly serious, the committee was understandably keen to study the data that would allow it to either refute or verify such allegations. To this end, the committee formally requested data from RFG on multiple occasions. RFG refused to provide such data on four occasions.

4.60 It seems reasonable to the committee to draw one of two conclusions from the refusal. One possibility is that RFG is seeking to avoid providing data that would in fact substantiate the allegation that RFG churned sites across its networks. If this is the case, then RFG may not only have engaged in unethical business practices, but may also have misled Parliament.

4.61 The other possibility is that RFG, its board and management were incompetent. The committee is firmly of the view that the management and board of every franchisor should be acutely aware of any outlets in their networks that are failing and churning through multiple franchisees. Across a three year period, RFG opened, closed and transferred about 200 outlets respectively on an annual basis. Given such high rates of outlet turnover, the committee finds it incomprehensible that nobody in an organisation the size of RFG undertook sufficient due diligence to ascertain whether certain outlets were being churned. If that was the case, it points to negligence on the part of the board and senior executives.

4.62 Rapid expansion combined with a business model based on squeezing the franchisee can lead to a high failure and closure rate. The committee is concerned that the high rate of outlet opening, matched by an equally high rate of outlet closing by

RFG (as shown in Figure 4.1) may indicate that the 'burning' of franchisees is occurring at RFG. Such practices are not acceptable and should be investigated by the ACCC and ASIC.

Lack of comprehensive, systemic and forensic investigations by the regulators

4.63 One sixth of the franchisee submissions received by this inquiry related to RFG. It seems plausible that RFG and the franchise brands that it owned were the subject of multiple complaints to regulators. Given the allegations made by RFG franchisees to this inquiry (including those received on a confidential basis), the committee is surprised that none of the relevant regulators appear to have undertaken any investigation that has led to court action, or, at the very least, public acknowledgement of misconduct.

4.64 The committee considers that RFG's business model remains a high risk because it appears to rely on acquiring previously successful brands, opening new outlets, stripping out costs, exploitative fee gouging and increased costs to franchisees, and cutting services to franchisees. These are not isolated cases and continue. Rather, this is a strategic system-wide approach to business whereby RFG's 'success' relied on extracting profits from its franchise systems with hugely deleterious results for franchisees. When a business model displays such apparent risks, discrete investigations into individual franchises are insufficient.

4.65 The committee acknowledges that it is possible that RFG and its officers acted entirely within the bounds of the Franchising Code and other relevant laws. Given the potential exploitation of franchisees through churning and burning within the RFG system, this is a highly troubling proposition because it speaks to the extent to which an outfit such as RFG is able to engage in harmful but legal behaviour.

4.66 Having said that, the committee notes the ACCC, the ATO and ASIC are yet to conduct comprehensive, systemic and forensic investigations into the actions and operations of RFG and its current and former executives. The evasive conduct of RFG and its current and former executives has done nothing to instil any confidence in the committee that all their actions are above board and would withstand thorough scrutiny by the regulators.

4.67 The ACCC should monitor large franchise systems to check whether churning and burning are occurring. The committee notes that it is very important for churning and burning investigations to focus on patterns of behaviour of franchisors, not just on isolated outlets based in individual complaints, because for an individual outlet it may be possible to argue that there were other extenuating circumstances. However, where churning or burning appears to be a repeated practice across multiple outlets in a franchise system, it is much easier to demonstrate that the franchisor may have deliberately engaged in such exploitative practices. Furthermore, where a franchisor is listed on a securities exchange and such information is not appropriately reported to the market, ASIC should also investigate compliance with continuous disclosure obligations.

Proposed new regulatory powers

4.68 To allow appropriate enforcement action to occur where investigations indicate that churning and burning are occurring, the ACCC should be given powers to intervene to prevent franchisors from marketing and selling such franchises during an investigation. These powers could be similar in nature to the proposed product intervention powers that would allow ASIC to intervene to prevent financial products from being marketed and sold to unsophisticated investors. A bill to implement such financial product intervention powers is currently before the Parliament and has been examined by the Senate Economics Legislation Committee.⁵⁸

4.69 The explanatory memorandum for the relevant bill noted that:

The Corporations Act relies heavily on disclosure to assist consumers understand and select appropriate financial products. However, disclosure can be ineffective for a number of reasons, including consumer disengagement, complexity of documents and products, behavioural biases, misaligned interests and low financial literacy. The availability of financial advice may not be sufficient to overcome these issues. A consumer may not seek financial advice or may receive poor-quality advice.

The Financial System Inquiry recognised these shortcomings of the existing disclosure regime. In response, it recommended the introduction of a targeted and principles-based product design and distribution obligation. The Government accepted this recommendation to introduce design and distribution obligations.⁵⁹

4.70 These obligations are designed to assist consumers to obtain appropriate financial products by requiring issuers and distributors to have a customer-centric approach to designing, marketing and distributing financial products.⁶⁰

4.71 While the committee received evidence about churning and burning in other franchise systems, the problems appear to be far greater at RFG. In this respect, the committee is concerned about both the aggregator model of acquiring existing franchising brands used by RFG as part of its inorganic growth strategy, and also the implications of RFG's listing on the stock market.

4.72 The committee notes that the intervention power recommended for the ACCC is only targeted at the most egregious behaviour by franchisors, such as systematic churning and burning. Therefore, this new power would not become red tape for the majority of franchisors. The committee notes that several participants in the inquiry supported such a power being implemented.⁶¹

58 Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018.

59 Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018, *Explanatory Memorandum*, p. 5.

60 Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018, *Explanatory Memorandum*, pp. 5–6.

61 Dr Tess Hardy, answers to questions on notice, 3 October 2018 (received 19 October 2018); Dr Sudha Mani, answers to questions on notice, 3 October 2018 (received 19 October 2018);

Recommendation 4.1

4.73 The committee recommends that the Australian Competition and Consumer Commission be given power to intervene and prevent the marketing and sales of franchises where a franchisor shows a track record of churning and/or burning.

4.74 The committee notes that the share market has, somewhat belatedly, delivered a damning assessment of RFG's business model. This negative assessment is mirrored by the stringent terms and conditions imposed on RFG by its lenders and the independent auditor's assessment that identifies significant doubt regarding RFG's capacity to continue as a going concern. While the ultimate verdict of the market probably comes as no surprise to those who have observed and experienced RFG's operations up close, it provides scant comfort either to the franchisees whose lives have been destroyed by RFG's business practices, or to those struggling franchisees that are still locked into RFG's business model and would be negatively affected if RFG is unable to keep its lenders happy.

4.75 Finally, without detracting from the serious issues within other franchise systems such as 7-Eleven, RFG has damaged the reputation of franchising more broadly within Australia. Franchising has traditionally been promoted as a safe option for new business owners to get started with a proven system. However, there is a power asymmetry within franchising that is governed by a franchise agreement drawn up by the franchisor. This power imbalance is inherent to the structure, given the franchisor owns the business and has control over operations and franchisee contracts. However, it also means that franchisees are exposed to the risk of being exploited by unscrupulous franchisors. In instances where the franchise system operates in a mutually beneficial manner, this risk does not eventuate. But when outfits such as RFG acquire already-existing franchise systems, the franchisees in those systems are suddenly exposed to strategic risk and may be exploited in a system where they currently have little chance of either redress or escape.

Recommendation 4.2

4.76 The committee recommends that the Australian Competition and Consumer Commission, the Australian Securities and Investments Commission and the Australian Tax Office, conduct investigations into the operations and dealings of Retail Food Group, its former and current directors and senior executives and companies and trusts they own, direct, manage or hold a beneficial interest in, with regard to matters including, but not limited to, the Australian Consumer Law, the Franchising Code of Conduct, insider trading, short selling, market disclosure obligations (including related party obligations), compliance with directors' duties, audit quality, valuation of assets (including goodwill), and tax avoidance.

Chapter 5

Industry associations

Introduction

5.1 This chapter considers the role and effectiveness of industry bodies and associations in the franchising sector. The chapter begins by considering the Franchise Council of Australia and examines its effectiveness in representing the franchising industry. Other industry associations are then discussed.

Franchise Council of Australia

5.2 The Franchise Council of Australia (FCA) is the peak body for Australia's franchise sector. In its submission, the FCA described itself as representing 'franchisees, franchisors and suppliers', stating that:

The FCA has a strong track record of working collaboratively with government and regulators to advance the best interests of Australian franchising, and has supported constructive efforts to reform the Code [Franchising Code of Conduct] since the enactment of the legislation in 1998.¹

5.3 At a public hearing in September 2018, the FCA asserted that it represented franchising as a sector, but acknowledged that most of its members were franchisors. Under questioning from the committee, the FCA admitted that while it had 483 franchisor members, it had only two franchisee members.²

5.4 The NSW Small Business Commissioner submitted that 'the franchising sector's most prominent industry body, the Franchise Council of Australia, predominantly represents franchisor interests'.³

5.5 Spindletop Strategists, Advisers and Mediators were critical of the FCA's claim that it represented the sector and argued that the FCA membership contains too many third parties seeking networking opportunities and does not have:

- a representative sample of franchisee members;
- franchisees on its board;
- a fee structure for franchisees;
- training courses for franchisees; or
- a national convention or meeting that can cater for franchisee topics of discussion.⁴

1 Franchise Council of Australia, *Submission 29*, p. 2.

2 Ms Mary Aldred, Chief Executive Officer, Franchise Council of Australia, *Committee Hansard*, 21 September 2018, pp. 13, 16.

3 NSW Small Business Commissioner, *Submission 49*, p. 6; see also Mr Robert Whittet, Private capacity, *Committee Hansard*, 8 June 2018, p. 67.

5.6 The 7-Eleven Franchisee Association submitted that it was concerned about the lack of franchisee representation on the FCA.⁵ The Franchisee Federation of Australia shared this concern, submitting that:

... the Franchise Council of Australia represents the interests of franchisors over those of franchisees. One need only look at their recommendations to this Committee for proof of that. If, as the FCA say, there is little or no change needed to the industry it is further proof of the massive, undeniable and unacceptable power imbalance within the industry.⁶

5.7 In the context of the evidence showing that the FCA's membership is primarily made up of franchisors, Professor Elizabeth Spencer drew attention to the risks of regulatory capture in franchising, noting that:

...the regulator has much easier access to the franchisor side of the equation because of the existence of the Franchise Council of Australia, which principally represents the interests of franchisors... [F]ranchisees' input may be sought but it isn't often attained as widely and as comprehensively as it could be and franchisees then aren't represented in the regulatory process.⁷

Franchisee associations

5.8 There are a range of franchisee associations that aim to represent groups of franchisees. However, most of them are specific to particular franchise systems or industry sectors. There does not appear to be a broad-based association to represent the interests of franchisees. Examples of franchisee associations include:

- The Caltex National Franchise Council;⁸
- Franchisee Association of Craveable;⁹
- Post Office Agents Association Limited;¹⁰
- Motor Trade Association of Australia;¹¹
- Australian Automotive Dealer Association;¹²

4 Spindletop Strategists, Advisers & Mediators, *Submission 40*, p. 6.

5 7-Eleven Franchisee Association, *Submission 114*, p. 16.

6 Franchisee Federation of Australia, *Supplementary Submission 113.1*, p. 1.

7 Professor Elizabeth Spencer, Private capacity, *Committee Hansard*, 16 October 2018, p. 3.

8 Mr Bruce Hollett, Member, Caltex National Franchise Council, *Committee Hansard*, 29 June 2018, p. 21; Mr Sanjeev Bajaj, Private Capacity, *Committee Hansard*, 22 June 2018, p. 14; Mr Julian Segal, Chief Executive Officer and Managing Director, Caltex Australia, *Committee Hansard*, 14 September 2018, p. 54.

9 Franchisee Association of Craveable, *Submission 10*.

10 Post Office Agents Association Limited, *Submission 42*.

11 Motor Trade Association of Australia, *Submission 55*.

12 Australian Automotive Dealer Association, *Submission 84*.

- Australian Lottery and Newsagents Association & Lottery Retailers Association;¹³
- Franchise Federation of Australia;¹⁴
- 7-Eleven Franchisee Association;¹⁵ and
- Salts of the Earth Franchisee Association;¹⁶

5.9 Ms Maria Varkevisser, a franchisee, argued that a dedicated franchisee member organisation would strengthen the position of franchisees in the industry and provide an opportunity for collective bargaining.¹⁷

5.10 Professor Spencer supported the development of an organisation to properly represent franchisee interests, but was cautious about its effectiveness given past experience. She noted that franchisors often pre-emptively set up franchisee representative groups in an attempt to control the input and collective views of the franchisees. She also observed that franchise agreements severely constrain the extent to which franchisees can freely express their views while within the franchise system.¹⁸

5.11 In the United States, franchisee associations have established a Coalition of Franchisee Associations to leverage their collective strengths for the benefit of the franchisee community. The Coalition of Franchisee Associations described its role as follows:

- it provides a forum for its members to share best practices, knowledge and resources for the benefit of the entire franchisee population; and
- it focusses its efforts on government affairs at the state and federal levels, franchisee education and training, executive leadership development and collective buying opportunities.¹⁹

5.12 In addition, the American Association of Franchisees and Dealers (AAFD) was founded to provide a counter balance in the franchising industry.²⁰ The AAFD

13 Australian Lottery and Newsagents Association & Lottery Retailers Association, *Submission 68*.

14 Franchisee Federation of Australia, *Submission 113*.

15 7-Eleven Franchisee Association, *Submission 114*.

16 Salts of the Earth Franchisee Association, *Submission 144*.

17 Ms Maria Varkevisser, *Submission 79*, p. 4.

18 Professor Elizabeth Spencer, Private Capacity, *Committee Hansard*, 16 October 2018, p. 3; see also Rupert M. Barkoff, International Franchise Association, *Franchisee associations: Nothing to fear but fear itself, usually*, www.franchise.org/franchisee-associations-nothing-to-fear-but-fear-itself-usually (accessed 11 January 2019).

19 Coalition of Franchisee Associations, *CFA history*, <https://thecfainc.com/about-us/cfa-history/> (accessed 11 January 2019).

20 American Association of Franchisees and Dealers, *The AAFD story*, www.aafd.org/the-aafd-story/ (accessed 11 January 2019).

have created Fair Franchising Standards to provide objective criteria to serve as the basis by which to judge a franchise opportunity. The Fair Franchising Standards also serve as the basis for accrediting franchisors. The Fair Franchising Standards were developed collaboratively by 40 leaders of the franchise community, including both franchisor and franchisee business executives and entrepreneurs, attorneys and franchise business consultants.²¹

Circumvention of legislative requirements

5.13 The above sections discussed the effectiveness of industry associations in representing different stakeholders in the industry and influencing the regulatory framework.

5.14 However, during the inquiry the committee became aware that franchisors may try to circumvent or work around laws and regulations intended to protect franchisees:

- as discussed in chapter 16, the FCA suggested that franchisors could seek to increase upfront fees to circumvent any laws to prohibit franchisors from passing on to a prospective franchisee the legal costs of preparing, negotiating and executing documents;
- in a 2017 submission on proposed amendments to the Fair Work Act to make franchisors partially liable for the underpayment of wages, the FCA indicated that franchisors could 'restructure themselves to avoid potential liability' and stated that 'arguably a franchisor's lawyer would be duty bound to point out the structuring advantages';²² and
- following the application of unfair contract terms laws to standard form small business contracts, a franchising lawyer advocated that franchisors should 'allow the franchisee to review the franchise agreement and at least occasionally consider granting one or two concessions in the documentation—and record those concessions in writing', because 'even trivial concessions should allow a franchisor to prove that there is the ability for any franchisee to negotiate the agreement and therefore avoid the application of the legislation'.²³

21 American Association of Franchisees and Dealers, *Fair Franchising Standards*, 2012, p. VII.

22 Franchise Council of Australia, *Supplementary submission to the Minister*, On proposed wording of the amendments to the Fair Work Act to extend liability to franchisors and parent companies in certain situations, 20 February, 2017, p. 11.

23 Timothy Mak, *What you need to know about franchise agreements and unfair contract terms*, Inside Business Franchise, 27 June 2016.

Committee view

5.15 The committee notes that the FCA does not provide a balanced representation of franchisor and franchisee views and that this is likely to be due to its membership composition.

5.16 Effective franchise systems work as a partnership between the franchisor and the franchisees. However, in many franchise systems, franchisees currently have minimal insight into strategic business decisions and virtually no capacity to influence or formally record objections to such decisions. The committee considers that a more balanced representation of views would be of benefit to the entire franchise industry. For example, the committee observes that the existence of strong franchisee associations in the United States has enabled the development of Fair Franchise Standards that can be used to assess and accredit franchise systems.

5.17 The committee considers that it is for industry to determine the most appropriate way to enable a more balanced representation of views. However, the committee notes some options that could be considered:

- (a) a separate franchisee peak body could be established and the FCA could remain as a franchisor peak body. The separate franchisee peak body could be a standalone national organisation, or a federation or coalition of franchisee associations; or
- (b) an existing small business association could broaden its charter to encompass franchisees or establish a specific focus on franchising.

5.18 Many of the problems considered in this report, including the unbalanced regulatory framework, are at least partially a result of a lack of effective representation of franchisee views. The committee therefore considers it important that the relevant government departments and agencies are keenly aware of the risk that the policy and regulatory debate can be easily captured by franchisors and their representatives.

5.19 The committee considers that, until a suitable body exists to adequately represent the interests of franchisees, the Franchising Taskforce should examine how consultation processes associated with franchising policy, regulation and legislation can achieve an appropriate level of input from franchisees. Such an examination should include, but not be limited to, whether it is appropriate for a franchisee representative to be a voting member of the franchisor's board.

5.20 Finally, the FCA has influenced the development of the current regulatory arrangements to benefit the interests of franchisors and potentially to the detriment of franchisees. In addition, the committee has noted a number of examples of participants in the franchise industry indicating how franchisors may circumvent laws intended to protect franchisees. The committee is concerned to hear such things being discussed by the FCA which claims to represent the industry as a whole. This suggests that vigilant, ongoing oversight of the franchising industry is required. The committee therefore recommends that the Franchising Taskforce examine how the government could be provided with regular reports and updates on the effectiveness of regulatory settings for franchising and the extent to which industry participants may be seeking to circumvent regulatory arrangements.

Recommendation 5.1

5.21 The committee recommends that, until a suitable body exists to adequately represent the interests of franchisees, the Franchising Taskforce examine how consultation processes associated with franchising policy, regulation and legislation can achieve an appropriate level of input from franchisees, including whether it is appropriate for a franchisee representative to be a voting member of the franchisor's board.

Recommendation 5.2

5.22 The committee recommends that the Franchising Taskforce examine how the Australian Government could be provided with regular reports and updates on the effectiveness of regulatory settings for franchising, including the extent to which industry participants are seeking to circumvent the regulatory arrangements.

Chapter 6

Disclosure and registration

Introduction

6.1 This chapter examines the disclosure requirements under the Franchising Code of Conduct (Franchising Code) and the extent to which they help address the asymmetry of information that exists between a franchisor and a prospective franchisee.

6.2 During the inquiry, many participants raised concerns about the asymmetry of information between franchisors and franchisees. Information asymmetry occurs when one party to an economic transaction holds materially greater information than the other party. Information asymmetry is recognised as a type of market failure¹ and is common where the party selling a good or service has greater knowledge than the buyer.

6.3 It is well accepted that an inequality of power exists in the franchise relationship. The Office of the NSW Small Business Ombudsman noted that:

This inequality is commonly reflected in an asymmetry of resources, business experience, education, and sophistication between franchisees and franchisors.²

6.4 A well-functioning and efficient franchise sector requires franchisees to be well-informed. Generally, information asymmetry is inherent in the business format franchise relationship as a result of the requirement for uniformity.³

6.5 However, information asymmetry that favours franchisors can hamper franchisees in conducting due diligence and making informed decisions because of a lack of understanding about fees and other costs, contractual obligations and personal risks. This is particularly problematic where relevant information cannot be obtained independently of the franchisor.⁴ For example, in cases where a franchisor has an incentive not to provide negative information to a franchisee because it may result in a lost or diminished sale for the franchisor, it may also result in franchises being sold at inflated prices compared to the true value of the business.⁵

1 The Treasury, Regulation Impact Statement, *Proposed changes to franchising regulation*, March 2014, p. 11.

2 Office of the NSW Small Business Ombudsman, *Submission 49*, p. 4

3 Professor Elizabeth Spencer, *Consequences of the Interaction of Standard Form and Relational Contracting in Franchising*, *Franchise Law Journal*, Vo. 29, Iss.1, 2009, pp. 31–39, 57.

4 The Treasury, Regulation Impact Statement, *Proposed changes to franchising regulation*, March 2014, p. 11.

5 The Treasury, Regulation Impact Statement, *Proposed changes to franchising regulation*, March 2014, p. 11.

6.6 Ensuring adequate disclosure is a key regulatory concern in many sectors of the economy, including franchising. Disclosure comprises both up front disclosure and disclosure during the term of a franchise agreement.

6.7 The chapter examines the current disclosure provisions in relation to the following aspects of franchising:

- upfront and pre-contractual disclosure to prospective franchisees:
 - the adequacy of mandatory disclosure documentation;
 - the provision and accuracy of earnings information;
 - the involvement of franchise brokers in the sale of franchises;
- disclosure during the term of the franchise agreement:
 - the disclosure of marketing fees and funds; and
- the necessity of a franchisor registration system.

The public disclosure regime—up-front disclosure

Disclosure requirements under the Franchising Code

6.8 The primary means of disclosure for franchised businesses is the mandated provision of a disclosure document in Annexure 1 of the Franchising Code. This document must be provided to prospective franchisees or existing franchisees proposing to:

- enter into a franchise agreement; or
- renew a franchise agreement; or
- extend the term or scope of a franchise agreement.

6.9 Under the current disclosure regime, franchisors are subject to a number of mandatory requirements, which are primarily outlined in Part 2 of the Franchising Code. Clause 9 provides that a franchisor must give a franchisee or prospective franchisee:

- a copy of the Franchising Code;
- a copy of an up to date disclosure document in compliance with the Franchising Code;
- a copy of the franchise agreement, in the form in which it is to be executed.

6.10 Clause 11 of the Franchising Code stipulates that an information statement on the general risks and rewards of franchising is to be given to prospective franchisees.⁶

6.11 The documents are required to be provided to a franchisee or prospective franchisee a minimum of 14 days prior to any of the following:

- entering into a franchise agreement;
- an agreement to enter into a franchise agreement;

6 Competition and Consumer (Industry Codes – Franchising) Regulation 2014, cl. 11.

- the making of a non-refundable payment to the franchisor or an associate of the franchisor in relation to the franchise agreement.⁷

6.12 Belperio Clark Lawyers argued that franchisors should be required to provide an electronic copy of disclosure documents. They submitted that the provision of a hard copy limits the ability of franchisees to obtain legal advice, particularly if the prospective franchisee is attending interstate training.⁸

The purpose and scope of disclosure

6.13 The purpose of the disclosure document is to provide the prospective or current franchisee with information from the franchisor so that a reasonably informed decision about the franchise can be made.⁹

6.14 Within this context, the committee received a range of views on the purpose of disclosure. MST Lawyers pointed out that the purpose of disclosure was to assist franchisees to make reasonably informed decisions, not to prescribe full disclosure:

Clause 8(2) of the Franchising Code stipulates that *the* purpose of the disclosure document is to *assist* a prospective franchisee to make a *reasonably* informed decision about the franchise and to provide current information that is *material* to the running of the franchised business.¹⁰

6.15 MST Lawyers argued that the current Franchising Code achieves a fair balance and does not overburden franchisees or franchisors:

Inflating the current disclosure obligations where there is no pressing need to do so will merely add to the mass of paperwork engulfing franchisees, the costs and time spent by franchisees in seeking legal advice, and the compliance costs of a franchisor and their advisers in drafting and updating disclosure documents. Counterproductively, increasing the overall length of a disclosure document may result in critical information that franchisees ought to focus on being overlooked as they attempt to skim an unwieldy and complicated legal document.¹¹

6.16 The Australian Small Business and Family Enterprise Ombudsman submitted that the information in the disclosure document should be prescribed and include, at a minimum:

- the applicable awards for the range of employees the business requires;
- the franchisor's future expansion plans to support the sustainability of the chain; and

7 Competition and Consumer (Industry Codes – Franchising) Regulation 2014, cl. 9.

8 Belperio Clark Lawyers, *Submission 87*, pp. 7–8.

9 Competition and Consumer (Industry Codes – Franchising) Regulation 2014, cl. 8.

10 MST Lawyers, *Submission 39*, p. 2; see also Bakers Delight Holdings, *Submission 41*, p. 3.

11 MST Lawyers, *Submission 39*, p. 3.

- the establishment costs, recurring and one-off costs, and past financial performance.¹²

6.17 Belperio Clark Lawyers argued that franchisees' contractual rights were not adequately disclosed to franchisees, particularly in relation to termination rights and geographical exclusivity.¹³

6.18 However, the Franchise Council of Australia (FCA) rejected calls for greater disclosure, arguing that the existing legislation provided strong enforcement mechanisms to address inadequate disclosure:

In summary, if a franchisor somehow failed to disclose relevant information not only would that be a breach of the Code, but it would constitute misleading and deceptive conduct under the Australian Consumer Law. Significant penalties would apply, the ACCC would have a clear basis for taking enforcement action and an affected franchisee would have a clear right of civil action.¹⁴

6.19 Over the past two decades, the ACCC has litigated 33 matters and agreed 16 court enforceable undertakings relating to noncompliance with the Franchising Code. Legislative amendments in 2015 allowed the ACCC to issue infringement notices for likely breaches of the Franchising Code. Since 2015, the ACCC has issued three infringement notices for breaches of the Franchising Code.¹⁵

Access to current and former franchisees for the purposes of disclosure

6.20 Mrs Marianne Marchesi, Principal Lawyer at Legalite, stated that the Franchising Code stipulates that franchisors must provide franchisees with a contact number for current and former franchisees. Ms Marchesi recommended that the Code should specify that a mobile number should also be provided.¹⁶

6.21 Mr Nader Seifen, Principal of Spindletop Strategists, Advisers and Mediators, observed that some franchisors obstruct the franchisee from undertaking full due diligence by selectively removing particular franchisees from the disclosure information. Mr Seifen noted that this removal is explained as 'franchisee has requested privacy'. Further, there may be franchisees who are unable to contribute to the disclosure process because they are subject to a confidentiality agreement.¹⁷

6.22 However, some witnesses cautioned against the practice of prospective franchisees relying on the testimony of current franchisees. In a joint submission, the Australian Lottery and Newsagents' Association and the Lottery Retailers Association

12 Australian Small Business and Family Enterprise Ombudsman, *Submission 130*, p. 1.

13 Belperio Clark Lawyers, *Submission 87*, p. 4.

14 Franchise Council of Australia, *Submission 29*, p. 17.

15 Australian Competition and Consumer Commission, *Submission 45*, p. 1.

16 Mrs Marianne Marchesi, Principal Lawyer, Legalite, *Committee Hansard*, 22 June 2018, p. 73.

17 Spindletop Strategists, Advisers & Mediators, *Submission 40*, p. 3; see also Small Business Development Corporation, *Answer to questions on notice*, 16 October 2018, (November 2018), p. 3.

argued that franchisors attempting to take a 'hands off' approach by pushing the franchisees to conduct due diligence by talking to current or former franchisees was putting the onus back on the prospective franchisee and potentially placing liability on informants:

This practice can result in some benefits, and detriments to the prospective franchisee, depending on who they choose to consult with about the performance of sites and the system in general.

There is no filter or prescriptive way for this information to be provided which also makes it an inexact science or process. Existing franchisees will also approach this with caution as they often view any new franchisee (particularly greenfield sites) as a potential competitor. Well informed existing franchisees will also be concerned about becoming exposed to some legal liability for misrepresentation or omission of information about the systems performance.

It is evident existing franchisees who do provide information to prospective franchisees may not understand that they may be exposed to potential legal liability. Many franchisors have termination clauses in the franchise agreement that limit what a franchisee can say about the franchisor and business in general i.e. "...the Franchisor may terminate this Agreement in accordance with clause X if the Franchisee: acts in any manner which in the bona fide opinion of the Franchisor may damage or injure the Goodwill, business and/or reputation of the Franchisor".

These and other confidentiality clauses in franchise agreements make existing franchisees very cautious about what they say about the franchisor and franchise business.¹⁸

Paucity of publicly available data

6.23 Some submitters to the inquiry contended that they are constrained in their research by the lack of public information on Australian franchises.¹⁹ Professor Andrew Terry highlighted a number of issues with the reliability of data collected by Griffith University for its biennial Franchising Australia Survey. This is because the data set relies on the voluntary provision of responses, and the usual response rate is only 11 per cent.²⁰

6.24 Some researchers have had to source data on the franchising sector from other jurisdictions that have more comprehensive public disclosure requirements.²¹ For example, Dr Sudha Mani informed the committee that research about the relationship between franchisors and franchisees was being conducted on data obtained from overseas:

18 Australian Lottery and Newsagents' Association and the Lottery Retailers Association *Submission 68*, p. 2.

19 Dr Tess Hardy, *Submission 91*, p. 6.

20 Professor Andrew Terry, *Submission 108*, pp. 6–7.

21 Dr Sudha Mani, *Submission 107*, p. 2; Dr Jenny Buchan, *Submission 16*, p. 1.

In the United States, some states (for example, Wisconsin) make the most recent franchise disclosure documents publicly available. The Wisconsin state website currently has over 1400 franchise disclosure documents available for access to prospective franchisees and others with interest in the area. Public access to disclosure documents will enable prospective franchisees to read and understand the business without the sales pressure from franchisors. It also enables prospective franchisees to engage in adequate due diligence of more than one franchise system, if needed, before engaging with the franchisor. Further, public availability of franchise disclosure documents will facilitate evidence-based research on franchising in Australia.²²

6.25 Dr Mani recommended that the ACCC build a repository of disclosure documents that are freely available to the public.²³

Disclosure of earnings information

6.26 Under the Franchising Code, it is not mandatory for franchisors to provide prospective franchisees with earnings information or the financial statements for existing businesses. Clause 8 of the Franchising Code prescribes that if the franchisor provides earnings information, it must be set out in the form and order of Annexure 1. Item 20.2 of Annexure 1 prescribes earnings information as:

- historical earnings data for the franchised business or a franchise in the franchise system;
- differences between the franchised business for sale and the franchised business used to provide historical earnings data;
- projected earnings for the franchised business and the assumptions on which the projections are based; and
- any other information from which historical or future earnings information of the franchised business can be assessed.²⁴

6.27 If the franchisor chooses not to provide earnings information, then Item 20.3 must be included in the disclosure document:

The franchisor does not give earnings information about a [*insert type of franchise*] franchise.

Earnings may vary between franchises.

The franchisor cannot estimate earnings for a particular franchise.²⁵

22 Dr Sudha Mani, *Submission 107*, p. 2.

23 Dr Sudha Mani, *Submission 107*, p. 2.

24 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, *Annexure 1*, Item 20.2.

25 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, *Annexure 1*, Item 20.3.

Exclusion clauses regarding the accuracy of financial information

6.28 Haarsma Lawyers submitted that the Franchising Code allowed franchisors to provide prospective franchisees with financial information outside of the Code's provisions. They observed that:

- there is no clarity about whether financial information provided to the franchisee separately to the disclosure document is earnings information as contemplated by Item 20 of Annexure 1 to the Code (Item 20.3). The industry practice in our experience is that as long as the financial information is not included with the disclosure document, it is not caught by Item 20;
- if earnings information as contemplated by Item 20 is limited to information provided with the disclosure document, then franchisors are unlikely to provide financial information with the disclosure document (as the Item 20 obligations can be avoided by providing the financial information separately);
- the prescriptive nature of Appendix 1 to the Code requires the franchisor to make the Item 20.3 statement if earnings information is not provided with the disclosure document (in the manner prescribed by the disclosure document) even though it may have been provided separately.²⁶

6.29 Evidence indicates that some franchisors include provisions in the pre-contractual documentation given to prospective franchisees that has the effect of the prospective franchisee not being able to rely on the information provided in financial statements, or absolving the franchisor from liability for inaccuracies in the financial statements.²⁷

6.30 For example, 7-Eleven provided an excerpt from a franchise business transfer disclosure document that included the following statement regarding the reliability of the financial information provided to the prospective franchisee:

The only limitations on the basis and reliability of the financial information provided [i]n the attached statements [i]s that the details and calculations contained therein are based on information provided to 7-Eleven by the existing retailer and 7-Eleven [i]s unable to warrant [i]ts accuracy nor does it represent accordingly that such financial [i]nformation necessarily accurately portrays the profitability of that fuel re-selling business.²⁸

Reluctance to provide earnings information

6.31 The committee heard that franchisors are often unwilling to provide earnings information to prospective franchisees for fear that the previous franchisee's records are inaccurate and may be subject to litigation.²⁹

26 Haarsma Lawyers, *Submission 51*, p. 2.

27 Mr Heath Adams, *Submission 81*, p. 3; Haarsma Lawyers, *Submission 51*, p. 2.

28 7-Eleven Stores, Answer to question on notice, 2 October 2018, (received 19 and 25 October 2018), p. 7.

29 Mr Derek Sutherland, *Submission 53*, p. 22.

6.32 Mr Emmanuel Martin, former National Finance Commercial Manager of Gloria Jeans, observed that some of the reasons franchisors give for not providing specific financial trading information included:

- providing this information exposes their risk of misrepresentation and legal liability;
- the franchise model has not traded long enough to represent critical financial indicators;
- the franchisee is not required to provide financial information as per the franchise agreement;
- the franchisee has not provided financial information although the franchise agreement stipulates it;
- key financial indicators may not be attractive in selling further franchises.³⁰

6.33 Mr Serge Infanti, Managing Director of Foodco Group, indicated that when a new store is established, it is expected that prospective franchisees will come up with their own projections based on the information they are able to obtain through the due diligence process:

We give them average parameters, as I said before. We're very careful not to mislead them down a certain path. We can't really give them all the data to make a fully-informed decision because we're just not given the data by the shopping centre. So they have to go to their own accountant and they have to do their due diligence—go around to look at stores, talk to our franchise partners about similar arrangements and how they're performing and then come up with their own projections.³¹

6.34 Mr Derek Sutherland, an experienced lawyer in the franchise sector, argued that franchisors should have the right to decide whether or not to provide historical earnings information or information that amounts to a projection in relation to 'greenfield' sites:

That includes deciding whether to give historical earnings information (earnings information) or to give earnings information that amounts to a projection or forecast by making a representation as to a future matter such as turnover, earnings or profit (a financial performance representation).³²

6.35 Mr Andrew Hahn, a franchisee with The Finn Group, noted that court findings that determined franchisors had mislead franchisees about earning information were prompting franchisors not to put information in writing or specify estimated future earnings:

Instead, they rely around the vagueness of the disclosure document (regards potential expenses) and the focus on total revenue being earned combined

30 Mr Emmanuel Martin, *Submission 118*, p. 3.

31 Mr Serge Infanti, Managing Director, Foodco Group Pty Ltd, *Committee Hansard*, 14 September 2018, p. 50.

32 Mr Derek Sutherland, *Submission 53*, p. 22.

with general market data such as population or visitor numbers or other miscellaneous ABS data and large amounts of marketing spin. This is often very difficult for a potential franchisee, who is generally new to the industry and lacks the business and industry knowledge to translate raw potential market statistics to an actual business model and likely profit for themselves and their family.³³

Accuracy of earnings information

6.36 One submitter with experience as both franchisee and franchisor noted that:

Where a franchise is on the market for sale, it is often priced for perfection i.e. the business is operated perfectly with ideal COS [Cost of Sales], Labour% & turnover. This is rather unfair and misleading for unsuspecting/inexperienced franchisees who would not know any better.³⁴

6.37 The committee also heard that the earnings information for an established franchise business is unlikely to be similar to the expected earnings of a new franchise business. For example, Mr Stephen Giles, Board Director of the FCA, informed the committee that franchisees should expect to have to invest in the business for the first 18 months before it becomes cash flow positive:

The industry statistics are that a small business typically takes three to 3½ years to become cash flow positive. With the statistics on franchising, that period is around 18 months. So it's not immediate. To your point, franchisees would expect that in the first 18 months they will essentially have to invest in the business.³⁵

6.38 Some submitters alleged that while the earning information provided to the prospective franchisee prior to entering the franchise agreement appeared accurate, the reasons provided for the state of the figures were false. For example, Mr John and Mrs Julia Banks, Donut King franchisees, alleged that they were informed by Retail Food Group (RFG) that the decline in earnings was due to RFG's poor operation of the store, rather than other factors, including the influence of newer shopping centres close by attracting customers and lack of proper maintenance.³⁶

6.39 Mr Mark Connors, Secretary at RFG, noted that while RFG checked franchisees financial statements against their records when an existing franchisee is disclosing financial information to a prospective franchisee, it warns prospective franchisees that RFG is unable to guarantee the accuracy of that information:

33 Mr Andrew Hahn, *Submission 147*, p. 4. See also, for example, *Australian Competition and Consumer Commission v South East Melbourne Cleaning Pty Ltd (in liq) (formerly known as Coverall Cleaning Concepts South East Melbourne Pty Ltd)* (No 2) [2015] FCA 257; *Trans-It Freighters P/L (ACN 076 074 210) (as trustee of the Pollard Family Trust) & Ors v Billy Baxters (Franchising) P/L* [2012] VSCA 71.

34 Name Withheld, *Submission 173*, p. 1; See also, Name Withheld, *Submission 182*, p. 1.

35 Mr Stephen Giles, Board Director, Franchise Council of Australia, *Committee Hansard*, 21 September 2018, p. 18.

36 Mr John and Mrs Julia Banks, *Submission 100*, p. 2; see also Salts of the Earth Franchisee Association, *Submission 144*, p. 5.

Certainly we'll cross-check against our turnover records to make sure it's an appropriate representation, but what we do make clear to an incoming franchisee is that we haven't prepared any profit-and-loss financial information that may have been provided by an outgoing or a vendor franchisee...we would recommend they get financial advice in relation to it and also indicate that we're unable to guarantee the accuracy of it, given that we haven't prepared it, audited it or verified it.³⁷

Proposed reforms

6.40 Some submitters argued that there should be additional requirements on franchisors to ensure accurate financial information is provided to prospective franchisees.³⁸ For example, Mr Martin proposed that franchisors be required to obtain information from franchisees that included the following:

- actual net sales;
- actual cost of goods sold;
- actual total labour/employment costs (wages etc. including on-costs);
- actual occupancy/rental costs including outgoings; and
- estimated other overheads (all other costs excluding royalty and marketing fees).³⁹

6.41 Mr Sutherland contended that there is a strong argument for requiring historical earnings information to be provided to prospective franchisees, though the obligation should apply to the outgoing franchisee rather than the franchisor. The committee heard that this disclosure may assist a prospective franchisee to 'make a more meaningful decision particularly if it seeks experienced accounting advice on that information'.⁴⁰ The disclosure from the outgoing franchisee should:

...include an appropriate certification by the accountant for the franchisee but also the directors or owners of the franchisee including as to outstanding obligations to its employees.⁴¹

6.42 Mr Connors informed the committee that there was nothing currently in the Franchising Code that would prevent a franchisor from providing prospective franchisees with financial statements, as lodged with the Australian Taxation Office (ATO) to prospective franchisees, noting that:

In the majority of cases, franchisees are providing that profit and loss information to their proposed purchaser.⁴²

37 Mr Mark Connors, Director Corporate Services and Company Secretary, Retail Food Group Limited, *Committee Hansard*, 11 September 2018, p. 14; see also The Coffee Club, *Submission 77*, p. 2.

38 Mr Peter Sanfilippo, *Submission 83*, p. 1; Mr Emmanuel Martin, *Submission 118*, pp. 3–4; Name Withheld, *Submission 173*, p. 1.

39 Mr Emmanuel Martin, *Submission 118*, pp. 3–4.

40 Mr Derek Sutherland, *Submission 53*, p. 22.

41 Mr Derek Sutherland, *Submission 53*, p. 24.

6.43 Some inquiry participants raised concerns about making franchisors liable for providing false or inaccurate financial information to prospective franchisees when the information has been obtained from existing or former franchisees. The committee heard that the franchisor often does not collect all the financial information in relation to the business or that the existing or former franchisee may have provided data that the franchisor is not able to verify is accurate. For example, The Coffee Club noted that the company does not keep full financial records of franchisee's stores.⁴³

Disclosure and the role of brokers in the sale of franchises

6.44 Brokers are often involved in the purchase and sale of franchised businesses.⁴⁴ However, evidence to the committee indicated that the role of brokers with respect to disclosure in the pre-contractual stage has caused problems. Submissions referred to instances where the broker was not independent, or where brokers could be used by the franchisor to shift liability for the provision of disclosure information.⁴⁵ Notably, brokers are not referred to in the Franchising Code.

6.45 The Office of the NSW Small Business Ombudsman submitted that brokers played a 'problematic' role at the pre-contractual stage. It described brokers as third party operators seeking a commission from franchisors for facilitating the formation of a franchise agreement. In its submission, it identified two primary issues that are widely reported with the involvement of brokers in the sale and purchase of a franchise business:

- brokers have no interest in either the terms of the contract or the enduring welfare of the signatories. Franchise agreements commonly include a clause to the effect that a broker is not an agent of the franchisor as well as an 'entire agreement' (merger) clause providing that the written agreement represents the entire agreement between the parties; and
- brokers commonly make misinformed or knowingly unreliable warranties to prospective franchisees, contradicting the disclosure documentation and the franchise agreement.⁴⁶

6.46 The Office of the NSW Small Business Ombudsman indicated that franchisors may support broker conduct that misinforms franchisees. This conduct

42 Mr Mark Connors, *Committee Hansard*, 11 September 2018, p. 18.

43 The Coffee Club, *Submission 77*, p. 2.

44 Office of the NSW Small Business Ombudsman, *Submission 49*, p. 7; The Coffee Club, *Submission 77*, p. 5; Mr Derek Sutherland, *Submission 53*, p. 5; Mr Alan Evans and Ms Michelle Wolstenholme, *Submission 137*, p. 2; Salts of the Earth Franchisee Association, *Submission 144*, p. 7.

45 Office of the NSW Small Business Ombudsman, *Submission 49*, p. 7; Mr John and Mrs Julia Banks, *Submission 100*, p. 1; Mr Jaspal Singh, *Submission 104*, p. 2; Mr Michael Fraser, Director, Franchise Redress, *Committee Hansard*, 8 June 2018, p. 29; Name Withheld, *Submission 204*, p. 1.

46 Office of the NSW Small Business Ombudsman, *Submission 49*, p. 7.

diminishes the Franchising Code's disclosure function, irrespective of the quality of the disclosure documentation. It submitted that:

- the legislative provisions concerning misleading and deceptive conduct in trade or commerce, which formally prohibits brokers from engaging in such conduct, would be enhanced by contemplation of their role within the Franchising Code; and
- the Franchising Code should prohibit the use of 'no agent' clauses and 'entire agreement' clauses in franchise agreements as this would incentivise franchisors to ensure they are not being misrepresented by brokers and still allow franchisors to 'pass on' a contractual obligation to brokers not to misrepresent the franchise agreement.⁴⁷

6.47 The Victorian Small Business Commission argued that measures to enhance due diligence should be applied to the transfer of a franchise so that third parties, such as brokers and agents 'cannot muddy the waters of disclosure'.⁴⁸

Disputes relating to disclosure

6.48 The Small Business Development Corporation (SBDC) expressed concern that there are deliberate actions by parties to a franchise agreement that offend the Franchising Code's intent and that are not subject to pecuniary penalty. The SBDC submitted that it is aware of the following occurring:

- failure to disclose the rebates or benefits provided by suppliers (Item 10(j) and 10(k) of Annexure 1 of the Franchising Code);
- failure to disclose how marketing funds are expended and how effective promotional activities are in terms of returning benefit to franchisees (clauses 15 and 31 of the Franchising Code);
- failure to provide financial statements for existing or former franchised businesses being taken over by a new franchisee (Item 20 of Annexure 1 of the Franchising Code); and
- failure to provide up-to-date contact details of former franchisees that have recently exited the system (Item 6 of Annexure 1 of the Franchising Code).⁴⁹

6.49 Other issues include vague and unhelpful disclosure of price ranges. The ACCC noted that some franchisors appear to be providing excessively wide price ranges that diminishes the meaningfulness of the information provided to franchisees:

The example that we provided was in relation to a fit-out. You can see a very low range and a very high range, but, if you're trying to work out what the costs are of establishing a business, it's very difficult to know where you

47 Office of the NSW Small Business Ombudsman, *Submission 49*, p. 7.

48 Victorian Small Business Commission, *Submission 38*, p. 4.

49 Small Business Development Corporation, Answer to questions on notice, 16 October 2018, (November 2018), p. 3.

sit. To make that more meaningful information, more facts and assumptions should be provided.⁵⁰

6.50 The Law Council of Australia (Law Council) acknowledged that many disputes emanate from a lack of information or incorrect information and noted that:

This can be as a result of many factors including ambiguous wording of existing specific items, poor interpretation of what information is required and the degree of aptitude and experience a franchisor or its advisor has in preparing disclosure documents.⁵¹

6.51 The Department of Jobs and Small Business submitted that alleged issues relating to disclosure or misrepresentation constituted 10 per cent of the 286 mediation requests lodged with the Office of the Franchising Mediation Adviser between 1 January 2017 and 30 December 2017.⁵²

6.52 The Law Council proposed pre-vetting and post-vetting of disclosure documents as a useful measure to assist with the removal of interpretation issues resulting from, for example, ambiguous wording, and improve baseline disclosure standards. The Law Council also called for the ACCC to be more active in enforcement.⁵³

Disclosure during a franchise agreement—marketing fees and funds

6.53 Franchisors typically require franchisees to pay a fee to the franchisor for the purposes of marketing and advertising the brand. These fees are usually pooled. This section discusses the current provisions for marketing funds in the Franchising Code, as well as franchisor compliance with those provisions, inconsistencies in the drafting of certain provisions, and the role of auditors.

6.54 The primary concerns raised by submitters in relation to marketing and advertising funds consisted of:

- a lack of clarity around the definition of marketing fund and marketing fees in the Franchising Code;
- franchisor misuse of funds and lack of accountability;
- reporting requirements not providing meaningful information to franchisees; and
- a lack of franchisor and auditor understanding of what is required to meet the reporting requirements.

50 Ms Kristie Piniuta, Director, Small Business and Industry Codes, Australian Competition and Consumer Commission *Committee Hansard*, 21 September 2018, p. 58.

51 Law Council of Australia, *Submission 59*, p. 5.

52 Department of Jobs and Small Businesses, *Supplementary submission 20.2*, pp. 17–18.

53 Law Council of Australia, *Submission 59*, p. 5.

6.55 Several submitters, including the ACCC, supported greater clarity and franchisor accountability in relation to management, reporting and use of marketing and advertising funds.⁵⁴

6.56 Thirty one per cent of confidential submitters raised the poor accountability of a franchisor's use of marketing funds as a substantive concern.

Provisions under the Franchising Code

6.57 Marketing funds and fees are regulated by clauses 15 and 31 of the Franchising Code. A franchisor is required to keep a separate bank account for marketing fees and advertising fees contributed by franchisees. Franchisors are also required to contribute fees on behalf of each unit of marketing on the same basis as other franchisees.⁵⁵

6.58 Irrespective of terms in the franchise agreement, marketing fees may only be used to:

- meet expenses that:
 - have been disclosed to franchisees in the disclosure document; or
 - are legitimate marketing expenses; or
 - have been agreed to by the majority of franchisees; or
- pay the reasonable costs of administering and auditing a marketing fund.⁵⁶

6.59 The Franchising Code stipulates that within four months of the end of each financial year, the franchisor must prepare an audited annual financial statement detailing all marketing fund receipts and expenses for the previous financial year and provide the statement and auditor's report to franchisees within the subsequent 30 days. The penalty for not preparing and providing these documents to franchisees that contribute to the marketing fund is 300 penalty points. From 1 July 2017, the value of a penalty unit was raised to \$210, meaning the maximum penalty for a breach of this provision is \$63 000. This requirement does not have to be complied with in the event that 75 per cent of the franchisees that contribute to the fund vote that compliance is not necessary.⁵⁷

54 Australian Competition and Consumer Commission, *Submission 45*, p. 14; Victorian Small Business Commission, *Submission 38*, p. 4; Professor Andrew Terry, *Submission 108*, p. 5; Franchise Relationships Institute, *Submission 47*, p. 7.

55 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, cl. 31.

56 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, sub cl. 31(3).

57 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, c. 15.

Clarity and accountability: reform of clauses 15 and 31—marketing funds and fees

6.60 Several submitters variously drew attention to:

- a loophole between clauses 15 and 31 of the Franchising Code;
- a lack of clarity in clause 31; and
- the lack of a penalty provision in clause 31.

Loophole

6.61 The ACCC noted that reference to a 'marketing fund' in clause 15 and 'marketing and advertising fees' in clause 31 of the Franchising Code created a loophole for franchisors to argue they were not obliged to comply with the clause 15 reporting obligations 'because they do not operate a 'marketing fund' per se'.⁵⁸

6.62 The ACCC argued that the drafting of clauses 15 and 31 of the Franchising Code should be amended to provide that both clauses apply where a franchisee is required to make regular payments to the franchisor to cover advertising and marketing activities.⁵⁹

6.63 The ACCC submitted that similar provisions should be considered for the Oil Code.⁶⁰ Currently, the Oil Code stipulates that statements need to be prepared and audited within three months of the end of the financial year, but are only required to provide a copy to the franchisee if the franchisee requests it. The franchisor has 30 days to comply with the request except where 75 per cent of retailers agree that the supplier is not required to comply.⁶¹

6.64 Mr Sutherland argued that the Franchising Code should be amended so that master franchisors⁶² are required to comply with the Code as it relates to the maintenance and use of marketing and other cooperative funds:

Clause 12 should be amended so that it does not exclude the obligation of a master franchisor to comply with clauses 15 and 31 where the subfranchisee is directly or indirectly required to contribute to a marketing or cooperative fund controlled or administered by the master franchisor in Australia. If contributions are paid to the master franchisor it should be obliged to comply. Similarly some master franchisors may control or receive rebates from suppliers—there should be an obligation in Item 7/Item 10 of the disclosure document for this to be disclosed because currently disclosure in Item 10 only is limited to whether the franchisor receives rebates. There is no mention made of a master franchisor...

58 Australian Competition and Consumer Commission, *Submission 45*, p. 14.

59 Australian Competition and Consumer Commission, *Submission 45*, p. 14.

60 Australian Competition and Consumer Commission, *Submission 45*, p. 14.

61 Competition and Consumer (Industry Codes—Oil) Regulations 2017, c. 28.

62 See definitions at paragraph 2.21 in chapter 2: a master franchisor means a franchise in which the franchisor grants to a subfranchisor the right to grant a subfranchise, or to participate in a subfranchise.

There are a number of funds controlled by master franchisors. The master franchisees collect the payments or make payments go directly to the fund. Unless the master franchisee also contributes to that fund for corporate units it operates there may be no obligation for a franchisor to comply with clause 15 and 31 or even item 15.⁶³

Clarity

6.65 Other submitters argued that clause 31 lacked clarity.⁶⁴ The Office of the NSW Small Business Commissioner noted that franchisors commonly abuse marketing funds and that the definition of 'legitimate' marketing and advertising expenses should be further defined:

In particular, the Code requires that marketing funds are used for 'legitimate' marketing and advertising expenses. However, it does not define 'legitimate'. While the OSBC [Office of the Small Business Commissioner] acknowledges that such expenses may be expected to encompass a wide range of potential activities, the vagary of the clause allows for franchisor abuse. For example, a franchisor—typically holding unfettered control of the marketing fund—may regard expenditure to on-sell a vacant business, or support its own online sales, as entirely legitimate. The franchisees paying for these activities but receiving no direct benefit, or even a potential detriment, are likely to disagree. The Code should require that funds provided to a marketing fund by franchisees are spent on activities directly supporting the interests of those franchisees (subject to the existing proviso that franchisees may agree to expenditure for a separate purpose).⁶⁵

Civil penalty provision

6.66 The Law Council pointed out that only clause 15 of the Franchising Code governing 'the preparation and distribution of marketing and cooperative fund financial statements is a civil penalty provision'. The Law Council noted anecdotal evidence of widespread non-compliance in relation to marketing funds and submitted that civil penalties should apply to clause 31 of the Franchising Code.⁶⁶

6.67 Mr Sutherland agreed that penalties should apply to clause 31, stating:

I am surprised that clause 31 was not made a civil remedy provision when the new code commenced even though clause 15 was. There can be no real accountability for administration of marketing and cooperative funds unless clause 31 is made a civil remedy provision with a fine or penalty for contravention and some way for a franchisee to determine whether they have complied before the expense is incurred.⁶⁷

63 Mr Derek Sutherland, *Submission 53*, p. 28.

64 Office of the NSW Small Business Commissioner, *Submission 49*, p. 11; Franchise Relationships Institute, *Submission 47*, p. 7; Professor Andrew Terry, *Submission 108*, p. 5.

65 Office of the NSW Small Business Commissioner, *Submission 49*, p. 11.

66 Law Council of Australia, *Submission 59*, p. 6.

67 Mr Derek Sutherland, *Submission 53*, p. 32.

Franchisor compliance with financial reporting obligations for the marketing fund

6.68 Several submitters raised concerns about franchisor compliance with financial reporting obligations for the marketing fund.

6.69 The ACCC noted two common issues identified during their compliance check program:

- the provision of marketing fund statements to franchisees with insufficient detail to provide meaningful information about sources of income and items of expenditure as required by clause 15 of the Franchising Code; and
- marketing fund statements not being audited within four months of the end of the franchisor's financial year.⁶⁸

6.70 Mr Hank Spier, from the Law Council, noted that franchisors are often not open to discussing marketing fund financial statements with franchisees.⁶⁹

6.71 Mr Sutherland noted that the provision of the financial statement and audit report to franchisees is not helpful if franchisees are not able to challenge the items contained in the statements 'after the event':

In some cases a statement can indicate at the end of a year that the fund in significant arrears simply because the marketing spend has continued and the marketing strategy and spend not been adjusted even though contributions have decreased.⁷⁰

6.72 For example, Mr Brett Roveda, a former experienced senior corporate executive, and more recently a franchisee, submitted that:

...somehow the franchisor seems to have spent \$3.1M on advertising and none of us has seen any; somehow we seem to have spent nearly \$1.0M on Point of Sales Promotions and Materials and none of us can see where this has gone; somehow we seem to have spent \$1.5M on payroll when we are aware of only 2-3 FTEs in the franchisor marketing department (and this department is now a shared service within the franchisor). In total, we find ourselves with an ad fund account now \$1.8M in deficit with apparently nothing (positive) to show for it.⁷¹

6.73 Mr Sutherland also argued that there should be a clear understanding of the kind of goods or services that a franchisor or its associate provides to the fund and the cost or method or basis of how it is calculated and charged to the fund. Mr Sutherland submitted that it would be useful for a standard Charter of Accounts to be developed and published for presentation of financial reports of a fund including notes and

68 Australian Competition and Consumer Commission, *Submission 45*, p. 14.

69 Mr Hank Spier, Committee Member, Small and Medium Enterprises Committee, Business Law Section, Law Council of Australia *Committee Hansard*, 21 September 2018, p. 32.

70 Mr Derek Sutherland, *Submission 53*, p. 29.

71 Mr Brett Roveda, *Submission 131*, p. 4.

guidance on how it should be presented. Standardisation of coding for particular items would prevent franchisors from reporting expenses as 'Other'.⁷²

Auditor expertise regarding franchisor obligations under the Franchising Code

6.74 Submitters were also concerned that auditors did not have a comprehensive understanding of the franchisor's compliance obligations under the Franchising Code.

6.75 The Law Council observed that the Auditing and Assurance Standards Board has prepared a guidance document in relation to item 21 of Annexure 1 of the Franchising Code in relation to financial details about the franchisor. However, there is no similar guidance document for clause 15 regarding the preparation and provision of a copy of the financial statements and audit report for marketing fund to the franchisee. The Law Council submitted that:

...it may be appropriate for the Government to direct the AUASB [Auditing and Assurance Standards Board] to prepare a guidance document in relation to the auditing of marketing and cooperative funds under clause 15 of the FCC [Franchising Code].⁷³

6.76 Mr Sutherland expressed the view that many accounting firms who assist franchisors with preparing annual statements of marketing funds and marketing fund audit reports may not fully understand or appreciate the financial reporting obligations imposed under the Franchising Code and the disclosure required by franchisors.⁷⁴ Mr Sutherland submitted that:

I have seen quite a number of marketing fund financial reports. Many contain fundamental mistakes or limited opinions. On several occasions I have had to ask auditors to reissue the report because of those mistakes.⁷⁵

The role of the ACCC

6.77 In response to ongoing compliance issues, the ACCC sent franchisors a series of bulletins in 2017 outlining what franchisors must do to comply with the Franchising Code in relation to marketing funds.⁷⁶

6.78 The FCA submitted that the ACCC and accounting bodies should work together with the FCA to develop 'template financial reports for marketing funds that contain meaningful information to demonstrate compliance with financial reporting as well as compliance obligations under the Code'.⁷⁷

6.79 The FCA noted the ACCC has been active in its educational and enforcement activities to ensure franchisors comply with the provisions for marketing funds in the Franchising Code, particularly in relation to defining what it expects to see in the

72 Mr Derek Sutherland, *Submission 53*, pp. 30–32.

73 Law Council of Australia, *Submission 59*, p. 6.

74 Mr Derek Sutherland, *Submission 53*, p. 28

75 Mr Derek Sutherland, *Submission 53*, p. 30.

76 Australian Competition and Consumer Commission, *Submission 45*, p. 21.

77 Franchise Council of Australia, *Submission 29*, p. 36.

context of 'meaningful information'.⁷⁸ The FCA suggested the ACCC release an enforcement guideline or bulletin in order to enhance disclosure.⁷⁹

Allocation of marketing funds if the franchisor is wound up

6.80 KordaMentha pointed out that, as marketing funds are generally non-refundable, there is no provision for how unused marketing funds should be treated in the event of the winding up of the franchisor. This places liquidators in the difficult position of determining whether the funds should be counted as a circulating asset of the franchisor and made available to pay priority employee entitlements in line with the *Corporations Act 2001*, or returned to franchisees as would be consistent with the obligations of clause 31 of the Franchising Code. Using funds to pay employees may constitute a breach of the Franchising Code and franchise agreement. KordaMentha noted that the lack of clarity necessitates legal advice and potentially court intervention which reduces the pool of assets available to be distributed.⁸⁰

Registration

6.81 Another aspect of disclosure relates to the establishment of a franchise registry that holds franchise disclosure documents and franchise agreements.

Current situation

Joint Committee 2008 report and Government response

6.82 In its 2008 report, the committee recommended that the government investigate the benefits of developing an online registration system for the Australian franchise sector.⁸¹ The government indicated that the cost of an online registration system would need to be borne by businesses in the franchise sector, and that the benefits would be unlikely to outweigh the costs.⁸² In addition, the government was of the view that requiring franchisors to register guarantees of compliance would not improve actual compliance as the government would not be verifying the accuracy of franchisors' statements. Further, such a system could reduce the due diligence undertaken by prospective franchisees and create an expectation that the regulator has endorsed the franchise system.⁸³

78 Franchise Council of Australia, *Submission 29*, p. 36; Franchise Council of Australia, *Supplementary submission 29*, pp. 13 and 21.

79 Franchise Council of Australia, *Supplementary submission 29*, p. 22.

80 KordaMentha, *Submission 54*, pp. 2–3.

81 Parliamentary Joint Committee on Corporations and Financial Services, *Opportunity not opportunism: improving conduct in Australian franchising*, 1 December 2008, p. 49. The *Competition and Consumer Act 2010* supersedes the *Trade Practices Act 1974*.

82 Australian Government Response to the report of the Parliamentary Joint Committee on Corporations and Financial Services – *Opportunity not opportunism: improving conduct in Australian franchising*, p. 11.

83 Australian Government Response to the report of the Parliamentary Joint Committee on Corporations and Financial Services – *Opportunity not opportunism: improving conduct in Australian franchising*, pp. 11–12.

Australian Franchise Registry

6.83 In 2014, FRANdata launched the Australian Franchise Registry.⁸⁴ As of 31 October 2018, the Australian FRANdata Registry listed 1060 brands out of an estimated 1180 franchise systems in Australia.⁸⁵

6.84 While FRANdata confirms the status of a franchise on receipt of an up-to-date disclosure document and franchise agreement, FRANdata does not verify whether the franchise documentation complies with the Code or relevant laws.⁸⁶ Nor does it publish the documents on its website. Further, the lender profiles are available to authorised lenders only.⁸⁷

6.85 FRANdata submitted that it had received disclosure documents from approximately 150 of the listed brands, or roughly 13 percent of franchise systems in Australia.⁸⁸ FRANdata noted that the small number of franchisors willing to provide disclosure documents may be due to some franchisors not updating their disclosure documentation annually as required by the Franchising Code.⁸⁹

Views on a mandatory public franchise registry

6.86 Several submitters pointed to the benefits of a franchise registration system where franchisors are required to register their franchise systems.⁹⁰

6.87 Several submitters were of the view that a free public franchise registry should be administered by the ACCC and include the lodging of disclosure documents with the regulator.⁹¹

6.88 Submitters also pointed out that many states and territories require lessors to register commercial leases on a registry. There are precedents for the reporting of agreements between parties, such as the requirement for landlords to notify the state

84 FRANdata was founded in the US and holds more than 50 000 disclosure documents through its US Franchise Registry service.

85 Australian Franchise Registry, *Lender profile request*, (accessed 9 January 2019).

86 Australian Franchise Registry, *The Franchise Registry™ Is The Only Registry Of Australian Franchise Systems*, (accessed 9 January 2019).

87 Australian Franchise Registry, *Lender profile request*, (accessed 9 January 2019).

88 FRANdata, *Submission 46*, p. 2.

89 FRANdata, *Submission 46*, p. 2.

90 Office of the NSW Small Business Ombudsman, *Submission 49*, p. 2, 8; Dr Jenny Buchan, *Submission 16*, p. 3; Mr Michael Sherlock, *Submission 3*, p. 3; Franchise Council of Australia, *Submission 29*, p. 23; Dymocks Franchise Systems (NSW) Pty Ltd, *Submission 67*, p. 6; Dr Sudha Mani, Answer to questions on notice, 3 October 2018, (19 October 2018), p. 2; Dr Tess Hardy, *Submission 91*, p. 5; Mr Derek Sutherland, *Submission 53*, p. 16.

91 Office of the NSW Small Business Ombudsman, *Submission 49*, p. 2, 8; Dr Jenny Buchan, *Submission 16*, p. 3; Mr Michael Sherlock, *Submission 3*, p. 3; see also Dr Sudha Mani, Answer to questions on notice, 3 October 2018, (19 October 2018), p. 2.

Small Business Commissioner of an agreed commercial lease and provide certain details under section 25 of the *Retail Leases Act 2003* (Vic).⁹²

6.89 Mr Michael Sherlock made a similar comparison, stating:

...I think franchise deeds and disclosure documents should be like commercial leases. They should be registered. Registration fees should apply based on the amount of stores in the network. They should be discoverable for researchers so that everyone can see them—more like a name-and-shame scenario. The money would go to ACCC, and they would be more resourced to be able to oversee.⁹³

6.90 Dymocks Franchise Systems (NSW) submitted that a national public database would be beneficial for both franchisees and franchisors, especially where it could assist with reducing the length and repetition contained in disclosure documents.⁹⁴

6.91 Mr Sutherland outlined two consequences of the absence of a scheme requiring registration of documents with a government body such as the ACCC:

- firstly, there is no pre-vetting of documents for minimum levels of disclosure compliance by the ACCC before a disclosure document is given to a prospective franchisee; and
- secondly, the ACCC is required to request disclosure documents from franchisors in order to review them and historically only checks a small number of documents per year compared to the number of franchise systems operating.⁹⁵

6.92 FRANdata similarly noted:

There appears to be a significant compliance and information gap in Australian franchising. Policy makers and regulators are unable to access definitive compliance information, which leaves the ACCC reliant on a complaints based mechanism to frame enforcement activities.⁹⁶

6.93 Mr Jason Gehrke, Director at the Franchise Advisory Centre, agreed that a centralised list of franchisors should be run by the ACCC.⁹⁷ He considered that franchisors should be required to meet some entry level requirements before it can be registered, noting that there are no barriers to a franchisor starting a franchise in Australia today. However, he cautioned that requiring the lodgement of disclosure

92 *Victorian Retail Leases Act 2003*, s. 25.

93 Mr Michael Sherlock, *Committee Hansard*, 8 June 2018, p. 49.

94 Dymocks Franchise Systems (NSW) Pty Ltd, *Submission 67*, p. 6.

95 Mr Derek Sutherland, *Submission 53*, p. 16; see also Mr Stephen Giles, Board Director, Franchise Council of Australia, *Committee Hansard*, 21 September 2018, p. 16.

96 FRANdata, *Submission 46*, p. 2.

97 Mr Jason Gehrke, Director, Franchise Advisory Centre, *Committee Hansard*, 24 August 2018, p. 34.

documents and vetting such documents for compliance could create a liability for the government.⁹⁸

6.94 However, Ray White, a real estate franchisor, did not support mandatory franchisor registration with a government body as it would increase costs without providing any material benefits, noting that franchisors already fulfil requirements by annually updating disclosure documents and that a registration system would only duplicate this process.⁹⁹

6.95 Mr Greg Nathan, from the Franchise Relationships Institute, pointed out that the Franchising Code requires franchise disclosure documents to disclose the details of current and former franchisees, including a contact number, thereby negating the need for a public register of franchisees.¹⁰⁰

6.96 The FCA submitted that registration with the privately run Australian Franchise Registry should be mandatory, and that the ACCC should be provided with powers to penalise franchise systems that have failed to register.¹⁰¹

6.97 Mr Terence O'Brien, Senior Associate at Brand Partners Commercial Lawyers, argued that disclosure documents should receive audit certification and be lodged for approval with the ACCC:

...given the potential damage that can be caused by a deficient disclosure document, a disclosure document as a minimum should be accompanied by an audit certification and be lodged with the ACCC for approval.¹⁰²

ACCC view

6.98 While the ACCC acknowledged proposals to require disclosure documentation to be lodged with the ACCC, it expressed concern that this approach may provide a false perception to prospective franchisees that the ACCC had verified the compliance of disclosure documents:

We don't think this will solve the problem. Our concern with this proposal is that it creates the very real risk of a perception that a particular franchise has been accredited by the ACCC and that prospective franchisees therefore do not need to seek advice or to conduct as detailed a business assessment before agreeing to sign up.¹⁰³

98 Mr Jason Gehrke, Director, Franchise Advisory Centre, *Committee Hansard*, 24 August 2018, p. 34.

99 Ray White, *Submission 31*, p. 6.

100 Mr Greg Nathan, Founder, Franchise Relationships Institute, *Committee Hansard*, 22 June 2018, p. 73. However, some submitters argued that franchisee information should be collected on a public database. See Dr Tess Hardy, *Submission 91*, p. 5.

101 Franchise Council of Australia, *Submission 29*, p. 23.

102 Mr Terence O'Brien, Senior Associate, Brand Partners Commercial Lawyers, *Submission 112*, p. 4.

103 Mr Mick Keogh, Deputy Chair, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 50.

6.99 The ACCC indicated that understanding the number of franchisees or franchise systems was not necessary for effective enforcement:

Understanding the number of franchisees or franchise systems is not required to effectively regulate a sector. The ACCC already regulates a number of sectors without having this information.

In accordance with our Compliance and Enforcement Policy, the ACCC uses a range of compliance and enforcement tools to encourage compliance with the Act [CCA]. In deciding which compliance or enforcement tool (or the combination of such tools) to use, our first priority is always to achieve the best possible outcome for the community and to manage risk proportionately. Knowing the number of franchisees or franchisors operating is unlikely to change our approach to enforcement or compliance.¹⁰⁴

6.100 The ACCC also informed the committee that under section 51ADD of the CCA it can issue a notice requiring a franchisor to provide information or documents that they are required to keep or publish under the Franchising and Oil Codes. However, the ACCC raised the concern that if the franchisor refuses or fails to comply with the notice, the only option available to the ACCC is to apply to a court for a court order. The ACCC argued that:

The availability of a civil pecuniary penalty and infringement notices for failing to comply with a s51ADD notice would be significantly stronger incentive for [f]ranchisors to comply with the notice and significantly improve the ACCC's ability to effectively monitor compliance with prescribed industry codes.¹⁰⁵

Committee view

6.101 Evidence from a number of stakeholders drew attention to the asymmetry of resources, business experience, education, and sophistication that exists between franchisees and franchisors. As noted earlier, information asymmetry that favours franchisors can hamper franchisees in conducting due diligence. It is difficult for franchisees to make informed decisions if they lack an understanding of fees and other costs, contractual obligations and personal risks.

6.102 The committee acknowledges that a well-functioning and efficient franchise sector requires franchisees to be well-informed. Accordingly, the recommendations in this chapter address both pre-contractual and in-term disclosure.

Up-front and pre-contractual disclosure

6.103 The committee recognises that franchisors are currently required to disclose a substantial amount of information to prospective franchisees. Disclosure documentation can mean the provision of hundreds of pages of information to prospective franchisees. This can create a significant financial and resource burden for

104 Australian Competition and Consumer Commission, *Answer to questions on notice*, 21 September 2018, (19 October 2018), p. 2.

105 Australian Competition and Consumer Commission, *Submission 45*, p. 5.

some franchisors. The committee also acknowledges that franchisees are unlikely to read disclosure documents in their entirety, and may not have a full understanding of the terms in the disclosure document and franchise agreement. Any increase to the amount of information provided during the disclosure process would likely make it more difficult and expensive for legal advisers and accountants to thoroughly assess the documentation. The time and expense dedicated to assessing disclosure documentation also likely limits the prospective franchisee's ability to compare multiple franchise systems, despite the uniform presentation of the documents as per the provisions in the Franchising Code.

6.104 Therefore, the committee has focused on practical changes to improve the simplicity, accuracy and availability of information to franchisees. The committee makes recommendations in other chapters to better manage disputes arising from inaccurate disclosure by improving exit rights for franchisees (chapter 11) and collective bargaining rights (chapter 14).

6.105 Given the complexity and size of the documents, the committee is of the view that the due diligence process would be greatly assisted by having access to all documents in electronic form. The committee considers that the Franchising Code should be amended to require the franchisor to make available both a hard and electronic copy of the disclosure documents and the franchise agreement to the franchisee or prospective franchisee.

6.106 The committee also considers that Annexure 2 of the Franchising Code should be provided to franchisees as a separate document that is subject to the disclosure and cooling off provisions, and not merely as an attachment to the copy of the Franchising Code that is provided to franchisees.

Recommendation 6.1

6.107 The committee recommends that the Australian Government amend the Franchising Code of Conduct to provide that the disclosure document and franchise agreement must be made available in both electronic and hardcopy form.

Recommendation 6.2

6.108 The committee recommends that the Australian Government amend the Franchising Code of Conduct to provide that franchisors must provide the information statement set out in Annexure 2 to franchisees as a separate document that is also subject to the disclosure and cooling off provisions, and not as an attachment to the Franchising Code of Conduct.

Provision and accuracy of earnings information

6.109 Evidence to the inquiry indicated that the provision of accurate earnings information to prospective franchisees was particularly problematic.

6.110 The committee is concerned that earnings information and other financial information relating to the franchise business is being provided to the franchisee separately to the disclosure document in order to avoid complying with the requirements in the Franchising Code.

6.111 The committee is also concerned that franchisors and/or selling franchisees may provide potentially inaccurate financial information. This is a particular concern when franchisors provide a statement to the effect that the financial information cannot be relied upon by the prospective franchisee.

6.112 The committee acknowledges that franchisors are concerned about creating a potential legal liability if they were to unintentionally provide prospective franchisees with inaccurate or misleading earnings information, particularly where the information has been obtained from franchisees in the system.

6.113 Nevertheless, the committee considers that prospective franchisees are unable to conduct comprehensive due diligence without accurate financial information.

6.114 In chapter 19 (financing), the committee notes that all businesses are required to lodge Business Activity Statements (BAS) with the ATO. The committee considers that a BAS is likely to provide a true and accurate picture of a business including revenues, costs, and gross profits. The committee considers that any prospective purchaser of an existing franchise outlet should be given at least the previous two years' BAS as well as other financial information including profit and loss statements, balance sheets, and an assessment of labour costs. Without access to the BAS, a franchisee has no reasonable basis to assess the viability of the business.

6.115 The committee sees merit in mandating that the vendor franchisee's BAS be provided to prospective franchisees in the disclosure document. In this way, franchisors will also remain subject to the general misleading and deceptive conduct provisions, but will not be required to undertake excessive processes to verify the financial information provided by franchisees. It would also motivate franchisors to introduce systems to automatically collect and retain financial information about its franchisees' businesses.

Recommendation 6.3

6.116 The committee recommends that the Australian Government amend the Franchising Code of Conduct to provide that:

- **the vendor franchisee or franchisor must provide the prior two years' Business Activity Statements, a profit and loss (income) statement and balance sheets (statement of financial position) and an assessment of labour costs for that particular franchise business to the prospective franchisee, or franchisor if the vendor franchisee is closing or selling back to the franchisor, in the disclosure document or attached to the disclosure document; or**

- if the franchise is a greenfield franchise, then the franchisor must provide the prospective franchisee the Business Activity Statements, profit and loss statements and balance sheets for the two year period of a comparable franchise to the prospective franchisee in the disclosure document or attached to the disclosure document.

Recommendation 6.4

6.117 The committee recommends that the Australian Government amend the Franchising Code of Conduct to provide that all financial information relating to the franchise business must not be provided to the franchisee separately to the disclosure document (that is, it must be provided in or attached to the disclosure document).

Recommendation 6.5

6.118 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require the franchisor to include the following statement in the franchise disclosure document concerning financial statements it provides:

"To the best of the franchisor's knowledge, the earnings and other financial information provided in this disclosure document are:

- a) accurate, correct and compliant with the Franchising Code of Conduct and relevant Australian Accounting Standards Board standards at the time of signing;**
- b) except where discrepancies have been identified in writing at the time of signing."**

Franchise agreement brokers

6.119 The committee recognises the seriousness of the issues raised by the Office of the NSW Small Business Ombudsman in relation to the involvement of brokers in the formation of franchise agreements. The committee considers that franchisors that sell franchise opportunities through brokers should not be able to defer all liability for any misrepresentation of the franchise opportunity to a prospective franchisee.

6.120 The committee acknowledges that brokers are subject to legislative provisions concerning misleading and deceptive conduct in trade or commerce. However, given the concerns expressed by the Office of the NSW Small Business Ombudsman, the committee considers that the Franchising Taskforce should review the use of third party brokers in the selling of franchises and the appropriateness of 'no agent' and 'entire agreement' terms in the franchise agreement.

Recommendation 6.6

6.121 The committee recommends that the Franchise Taskforce review the use of third party brokers in selling franchise businesses and the continued appropriateness of the use of 'no agent' and 'entire agreement' terms in franchise agreements, and if so, whether additional disclosure on the meaning and effect of such clauses should be mandated in the Franchising Code of Conduct.

Marketing fees and marketing funds

6.122 A substantial body of evidence to the inquiry related to problems arising from marketing funds and fees. Key issues were:

- the lack of clarity around the definitions of marketing funds and marketing fees in the Franchising Code, and a loophole in relation to clauses 15 and 31;
- the lack of a civil penalty provision in clause 31;
- current ability of master franchisors to avoid certain obligations under the Franchising Code in relation to marketing funds;
- franchisor misuse of funds and lack of accountability;
- reporting requirements not providing meaningful information to franchisees;
- a lack of franchisor and auditor understanding of what is required to meet the reporting requirements; and
- the distribution of unused marketing funds in the event of the franchisor winding up.

6.123 On the evidence received, the committee considers that some franchisors have abused the marketing fund and used the marketing fees collected from franchisees inappropriately.

6.124 The committee notes the observation of the ACCC that reference to a 'marketing fund' in clause 15 and 'marketing and advertising fees' in clause 31 of the Franchising Code has created a loophole for franchisors to argue they are not obliged to comply with the clause 15 reporting obligations. The committee supports the view of the ACCC that the drafting of clauses 15 and 31 of the Franchising Code should be amended to provide that both clauses apply where a franchisee is required to make regular payments to the franchisor to cover advertising and marketing activities.

6.125 The committee also notes the failure of some franchisors to comply with their financial reporting obligations with respect to the marketing fund. The ACCC found instances of marketing fund statements not being audited within four months of the end of the franchisor's financial year. The committee considers that franchisors must comply with clauses 15 and 31 so that franchisees are provided with an audited marketing fund statement within 30 days of preparing the statement and that clause 31 should include a civil pecuniary penalty provision in order to ensure appropriate accountability in relation to the administration of marketing and cooperative funds.

6.126 The committee also considers that franchisees should be provided with the actual financial statements for the marketing fund account within 30 days of the end of each quarter. This would enable franchisees to see the amounts going into the fund and each expense. Accounting for the fund each quarter would also lower the potential risk of franchisee's contributions being misused by the franchisor throughout the year and assist early detection if the franchisor redirects substantial funds to other creditors. The committee notes that while this recommendation would allow franchisees to see the payment times of other franchisees in the network, it would also allow franchisees to see the mandatory contributions of company stores. The committee considers that the benefit of additional protection for franchisee contributions, and greater

accountability around franchisor contributions and expenses, outweighs the concerns around the confidentiality of franchisee payments.

6.127 Similarly, the committee considers that clause 12 of the Franchising Code should be amended to provide that a master franchisor (that is, a franchise in which the franchisor grants to a subfranchisor the right to grant a subfranchise, or to participate in a subfranchise) must comply with clause 15 and clause 31 where the subfranchisee is directly or indirectly required to contribute to a marketing or cooperative fund that is controlled or administered by the master franchisor, noting that the master franchisor may not reside in Australia.

6.128 The committee shares the concerns of submitters that some auditors do not appear to have a comprehensive understanding of the franchisor's compliance obligations under the Franchising Code. In order to assist accountants and franchisors to prepare financial statements for a marketing and cooperative fund, and to ensure comprehensive audits are conducted, the committee supports the Law Council's proposal that the Australian Government direct the Auditing and Assurance Standards Board to prepare a guidance document in relation to the auditing of marketing and cooperative funds under clause 15 of the Franchising Code.

6.129 The committee is concerned that the drafting of clause 28 of the Oil Code does not require the provision of a marketing fund statement to retailers (franchisees) except on request. It is also concerned that the Oil Code does not require retailers to vote on whether the franchisor should provide the marketing fund statement to retailers within a specified time frame, for example three months from when the statement is prepared (as is required in the Franchising Code).

6.130 The committee considers that, subject to the other recommendations made regarding marketing funds and fees in the Franchising Code, the Oil Code should be amended so that it contains the same provisions as the Franchising Code in relation to marketing funds and fees.

6.131 The committee also considers that it would be beneficial to clarify the distribution of unused marketing funds in the event of the franchisor winding up.

Recommendation 6.7

6.132 The committee recommends that the Australian Government amend clauses 15 and 31 of the Franchising Code of Conduct to provide that both clauses apply where a franchisee is required to make regular payments to the franchisor to cover advertising and marketing activities. The language used in clauses 15 and 31 needs to be consistent.

Recommendation 6.8

6.133 The committee recommends that the Australian Government amend clause 31 of the Franchising Code of Conduct to provide for civil pecuniary penalties for a breach of the clause.

Recommendation 6.9

6.134 The committee recommends that the Australian Government amend clause 15 of the Franchising Code of Conduct to provide that the actual financial statements for the marketing fund account be provided to franchisees within 30 days of the end of each quarter with sufficient detail as to be prescribed in the Franchising Code of Conduct and relevant standards set by the Australian Accounting Standards Board.

Recommendation 6.10

6.135 The committee recommends that the Australian Government amend clause 12 of the Franchising Code of Conduct to provide that a master franchisor must comply with clauses 15 and 31 where the subfranchisee is directly or indirectly required to contribute to a marketing or cooperative fund controlled or administered by the master franchisor.

Recommendation 6.11

6.136 The committee recommends that the Auditing and Assurance Standards Board prepare and issue an audit guidance and Chart of Accounts for marketing and cooperative fund audits in order to:

- assist accountants and franchisors in the preparation of financial statements for a marketing or cooperative fund; and
- assist auditors to prepare audit reports for marketing or cooperative funds.

Recommendation 6.12

6.137 The committee recommends that the Australian Government clarify, through legislation, the distribution of unused marketing funds in the event of the franchisor winding up.

Recommendation 6.13

6.138 The committee recommends that, subject to the other recommendations in this report in relation to marketing funds and fees in the Franchising Code of Conduct, the Oil Code of Conduct should be amended so that it contains the same provisions as the Franchising Code of Conduct in relation to marketing funds and fees.

Franchise registration

6.139 The committee notes the arguments from FRANdata and the FCA that compulsory registration of franchisors with the Australian Franchise Registry could force franchisors to maintain up to date disclosure documentation.

6.140 However, the committee is mindful of three issues with this proposal:

- firstly, mandating registration with the Australian Franchise Registry would impose some resource and financial burden on the franchisor, with franchisors charged a nominal fee;
- secondly, the Australian Franchise Registry is not freely accessible to the public. While the website claims to have a searchable function, franchisees

are only able to identify whether a specific corporation is a franchise and has an up to date disclosure document and franchise agreement. The prospective franchisee is not able to review the contents of the documents held by the registry, and therefore is unable to compare the document they have received from the franchisor with the documents held by the registry;

- thirdly, mandatory registration with the Australian Franchise Registry would not assist the ACCC with enforcement by way of access to disclosure documentation and franchise agreements. This is because the ACCC can request documents directly from franchisors under section 51ADD of the Competition and Consumer Act.

6.141 The committee also acknowledges the concerns that the ACCC put forward regarding the operation of a franchise register. However, the committee is not convinced that a public register of franchise systems would necessarily be viewed as an endorsement of those systems. The committee sees merit in the ACCC operating a franchise register with franchisors providing updated disclosure documents and template franchise agreements annually in compliance with the Franchising Code. If it is determined that the ACCC is the most appropriate agency to operate the register, the information should be publicly available online with a disclaimer that the ACCC does not endorse the franchise systems listed. Civil penalties should apply for non-compliance.

6.142 The committee is also of the view that amending section 51ADD of the Competition and Consumer Act so that civil pecuniary penalties are provided for non-compliance with a section 51ADD notice will enhance ACCC access to the documents it requires to regulate the Franchising and Oil Codes effectively.

Recommendation 6.14

6.143 The committee recommends that the Franchising Taskforce investigate options for a public franchise register with franchisors providing updated disclosure documents and template franchise agreements annually in compliance with the Franchising Code of Conduct and Oil Code of Conduct. The Franchising Taskforce should examine:

- the appropriateness of the Australian Competition and Consumer Commission (ACCC), or another agency, operating the register;
- the information being made publicly available online with a disclaimer that the ACCC (or another agency) does not endorse the franchise systems listed; and
- the application of civil penalties for non-compliance.

Recommendation 6.15

6.144 The committee recommends that the Australian Government amend section 51ADD of the *Competition and Consumer Act 2010* to provide civil pecuniary penalties for non-compliance with a section 51ADD notice.

6.145 Evidence to the inquiry indicated that some franchisees may need additional disclosure relating to employment matters. The committee considers that the Australian Government should amend the Franchising Code to require, as part of

mandatory disclosure, guidance on employment matters, especially Awards, minimum wages, and overseas workforce issues to be developed by the Fair Work Ombudsman (FWO). The committee does not consider this to be an exhaustive list of information that the FWO should include in the guidance material. The committee also considers that it remains primarily the franchisee's responsibility to inform themselves of all relevant employment laws.

Recommendation 6.16

6.146 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require, as part of mandatory disclosure, guidance on employment matters, especially Awards, minimum wages, and overseas workforce issues to be developed by the Fair Work Ombudsman.

Chapter 7

Third line forcing

Introduction

7.1 Third line forcing is a form of exclusive dealing that involves one party either supplying goods or services on the condition that the purchaser acquires goods or services from a particular third party, or refusing to supply because the purchaser will not agree to that condition.¹

7.2 A franchisor may apply third line forcing by directing its franchisees to purchase goods or services from a particular third party supplier. For example, food retail franchisors may insist that franchisees purchase a particular brand and grade of coffee beans from the same supplier or that all its franchisees must use selected Information Technology (IT) services. Third line forcing is one of a range of possible vertical agreements under which a business at one stage of the production process applies restrictions on the conduct of another business that controls a later stage.

7.3 This chapter examines the rules around third line forcing and its use by franchisors in the provision of supplies to its franchisees. The chapter provides necessary context for the committee's chapter on supplier rebates (chapter 8).

Recent changes to third line forcing provisions

7.4 Prior to 6 November 2017, engaging in third line forcing was a breach of the *Competition and Consumer Act 2010* (CCA). A franchisor that wished to engage in third line forcing was required to lodge a notification with the Australian Competition and Consumer Commission (ACCC) which, subject to no concerns being raised by the ACCC, provided the company with protection from prosecution under the exclusive dealing provisions.²

7.5 However, this arrangement has recently changed. Third line forcing will now only present a breach of the CCA where the conduct has the effect, or is likely to have the effect, of substantially lessening competition in the relevant market.³ The ACCC guidelines advise that lodging a notification is only necessary if there is a risk of breaching this purpose or effect test.⁴

7.6 The amendment followed recommendations made by Professor Ian Harper's Competition Policy Review March 2015 (the Harper Review). The Harper Review concluded that:

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- 1 Australian Competition and Consumer Commission, Notification, www.accc.gov.au/business/exemptions/notification (accessed 22 January 2019).
 - 2 Australian Competition and Consumer Commission, *Submission 45*, pp. 20, 35–36; Australian Competition & Consumer Commission, Exclusive dealing notification guidelines, November 2017, pp. 2–3.
 - 3 Australian Competition and Consumer Commission, *Submission 45*, p. 20.
 - 4 Australian Competition and Consumer Commission, Exclusive dealing notification guidelines, November 2017, pp. 2–3.

The Panel sees no need for third-line forcing to be singled out from other forms of vertical trading conditions and be prohibited per se. As notifications to the ACCC demonstrate, third-line forcing is a common business practice and rarely has anti-competitive effects.⁵

7.7 For this reason, the Harper Review recommended that 'third line forcing only be prohibited where it has the purpose, effect or likely effect of substantially lessening competition'.⁶

7.8 The ACCC advised the committee that the practice of third line forcing in the context of franchising would arise in a situation where the franchisor refused to enter into a franchise agreement with a franchisee, or provide services under the franchise agreement, unless the franchisee agreed to purchase goods or services from a particular supplier, including for products to be resold or equipment to be used in the business.⁷

7.9 The ACCC advised the committee that an assessment of whether a company has engaged in third line forcing will also consider:

- the effect on the competition in the overall market for a particular product and its substitutes;
- whether the refusal to supply would substantially restrict the availability of that type of product to consumers; and
- whether consumers are severely restricted in their ability to buy a product or its substitutes because the business has imposed territorial restrictions as a condition of supply.⁸

7.10 However, the ACCC determined that the use of third line forcing arrangements between franchisors and franchisees would be unlikely to substantially lessen competition when both franchisors and suppliers compete between multiple businesses:

In the ACCC's experience, third line forcing arrangements in the franchising sector are unlikely to substantially lessen competition where the franchise itself and the supplier both compete with a number of other businesses to supply the same or similar products.⁹

7.11 The Franchise Advisory Centre took a similar view, warning that the new anti-competitive tests are unlikely to include a determination as to whether franchisees may be suffering detriment, noting that:

Recent amendments to consumer law now make it easier for franchisors to enter exclusive supply arrangements, however the test to assess whether these are anti-competitive is often more focussed on the end user (ie. the

5 Professor Ian Harper, *Competition Policy Review*, March 2015, p. 63.

6 Professor Ian Harper, *Competition Policy Review*, March 2015, p. 63.

7 Australian Competition and Consumer Commission, *Submission 45*, p. 35.

8 Australian Competition and Consumer Commission, *Submission 45*, p. 35.

9 Australian Competition and Consumer Commission, *Submission 45*, p. 35.

consumer), rather than purchasers under such arrangements (i.e. the franchisees).¹⁰

Concerns about third line forcing

7.12 Concerns about third line forcing were raised by many submitters to the inquiry.¹¹ Almost half of confidential submitters (46 per cent) raised third line forcing in conjunction with supplier rebates as a primary concern. Several inquiry participants argued that there was very little consideration by the franchisor of how supply arrangements affect franchisees. Particular concerns were both the excessive cost of goods, and automatically allocated volumes of supplies above what could realistically be sold.

7.13 Mr Heath Adams, a lawyer who has worked with franchisees, maintained that contracts that compel a franchisee to purchase goods or services from a specified third party represent a conflict of interest on the part of the franchisor if the franchisor received a rebate or similar benefit from the transaction. Mr Adams pointed out that 'this issue is more likely to be a cause of conflict given the changes last year [November 2017] to the third line forcing provisions under the Competition and Consumer Act'.¹²

7.14 The Franchise Advisory Centre observed that difficulties arise if 'franchisees are forced into third party supply arrangements that put them at a long term commercial disadvantage compared to the open market'.¹³

7.15 Some franchisees explained that where the franchisor enforced a policy of purchasing only from selected suppliers, prices for goods and services could increase above market prices. For example, Mr Brett Roveda, a former franchisee, stated that the cost of goods compared to the resale price rose from 25 per cent to 35 per cent over the term of his franchise agreement and products could often be purchased elsewhere for half the price. Further, he noted that:

...the franchisor enjoys significant volume discounts associated with many products which motivates their behaviour to drive us to purchase (often through auto-ship programs) products which have limited or no sale value to our businesses.¹⁴

7.16 Mrs Xiaoyan Lu, a Michel's Patisserie franchisee in the Retail Food Group (RFG) network, noted that the annual increase in the cost of some goods meant that some goods purchased from the franchisor cost more than the average retail price. At the same time, the quality deteriorated and wastage doubled. And yet, a failure to

10 Franchise Advisory Centre, *Submission 138*, p. 3.

11 See, for example, Australian Small Business and Family Enterprise Ombudsman, *Submission 130*, p. 1; Mr Brett Roveda, *Submission 131*, p. 2; Australian Lottery and Newsagents' Association & Lottery Retailers Association, *Submission 68*, p. 4.

12 Mr Heath Adams, *Submission 81*, p. 2.

13 Franchise Advisory Centre, *Submission 138*, p. 3.

14 Mr Brett Roveda, *Submission 131*, p. 2.

purchase supplies from RFG's recommended suppliers would constitute a breach of contract.¹⁵

7.17 Another submitter from the RFG network similarly relayed how the franchisor did not account for the suitability or long term sustainability of supply arrangements for the franchisee's store:

Gloria Jeans would run a marketing campaign that would have auto allocated products for each shop. These products were often not suitable to our demographic, were expensive to buy, poor quality, and because they were auto allocated with a set quantity, I would have far too much stock that didn't sell and would then go out of date and be thrown out. There was no recourse or ability to change the quantity supplied.¹⁶

7.18 Mr Dean Stewart, a former franchisee of Croissant Express, argued that when there was a change of suppliers made by brand owner Consolidated Food Holdings, no analysis on sales was carried out after the switch to see if it had any negative effects on franchisees:

They changed from Coke to Pepsi with a financial gain to them. Franchisees lost their rebate on this change and no attempt was made to monitor the affect this had on the drink sales in all the stores. We suffered a 50% drop in drink sales by this move. We were told that they received a lucrative sum from Pepsi.¹⁷

7.19 Mr Kyle Hudspeth, also a former franchisee of Croissant Express, noted that a franchisor which makes poor decisions in favour of its income stream can cause substantial damage to a franchisee's business, such as causing lasting losses to the franchisee's customer base, even after the decision has been reversed.¹⁸

7.20 Franchisees frequently have limited or no power to influence which suppliers the franchisor chooses or the arrangements made. Mr Pavel Cherniakov, a former Subway franchisee, observed that franchisees have a limited ability to negotiate supply contracts to seek to improve outcomes for franchisees. This is because:

To purchase from an approved supplier a franchisee must sign a supply contract with them. Such contracts are often on non-negotiable terms that very heavily favo[u]r the supplier. A franchisee is often given no choice but to agree to whatever 'standard' terms he is prescribed, thereby relegating the concept of fairness in a two-sided contract.¹⁹

7.21 Some franchisees raised concerns that franchisors were making arrangements with suppliers that raised the cost of purchasing goods and services for franchisees, but the recommended or maximum retail prices would remain unchanged. For example, Mr Kamran Keshavarz Talebi, a former Domino's Pizza Enterprises

15 Mrs Xiaoyan Lu, *Submission 151*, p. 1.

16 Name Withheld, *Submission 160*, p. 3.

17 Mr Dean Stewart, *Submission 145*, p. 2.

18 Mr Kyle Hudspeth, *Submission 34*, p. 2.

19 Mr Pavel Cherniakov, *Submission 93*, p. 3.

(Domino's) franchisee, pointed out that while the cost of inputs continued to rise, often the prices consumers paid had decreased:

It is problematic, because franchisees can be ripped off by the company when forced to buy supplies at a higher price than they could get through their wholesalers. It is my belief that their approach is not an isolated one but is a systematic one, built into their business modelling and planning with no regard as to how this impacts the franchisee's bottom line. Since 2014 the cost of food, labour, rent and other fixed costs have risen. While I was a franchisee, the prices of pizzas were in decline. Customers can now buy pizzas at 1990s prices. In the meantime, Domino's profit is on the rise. So customers are winning, because they receive a cheaper product, and Domino's is winning, because their profit is skyrocketing. Nobody is left to pay for this but the franchisees.²⁰

7.22 Similarly, Peter and Dianne Horvath, former franchisees of Wendy's Ice Cream, noted that franchisors could push preferred supply arrangements despite increased costs to franchisees:

It appears now that Wendy's will attempt to promote products that provide Wendy's with the highest rate of rebate as the products they are forcing us to promote make no sense in our standard product line.

In fact, one of our critical suppliers have increased their base cost by 31% over the last 6 months, and Wendy's now wish to include that supplier's branding on our promotional material. This is nonsensical considering the increases by that supplier necessitate an increased RRP of one of our core product lines.²¹

7.23 Some franchisees raised concerns about product quality, particularly where franchisees were forced to have products delivered from other states. Mrs Lynette Bayakly, a former franchisee of Yum! Restaurants (Yum!), informed the committee that franchisees were forced to stop buying fresh produce locally and were instead made to purchase produce delivered from another state by an unreliable supplier.²²

7.24 A former Michel's Patisserie franchisee also noted that franchisors have the ability to compel franchisees to sell any product at any time:

The Franchise Agreement states 'The Franchisor may from time to time supply or cause to be supplied seasonal or promotional products which shall form part of the Michel's Products.' Based on this clause, franchisees' profitability on the sales of these products is dictated by [the] franchisor's discretions on the price, volume and timing of these product supplies. Based on this clause, franchisees forgo the right to decline acceptance of these goods on the ground of price, volume or timing, even on the quality of the goods.²³

20 Mr Kamran Keshavarz Talebi, Private capacity, *Committee Hansard*, 22 June 2018, p. 29.

21 Mr Peter Horvath, *Submission 119*, p. 3.

22 Mrs Lynette Bayakly, *Submission 13*, p. 2; see also Mrs Abi and Mr Trenton Scaf, *Submission 28*, p. 1.

23 Name Withheld, *Submission 167*, p. 4.

Views on altering the application of third line forcing provisions

7.25 The committee received differing views about the application of third line forcing provisions to franchising and whether any alterations were necessary.

7.26 The Franchise Advisory Centre argued that third line forcing provisions should return to its former, stricter iteration regarding the authorisation and notification process and involve more consultation with franchisees and an annual review by the ACCC (see chapter 8).²⁴ In their joint submission, the Australian Lottery and Newsagents' Association and the Lottery Retailers Association suggested that restrictions on third line forcing may need to be considered in the Franchising Code to address competition and efficiency concerns.²⁵

7.27 However, MST Lawyers disagreed, arguing that the changes to the third line forcing rules should not be further complicated by superimposing additional obligations via the Franchising Code.²⁶

7.28 Mr Derek Sutherland, an experienced lawyer in the franchise sector, warned reverting to the previous third line forcing arrangements would only prompt franchisors to take over the supply chains to franchisees in order to avoid the public detriment test.²⁷

7.29 In this respect, the committee notes that the vertical integration of supply chains by franchisors would negate the application of third line forcing provisions as third line forcing provisions do not apply where the dealings are between related entities. Subsection 47(12) of the CCA states that the exclusive dealing provision does not apply with respect to related body corporates.²⁸

Volume control

7.30 Foodco Group explained that suppliers offered lower prices based on higher volumes and therefore the franchisor's negotiations with suppliers focused on volume rather than rebates:

The greater our volume the better our negotiating position with any supplier. However, suppliers are not always able to guarantee us their lowest price as they often have other customers with larger volumes. For example, we will never be able to compete with the likes of Coles or Woolworths on volume or price.²⁹

24 Franchisee Advisory Centre, *Submission 138*, p. 3.

25 Australian Lottery and Newsagents' Association & Lottery Retailers Association, *Submission 68*, p. 4.

26 MST Lawyers, *Submission 39*, p. 11.

27 Mr Derek Sutherland, Private capacity, *Committee Hansard*, 8 June 2018, p. 11.

28 *Competition and Consumer Act 2010*, ss. 47(12).

29 Foodco Group, *Submission 217*, p. 4.

7.31 However, some submitters noted that goods and services could be ordered by the franchisor and delivered to the franchisee with no franchisee discretion as to volume or frequency.³⁰

7.32 Mrs Lu, a former franchisee of the RFG network, informed the committee that RFG practiced automated ordering of products during holiday periods and made franchisees pay for goods that they had not ordered.³¹

7.33 The Motor Trades Association of Australia (MTAA) advised that manufacturers can put the financial viability of dealers at risk by forcing unwanted stock onto dealers and then 'demanding dealers sell the stock against revised targets that are either unattainable or [place] at risk the financial viability of the dealer'. Further, 'failure to achieve the revised target can then be used as a potential breach of the agreement'.³²

Resale Price Maintenance

7.34 Franchisors are able to set recommended prices for the goods or services sold in a franchisee's business. Franchisors must be careful, however, to ensure that the price is simply a recommendation and that there is no agreement between the franchisor and the franchisee to charge those particular prices as this could constitute price fixing, or resale price maintenance (RPM).³³ Following the Harper Review, changes to the rules around RPM were implemented with the *Competition and Consumer Amendment (Competition Policy Review) Act 2017*.³⁴

7.35 The Harper Review concluded that there was no sufficient reason to change the provisions for RPM from a per se prohibition to a competition-based test. However it did recommend that businesses be able to seek an exemption more easily.³⁵ In response, the government amended section 48 of the CCA to make notification available for RPM.³⁶ As a result, franchisors no longer require the ACCC to affirm the exemption. Instead, the exemption commences 28 days after notification unless the ACCC withdraws the notification on account of potential detriment to the public benefit from reduced competition.³⁷ As per regulation 9(b) of the Competition

30 Mrs Danuta Dwornik, *Submission 99*, p. 2; Pole Position MC, *Submission 75*, p. 1.

31 Mrs Xiaoyan Lu, *Submission 151*, p. 1.

32 Motor Trades Association of Australia, *Submission 55*, p. 11.

33 Australian Competition and Consumer Commission, *Submission 45*, p. 36

34 *Competition and Consumer Amendment (Competition Policy Review) Act 2017*, ss. 48(2).

35 Professor Ian Harper, *Competition Policy Review*, March 2015, p. 63.

36 *Competition and Consumer Act 2010*, s. 48.

37 *Competition and Consumer Act 2010*, ss. 48(2); para. 93(1)(b); See also, Australian Competition and Consumer Commission, *Resale Price Maintenance notification guidelines*, November 2017, p. 4.

and Consumer Regulations 2010, the relevant period for the commencement of the exemption reduced from 28 days to 14 days after 6 November 2018.³⁸

7.36 The ACCC *Resale Price Maintenance notification guidelines* observe that RPM is unlikely to result in public detriment in markets that are highly competitive because suppliers are less likely to set prices above the competitive rates.³⁹

Maximum pricing limit

7.37 Franchisors and suppliers are prohibited from setting minimum or fixed resale prices. However, provided that it does not infringe RPM constraints, franchisors and suppliers are not restricted from setting maximum resale prices for products the franchisee sells.⁴⁰ Some franchisees raised concerns about franchisors having the power to do this.⁴¹

7.38 Terceiro Legal Consulting, a consulting firm that has worked with both franchisees and franchisors, informed the committee that even where franchisors allow franchisees to purchase products from non-preferred suppliers, franchisors may deter this practice by applying a lower maximum retail price margin to these products compared to products purchased from preferred suppliers:

By way of example, assume that the franchisor supplies particular products through its preferred suppliers at a wholesale price of \$100 each and that each of these products are resold at the retail level for \$150, at a gross profit margin of \$50. However, the franchisee can also buy these same products from an outside supplier at a wholesale price of \$75, which would net the franchisee a net profit margin of \$75, based on the same retail price of \$150.

...franchisors are able to discourage this practice (in order to safeguard their own preferred supplier arrangements) by forcing the franchisees to sell outside purchases at low retail margins. Using the above example, a franchisor may decide to set a maximum retail margin of 20% on the outside purchases meaning that the franchisee would only be able to sell the outside purchase which they had purchased at a wholesale price of \$75 for \$90 retail, with a \$15 gross profit margin.⁴²

38 Competition and Consumer Regulations 2010, reg. 9; Australian Competition and Consumer Commission, *Resale Price Maintenance notification guidelines*, November 2017, p. 4.

39 Australian Competition and Consumer Commission, *Resale Price Maintenance notification guidelines*, November 2017, p. 4.

40 Australian Competition and Consumer Commission, *Submission 45*, p. 36; Australian Competition and Consumer Commission, *Imposing minimum resale prices*, www.accc.gov.au/business/anti-competitive-behaviour/imposing-minimum-resale-prices (accessed 23 January 2019).

41 Mr Matthew Wheatley, President, Franchisee Federation of Australia, *Committee Hansard*, 29 June 2018, p. 76.

42 Terceiro Legal Consulting, *Submission 124*, p. 3.

7.39 According to a research paper by Mr Roger Blair and Ms Amanda Esquibel, it is in the interests of the franchisor to limit the resale price that a franchisee may charge for the franchised product:

Economic analysis shows that, where the franchisee does possess some degree of monopoly power, limiting the prices charged by the franchisee actually will enhance the franchisor's profits. At the same time, however, these lower resale prices reduce the franchisee's profits.⁴³

7.40 Franchisors and suppliers are also able to set the maximum resale price below the cost price of the goods except in certain circumstances. For example, it may be illegal if the purpose is to eliminate or substantially damage a competitor (such conduct is known as predatory pricing). However, a number of factors need to be considered such as how long the goods were sold below cost and how much market power the seller has.⁴⁴ Franchisors may also establish a strategy that includes loss leader selling where the sale price is kept below the cost price in order to promote the business or attract customers likely to purchase other goods or services.⁴⁵

Pizza Hut case

7.41 In June 2014, Yum! implemented a pricing strategy through its Pizza Hut brand as it engaged in a price war with Domino's. Yum! imposed reduced maximum resale prices for the products sold by franchisees, including two pizza ranges which decreased from \$9.95 to \$4.95, and \$11.95 to \$8.50.⁴⁶ Franchisees lodged a class action, stating that they suffered a loss in profit as a result of this strategy, and that Yum! had breached the contract, breached its duty of care (in negligence) and contravened section 21 of the Australian Consumer Law.

7.42 In the Federal Court case of *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 432016, Justice Bennett held that Yum! had no implied obligation or duty of care to ensure the profitability of franchisees' businesses. Justice Bennet maintained that the \$4.95 price applied to the Classics pizza range was more than the cost of production, and that while it may be accepted that other costs must be taken into account to allow for store overheads, the plaintiffs did not establish that it was reasonable for Yum! to have accounted for depreciation and the cost of capital. Further, the plaintiff did not provide evidence that Yum! was aware, or made aware by franchisees, of the varying cost of capital each franchisee had.⁴⁷

43 Mr Roger D. Blair, et al., 'Maximum resale price restraints in franchising', *Antitrust Law Journal*, Vol. 65, No. 1 (Fall 1996), p. 158.

44 Australian Competition and Consumer Commission, *Setting prices*, www.accc.gov.au/business/pricing-surcharging/setting-prices (accessed 23 January 2019).

45 Australian Competition and Consumer Commission, *Imposing minimum resale prices*, www.accc.gov.au/business/anti-competitive-behaviour/imposing-minimum-resale-prices (accessed 23 January 2019).

46 *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 432016 [1]

47 *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 432016 [367].

7.43 The court found that the strategy implemented by Yum! intended for franchisees to maintain the same level of profit, after taking into account the predicted first mover advantage, 34.5 per cent uplift, the reversal of market share, and the advertising campaign.⁴⁸ Justice Bennett did not find that Yum! had breached its duty to act in good faith as it did not act unreasonably or dishonestly, and undertook detailed research before imposing the strategy. The franchisees' loss was instead incurred as a result of competition from Domino's, which had obtained the first mover advantage by implementing the price reduction before Yum!.⁴⁹ In 2017, a separate applicant appealed the decision in *Virk Pty Ltd (in liq) v YUM! Restaurants Australia Pty Ltd* but the appeal was dismissed.⁵⁰

7.44 Mr David Eaton, Western Australian Small Business Commissioner at the Small Business Development Corporation, noted that the case may have had a different ruling if the franchise agreement had not allowed for the franchisor to act with broad discretion. Mr Eaton suggested that the application of the subsequently introduced unfair contract terms legislation may have changed the outcome of the Pizza Hut case as terms providing the franchisor with broad discretion may have been declared void (see chapter 9).⁵¹

Committee view

7.45 Third line forcing is prohibited if it has the purpose, effect or likely effect, of substantially lessening competition. However, this test has historically only been judged on how the lessened competition affects consumers and is unlikely to provide any protection for franchisees. The committee notes that the current legal framework does not place any restrictions on franchisors making arrangements with suppliers that are disadvantageous to franchisees.

7.46 The committee considers that the current third line forcing provisions do not appropriately take into account the almost complete reliance of franchisees on the franchisor, nor the very significant interest and control the franchisor has over the franchisee's business. Independent small businesses frequently have more choice in the supplier arrangements available to them while franchisees are rarely permitted the same discretion.

7.47 The committee considers that the current third line forcing arrangements may incentivise opportunistic behaviour by franchisors. Such practices include forcing franchisees to purchase excessive amounts of stock at a rate above what the franchisee is able to sell. And, as detailed in the next chapter, third line forcing arrangements may also encourage a franchisor to increase its profit margins by selling goods to franchisees at inflated prices, at times even greater than the open market price, often

48 *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 432016 [365].

49 *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 432016 [370].

50 *Virk Pty Ltd (in liq) v YUM! Restaurants Australia Pty Ltd* [2017] FCAFC 190.

51 Mr David Eaton, Western Australian Small Business Commissioner, Small Business Development Corporation, *Committee Hansard*, 16 October 2018, p. 12.

while applying fees associated with the supply of goods and services, royalties and advertising fees.

7.48 The committee is concerned that some franchisors appear to have little concern for the diminishing profit margins of their franchisees. This is partly due to the common practice of the franchisor taking the royalty from franchisee top line sales (turnover), and thus the franchisor is not exposed to the bottom line profit (or loss), and incentivized to drive inventory sales volume. The CCA does not prohibit franchisors from setting maximum resale prices. However, the committee considers that the franchisor should be required to include within the disclosure document to franchisees if and when, in the two year period prior to the franchisee entering the franchise, the maximum resale price of each item has been below the cost price of the product purchased by the franchisee including, but not limited to, the cost of the product inclusive of any fees associated with the purchase of the product, the rebate amount, royalties, other fees and fixed and variable costs in relation to the purchase and sale of the product have been added. The committee acknowledges concerns about commercially sensitive material, but notes that what is being recommended is the disclosure of historical data (not future costs and expected earnings) to enable a prospective franchisee to form an accurate financial understanding of the earnings and costs of the business.

7.49 The committee recognises that the aims of the franchisor and franchisees are aligned in some areas. However, they may diverge in others. The committee believes that franchisees should have a better understanding of the franchise business model before entering the franchise system. This is particularly important where the franchisor uses a loss leader strategy and sets a maximum resale price below cost on popular products. The committee recognises that setting maximum prices below cost, or above cost but below an amount that will cover the franchisees' fees and overheads, is a cause of confusion and dispute between franchisees and franchisors. The committee believes that if franchisees understand upfront which products are likely to create a loss for their business, then franchisees will appreciate how franchise profits are derived. The approach will allow franchisees to examine whether these products can maintain the profitability of the business before entering the franchise. It is also important for franchisees to understand that in a franchise system where the franchisor collects a royalty as a percentage of sales, that loss leader products will accrue a royalty fee, as well as the products from which franchisees are expecting to make a profit.

7.50 The committee further considers that the committee's proposals with respect to the unfair contract terms legislation (see chapter 9) may provide more protections for franchisees by limiting the broad discretionary powers currently available to the franchisor through the franchise agreement, as may the committee's recommendation with respect to franchisees triggering a no fault exit of the franchise agreement (see chapter 11).

7.51 Finally, the committee notes that one option would be to amend the third line forcing arrangements. The committee believes it is unacceptable that franchisees can be required to purchase goods which can be sourced for a lower price on the open market. However, the committee recognises the arguments advanced by franchisors

about the imperative to maintain tight control over product quality and consistency in order to maintain brand quality, recognition, and differentiation. Rather, the committee makes recommendations in the next chapter in relation to the disclosure in percentage terms of the rebates that franchisors receive from suppliers.

Recommendation 7.1

7.52 The committee recommends that the Franchising Taskforce examine how to amend the Franchising Code of Conduct to provide that franchisors are required to include within the disclosure document to franchisees for the two year period prior to the franchisee entering the franchise:

- where the maximum resale price of each item has been below the cost price of the product purchased by the franchisee including, but not limited to, the cost of the product inclusive of any fees associated with the purchase of the product, royalties, other fees and fixed and variable costs in relation to the purchase and sale of the product have been added; and
- the margin between the purchase price paid by the franchisee and the maximum price or recommended resale price of the top five by volume of goods and services sold by the franchisee; and
- if data is not available for that particular franchise, then data for a comparable franchise needs to be provided.

Recommendation 7.2

7.53 The committee recommends that the Franchising Taskforce consider whether the Australian Competition and Consumer Commission should conduct an inquiry into all terms in franchise agreements relating to the discretion of the franchisor to decide the volume and frequency of supply orders for goods and services to be sold in the franchised business to prevent exploitative behaviour around over-ordering.

Chapter 8

Supplier rebates

Introduction

8.1 This chapter examines the practice of franchisors receiving rebates from suppliers and whether the current disclosure obligations imposed on franchisors in relation to supplier rebates are sufficient.

8.2 A supplier rebate is an incentive that is provided to a purchaser for various reasons including as a discount, advertising allowance or deferred credit.¹ It is common for franchisors to receive rebates from third party suppliers when franchisees, sometimes on an involuntary basis, make a purchase of goods or services from the supplier. Under the current legal framework, franchisors are able to receive rebates from a charge applied on franchisee purchases as long as the agreements between the franchisors, franchisee and supplier do not have substantially anti-competitive effects or constitute a misuse of market power.²

8.3 One of the commonly held conceptions about the benefits of the franchise model is that franchisees can benefit from the group buying arrangements of the franchisor. Further, it might be assumed that any rebates from suppliers would be used to improve the competitiveness of franchisees.

8.4 However, supplier rebates provide a temptation for franchisors to price squeeze the franchisee by maintaining or raising the cost of goods and services while keeping the maximum resale price of the products low. The franchisor is unlikely to suffer any short term negative effects from this decision. If the franchisor has an interest in increasing purchase order volumes to increase the fees derived from those purchases, the franchisor may use heavy discounts to drive sales volumes. This approach may make it difficult for franchisees to cover fixed costs while the franchisor maintains a reasonably similar income from the royalty and rebate streams.

8.5 As noted in chapter 7, the franchisor has the ability to control who supplies particular goods and services to the franchisee through third line forcing arrangements. This sets up a potential conflict of interest. For example, other things (such as quality) being equal, the franchisor may choose a particular supplier based on the size of the rebate rather than the best price. If the franchisor compels the franchisee to purchase a product from which they receive and retain a rebate or financial incentive, the franchisor could be acting in its own interest and against the interest of its franchisees. Further, there may be no way for the franchisee to source a different supplier as that could be treated as a breach of contract by the franchisor.

1 Australian Taxation Office, *GST and rebates*, 10 April 2017, www.ato.gov.au/business/gst/in-detail/rules-for-specific-transactions/gst-and-rebates/ (accessed 5 December 2018).

2 *Competition and Consumer Act 2010*, s. 46; Australian Competition and Consumer Commission, *Guidelines on misuse of market power*, August 2018, p. 12.

8.6 This chapter begins by outlining the current disclosure requirements for supplier rebates and how franchisors accrue and apply rebates. The various perspectives on supplier rebates are then presented. Next, the perspectives for and against greater disclosure are considered.

Current disclosure requirements for supplier rebates

8.7 In 2006, Mr Graeme Matthews' *Review of the Disclosure Provisions of the Franchising Code of Conduct* (the Matthews Review) recommended that the disclosure provisions in the Franchising Code of Conduct (Franchising Code) be changed to provide greater transparency in relation to the amounts or method of calculation of the supplier rebate:

That item 9.1(j) of Annexure 1 to the Code be extended to include disclosure of the amounts or method of calculation of rebates or other financial benefits to the franchisor or an associate of the franchisor from the supply of goods or services to franchisees.³

8.8 The government agreed to the recommendation, stating that 'the disclosure of information about financial arrangements provides greater transparency in the relationships between the participants in franchising'.⁴ However, the subsequent changes made to the Franchising Code in early 2008 did not implement the Matthews Review recommendation.

8.9 Instead of requiring franchisors to disclose the amount of the rebate, the Franchising Code was amended to require franchisors to disclose whether the franchisor 'will receive a rebate or other financial benefit from the supply of goods or services to franchisees, including the name of the business providing the rebate or financial benefit'.⁵

8.10 The current Franchising Code therefore does not include the recommendation from the Matthews' Review. Instead it prescribes that franchisors are obliged to disclose to franchisees:

- whether they will receive a rebate or financial benefit from the supply of goods or services to franchisees;
- the name of the business providing the rebate or financial benefit; and
- whether the rebate is shared directly or indirectly with franchisees.⁶

3 Mr Graeme Matthews, *Review of the Disclosure Provisions of the Franchising Code of Conduct*, 31 August 2006, pp. 10, 35.

4 Australian government response to the Review of the Disclosure Provisions of the Franchising Code of Conduct, 1 February 2007, p. 2.

5 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Annexure 1, 'Disclosure document for franchisee or prospective franchisee', Item 10.1(j).

6 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Annexure 1, 'Disclosure document for franchisee or prospective franchisee', Item 10.1(j).

Recent reviews of supplier rebates

8.11 Disclosure provisions for supplier rebates were reviewed by the Parliamentary Joint Committee on Corporations and Financial Services in its 2008 report and by Mr Alan Wein's Review of the Franchising Code of Conduct in 2013 (the Wein Review). Both reports noted the absence of a requirement in the Franchising Code for franchisors to disclose the dollar amount received from rebates.⁷ However, neither report contained any recommendations to amend the Franchising Code beyond those following the Matthews' Review.

8.12 The Wein Review considered that although some parties had raised concerns about supplier rebates during the consultation, there had not been 'a significant or consistent call for more or less disclosure of rebates paid to franchisors by suppliers and other third parties in relation to goods supplied to franchisees'.⁸ Instead, the Wein Review concluded that the disclosure requirements had struck the right balance between providing transparency and not unduly burdening the franchisor 'to reveal sensitive commercial information'.⁹

How franchisors accrue and apply rebates

8.13 The Australian Taxation Office considers a rebate to be an incentive that is offered by a supplier or received by a purchaser in a range of circumstances. It may also be called a:

- trade incentive payment;
- trade discount;
- trade price rebate;
- volume rebate;
- promotional rebate;
- incentive rebate;
- cooperative advertising allowance;
- case deal;
- deferred credit; or
- third party payment.¹⁰

8.14 Supplier rebates can accrue to the franchisor in a number of ways, including:

- lump-sum payments (also called a signing bonus or access fee);

7 Parliamentary Joint Committee on Corporations and Financial Services, *Opportunity not opportunism: Improving conduct in Australian franchising*, December 2008, pp. 43–44.

8 Mr Alan Wein, *Review of the Franchising Code of Conduct 2013*, April 2013, p. 54.

9 Mr Alan Wein, *Review of the Franchising Code of Conduct 2013*, April 2013, p. 54.

10 Australian Taxation Office, *GST and rebates*, 10 April 2017, www.ato.gov.au/business/gst/in-detail/rules-for-specific-transactions/gst-and-rebates/ (accessed 5 December 2018).

- continuous rebates or similar payments, generally as a function of the level of system-wide purchases;
- purchases by franchisors (that operate company-owned units) at a price lower than that available to franchisees; and
- purchases by franchisors (acting as wholesalers) that receive special wholesale pricing based on system-wide purchases.¹¹

8.15 During the inquiry, the committee received evidence that suggested it is not uncommon for franchisors to apply various methods of managing supplier rebates, including:

- the repatriation of all or a portion of the rebates to the franchisee;¹²
- applying all or a portion of the rebates as corporate income or a reduction in expenses;¹³ and
- contributing all or a portion of the rebates to the system's advertising or brand marketing fund.¹⁴

8.16 The committee received evidence that some franchisors are able to accrue increased benefits over the term of a contract with a supplier due to annual stipulated price increases or reviews of price arrangements. Mr Tony Alford, a former CEO and Managing Director of Retail Food Group (RFG), indicated that supply agreements between RFG and suppliers were generally for a specified term and included either stipulated annual price increases or a review to determine price adjustment. Mr Alford stated:

...if you have a supply agreement and the supply agreement is for five years, you can't change that supply agreement. You can't change the terms of that supply agreement and increase the costs to the franchisee within the term of that agreement... [T]here would be a price with an annual escalation or review between the supplier and RFG for the provision of those goods into the franchise system.¹⁵

8.17 Mr Alford also admitted that supplier rebates could increase costs to franchisees through purchase price increases, acknowledging that 'if there were a volume rebate or a network access fee then the manipulation or increase of that fee could affect the price of the product to the franchisees'.¹⁶

11 Steven B. Feirman, *The Legality Of Rebates From Suppliers*, Franchise Law Journal, Vol. 23, No. 2, 2003, p. 71.

12 Kentucky Fried Chicken Pty Limited, *Submission 60*, pp. 2–3.

13 Mr Heath Adams, *Submission 81*, p. 2; Mr Brett Houldin, CEO, Craveable Brands Pty Ltd, *Committee Hansard*, 14 September 2018, p. 95.

14 Franchising Council of Australia, *Submission 29*, p. 9; Mr Martin de Haas, *Submission 210*, p. 3.

15 Mr Tony Alford, Private capacity, *Committee Hansard*, 26 November 2018, p. 28.

16 Mr Tony Alford, Private capacity, *Committee Hansard*, 26 November 2018, p. 28.

8.18 Mr Derek Sutherland, an experienced lawyer in the franchise sector, also concluded that rebate arrangements increased costs to franchisees, asking 'Will the price to franchisees go up because I'm [the franchisor] getting a rebate? The answer logically is yes it will'.¹⁷

Perspectives on rebates

8.19 Evidence received during the inquiry indicated that franchisees mostly objected to rebates on the basis that:

- suppliers may be selected based not on the value proposition or quality of goods supplied but rather on the financial benefit to the franchisor;¹⁸
- rebates increase the price of goods that the franchisees would otherwise pay;¹⁹ and
- rebates may not contribute to a tangible benefit for franchisees, or may represent a benefit that is distributed unequally between all franchisees.²⁰

8.20 Mr Derek Minus, Mediation Adviser at the Office of the Franchising Code Mediation Adviser (OFMA), noted that if franchisors are sharing rebates with franchisees, the franchise relationship often remains positive. However, problems arise when all the benefits accrue to the franchisor:

...a lot of concern in the network is where a franchisor seeks not to disclose that commission—or only mention that they're getting it but not disclosing the amount of it—takes the entire benefit of it for themselves and leaves the franchisee with a high-priced item that they could probably buy somewhere else cheaper.²¹

8.21 The Franchise Relationships Institute suggested that the disclosure of marketing funds and the disclosure of rebates from suppliers 'could be tightened in the Franchising Code'. The Institute observed that:

These two sources of revenue [marketing funds and supplier rebates] provide opportunities for unscrupulous franchisors to boost their own short-term revenue streams or reduce the costs of running their head offices at the expense of their franchisees.²²

17 Mr Derek Sutherland, Private capacity, *Committee Hansard*, 8 June 2018, p. 11.

18 Mr Bruce Hollett, Member, Caltex National Franchise Council, *Committee Hansard*, 29 June 2018, p. 21; Franchisee Association of Craveable, *Submission 10*, p. 8; Isaac Chalik, *Submission 202*, p. 3.

19 Mr Derek Minus, Franchising Code Mediation Adviser, Office of the Franchising Code Mediation Adviser; Oilcode Dispute Resolution Adviser, Office of the Oilcode Dispute Resolution Adviser, *Committee Hansard*, 8 June 2018, p. 4.

20 Mrs Lynette Bayakly, *Submission 13*, p. 2.

21 Mr Derek Minus, Franchising Code Mediation Adviser, Office of the Franchising Code Mediation Adviser; Oilcode Dispute Resolution Adviser, Office of the Oilcode Dispute Resolution Adviser, *Committee Hansard*, 8 June 2018, p. 4.

22 The Franchise Relationships Institute, *Submission 47*, p. 6.

8.22 Some evidence suggested that franchisors may be engaging in uncompetitive behaviour by sourcing lower quality goods from suppliers and maximising rebates for higher returns to the franchisor. Mr Emmanuel Martin, a former employee of Gloria Jeans Coffees, noted:

A common area of contention and conflict between franchisor and franchisees is the cost of goods sold. There have been several instances of franchisees being able to source the exact products and services cheaper from outside sources, than the franchisor's supply chain.²³

8.23 The perception of many witnesses and submitters was that the typical franchisor was focused on the rebate, and not on the impact on the business of the franchisee. For example, Mr Geoff Morrisey, a franchisee with a range of prior business experience, argued that franchisors often pursue strategies that will increase company revenue but are disconnected from the long term impact these strategies can have on franchisees:

The outcome such as increased revenue may be viewed in isolation as a business positive without the more important consequence of profit loss, being understood. The franchisor management mindset evolves that discounting increases revenue which increases their royalty and thus becomes a business goal. At a later time, it is realized that franchisee profitability has decreased but its cause is not linked to discounting. Often the management justification is that discounting can be funded by greater sales volumes reducing operating or supply costs. In the highly competitive markets of today these cost savings are seldomly [sic] attainable. If there were savings in these areas they should have been implemented to increase profit not recover losses.²⁴

8.24 Another submitter similarly noted that 'In one other case, products are continuously changed by [the] franchisor to a more inferior quality at a more expensive price just to get more rebates'.²⁵

8.25 Some franchisees asserted that even when purchasing from the same supplier, they were required to pay a higher cost for the goods under the brand name than if they were an independent small business. One former Gloria Jeans franchisee relayed how quotes obtained from suppliers under the brand name were higher than quotes received when inquiring as a sole trader:

When we contacted a supplier we had a 'special' price list for Gloria Jeans shops. The pricing of the stock was often higher than if I enquired as a 'sole trader'... Loyalty, incentives and rewards from suppliers [were] not given to the franchisee[;] these were paid direct to Gloria Jeans head office. It was an additional form of revenue.²⁶

23 Mr Emmanuel Martin, *Submission 118*, p. 7.

24 Mr Geoff Morrisey, *Submission 129*, p. 2.

25 Name Withheld, *Submission 179*, p. 1.

26 Name Withheld, *Submission 160*, p. 3.

8.26 Franchisees that negotiate collectively and benefit from rebates may lose this benefit when the franchisor takes over the supply chain. For example, Mr Bruce Hollett, a member of the Caltex National Franchise Council, described how Caltex's takeover of the supply chain removed franchisees' ability to collectively negotiate with suppliers:

Caltex also took control of the dry goods supply chain, which took away the ability for franchisees to collectively negotiate with suppliers directly and benefit from the discounts and rebates provided to them for bulk purchasing.²⁷

8.27 The committee also received evidence that some franchisor arrangements with suppliers can impose a financial burden on some franchisees while disproportionately benefiting other franchisees within the same system. Mrs Lynette Bayakly, a former Pizza Hut franchisee, described one such arrangement in her franchise system:

We were forced to buy the bulk of our orders through Bidvest who had excessive freight charges on all our orders to WA. There was an additional charge of something like 1.5 to 3% added to all purchases on all Bidvest orders due to an agreement between Yum and Bidvest. This was applied to all franchisees towards a fund to cover any franchisees who were in financial difficulty and could not pay the supplier. This eliminated the burden of the franchisor having to pay the supplier as Bidvest were our contracted supplier.²⁸

8.28 Disputes can also arise from the broad discretion afforded to franchisors to charge and apply rebates with limited transparency. Mr Brett Houldin, CEO of Craveable Brands, confirmed that some contracts between Craveable and the supplier included rebates, while Craveable also applied rebates to some of the items purchased by franchisees. Mr Houldin admitted that the company's disclosure of these practices did not make clear to franchisees the amount that the franchisor had applied on top of the cost price.²⁹

8.29 Mr Alford informed the committee that rebates received from franchisee purchases during his tenure as CEO and Managing Director of RFG were not disclosed to franchisees because 'there was no requirement to do so'.³⁰

Advertising funds and promotional services—accounting for rebates

8.30 Supplier rebates and the conditions on how they are applied or used are frequently prescribed by contractual arrangements between franchisors and suppliers. For instance, some supplier agreements may contain provisions for an exchange of services. An example of this is where a franchisor, through the contract, is obligated to

27 Mr Bruce Hollett, Member, Caltex National Franchise Council, *Committee Hansard*, 29 June 2018, pp. 21–22.

28 Mrs Lynette Bayakly, *Submission 13*, p. 2.

29 Mr Brett Houldin, CEO, Craveable Brands Pty Ltd, *Committee Hansard*, 14 September 2018, p. 95.

30 See the exchange between Mr Matt Keogh MP and Mr Tony Alford, Private capacity, *Committee Hansard*, 26 November 2018, p. 29.

promote the supplier's products in exchange for receiving payment or discounts from the supplier.³¹

8.31 The relationship between suppliers and retailers such as franchisors is complex, including not only the purchase of the inventory from the supplier, but also the marketing and promotion services franchisors may provide to suppliers. Such arrangements may impact how rebates are accounted for by the franchisor.³² In 2016, PricewaterhouseCoopers (PwC) released a paper detailing how supplier rebates should be accounted for by retailers after allegations arose that retailers had maximised rebates on stock not yet sold and recorded these rebates as income or reductions in other expenses, practices that could be in breach of accounting standards.³³

8.32 A number of inquiry participants informed the committee that contributions to marketing and advertising funds either directly by the supplier or by the franchisor through supplier rebate schemes are used to benefit franchisees within the system.³⁴

8.33 Mr Martin de Haas, a lawyer who has worked with franchisees, observed that supplier payments intended to provide advertising support could be used and accounted for according to the franchisors' discretion without consideration for reducing franchisees' costs:

What is in issue is that many manufacturers will provide advertising support and, in some franchise systems that advertising support is not accounted for to the franchisees. It is applied to the benefit of the franchisor either as a reduction in the cost of advertising the franchisor is obliged to pay or worse as a source of miscellaneous income. Again the franchise agreements that I have reviewed make accounting for this discretionary.³⁵

8.34 One submitter suggested that if franchisors apply rebates from suppliers as a financial income, then such an arrangement should only be allowed if the franchisor meets obligations to provide important services to franchisees in the form of quality control, on time arrival of deliveries, volume discounts and other sales related services.³⁶

8.35 The Franchise Council of Australia stated that 'In many cases franchisees do directly or indirectly benefit from rebates from suppliers where a franchisor is able to share those benefits including contributions to a marketing fund'.³⁷

31 Australian Taxation Office, *Accounting for a rebate as a separate sale*, www.ato.gov.au/business/gst/in-detail/rules-for-specific-transactions/gst-and-rebates/?page=4, 10 April 2017 (accessed 18 January 2019).

32 PricewaterhouseCoopers, *Supplier Rebates in Focus*, July 2016, p. 1.

33 PricewaterhouseCoopers, *Supplier Rebates in Focus*, July 2016, p. 1.

34 Franchising Council of Australia, *Submission 29*, p. 9; Ray White, *Submission 31*, p. 5; Queensland Law Society, *Submission 48*, p. 8.

35 Mr Martin de Haas, *Submission 210*, p. 3.

36 Name Withheld, *Submission 167*, p. 3.

37 Franchising Council of Australia, *Submission 29*, p. 9.

8.36 However, the committee notes that where franchisors contribute supplier rebates to advertising funds, dissatisfaction among franchisees could still occur if the franchisees are required, or perceive they are required, to make separate, non-subsidised payments to the advertising fund. As an example, in Domino's Pizza Enterprises Limited's *Annual Report 2017–18*, the company accounted for supplier rebates alongside royalties and franchise service fees, making it impossible for franchisees to determine the rebate amount accrued by the franchisor and what proportion of the rebate was returned directly or indirectly to the franchisee.³⁸

Is charging royalties and receiving rebates double dipping by the franchisor?

8.37 The committee heard that where franchisors received two income streams via margins added to franchisee purchases for goods as well as the collection of royalties on sales, it could be considered 'double dipping'.³⁹

8.38 The Franchise Advisory Centre considered that franchisors that charge franchisees royalty based on gross turnover and also enter into supply arrangements with a third party provider that pays rebates are effectively charging the franchisee twice, first on turnover and again on purchases.⁴⁰

8.39 Mr Alan Pearson, a former Foodco franchisee, told the committee that the combination of a margin added to purchase price of products plus the royalty fees impacted the financial sustainability of his business:

Foodco were obviously adding a margin to that cost product, which of course added to the commission that I was paying Foodco. It allowed them to make a double-dip... We were told that the margins were used for staff training, conferences and different things like that, but, at the end of the day, you've got a 10 per cent margin added to the cost price of the wholesale product and you then pay a franchise fee on the sale price of that product. There's not much margin in the business in the first place, so, if you take that 10 per cent away, it makes it very, very difficult to survive.⁴¹

8.40 Mr Alford, argued that a franchisor receiving both royalties and rebates did not constitute double dipping because unlike rebates, royalties were not 'based upon expenses'. However, Mr Alford admitted that an increase in turnover required the purchase of a greater volume of products and therefore the franchisor would receive an increase in both rebates and royalties.⁴²

Three-legged stool model

8.41 The committee heard that some of the most successful franchise systems that operate in Australia do not use supplier rebates as an income stream for the benefit of the franchisor, but instead pass on those benefits to franchisees.

38 Domino's Pizza Enterprises Limited, *Annual Report 2017–18*, p. 42.

39 Franchise Relationships Institute, *Submission 47*, p. 7.

40 Franchisee Advisory Centre, *Submission 138*, p. 3.

41 Mr Alan Pearson, Private capacity, *Committee Hansard*, 29 June 2018, pp. 38–39.

42 Mr Tony Alford, Private capacity, *Committee Hansard*, 26 November 2018, p. 29.

8.42 McDonald's Australia (McDonald's) informed the committee that it applies a 'three-legged stool' model whereby the franchisor, franchisees and suppliers share their prosperity and financial hardships. Mr Andrew Gregory, Managing Director and CEO of McDonald's, explained:

McDonald's is one leg and our suppliers and franchisees are the other two legs. So there are three legs to the stool. If one leg of the stool is not strong or not growing at the same pace, or is breaking, then, of course, the stool falls over and our McDonald's system fails. This is not just an idea; the concept of the three-legged stool is at the centre of our concept of shared success...⁴³

8.43 For this reason, McDonald's maintains only one income stream from its franchisees (other than the initial franchise fee) in royalties on sales, and simultaneously keeps a relationship with suppliers that is to the shared benefit, or detriment, of both the franchisor and its franchisees. Mr Gregory informed the committee that franchisees pay the original cost of the items only, with no rebates applied:

...we make money as a percentage of the sales as the franchisees grow the sales in their restaurants. We don't make money from rebates. We don't make money from supply chains. And on that shared success...the one thing we don't argue about is that growing the business and growing sales is the best way for us to both benefit.⁴⁴

8.44 Kentucky Fried Chicken described a similar model, which recognised the benefits of passing on the full rebate to its franchisees:

Our supply chain is operated on a not-for-profit basis. We use our scale and purchasing power in an effort to negotiate the best possible pricing from our suppliers for the benefit of the franchise system, without compromising on quality. We are open and transparent with our franchisee partners about pricing. When we receive a rebate from a supplier, we pass it back to our franchisees.⁴⁵

Perspectives on increased disclosure

8.45 This section considers the different perspectives on disclosure of supplier rebates. First, the arguments for greater disclosure are presented, including some possible methods of increased disclosure. Then the arguments for retaining the status quo are outlined.

Arguments for greater disclosure

8.46 A number of submitters argued that there is a lack of transparency regarding supplier arrangements with franchisors and that there should be increased disclosure

43 Mr Andrew Gregory, Managing Director and CEO, McDonald's Australia, *Committee Hansard*, 21 September 2018, p. 1.

44 Mr Andrew Gregory, Managing Director and CEO, McDonald's Australia, *Committee Hansard*, 21 September 2018, p.2.

45 Kentucky Fried Chicken Pty Limited, *Submission 60*, pp. 2–3.

requirements for supplier rebate arrangements. Specifically, the committee heard that there should be some form of disclosure regarding the franchisor's earnings from rebates, particularly when those rebates have been accrued from purchases made by franchisees.

8.47 Belperio Clark Lawyers submitted that the apparent abuse of product supply lines demonstrates that there is a public interest in disclosing rebate arrangements to franchisees which outweighs the franchisor's need for confidentiality:

For product supplies, the immediate counter-argument from franchisors [is] that such information is confidential. Any disclosure of the terms of trade or rebates could be disclosed to competitors of the franchisor. However the apparent abuse of product supply which is being reported to me across various brands demonstrates a public interest need which seems to outweigh this confidentiality or at least the general detail of the confidentiality.⁴⁶

8.48 Mr Heath Adams, a lawyer who has worked with franchisees, argued that rebates should be further disclosed to provide more transparency in an area where franchisors may have a conflict of interest:

The Disclosure Document should be amended to require disclosure also as to the nature and quantum of such rebate. This information is important given most Franchisors retain all rebates and do not share or otherwise pass on such rebates or financial incentives to their franchise network. There is also an inherent conflict of interest in [the] Franchisor's compelling franchise purchase of product from which they receive and retain a rebate or financial incentive.⁴⁷

8.49 Mr Pavel Cherniakov, a former franchisee in the Subway network, noted that the ways in which some franchisors make use of rebates can mean the income does not appear on the franchisor's financial statements, and that this reduces accountability and transparency.⁴⁸

8.50 Mr Martin de Haas, an adviser that has worked with franchisees, argued that fees should be redefined and disclosed according to how they have been charged and applied:

...franchise fees should be redefined as a concept and include all 'add-ons' that are not 'genuine wholesale' or at 'arms length', as well as any volume rebates or advertising subsidies that are not passed on to the franchisee. These concepts should be the subject of definitions.⁴⁹

8.51 The Franchise Relationships Institute argued that disclosure of rebates would enable prospective franchisees to determine if the franchisor is using rebates as a

46 Belperio Clark Lawyers, *Submission 87*, p. 5.

47 Mr Heath Adams, *Submission 81*, p. 2.

48 Mr Pavel Cherniakov, *Submission 93*, p. 3; see also Mr Faheem Mirza, *Submission 36*, p. 6.

49 Mr Martin de Haas, *Supplementary submission 210.1*, p. 1.

second income stream for its own interests or if rebates are being used to improve the competitive advantage of its franchisees:

...rebates from suppliers should be transparently declared. Franchisees can then decide whether they are a legitimate means for a franchisor to offset their business costs, or whether these are a form of 'double dipping' where a franchisor is gaining significant royalty revenues from their franchisees and also garnishing additional revenue from supply deals that should really be used to lower the costs of goods for franchisees. Ideally rebates from suppliers should be used to improve the competitiveness of franchisees, especially if they were attracted to the franchise by claims they would benefit from group buying arrangements.⁵⁰

8.52 Mr Sutherland noted that Annexure 1 of the disclosure document does not require a franchisor to give information about the revenue it derives from royalties, providing goods and services to franchisees (including those paid for by a marketing or cooperative fund) and rebates. He was of the view that providing greater transparency about these revenue streams before a franchisee entered the system would reduce disputes between franchisors and franchisees.⁵¹

8.53 Mr Sutherland also suggested that the Franchising Code should be amended to ensure that prospective franchisees are informed if rebates on purchases made by franchisees in the franchise network are paid to the master franchisor directly or indirectly.⁵²

Possible methods of greater disclosure

8.54 Some inquiry participants provided the committee with various options to improve disclosure of supplier rebates and franchisor income streams. Mr Sutherland suggested that disclosure could be improved by franchisors providing franchisees with a pie chart breaking down the franchisor's income streams so that franchisees can understand how revenue is acquired including through corporate stores and the provision of supplies.⁵³

8.55 Mr Sutherland argued that these reforms would inform franchisees about the possible effects of removing rebates as an income source for the franchisor. He pointed out that if franchisors removed rebates and reduced the cost of goods to franchisees, then the franchisor would likely revisit the franchise model and potentially raise other fees to cover the costs of supporting head office staff.⁵⁴

8.56 However, Mr Sutherland also noted that it may be difficult for some franchisors to disclose the breakdown of all sources of revenue:

[I]t would be too difficult for some franchisors to disclose ALL sources of revenue but some relevant disclosure of the types identified above would be

50 Franchise Relationships Institute, *Submission 47*, p. 7.

51 Mr Derek Sutherland, *Submission 53*, p. 29.

52 Mr Derek Sutherland, *Submission 53*, p. 48.

53 Mr Derek Sutherland, Private capacity, *Committee Hansard*, 8 June 2018, p. 15.

54 Mr Derek Sutherland, Private capacity, *Committee Hansard*, 8 June 2018, p. 15.

useful. Identifying the need to disclose the % or the weighting of those revenue sources is a more controversial issue and there may be legitimate reasons why a franchisor would not like to do that.⁵⁵

8.57 Belperio Clark Lawyers suggested the franchisor-supplier contract should be audited to assess the differences between the prices paid by franchisees compared to the typical market price. The auditor's report could then be provided to franchisees (together with the auditor's report on the marketing fund).⁵⁶

8.58 Some submitters made suggestions on how franchisors could disclose rebates received without compromising commercially sensitive information. Mr Michael Sherlock, the former Chief Executive Officer of Brumby's Bakeries with over 30 years' experience as both a franchisor and franchisee, argued that supplier rebates should be more transparent to franchisees and that consideration should be given to:

- distinguishing between the cost of the purchased item and the rebate added as a percentage;
- providing information on the top 20 items by dollar purchased by franchisees that have a rebate applied and the price difference as a percentage; and
- providing a comparison of the amount the franchisor has received in fees to the amount received from suppliers via rebates and to require the ratio to be provided in the disclosure document and be publicly available.⁵⁷

8.59 Likewise, Mr Emmanuel Martin, a former manager for Gloria Jeans, suggested that in order to increase trust and transparency between franchisors and franchisees, franchisors should provide a guide on profit margins by displaying percentages of the franchisors' earnings on items including shop fitouts, raw materials, packaging materials, and finished materials and products.⁵⁸

Arguments for keeping the status quo

8.60 A number of submitters warned that tightening provisions around supplier rebates would be detrimental. The Franchise Council of Australia (FCA) submitted that existing laws under the Australian Consumer Law and unconscionable conduct provisions already regulate the conduct of franchisors in relation to imposing mandatory supply arrangements. The FCA did not support any further extension of the disclosure obligations with respect to supplier rebates and endorsed the validity of franchisors and suppliers maintaining commercial confidentiality 'as to the precise term, nature and extent of individual rebate arrangements'.⁵⁹

8.61 The FCA also emphasised the importance of supplier rebates as a revenue source for franchisors:

55 Mr Derek Sutherland, *Submission 53*, p. 29.

56 Belperio Clark Lawyers, *Submission 87*, p. 6.

57 Mr Michael Sherlock, *Submission 3*, p. 2.

58 Mr Emmanuel Martin, *Submission 118*, p. [8].

59 Franchising Council of Australia, *Supplementary submission 29.1*, p. 13.

...rebates may be an important revenue source for franchisors where [their] business operating model plans for [these] to be used to defray their operating costs (including costs to coordinate these supply arrangements) and to keep royalties payable by a franchisee at a commercially competitive point.⁶⁰

8.62 Ray White, a real estate franchisor, similarly argued that additional regulation of the rebate system is likely to increase costs for franchisees:

Any attempt to regulate the operation of the rebate system within the franchise sector in any tighter manner than presently is likely to have an immediate and adverse impact on franchisees by increasing the amount they pay for the relevant goods, services and systems.⁶¹

8.63 The committee also heard that franchisor discretion on the use of income from rebates can be beneficial for the system. Franchisors can use the rebates to establish consistencies in the prices franchisees are required to pay despite geographical differences. Mr Don Meij, CEO of Domino's, told the committee that rebates facilitate a national pricing scheme so that franchisees are purchasing ingredients subsidised to be at the same price regardless of location.⁶²

8.64 The Queensland Law Society similarly noted that rebates are sometimes used to lower costs in other areas of the company, and ultimately to benefit franchisees:

Rebates can be important sources of revenue for a franchisor, particularly to assist in in-sourcing and approving suppliers and to reduce costs to keep royalties and other payments down. In many systems rebates may be shared, including in marketing funds or contributions to (or sponsorship of) annual franchise conferences.⁶³

8.65 The Franchise Advisory Centre stated that some franchisors depend entirely on supplier rebates in lieu of charging royalties, including franchisor entities owned by franchisees and networks that have formed buying groups and cooperatives, and that disclosure of rebate amounts 'risked compromising the competitive advantage of a network' if the information fell into the hands of a market rival.⁶⁴ The Franchise Advisory Centre therefore advised that additional disclosure in the form recommended by the 2006 Matthews Review should not be adopted:

Instead, the authorisation and notification process involving franchise networks should return to its former, stricter iteration, and all current and future authorisations include a process of consulting with franchisees and an annual reviewed by the ACCC.⁶⁵

60 Franchising Council of Australia, *Submission 29*, p. 9.

61 Ray White, *Submission 31*, p. 5.

62 Mr Don Meij, CEO, Domino's Pizza Enterprises, *Committee Hansard*, 22 June 2018, p. 57.

63 Queensland Law Society, *Submission 48*, p. 8.

64 Franchisee Advisory Centre, *Submission 138*, p. 3.

65 Franchisee Advisory Centre, *Submission 138*, p. 3.

8.66 While Mr Sutherland supported greater transparency about revenue streams to the franchisor, he warned that changing the regulation around suppliers could lead to franchisors integrating the supply chain into their business model.⁶⁶

Committee view

8.67 Supplier rebates are a matter of great concern to franchisees. As noted in chapter 7, almost half (46 per cent) of all confidential submissions to the inquiry identified supplier rebates in conjunction with third line forcing as a source of problems. Evidence to the inquiry showed that a franchisee's business can be materially impacted by the franchisor taking two income streams at the expense of the franchisee: royalties on sales and supplier rebates on purchases. The committee notes that franchisors which use both royalties and rebates as income streams have an incentive to:

- maximise sales volumes (with potential disregard to the cost of those sales) to increase their return from royalties, which commonly accrue as a percentage of sales; and
- maximise supplier rebates, which accrue with more frequent purchases of higher volumes by the franchisee.

8.68 Further, a conflict of interest arises when the franchisor uses third line forcing arrangements to mandate that franchisees purchase goods and services from particular suppliers and in particular quantities, while at the same time receiving a financial incentive in the form of supplier rebates, the amount of which remains hidden.

8.69 A question therefore arises as to how to deal with this apparent conflict of interest. The first option is to mandate better disclosure in an effort to manage the conflict. The second option is to remove the conflict.

Better disclosure of supplier rebates

8.70 The committee considers it fundamentally important for prospective franchisees to be able to properly assess the profitability of a business, especially when both royalties and rebates are applied simultaneously. Under current disclosure requirements, franchisors are only required to disclose to prospective franchisees whether they receive a supplier rebate, and not the rebate amounts applied on top of the wholesale price for goods and services that they purchase.

8.71 The committee is of the opinion that, without access to either the rebate amount or the method of calculation, the franchisor intends to use to apply rebates, it is unlikely a prospective franchisee would be able to conduct a complete assessment of the expenses of the franchise opportunity. This is because the prospective franchisee is unable to determine what the actual cost will be on purchases, or to factor in annual increases in rebates that may have been arranged between the franchisor and the supplier. Where annually increased rebates are added to the wholesale amount, it has a significant impact on a franchisee's costs over the life of

66 Mr Derek Sutherland, Private capacity, *Committee Hansard*, 8 June 2018, p. 11.

the business, particularly for businesses with narrow profit margins and high turnover of stock.

8.72 The committee acknowledges that giving prospective franchisees proper access to the details of supplier rebates raises the risk of compromising the competitive advantage of a franchisor. However, given the apparent abuse of product supply arrangements by franchisors, the committee is persuaded that subjecting supplier rebates to sunlight is long overdue. The committee considers that the proposals of Mr Sherlock, the former CEO of Brumby's Bakeries with over 30 years' experience as both a franchisor and franchisee, are eminently reasonable and could be implemented without compromising commercially sensitive information.

8.73 The committee therefore recommends that the Australian Government amend the Franchising Code of Conduct so that all supplier rebates, commissions and other payments in relation to the supply of goods or services to franchisees by the franchisor or suppliers mandated by the franchisor be disclosed as a percentage of the full purchase price on each transaction.

8.74 The committee recommends that the Franchising Taskforce consider amendments to item 10 of the Franchising Code of Conduct to require the franchisor to detail in percentage terms what proportion of the supplier rebate will be:

- retained by the franchisor; and
- directed to franchisees, including indirectly, through:
 - direct payment to franchisees;
 - free or subsidised training; or
 - advertising and marketing; or
 - subsidised goods and services; or
 - administration expenses.

Removing the conflict of interest by removing supplier rebates

8.75 The committee considered various proposals put during the inquiry to either require franchisors to pass on rebates to their franchisees, or to remove the rebate income stream altogether.

8.76 The committee can see both the merits and limitations of requiring a franchisor to pass on any supplier rebates to the franchisee in the form of a lower cost of goods and services. As the evidence from McDonald's indicates, there are some highly successful franchise operations where the franchisor does not retain any rebate from its suppliers and instead builds its business model around sharing the benefits of the franchise model with its franchisees and its suppliers. However, the committee also acknowledges evidence from franchisors, the FCA, and lawyers with experience in franchising, that franchisors will simply increase other fees and royalty revenues if the income stream from supplier rebates is curtailed. If this were to eventuate, there may be no net financial benefit to the franchisees in the system.

8.77 Two important matters arise here. Firstly, given the opacity of current supplier rebate arrangements, if the franchisor increased its royalty fees in response to the loss

of supplier rebates, it would at least be a more transparent revenue stream than a hidden supplier rebate. In fact, prospective franchisees would have access to more definitive information about the costs of the business and could therefore conduct a more thorough assessment of the business opportunity.

8.78 Secondly, if the franchisor is unable to prosper without pocketing supplier rebates at the expense of its franchisees, serious questions must be asked about the financial sustainability of that franchise system. Further, the committee received harrowing evidence from franchisees, particularly in the brands operated by RFG, of excessive fee gouging that contributed to the demise of many franchisee businesses. With respect to RFG, however, based on the evidence it received, the committee is concerned that excessive supplier rebates were taken in order to boost the profitability of the business, a primary concern given that RFG was a publicly listed company. This indicates that RFG was primarily motivated by its performance on the share market over and above any responsibility to its franchisees and the long-term financial sustainability of its overall business. In such circumstances, it is hard to avoid the conclusion that taking supplier rebates and royalty revenues constitutes double dipping.

8.79 The committee considers that preventing franchisors from retaining supplier rebates would avoid any conflict of interest arising from the combination of third line forcing arrangements and supplier rebates. It would certainly be a fairer and more transparent business arrangement.

8.80 The committee observes that the Parliament has legislated to ban or limit conflicted remuneration in sectors such as financial advice and life insurance. Interestingly, in those sectors, the vulnerable party retains the discretion to ignore product recommendations and select other products.

8.81 However, franchisees subjected to the combination of third line forcing and supplier rebates have no such discretion. Franchisors can effectively compel franchisees to buy products from the suppliers that give the franchisor the best rebates and benefits, rather than the best value for money products for the franchise system. Franchisees are therefore vulnerable to exploitation by unscrupulous franchisors.

8.82 The committee notes that in the financial advice and life insurance sectors, the regulator (the Australian Securities and Investments Commission) has investigated the nature and extent of conflicted remuneration and identified evidence of detriment. Such investigations have not been undertaken in franchising, and therefore the practical extent of the problem remains unquantified. The committee therefore considers that an important next step is for the Franchising Taskforce to conduct an investigation to examine conflicts of interest associated with supplier rebates and third line forcing.

8.83 In the meantime, the committee considers that mandatory disclosure in percentage terms should enable prospective franchisees to make a more informed appraisal of the business.

Recommendation 8.1

8.84 The committee recommends that the Australian Government amend the Franchising Code of Conduct so that all supplier rebates, commissions and other payments in relation to the supply of goods or services to franchisees by the franchisor or suppliers mandated by the franchisor be disclosed as a percentage of the full purchase price on each transaction.

Recommendation 8.2

8.85 The committee recommends that the Franchising Taskforce consider amendments to item 10 of the Franchising Code of Conduct to require the franchisor to detail in percentage terms what proportion of the supplier rebate will be:

- retained by the franchisor; and
- directed to franchisees, including indirectly, through:
 - direct payment to franchisees;
 - free or subsidised training; or
 - advertising and marketing; or
 - subsidised goods and services; or
 - administration expenses.

Recommendation 8.3

8.86 The committee recommends that the Franchising Taskforce conduct an investigation to examine conflicts of interest associated with supplier rebates and third line forcing, including:

- the extent to which tender processes for suppliers conducted by franchisors are influenced by rebates or other benefits provided back to franchisors;
- the nature and extent of rebates or benefits that flow from suppliers to franchisors;
- the extent to which those rebates or benefits coincide with the use of third line forcing;
- the extent to which such rebates or benefits may be conflicted remuneration;
- the extent of the detriment suffered by franchisees as a result of such rebates or benefits;
- whether any of the rebates or benefits (including any associated third line forcing) are in breach of the Franchising Code of Conduct or competition laws;
- whether, and if so, the extent to which rebates or benefits are passed through to and provide a benefit to franchisees; and

- **making recommendations for policy or regulatory change to address any problems that are identified.**

8.87 The committee also considers that franchisees should be informed about rebates as per items 7 and 10 of Annexure 2 of the Franchising Code if it is the master franchisor that receives the rebate from suppliers, not the franchisor itself, noting that a master franchisor may have granted the right to the franchisor to operate as a subfranchisor.

8.88 The committee therefore recommends that the Franchising Taskforce consider amendments to items 7 and 10 of the Franchising Code of Conduct to provide that if the master franchisor controls and/or receives rebates from suppliers, this is disclosed in the franchise disclosure document

Recommendation 8.4

8.89 The committee recommends that the Franchising Taskforce consider amendments to items 7 and 10 of the Franchising Code of Conduct to provide that if the master franchisor controls and/or receives rebates from suppliers, this is disclosed in the franchise disclosure document.

Chapter 9

Unfair contract terms

Introduction

9.1 This chapter considers the impact of the unfair contract terms (UCT) provisions on the franchise sector. The UCT provisions came into effect on 12 November 2016 through the *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015*. Under Australian Consumer Law (ACL), small businesses entering contracts in relation to the supply of goods and services are provided with some protection from the abuse of unfair terms contained in the contract. The provisions apply if the contract is a standard form contract, where one party to the contract meets the definition of a small business,¹ including that:

- the business employs fewer than 20 people at the time of entering the contract; and
- has an upfront price payable under the contract that either:
 - does not exceed \$300 000;
 - or does not exceed \$1 000 000 where the duration of the contract is more than 12 months.²

9.2 Under the UCT provisions, a term may be declared to be unfair and void by a court or tribunal if:

- it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
- it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and
- it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.³

9.3 In the event a term is considered to be unfair and declared void, the contract continues to bind the parties if it is capable of operating without the unfair term.⁴

9.4 The UCT legislation covering small businesses supplements existing laws addressing unfair behaviour between businesses. As the UCT laws apply across the economy, they do not impact franchisors differently to other businesses. While UCT laws have the potential to alter the power imbalance between franchisees and franchisors, they do not operate retrospectively.

1 *Competition and Consumer Act 2010*, Schedule 2, ss. 23(1).

2 *Competition and Consumer Act 2010*, Schedule 2, ss. 23(4).

3 *Competition and Consumer Act 2010*, Schedule 2, s. 24.

4 *Competition and Consumer Act 2010*, Schedule 2, ss. 23(2).

9.5 To provide some context, Mr David Eaton, the Western Australian Small Business Commissioner at the Small Business Development Corporation, argued that the application of UCT provisions could help address franchise agreements that are fundamentally flawed. He explained the outcome of *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 432016⁵ to illustrate the costs to franchisees who have signed a franchise agreement containing UCTs:

Just by way of example, there is the case with Pizza Hut...where the franchisor changed the price of the product significantly. The franchisor controlled the input cost because it provided most of the product to the pizzas. Even though the class action taken by franchisees said, 'This pricing strategy has destroyed our business and made it unprofitable,' it was deemed that it was legal because the franchising agreement allowed for that. That seems absurd. Therefore, had unfair contract terms legislation applied, perhaps we would have seen those terms made void and the court may have ruled otherwise.⁶

9.6 The chapter begins by examining the limited impact the UCT provisions have had on the franchise sector. It then considers why the UCT provisions have had such a limited impact on franchise agreements. The chapter then explores the application of the small business thresholds with respect to the UCT provisions, and considers whether the variation of a franchise agreement would negate the application of the UCT provisions.

Impact of UCT provisions on the franchise sector

9.7 Prior to the UCT provisions coming into effect, the Australian Competition and Consumer Commission (ACCC) reviewed a sample of franchise agreements to check compliance with the new laws.⁷ The ACCC identified four common types of contract terms contained in franchise agreements that it considered could be problematic:

- the right to unilaterally vary operations manuals;
- liquidated damages clauses;
- restraints of trade; and
- termination clauses that grant a franchisor an unreasonable power to terminate.⁸

9.8 The committee received a mixed response about whether the introduction of the UCT provisions to small business had impacted the terms contained in franchise agreements.

5 *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 432016.

6 Mr David Eaton, Western Australian Small Business Commissioner, Small Business Development Corporation, *Committee Hansard*, 16 October 2018, p. 12.

7 Australian Competition and Consumer Commission, *Unfair terms in small business contracts: A review of selected industries*, November 2016.

8 Australian Competition and Consumer Commission, *Submission 45*, p. 6.

9.9 Some franchisors advised the committee that they had conducted reviews of their franchise agreements and removed UCTs. For example, Tabcorp informed the committee that it had conducted a comprehensive review of the terms in their franchise agreements and made amendments to ensure compliance with UCT provisions.⁹ Bakers Delight also indicated it had worked with the ACCC to ensure all potential UCTs were removed from its franchise agreements.¹⁰ The Coffee Club advised that amending franchise agreements to comply with the UCT laws has had little impact on its own business commercially as it only exercised its powers under the documentation where it was reasonable to do so.¹¹

9.10 The Queensland Law Society noted some encouraging changes had occurred as a result of the implementation of UCT legislation, including:

- a greater willingness (and improved behaviour by franchisors) and advisors toward negotiating the terms of a franchise agreement;
- many franchisors voluntarily changing terms in franchise agreements that could be considered an UCT;
- alterations to franchise agreements to water down former wide-ranging powers, or a redrafting of franchise agreements to justify the purpose behind provisions which may appear 'unfair'.¹²

9.11 Mr Derek Sutherland, an experienced lawyer in the franchise sector, noted that franchisors who have amended their franchise agreements are likely to have fewer complaints about unfair terms in franchise agreements and that the UCT regime is improving pre-contractual negotiations:

If franchisors have properly conducted UCT reviews, there should now be fewer arguments about unfair terms in negotiations with prospective franchisees and with franchisees that are renewing. In my view the UCT regime is being more effectively used to assist in negotiations before entering into an agreement (or upon renewal or extension of the term or scope of an agreement).¹³

9.12 The Business Law Section of the Law Council of Australia (Law Council) submitted it had noticed that the new provisions have had a significant impact on the terms contained in franchise agreements, particularly by larger franchisors. The Law Council advised that further educational activity by the ACCC and other regulators may be necessary for smaller franchisors to understand their compliance obligations under the UCT laws, noting:

9 Tabcorp Holding Limited, *Submission 30*, p. 5.

10 Bakers Delight Holdings, *Submission 41*, p. 6.

11 The Coffee Club Franchising Company Pty Ltd, *Submission 77*, p. 5.

12 Queensland Law Society, *Submission 48*, p. 9.

13 Mr Derek Sutherland, *Submission 54*, p. 40.

One approach to achieve this outcome may be for the ACCC to reach out to the primary legal and financial advisors to this sector, namely suburban solicitors and local accountants.¹⁴

9.13 Some submitters argued that as the legislation commenced only recently, more time is needed to assess whether the UCT laws have been effective in the franchise sector.¹⁵

9.14 By contrast, some submitters contended that since their commencement, the UCT laws have had very little impact. The Australian Lottery and Newsagents Association (ALNA) and Lottery Retailers Association (LRA) noted in their joint submission that the UCT provisions don't appear to have changed the one-sided nature of the contractual rights and obligations between franchisors and franchisees. The ALNA and LRA submitted that they have reviewed current standard form contracts which are being provided to franchisees and 'they do not appear to have been revised' as a result of the introduction of the UCT provisions.¹⁶ Similarly, both Franchise Right and Legalite and the Franchise Advisory Centre submitted that the implementation of the UCT provisions have had little impact on the franchise sector.¹⁷

9.15 Despite the proactive approach of the ACCC to alert and assist franchisors to comply with UCT laws, at least one franchisor was tardy in addressing potential UCTs in its franchise agreements. The UCT provisions came into effect in November 2016. In November 2017, the ACCC contacted Retail Food Group (RFG) to raise concerns about potentially unfair contract terms in RFG franchise agreements. In May 2018, RFG provided the ACCC with revised clauses.¹⁸

9.16 It therefore took 18 months from the UCT provisions coming into effect, and action from the regulator, to prompt RFG to address UCTs in new and renewed franchise agreements. The clauses in RFG's franchise agreements identified by the ACCC as potentially unfair are set out in chapter 4. As noted in chapter 4, the committee asked RFG to provide a copy of RFG's and the ACCC's review of RFG's UCTs and to identify which UCTs had been removed from contracts when the UCT provisions came into effect. RFG refused multiple requests from the committee for this information. The committee is therefore unable to confirm whether the potentially unfair clauses have been removed from RFG's franchise agreements.

14 Law Council of Australia, Business Law Section, *Submission 59*, p. 3.

15 National Retail Association, *Submission 52*, p. 2; MST Lawyers, *Submission 39*, p. 14; Mr Derek Sutherland, *Submission 54*, p. 41; Queensland Law Society, *Submission 48*, p. 9.

16 Australian Lottery and Newsagents Association & Lottery Retailers Association, *Submission 68*, p. 8.

17 Franchise Right Pty Ltd & Legalite, *Submission 72*, p. 3; Franchise Advisory Centre, *Submission 138*, p. 4.

18 Australian Competition and Consumer Commission, answers to questions on notice, 8 November 2018 (received 22 November 2018), p. 2.

Reasons why the UCT provisions have had limited impact

9.17 The ACCC expressed concern that the current UCT regime did not appropriately protect franchisees, nor deter franchisors from including UCTs in their standard form contracts.¹⁹

9.18 The ACCC submitted that the current UCT provisions are inadequate, because it is not illegal to include a UCT in a franchise agreement, and the only enforcement measure available to the regulator is to take the matter to court (in order to have a potentially unfair term declared void). Further, because there is no penalty for having a UCT in a franchise agreement, there is little incentive for a franchisor to proactively remove them:

While s23 of the ACL [Australian Consumer Law] allows parties to the contract or an ACL regulator to challenge a potentially unfair contract term in a court and have the term declared void, it is not a contravention of the ACL to include a UCT in a standard form contract (i.e. it is not itself prohibited).

As including a UCT in is not illegal, the ACCC cannot seek civil pecuniary penalties when a term of a contract is declared unfair, and cannot issue infringement notices in relation to contract terms that are likely to be unfair. The fact that the only recourse is that a term of a contract could be declared void without any other penalty provides little incentive for Franchisors and other businesses to ensure that their standard form contracts do not contain UCTs.²⁰

9.19 Similarly, Franchise Right and Legalite argued that franchisors have little incentive to remove UCTs in their franchise agreements to comply with the UCT provisions because, under the new laws, a franchisee has to pursue court action to challenge a potentially unfair term and have it declared void:

The unfair contract provisions have had little to no effect on franchise agreements. Many franchisors and their lawyers will take the view that franchise agreements do not need to be amended for unfair contract terms, as the legislation deems these clauses void. However, this puts the onus on franchisees to dispute such clauses and we are again facing the situation of franchisees simply not having the money to fight these kinds of battles.²¹

9.20 The ACCC proposed two changes to the UCT legislation to enhance protections for small business and provide a deterrence to the inclusion of UCTs in contracts:

- that the law be amended to make it illegal for a standard form contract under the Competition and Consumer Act (CCA) to include a UCT; and

19 Australian Competition and Consumer Commission, *Submission 45*, p. 5.

20 Australian Competition and Consumer Commission, *Submission 45*, p. 6.

21 Franchise Right Pty Ltd and Legalite, *Submission 72*, p. 3.

- civil pecuniary penalties and infringement notices be made available for breaches of that UCT prohibition.²²

9.21 There was widespread support for the ACCC proposals amongst the various small business ombudsmen, commissions and corporations; including the Australian Small Business and Family Enterprise Ombudsman (ASBFEO),²³ the Office of the NSW Small Business Commissioner,²⁴ and the Small Business Development Corporation.²⁵ Franchise Right and Legalite argued that there should also be a process in which franchisees can report suspected UCTs to an independent body such as the ACCC.²⁶

Limited application of UCT provisions

9.22 Some submitters argued that the UCT provisions could be limited in their application to franchise agreements because paragraph 26(2)(c) and subsection 28(4) provide an exclusion for terms which are required, or expressly permitted, by a law of the Commonwealth.

9.23 The Department of Jobs and Small Business pointed out that while small business contracts, such as franchise agreements, were subject to the UCT laws, the provisions also allowed for terms that are expressly permitted by codes to be exempt from the UCT laws:

A small business contract that is covered by an industry code prescribed under the CCA, such as the Franchising Code, is also subject to the unfair contract terms law. However, if a contract term is required or expressly permitted by that code, the unfair contract term provisions do not apply to that particular term.²⁷

9.24 Further, the ACCC has recently been provided with the power to make class exemptions for specific types of business conduct, under Part IV [relating to restrictive trade practices] of the *Competition and Consumer Act 2010* (CCA), that may be at risk of breaching the law (but do not substantially lessen competition and/or are likely to result in a public benefit).²⁸

9.25 The committee understands that a class exemption for UCTs in franchise agreements would allow franchisors, or groups of franchisors, to secure exemptions from the UCT provisions and provide greater certainty for franchisors exercising

22 Australian Competition and Consumer Commission, *Submission 45*, p. 6.

23 Ms Anne Scott, Principal Adviser, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 21 September 2018, p. 43.

24 Office of the NSW Small Business Commissioner, *Submission 23*, p. 1.

25 Small Business Development Corporation, *Submission 76*, p. 5.

26 Franchise Right Pty Ltd and Legalite, *Submission 72*, p. 3.

27 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 14.

28 Australian Competition and Consumer Commission, *Potential ACCC class exemption for collective bargaining*, discussion paper, 23 August 2018, p. 1; Australian Competition and Consumer Commission, *Class exemptions*, www.accc.gov.au/business/exemptions/class-exemptions (accessed 7 January 2019).

powers granted by a contract that could be deemed unfair. For example, franchisors in the same industry, such as car manufacturers, would be able to apply as a group for class exemptions for terms that are reasonably necessary to protect their legitimate interests.

9.26 The Franchise Council of Australia (FCA) argued that the UCT provisions were less relevant to franchising compared to other sectors because 'the policy objectives of the UCT legislation were already reflected in numerous provisions of the Code regulating the provisions of a franchise agreement and the amendment of terms'.²⁹ The FCA noted that there are provisions relating to restraints of trade and termination in the Franchising Code.³⁰

9.27 However, other evidence does not support the FCA's view. For example, the ACCC identified termination and restraints of trade as two of the four most problematic clauses commonly found in franchise agreements.³¹ This indicates that those provisions in the Franchising Code are not similar to the UCT provisions and have not been effective in preventing unfair contract terms.

9.28 One of the possible sources of confusion in this area is the nature of the provisions in the Franchising Code. For example, in relation to restraint of trade, the Franchising Code includes a set of conditions that a franchisee must satisfy for a restraint of trade contract term to have no effect.³² This is not equivalent to a contract term being 'required or expressly permitted' by the Franchising Code, which is the test identified by the Department of Jobs and Small Business for the UCT provisions not to apply to a particular term in a franchise contract.³³

9.29 Mr Stephen Giles, a franchise lawyer and board member of the FCA, told the committee that in his view the difficulty with the UCT legislation is that it attempts to apply the same protections to small businesses that consumers receive when signing standard form contracts. Mr Giles argued that unlike business-to-business contracts, consumers don't have the opportunity to negotiate these types of contracts.³⁴ However, most of the evidence received by the committee and the ACCC's analysis of UCTs discussed earlier indicates that franchisees do not have any substantive capacity to negotiate the terms and conditions of franchise agreements.

9.30 Several franchisors and franchisor associations also submitted that the UCT laws were sufficient and should not be extended further.³⁵ For example, Industry

29 Franchise Council of Australia, *Submission 29*, p. 26.

30 Franchise Council of Australia, *Supplementary Submission 29.1*, p. 19.

31 Australian Competition and Consumer Commission, *Submission 45*, p. 6.

32 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, clause 23.

33 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 14.

34 Mr Stephen Giles, Board Director, Franchise Council of Australia, *Committee Hansard*, 21 September 2018, p. 21.

35 Federal Chamber of Automotive Industries, *Submission 58*, p. 8; Ray White, *Submission 31*, p. 8.

Hardware Group (IHG) argued that current protections outside of the Code sufficed and no further amendments to the Franchising Code were necessary.³⁶

9.31 ASBFEO disagreed with the views advanced by the FCA and other franchisors and noted that the majority of requests it received from franchisees were for assistance with contract disputes. ASBFEO submitted that the Franchising Code could be amended to require the principles of the UCT legislation to be applied to franchise agreements, and to expressly prohibit UCTs from franchise agreements.³⁷

9.32 Ms Anne Scott, Principal Adviser at ASBFEO, argued many sectors of the franchising industry had failed to remove UCTs from their franchise agreements, and that referring to the UCT legislation in the Franchising Code would lead to a greater awareness among franchisors of their compliance obligations.³⁸

Small business thresholds

9.33 The rationale for retaining a threshold to define a small business is set out in the explanatory memorandum (EM) to the *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Bill 2015*. The EM notes that a business size and transaction value threshold ensures that businesses over a certain size continue to engage legal advice and conduct their own due diligence on all contracts. In particular, the EM states that the transaction value threshold could be used to:

...limit the scope of the protections to maintain the onus on businesses to take reasonable steps to protect their interests. To achieve this, a threshold would be set at a value above which it would be considered reasonable for a business to undertake due diligence by, for example, seeking legal advice.³⁹

9.34 The EM also states that, in order to obtain lower contract prices, small businesses should be allowed to retain the option of signing contracts which contain unfair contract terms:

Providing a protection against unfair terms for small businesses engaging in such high-value contracts may reduce the possibilities available to small businesses. Specifically, small businesses are often offered contracts that contain terms which allow for a lower-priced contract, and if these terms are removed then the cost for small businesses under these types of contracts may increase. Some small businesses may prefer to take on more risk in exchange for a lower-priced contract.⁴⁰

36 Independent Hardware Group, *Submission 56*, p. 4.

37 Australian Small Business and Family Enterprise Ombudsman, *Submission 130*, p. 2.

38 Ms Anne Scott, Principal Adviser, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 21 September 2018, p. 43.

39 Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Bill 2015, *Explanatory Memorandum*, p. 54, https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r5497 (accessed 6 March 2019).

40 Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Bill 2015, *Explanatory Memorandum*, p. 54.

9.35 In November 2018, the Treasury undertook to review the *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015*.⁴¹ The discussion paper sought feedback from stakeholders on the impact of the extension of UCT protections to small business and potential improvements that could be made. The committee notes that Treasury was due to report on 1 February 2019, but at the time of writing the Treasury report had not been publicly released.

9.36 As noted previously, the UCT legislation is currently limited in its application to a small business that:

- employs fewer than 20 people at the time of entering the contract; and
- has an upfront price payable under the contract that either:
 - does not exceed \$300 000;
 - or does not exceed \$1 000 000 where the duration of the contract is more than 12 months.⁴²

9.37 However, the Australian Banking Association (ABA) recently reviewed the definition of small business in light of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The ABA review led to an increase in the small business threshold and a consequent change in the definition of small business in the Banking Code of Conduct, such that it now applies to businesses that:

- have an annual turnover of less than \$10 million in the previous year; and
- have fewer than 100 full time equivalent employees; and
- have less than \$3 million total debt to all credit providers.⁴³

9.38 Several submitters raised concerns that a large number of franchise agreements are excluded from the UCT provisions due to the current threshold for small business.⁴⁴ In particular, some franchisees in the fuel and car dealer industries are unlikely to meet the small business threshold due to the upfront investment amount exceeding \$1 million.⁴⁵ Some retail franchisees may also be excluded. For example, in 2014 McDonald's had an expected initial investment cost of \$1.6 million.⁴⁶

41 Department of the Treasury, Discussion Paper, *Review of Unfair Contract Term Protections for Small Business*, 21 November 2018, https://consult.treasury.gov.au/market-and-competition-policy-division-internal/c2018-t342379/supporting_documents/Discussion_Paper__Review_of_UCTs%20%20Final.pdf (accessed 3 January 2018).

42 *Competition and Consumer Act 2010*, Schedule 2, ss. 23(4).

43 Australian Banking Association, *Code of Banking Practice*, September 2018, p. 13.

44 Dr Tess Hardy, *Submission 91*, p. 3.

45 Motor Trades Association of Australia Limited, *Submission 55*, pp. 8, 11, 19, 20; Australian Automotive Dealers Association, *Submission 84*, p. 9; 7-Eleven Franchisee Association, *Submission 114*, p. 14.

46 McDonald's Australia, *Franchising Overview*, July 2014, p. 11.

9.39 Dr Jenny Buchan, an academic in franchise law, argued that UCT provisions should apply to all franchise agreements without consideration for small business thresholds:

I suggest that the unfair contract terms provisions should apply to all franchise agreements, irrespective of size of the investment or number of employees.⁴⁷

9.40 The committee heard that car dealers 'have not benefitted at all' from UCT legislation due to the small business thresholds.⁴⁸ The Australian Automotive Dealers Association (AADA) noted that return on investment for car dealers takes many years and often spans multiple contracts that include no security of tenure. This makes negotiating more balanced commercial terms extremely difficult for car dealers renewing contracts after making the initial investment. The AADA submitted that car dealers are therefore at greater risk of being subjected to contracts that include UCTs:

Many Dealer Agreements, allow the local importer to unilaterally vary the terms of the Dealer Agreement. Unilateral variation is specifically prohibited by the unfair contract terms legislation, but such legislation does not apply to franchised new car Dealers.⁴⁹

9.41 For these reasons, the AADA argued that the UCT legislation should be extended to franchised car dealer agreements.⁵⁰

9.42 The ACCC supported the view that the thresholds for small business should be increased to allow for greater coverage of businesses such as car dealers, but has not concluded what the threshold should be increased to.⁵¹

Application of standard form contract legislation in franchising

9.43 The CCA provides that if a party to a proceeding alleges that a contract is a standard form contract, it is presumed to be a standard form contract unless another party to the proceeding proves otherwise.⁵²

9.44 Subsection 27(2), Schedule 2, of the CCA sets out the factors that a court must take into account in determining whether a contract is a standard form contract, including:

- whether one of the parties has all or most of the bargaining power in the transaction;

47 Dr Jenny Buchan, *Submission 16*, p. 8; see also Mr David Eaton, Western Australian Small Business Commissioner, Small Business Development Corporation, *Committee Hansard*, 16 October 2018, p. 12.

48 Australian Automotive Dealers Association, *Submission 84*, p. 8.

49 Australian Automotive Dealers Association, *Submission 84*, p. 9.

50 Australian Automotive Dealers Association, *Submission 84*, p. 17.

51 Mr Timothy Grimwade, Executive General Manager, Consumer, Small Business and Product Safety Division, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 57.

52 *Competition and Consumer Act 2010*, Schedule 2, s. 27.

- whether the contract was prepared by one party before any discussion relating to the transaction occurred between the parties;
- whether the other party was given an effective opportunity to negotiate the terms of the contract (other than terms that define the main subject matter or set the upfront price payable), or if they were, in effect, required to accept or reject those terms in the form in which they were presented; and
- whether the terms of the contract take into account the specific characteristics of the other party or the particular transaction.⁵³

9.45 During the course of the inquiry, however, the committee was aware of public articles that counselled franchisors to encourage prospective franchisees to request minor changes to the franchise agreement in order to circumvent UCT laws.⁵⁴

9.46 A question therefore arose as to whether a franchise agreement would automatically be considered a standard form contract and attract the UCT protections if small changes were made to a franchise agreement prior to the franchisee signing it. In answers to questions on notice, the ACCC advised that the variation of a franchise agreement did not necessarily negate the application of UCT laws:

A change, variation or clarification to a franchise agreement before signing would not necessarily negate the application of the UCT law. It would depend on a consideration of the circumstances surrounding the agreement.⁵⁵

Perpetual/evergreen contracts

9.47 The committee also heard that the use of perpetual contracts (which rollover and are not replaced by new contracts) will continue to contain unfair contract terms as the UCT laws are not retrospective. Mr Hank Spier, representing the Law Council, told the committee:

It's a bit of a sleeper because there aren't too many franchise systems that would fit into that, but there are some. They are simply rolled over every year, and they have been going for obviously a long time. This means there is not a new contract, and it's claimed by the franchisor in those cases that the franchise code doesn't apply, unfair contract rules don't apply.⁵⁶

9.48 The Law Council proposed time limits after which grandfathering clauses cease to apply, including where the franchise agreement has not been renewed or varied.⁵⁷

53 *Competition and Consumer Act 2010*, Schedule 2, s. 27.

54 Mr Timothy Mak, *What you need to know about franchise agreements and unfair contract terms*, Franchise Business, 27 June 2016.

55 Australian Competition and Consumer Commission, Answer to question on notice, 3 August 2018 (28 August 2018), p. 2.

56 Mr Hank Spier, Committee Member, Small and Medium Enterprises Committee, Business Law Section, Law Council of Australia, *Committee Hansard*, 21 September 2018, p. 36.

57 Law Council of Australia, *Submission 59*, p. 5.

Operations manuals

9.49 Operations manuals which form part of standard form franchise agreements also need to comply with UCT laws. Ms Kristie Piniuta, the Director of Small Business and Industry Codes at the ACCC, told the committee that terms in franchise agreements which allow franchisors to unilaterally vary operations manuals beyond what is reasonably necessary for the legitimate business interests of the franchisor could be in breach of UCT laws. This is particularly important because franchisors may terminate a franchisee for breaching terms in an operations manual when it forms part of the franchise agreement.⁵⁸

Committee view

9.50 Evidence to the inquiry highlighted the harsh consequences that can befall franchisees when they are party to a franchise agreement that contains unfair contract terms. For example, in the Pizza Hut case, the courts found that the franchise agreement allowed the franchisor to slash the price of the pizzas sold by its franchisees even though that pricing strategy made numerous franchisees unprofitable and drove many franchisees out of business.

9.51 As noted throughout this report, franchising embodies an asymmetry of power. The purpose of applying the unfair contract terms legislation to franchising is to address certain aspects of this power imbalance.

9.52 The committee is therefore concerned that much of the evidence to the inquiry indicated that the unfair contract terms legislation has had little impact on the businesses within the franchising sector to which it should apply, and not only because the legislation is not retrospective. The committee heard that franchisors have little incentive to remove unfair contract terms in their franchise agreements because it is not a contravention of Australian Consumer Law to include an unfair contract term in a franchise agreement. In addition, a franchisee (or the regulator) has to pursue court action to challenge a potentially unfair term and have it declared void. Further, because having an unfair contract term in a franchise agreement is not illegal, the ACCC cannot seek civil pecuniary penalties when a term of a contract is declared unfair, and cannot issue infringement notices in relation to contract terms that are likely to be unfair.

9.53 The ACCC proposed two changes to the unfair contract terms legislation to enhance protections for small business and provide a deterrence to the inclusion of unfair contract terms in contracts:

- that the law be amended to make it illegal for a standard form contract under the Competition and Consumer Act to include an unfair contract term; and
- civil pecuniary penalties and infringement notices be made available for breaches of the unfair contract term prohibition.

58 Ms Kristie Piniuta, Director, Small Business and Industry Codes, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 60.

9.54 The committee notes the ACCC proposals were supported by the Australian Small Business and Family Enterprise Ombudsman, the Office of the NSW Small Business Commissioner, and the Small Business Development Corporation amongst others.

9.55 The committee also notes that a major franchisor, Retail Food Group (RFG), was particularly tardy in examining its franchise agreements for the presence of unfair contract terms. Further, RFG refused multiple requests from the committee for information to demonstrate that a raft of terms that the ACCC had identified as potentially unfair had in fact been removed from RFG's franchise agreements.

9.56 In the committee's view, it is unacceptable that franchisors are able to retain unfair contract terms in their franchise agreements without penalty. Given the power imbalance in franchising, the detriment that many franchisees have suffered as a result of unfair terms, and the fact that franchisors have little incentive to remove such terms, the committee is persuaded that the ACCC proposals regarding the unfair contract terms legislation should be implemented. The committee therefore recommends that the Franchising Taskforce examine the appropriateness of amending the law to:

- make it illegal for a standard form contract under the Competition and Consumer Act to include an unfair contract term;
- provide civil pecuniary penalties and infringement notices for breaches of the unfair contract terms prohibition; and
- provide that the ACCC compulsory information gathering powers under section 155 notices be available to allow the ACCC to obtain evidence about whether a standard form contract contains an unfair contract term (the committee notes that proposed legislation to extend ACCC compulsory information gathering powers in relation to unfair contract terms is currently before Parliament).

Recommendation 9.1

9.57 The committee recommends that the Franchising Taskforce examine the appropriateness of amending section 23 of Schedule 2 of the Australian Consumer Law to provide that:

- **unfair contract terms contained in small business contracts and franchise agreements are prohibited; and**
- **civil pecuniary penalties and infringement notices apply where the provision of a standard form contract (franchise agreement) to a small business contains an unfair contract term.**

Recommendation 9.2

9.58 The committee recommends that the Franchising Taskforce consider amendments to the *Competition and Consumer Act 2010* to ensure section 155 notices are available to allow the Australian Competition and Consumer Commission to obtain evidence about whether a standard form contract contains an unfair contract term.

9.59 The committee recognises that if unfair contract terms are to be prohibited and penalties established, it is important that franchisors have a mechanism through which they are able to protect their legitimate interests. In this regard, the committee notes that the ACCC now has the power to grant class exemptions that would allow franchisors, or groups of franchisors, to secure exemptions from the unfair contract terms provisions for terms that are reasonably necessary to protect their legitimate interests.

9.60 The committee notes that submitters argued that there should be a process in which franchisees can report suspected UCTs to a regulator. Assuming UCTs are made illegal as discussed above, and whistleblower protections for franchisees are implemented as recommended in chapter 3, franchisees could then blow the whistle on UCTs. The committee expects the ACCC to appropriately investigate all complaints or whistleblower reports about illegal unfair contract terms. Any investigation by the ACCC would be made easier by the implementation of a franchise register with franchisors providing updated disclosure documents and template franchise agreements annually in compliance with the Franchising Code of Conduct (see recommendation 6.14).

Recommendation 9.3

9.61 The committee recommends that the Australian Government resource the Australian Competition and Consumer Commission to enable it to appropriately investigate all complaints or whistleblower reports about illegal unfair contract terms.

9.62 The committee acknowledges there is some confusion about the application of the UCT provisions where topics with similar names appear in the Franchising Code. The committee notes that the FCA has argued that the UCT provisions are not needed because similar protections exist in the Franchising Code. The committee considers that the FCA is incorrect in its assessment. This is because the provisions in the Franchising Code, for example the provisions noted by the FCA relating to restraint of trade and termination, do not prescribe the extent that terms in franchise agreements around these two issues are permitted or constrained. For instance, clause 23 of the Franchising Code which relates to restraint of trade, provides former franchisees that satisfy the provisions of clause 23 to be exempt from restraint of trade terms in a franchise agreement. It does not, however, prescribe the nature of, or constraints that ought to be applied to, restraint of trade terms in a franchise agreement. Similarly, the Franchising Code does not permit or constrain terms relating to termination contained in franchise agreements. Instead, it sets conditions that must be satisfied by either party to the contract in order to exercise the termination terms that are contained in the franchise agreement. Therefore, the committee considers that where the Franchising Code does not expressly permit or constrain the form of a term contained in a franchise agreement, it does not prevent the application of unfair contract terms legislation in regulating the appropriateness and fairness of those terms. While the Franchising Code provides a level of constraint in respect of some specific areas which may increase fairness as compared to what would occur without the Franchising Code, it does not go to the general issues and requirements of the UCT legislation.

9.63 As a result, the committee is concerned that if the regulations are unclear to an industry body, there may also be confusion among franchisees, franchisors and their advisers. The committee therefore recommends that the Franchising Taskforce examine the appropriateness of including an explicit statement in the Franchising Code that the UCT provisions apply to franchise agreements unless the Franchising Code expressly requires or permits a specific contract term.

Recommendation 9.4

9.64 The committee recommends that the Franchising Taskforce examine the appropriateness of amending the Franchising Code of Conduct to require compliance with unfair contract terms legislation.

9.65 The committee also received evidence about small business thresholds and the application of unfair contract terms legislation to franchise agreements. The committee notes the two reasons identified in the explanatory memorandum of the *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015* for limiting unfair contract terms provisions to small business. Firstly, that the onus should be on the businesses over the small business threshold to invest in expert legal and commercial advice with respect to carefully contractual risks. And secondly, that a business ought to have the option of accepting the risks arising from unfair contract terms in exchange for a lower-priced contract.⁵⁹

9.66 However, the committee heard from many stakeholders that the imbalance of power created by franchise agreements is sufficiently one-sided that the unfair contract terms provisions should apply to all franchise agreements irrespective of the size of the investment or the number of employees. The committee also heard that most franchisees do not have the skills or experience to understand the implications of the terms they have been presented with in a franchise agreement. Neither do they have the resources to seek expert advice in order to find a franchise agreement without unfair contract terms, or attempt to negotiate unfair terms out of traditionally 'take it or leave it' franchise agreements.

9.67 The committee considers that applying the unfair contract terms provisions to all franchise agreements, irrespective of thresholds, would not create a disparity in advantage with non-franchised businesses in the same industry. This is because the regulations would only apply to the contract between franchisor and franchisee, while standard form contracts with other parties that contribute to the operation of any business, such as telecommunications and retail lease contracts, would remain covered by the small business threshold. For these reasons, the committee considers that the Franchising Taskforce should examine the appropriateness of amending section 23 of Schedule 2 of the Australian Consumer Law to provide that unfair contract terms provisions apply to all franchise agreements.

59 Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Bill 2015, *Explanatory Memorandum*, p. 28.

Recommendation 9.5

9.68 The committee recommends that the Franchising Taskforce examine how to amend section 23 of Schedule 2 of the Australian Consumer Law to provide that unfair contract terms provisions apply to all franchise agreements notwithstanding any other term in the franchise agreement or other agreements.

9.69 The committee also notes that if recommendation 9.5 is implemented so that unfair contract terms provisions apply to all franchise agreements, it could unintentionally leave automotive industry contracts unprotected if a separate code that applies only to the automotive industry is created (the committee makes recommendations in chapter 17 that the Department of the Treasury and the Department of Jobs and Small Business ensure that multiple codes remain aligned over time, noting that options may include establishing a core franchising code that applies generally, with industry-specific aspects in schedules or sub-codes that apply in addition to the core franchising code for relevant industries).

9.70 The committee also acknowledges concerns raised by the Law Council that a small number of perpetual contracts (which rollover and are not replaced by new contracts) will continue to contain unfair contract terms as the UCT laws are not retrospective. The committee considers that the Franchising Taskforce should consider options (including time limits after which grandfathering clauses cease to apply, including where the franchise agreement has not been renewed or varied) to address the existence of unfair contract terms in perpetual franchise agreements.

Recommendation 9.6

9.71 The committee recommends that the Franchising Taskforce consider options to address the existence of unfair contract terms in perpetual franchise agreements.

9.72 As noted above, the thresholds for small business mean that car dealers are not currently covered by the UCT legislation. Therefore, even though unilateral variation of a contract by the franchisor is specifically prohibited by the UCT legislation, the AADA pointed out that many motor vehicle dealer agreements allow the local importer to unilaterally vary the terms of the dealer agreement.

9.73 The committee acknowledges that the return on investment for car dealers takes many years and often spans multiple contracts that include no security of tenure (see chapter 21 on capital expenditure). This renders it difficult for car dealers to negotiate balanced commercial terms when renewing the dealer contract with the franchisor/manufacturer. The committee acknowledges that car dealers are therefore at greater risk of being subjected to contracts that include UCTs.

9.74 However, evidence to the committee, including on a confidential basis, indicates that the issue of UCTs in franchise agreements is widespread in the franchise sector. The committee therefore considers that Franchising Code should be amended to require that where any franchise agreement provides for what would otherwise be unilateral variation to the terms of the agreement, that such variation can only be made with the agreement of the majority of franchisees or representatives elected by a majority of franchisees.

Recommendation 9.7

9.75 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require that where any franchise agreement provides for what would otherwise be unilateral variation to the terms of the agreement, that such amendment can only be made with the agreement of the majority of franchisees within the same franchise system or representatives elected by a majority of franchisees within the same franchise system.

9.76 The ACCC pointed out that operations manuals which form part of standard form franchise agreements also need to comply with UCT laws. Prior to the UCT provisions coming into effect, the ACCC found that franchise agreements commonly included a provision allowing franchisors to unilaterally vary operations manuals.

9.77 The committee notes the ACCC evidence that terms in a franchise agreement which allow franchisors to unilaterally vary operations manuals beyond what is reasonably necessary for the legitimate business interests of the franchisor could be in breach of UCT laws. The committee considers this to be an important point because a franchisor typically has the capacity to terminate a franchisee for breaching terms in an operations manual when it forms part of the franchise agreement.

9.78 The committee therefore considers that the Franchising Taskforce should consider whether the Franchising Code should place restrictions on franchise agreements providing for what would otherwise be unilateral variation to subsidiary requirements to franchise agreements, such as franchise manuals or policies.

Recommendation 9.8

9.79 The committee recommends that the Franchising Taskforce consider whether the Franchising Code of Conduct should place restrictions (including whether such amendments can only be made with the agreement of the majority of franchisees, or representatives elected by a majority of franchisees, within the same franchise system) on franchise agreements providing for what would otherwise be unilateral variation to subsidiary requirements to franchise agreements, such as franchise manuals or policies.

Chapter 10

Cooling off period

Introduction

10.1 The cooling off period provisions of the Franchising Code of Conduct (Franchising Code) entitle a franchisee to a seven day cooling off period after signing the franchise agreement, during time which the franchisee may terminate the agreement. The Oil Code of Conduct (Oil Code) contains similar provisions which are worded slightly differently but have a similar effect.

10.2 This chapter examines evidence to the inquiry regarding the 'cooling off period' provisions and discusses the following issues:

- the length and start time of the cooling off period;
- the application of cooling off periods from transfers and renewals of franchises; and
- whether a cooling off period should also apply to franchisors.

The length and start time of the cooling off period

10.3 The length and start time of the cooling off period were referred to by a number of submitters including:

- the length of the cooling off period; and
- uncertainty about the start date of the cooling off period.

Length of the cooling off period

10.4 Dr Courtenay Atwell, an individual who has conducted research on the business format franchise model, noted that some franchisees are unclear about whether the cooling off period is measured in calendar or business days. Dr Atwell clarified that the *Acts Interpretation Act 1901* states that the cooling off period is measured in calendar days. However, both Dr Atwell and Dr Jenny Buchan, an academic in franchise law, argued that it was unreasonable to expect prospective franchisees to be aware of that, and therefore the Franchising Code should make it clear.¹

10.5 The committee heard various views about the length of the cooling off period. However, most submitters suggested that the cooling off period should be increased. Evidence on this point included the following:

- Mr Graham Evans noted that his cooling off period was over before he completed the training and he was not able to visit his franchise territory.²

1 Dr Courtenay Atwell, *Submission 1*, p. 5. Dr Atwell noted that a similar issue arises in relation to the 14-day disclosure period (see chapter 6): Dr Courtenay Atwell, Private capacity, *Committee Hansard*, 29 June 2018, p. 1; Dr Jenny Buchan, *Submission 16*, p. 12.

2 Mr Graham Evans, *Submission 7*, p. 2.

- Mr Hendrik Grebe submitted that he was not able to effectively use his cooling off period because it overlapped with compulsory training. Mr Grebe argued for the cooling off period to be extended to three months.³
- Mr Peter Horvath argued for a 12 month cooling off period to allow time for franchisees to check that a store is viable.⁴
- Mr Alan Evans and Ms Michelle Wolstenholme argued for a three month cooling off period—to start at the commencement of trading—to check that the franchise store is viable.⁵
- Mr John Wood argued for an extended cooling off period tied to the franchise meeting a set of performance targets.⁶
- One association of franchisees alleged that some franchisees were not given a cooling off period at all.⁷

10.6 Mr Derek Sutherland, an experienced lawyer in the franchise sector, told the committee he supported an extension of the cooling off period. However, he suggested that franchisees should also have the capacity to waive the cooling off period. Mr Sutherland also noted that:

...there is only a small percentage of franchisees who pull out, because they are so invested at that stage they can't pull out. They've lined up a lease and they've committed to capital expenditure.⁸

10.7 Some submitters were less supportive of the idea of extending the cooling off period. For example, Retail Food Group (RFG) noted that the seven day cooling off period follows a 14 day disclosure period and a potentially longer interaction prior to that.⁹ MST Lawyers informed the committee that in their view the cooling-off period provisions generally operated fairly and effectively.¹⁰

Start time of the cooling off period

10.8 There is some uncertainty about when the seven day cooling off period begins. This appears to be caused primarily by a lack of clarity about what circumstances may trigger the start of the cooling off period, coupled with apparent inconsistencies between various clauses in the Franchising Code.

3 Mr Hendrik Grebe, *Submission 200*, pp. 4, 12.

4 Mr Peter Horvath, *Submission 119*, p. 6.

5 Mr Alan Evans and Ms Michelle Wolstenholme, *Submission 137*, p. 4.

6 Mr John Wood, *Submission 18*, p. 3.

7 Association of Croc's Playcentre Franchisees, *Submission 155*, p. 7.

8 Mr Derek Sutherland, Private capacity, *Committee Hansard*, 8 June 2018, pp. 9–10.

9 Mr Richard Hinson, Director of Franchisor and Chief Executive Officer, Retail Food Group Limited, *Committee Hansard*, 11 September 2018, p. 16; Mr Anthony (Mark) Connors, Director Corporate Services and Company Secretary, Retail Food Group Limited, *Committee Hansard*, 11 September 2018, p. 16.

10 MST Lawyers, *Submission 39*, p. 14.

10.9 Annexure 1 of the Franchising Code requires the front page of every disclosure document to include the statement 'you will be entitled to a seven day cooling off period after signing the agreement, during which you may terminate the agreement.'¹¹ Annexure 1 of the Oil Code contains a similar provision, which is focussed on the signing of an agreement.¹²

10.10 However, there is the potential for the cooling off period to begin when payments occur or when there is an agreement to enter into a franchise agreement (as opposed to actually entering a franchise agreement). Subclause 26(1) of the Franchising Code provides:

26 Termination—cooling off period

- (1) A franchisee may terminate an agreement (being either a franchise agreement or an agreement to enter into a franchise agreement) within 7 days after the earlier of:
 - (a) entering into the agreement; and
 - (b) making any payment (whether of money or of other valuable consideration) under the agreement.¹³

10.11 Mr Sutherland described issues with the interpretation and application of particular provisions in the Code, including the cooling off period provisions in clause 26. For example, he observed that it may be unclear if the cooling off provisions apply if the franchisee makes payments but then decides to withdraw before the franchise agreement is signed. However, he noted that any changes or refinements would require consultation between Treasury, the ACCC and stakeholders in the sector.¹⁴

10.12 Mr Sutherland put forward a detailed list of proposed changes to the Franchising Code, including changes to remove the inconsistency in paragraph 9(1)(e) and clause 10 to 'ensure that it is much clearer that a non-refundable payment...cannot be accepted by a franchisor or an associate unless the requirements in subclause 9(1) [relating to the requirement that the franchisor provide the franchisee with a copy of the disclosure document, Franchising Code and franchise agreement at least 14 days before the signing of the agreement or making of a payment] and subclause 10(1) [relating to the franchisee providing the franchisor with a written statement confirming they have received, read and had a reasonable opportunity to understand the documents provided in 9(1)] are completed first'.¹⁵

10.13 The Business Law Section of the Law Council of Australia (Law Council) also identified concerns that subclause 9(1), paragraph 10(1)(e) and clause 26 in

11 *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*, Annexure 1, Item 1.1(e).

12 *Competition and Consumer (Industry Codes—Oil) Regulation 2017*, Annexure 1, Item 1.1(d).

13 *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*, sub cl. 26(1); see also Mr Derek Sutherland, *Submission 53*, p. 45.

14 Mr Derek Sutherland, *Submission 53*, Schedule of suggested amendments, p. 1.

15 Mr Derek Sutherland, *Submission 53*, Schedule of suggested amendments, pp. 2–6.

relation to the cooling off period may be inconsistent—specifically regarding the types of payments that are refundable. The Law Council noted that Annexure 1, Item 1.1(e), clarifies that the cooling off period begins when the franchisee signs the agreement.¹⁶

Application of the cooling off period to transfers and renewals

10.14 Subclause 26(2) of the Franchising Code provides that the cooling off period only applies to new franchise contracts being agreed with franchisors. It does not cover franchises that are transferred or renewed or extended.¹⁷ The explanatory statement that accompanied the introduction of the 2014 regulation did not elaborate on why transfers, renewals and extensions were excluded from the cooling off period.¹⁸

10.15 Similarly, the Oil Code does not allow a cooling off period for transfers or renewals or extensions,¹⁹ and the explanatory statement does not clarify why transfers, renewals and extensions were excluded from the cooling off period.²⁰

Refunds under the cooling off period

10.16 Subclauses 26(3) and 26(4) of the Franchising Code set out the terms on which a franchisor must repay all payments made by the franchisee to the franchisor under the franchise agreement:

- (3) If the franchisee terminates an agreement under subclause (1), the franchisor must, within 14 days, repay all payments (whether of money or of other valuable consideration) made by the franchisee to the franchisor under the agreement.

Civil penalty: 300 penalty units.

- (4) However, the franchisor may deduct from the amount repaid under subclause (3) the franchisor's reasonable expenses if the expenses or their method of calculation have been set out in the agreement.²¹

10.17 The Department of Jobs and Small Business submitted that the provision for franchisors to charge franchisees for reasonable expenses where a franchise is terminated during the cooling off period was added in March 2008 in response to the

16 Law Council of Australia, Business Law Section, *Submission 59*, pp. 6–7.

17 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, sub cl. 26(2); see also Mrs Maria Varkevisser, Private capacity, *Committee Hansard*, 8 June 2018, p. 42.

18 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, *Explanatory Statement*, cl. 26.

19 Competition and Consumer (Industry Codes—Oil) Regulation 2017, cl. 24.

20 Competition and Consumer (Industry Codes—Oil) Regulation 2017, *Explanatory Statement*, cl. 24.

21 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, cl. 26; see also Mr Derek Sutherland, *Submission 53*, p. 45.

report of the Matthews Review into the disclosure provisions of the Franchising Code.²²

10.18 The Oil Code differs from the Franchising Code in that it does not have a civil penalty attached to a failure of the supplier to return all money to the retailer (franchisee).²³

Extension of cooling off period to franchisors

10.19 Dr Buchan suggested that franchisors could also be given the right to a seven day cooling off period. She suggested this may be appropriate if the franchisor became aware during the cooling off period that the franchisee was unsuitable and that it would be better to pay money back and free both parties from the contract, rather than force them to continue.²⁴

10.20 Dr Atwell also suggested that the cooling off period should be available to franchisors, noting that franchisees may demonstrate during training programs that they are not suitable for the role.²⁵

10.21 Dr Atwell informed the committee that from her research, it appears that franchisors terminate agreements (through unofficial in-term withdrawal rights) more often during the cooling off period than franchisees:

Upon speaking to the brokers and the franchise lawyers that were involved in the early stages, what became evident—and this was the pattern no matter who I spoke to—was that the waiting period and the cooling-off period were in fact used by the franchisors and not the franchisees. There was no expert that I spoke to for the research that I undertook that could identify an example of a franchisee using the waiting period or the cooling-off period. In all instances of the particular use of those provisions, it has been at the franchisor's insistence; they have been the ones who have pulled out.²⁶

Committee view

10.22 It is clear to lawyers that the cooling off period and the 14 day disclosure period are specified in calendar days. However, the committee considers that franchisees and small franchisors should be able to find that information easily in the Franchising Code. The committee is therefore recommending that it be clarified in the Franchising Code that calendar days are used for both the cooling off period and the 14 day disclosure period.

10.23 The committee is aware that there is some uncertainty about when the cooling off period begins because it can be triggered by payments (and agreements to enter a

22 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 22.

23 Competition and Consumer (Industry Codes—Oil) Regulation 2017, cl. 24.

24 Dr Jenny Buchan, *Submission 16*, p. 8.

25 Dr Courtenay Atwell, *Submission 1*, p. 2.

26 Dr Courtenay Atwell, Private capacity, *Committee Hansard*, 29 June 2018, p. 4;
Dr Courtenay Atwell, *Submission 1*, p. 2.

franchise agreement) in addition to actually signing a franchise agreement. The committee also notes the issues identified in chapter 20 that franchisees may be subject to leasing terms and conditions in addition to the franchise agreement. The committee further observes Mr Sutherland's point that if a payment is made, but a franchisee agreement has not been signed, it may be unclear if the cooling off period under the Franchising Code applies.

10.24 Most submitters supported an extension of the seven day cooling off period. In combination with the change to the timing recommended below, the committee considers that increasing the length of the cooling off period to 14 days is a reasonable adjustment that should allow the prospective franchisee to complete all due diligence and make their final assessment in a timely manner.

10.25 The committee considers that clarity around the timing of the cooling off period could be best achieved with simple arrangements. For example, a franchisee may exercise their right to exit any arrangements associated with a franchise at any time from the first of the following events, up until 14 days after all four of the following have occurred:

- a franchise agreement has been signed;
- a payment to the franchisor has been made;
- the required disclosure documents have been received by the franchisee; and
- a copy of the lease has been received by the franchisee.

10.26 As an example, the cooling off period would begin from the time that the prospective franchisee makes the first payment to the franchisor or an associate of the franchisor, even if the franchise agreement has yet to be signed by the prospective franchisee and franchisor. This would allow the franchisee to be refunded any amount paid in relation to the purchase of the franchise at any time until 14 days after the last requirement has occurred, noting that the cooling off period could ultimately extend beyond the minimum 14 day period. The committee recommends that this be clearly set out in clause 26 of the Franchising Code. The committee is of the view that more complex arrangements allowing the end of the cooling off period to occur before all four requirements of the arrangement are in place should not be used.

10.27 The committee considers that the stakes for the prospective franchisee are similar regardless of whether the franchisee is acquiring the franchise by transfer or from a franchisor. In both cases, the prospective franchisee must sign a franchise agreement with the franchisor, and in both cases, the prospective franchisee is potentially subject to the influence of business brokers, who are incentivised through commissions. In both instances, prospective franchisees are also at risk of making emotional rather than logical business decisions. The committee therefore considers that the provisions regarding the cooling off period should apply equally to transfers.

10.28 In the case of renewals and extensions, the committee acknowledges that there are some differences. For example, the franchisee should be better informed about the viability of the franchise. However, the stakes are still high, and there are some other attendant risks associated with new or substantially changed terms and conditions for both the franchise agreements and property leases. In addition, at the point of

considering a renewal or extension, the franchisee is also contemplating the option of exiting the franchise. Either option has very significant implications for the franchisee. A cooling off period in these circumstances has virtually no impact on the franchisor. The committee therefore considers that a cooling off period is appropriate in these circumstances.

10.29 The committee heard that transfers are not explicitly included in the 14-day disclosure period under the Franchising Code. The committee considers that a transfer may effectively be a new agreement for the purposes of clause 9 of the Franchising Code. However, it would be appropriate for the Franchising Code to state explicitly that the full disclosure is to occur at least 14 days before the transfer of a franchise.

10.30 The committee notes the observations by Dr Buchan and Dr Atwell that it is sensible to extend the cooling off period to franchisors. While the committee did not receive any other significant evidence on this matter, the committee suggests that it is worth further consideration.

10.31 Finally, the committee considers that the Franchising Code and the Oil Code should contain the same cooling off period provisions to prevent any confusion or uncertainty. Therefore, the committee is of the opinion that the same civil penalties should apply under the Oil Code to suppliers (the franchisor) failing to repay all money if a retailer (the franchisee) exercises their right to terminate a fuel re-selling agreement within the cooling off period.

Recommendation 10.1

10.32 The committee recommends that the Australian Government amend the cooling off period in the Franchising Code of Conduct to clarify that the cooling off and disclosure periods are measured in calendar days.

Recommendation 10.2

10.33 The committee recommends that the Australian Government amend the cooling off period in the Franchising Code of Conduct to clarify in clause 26 of the Franchising Code of Conduct that a franchisee may exercise their right to exit any and all arrangements associated with a franchise (including leases) at any time up until 14 days after the last of the following have occurred:

- **a franchise agreement has been signed;**
- **a payment to the franchisor has been made;**
- **the required disclosure documents set out in the recommendations in chapter 6 have been received by the franchisee (within the required disclosure period); and**
- **a copy of the lease has been received by the franchisee.**

Recommendation 10.3

10.34 The committee recommends that the Australian Government amend the cooling off period in the Franchising Code of Conduct to clarify in clause 9 of the Franchising Code of Conduct that the 14 day disclosure period must begin at least 14 days before the signing of a franchise agreement.

Recommendation 10.4

10.35 The committee recommends that the Australian Government amend the cooling off period in the Franchising Code of Conduct to apply to transfers, renewals and extensions (including decisions to renew or not to renew), together with longer notice periods for renewals and extensions (including decisions to renew or not to renew).

Recommendation 10.5

10.36 The committee recommends that the Australian Government amend the cooling off provisions contained in the Oil Code of Conduct to make them consistent with the Franchising Code of Conduct.

Recommendation 10.6

10.37 The committee recommends that the Australian Government amend the Oil Code of Conduct to make the disclosure provisions consistent with the Franchising Code of Conduct, and that it be made explicit that the disclosure provisions also apply to transfers.

Chapter 11

Exit arrangements

Introduction

11.1 The contractual arrangements for exiting a franchise relationship are governed by the franchise agreement. As noted in chapter 9, the franchise agreement is essentially a standard form contract prepared by the franchisor. Like the other clauses in the contract, the exit arrangements for a franchise agreement are, to all intents and purposes, offered on a 'take it or leave it' basis.

11.2 Given the asymmetry of power between franchisors and franchisees in the franchise relationship, the bulk of the evidence to the inquiry indicated that the exit arrangements in franchising are heavily weighted in the franchisor's favour. During the inquiry, the committee heard many stories from franchisees who appeared to be locked into failed or failing businesses with no effective way to exit the business without losing significant personal financial resources. Some of those stories are summarised in this chapter. The committee also heard that many franchisees lacked an adequate understanding of the exit arrangements in franchising.

11.3 This chapter examines the adequacy of the regulatory settings for exit arrangements for franchisees and franchisors. The current exit arrangements are described for both the Franchising and Oil Codes of Conduct. Other evidence and suggestions for reform to exit arrangements are then discussed.

11.4 The treatment of goodwill and restraints on trade can be significant aspects of exit arrangements. The committee's consideration of goodwill is in chapter 12 and restraint of trade is in chapter 13.

Termination provisions

11.5 This section sets out the termination provisions of the Franchising Code of Conduct (Franchising Code), followed by those under the Oil Code of Conduct (Oil Code).

Franchising Code of Conduct termination provisions

11.6 The Franchising Code provides for franchise agreements to be terminated by the franchisor, but not franchisees.

11.7 Different conditions apply under clauses 27 and 28 of the Franchising Code, depending on whether the franchisee has breached the franchise agreement. Clause 27 permits termination based on a breach of a franchise agreement, provided the franchisor gives reasonable notice and allows 30 days for remedy of the breach.

11.8 However, clause 28 allows for termination of the franchise agreement before it expires without the franchisee's consent, even if there has not been a breach by the franchisee. The franchisor must give reasonable written notice of the proposed termination, and reasons for it (noting that a court could apply a civil penalty to a franchisor that does not provide reasonable notice of, and reasons for, the termination).

11.9 Clauses 27 and 28 are set out below:

27 Termination—breach by franchisee

- (1) This clause applies if:
 - (a) a franchisee breaches a franchise agreement; and
 - (b) the franchisor proposes to terminate the franchise agreement.
- (2) The franchisor must:
 - (a) give to the franchisee reasonable notice, in writing, that the franchisor proposes to terminate the franchise agreement because of the breach; and
 - (b) tell the franchisee what the franchisor requires to be done to remedy the breach; and
 - (c) allow the franchisee a reasonable time to remedy the breach.

Civil penalty: 300 penalty units.
- (3) For paragraph (2)(c), the franchisor does not have to allow more than 30 days.
- (4) If the breach is remedied in accordance with paragraphs (2)(b) and (c), the franchisor cannot terminate the franchise agreement because of that breach.
- (5) Part 4 (resolving disputes) applies in relation to a dispute arising from termination under this clause.¹

28 Termination—no breach by franchisee

- (1) This clause applies if:
 - (a) a franchisor terminates a franchise agreement:
 - (i) in accordance with the agreement; and
 - (ii) before it expires; and
 - (iii) without the consent of the franchisee; and
 - (b) the franchisee has not breached the agreement.
 - (2) For subparagraph (1)(a)(iii), a condition of a franchise agreement that a franchisor can terminate the franchise agreement without the consent of the franchisee is not taken to be consent.
 - (3) Before terminating the franchise agreement, the franchisor must give reasonable written notice of the proposed termination, and reasons for it, to the franchisee.
- Civil penalty: 300 penalty units.
- (4) Part 4 (resolving disputes) applies in relation to a dispute arising from termination under this clause.²

1 Competition and Consumer (Industry Codes— Franchising) Regulation 2014.

2 Competition and Consumer (Industry Codes— Franchising) Regulation 2014.

11.10 In addition to the termination provisions in clauses 27 and 28, clause 29 of the Franchising Code permits the termination of franchise agreements by the franchisor under special circumstances should the franchisee:

- no longer comply with licensing arrangements;
- become insolvent in the case of a franchisee company;
- be deregistered by the Australian Securities and Investments Commission (ASIC);
- abandon the business or franchise relationship;
- be convicted of a serious offence;
- operate the business in a way that endangers public health or safety; or
- act fraudulently.

11.11 Clause 29 also allows for the termination of the franchise agreement by mutual agreement between the franchisor and franchisee.

Oil Code of Conduct termination provisions

11.12 The Oil Code contains similar but different provisions for the termination of fuel re-seller agreements. Clause 35 on termination for breach of the agreement by the retailer (franchisee) is similar to clause 27 of the Franchising Code. The supplier (franchisor) must give reasonable notice that the supplier proposes to terminate the fuel re-selling agreement, notify the retailer of what the supplier requires to be done to remedy the breach, and allow the retailer a reasonable time to remedy the breach. Further, if the breach is remedied, the supplier must not terminate the fuel re-selling agreement because of that breach. However, unlike the Franchising Code, clause 35 lacks any civil penalty if the supplier/franchisor breaches the clause.³

11.13 The Oil Code does not contain an equivalent to clause 28 of the Franchising Code regarding the termination of the agreement where no breach has occurred. However, if the initial non-refundable amount that the retailer paid to the supplier was less than \$20 000, the supplier may terminate the agreement under clause 37 and paragraph 32(11)(c).⁴

11.14 The Oil Code also has a provision (subclause 36(1)) for termination under special circumstances (such as loss of licence, deregistration, bankruptcy, abandonment, fraud, public safety or environmental breaches) that is similar to clause 29 of the Franchising Code. However, subclause 36(1) of the Oil Code has some additional terms, including a term that allows a supplier to terminate the agreement if it:

3 Competition and Consumer (Industry Codes—Oil) Regulations 2017.

4 Competition and Consumer (Industry Codes—Oil) Regulations 2017.

...is likely, by continued occupation of a retail site to which the fuel re-selling agreement relates, to cause substantial damage to the business, property or reputation of the supplier.⁵

11.15 The Australian Competition and Consumer Commission (ACCC) recommended amending the Oil Code to make it clear that franchisors can only terminate in the special circumstances listed in subclause 36(1) if that is expressly provided for in the franchise agreement because:

There are different interpretations within the fuel-reselling industry as to whether clause 36 of the Oil Code creates a statutory right of termination. When the Franchising Code was updated in 2015, an express statement was inserted to make it clear that no right of unilateral termination for special circumstances exists in the Code and that for a right of unilateral termination to exist it must be contained within the agreement.⁶

Other evidence received on the Oil Code termination provisions

11.16 The Franchise Council of Australia (FCA) was supportive of the tougher (on franchisees) termination provisions in the Oil Code:

In seeking to uphold new obligations on franchisors arising from recent Fair Work Act amendments to address policy concerns surrounding vulnerable workers, Oil Industry franchisors have terminated the franchise agreement for workplace relations irregularities at sites under Oil Code provisions. This would have otherwise required a far more extensive process including opportunities to redress franchisee performance deficiencies before termination had action to conclude a franchise agreement been pursued under the Franchising Code.⁷

11.17 The Federal Chamber of Automotive Industries also argued that the termination provisions in the Oil Code were an advantage relative to the Franchising Code.⁸

11.18 7-Eleven argued for the termination provisions in the Franchising Code and the Oil Code to provide franchisors with the right to immediately terminate a franchise agreement in the case of serious noncompliance with Commonwealth workplace laws or Fair Work instruments.⁹ 7-Eleven indicated that:

Currently, the franchising code permits us to issue a breach notice in the case of serious underpayment. However, provided that breach is rectified within a reasonable time frame, we are powerless to act unless there is evidence of fraud. The underpayment, breach notice and rectify cycle can continue for the life of the agreement and we are powerless to act. This not only harms the vulnerable workers who are being exploited but also harms

5 Competition and Consumer (Industry Codes—Oil) Regulations 2017, para. 36(1)(h).

6 Australian Competition and Consumer Commission, *Submission 45*, p. 15.

7 Franchise Council of Australia, *Submission 29*, p. 28.

8 Federal Chamber of Automotive Industries, *Submission 58*, p. 9.

9 Mr Angus McKay, Chief Executive Officer, 7-Eleven Stores Pty Ltd, *Committee Hansard*, 14 September 2018, p. 70.

the many other franchisees doing the right thing, as it potentially damages the franchisor's brand and may erode the value of the franchisee's investment.¹⁰

Current exit arrangements for franchisees

11.19 Franchisees may exit the franchise system via five possible avenues:

- contract termination by the franchisor;
- non-renewal of the franchise agreement by the franchisor or franchisee;
- re-acquisition of the franchised outlet by the franchisor;
- abandonment of the store by the franchisee; and
- transfer of the store to a new franchisee.¹¹

11.20 There are no statutory rights for a franchisee to exit by terminating the franchise agreement unless the franchisor agrees. In addition to poor performance or misconduct by the franchisor, franchisees may wish to exit a franchise system for a variety of reasons, including:

- the pursuit of other investment opportunities;
- preparation for retirement (with or without a successor);
- relocation;
- profit capitalisation;
- an unwillingness or inability to adapt to changes in the market or initiatives implemented by the franchisor; or
- the system not meeting the franchisee's expectations.¹²

11.21 The Franchising Code does not give franchisees any rights to terminate a franchise agreement under any conditions if the franchisor does not agree to terminate the agreement, except during the cooling off period, as set out in chapter 10. Further, the Code provides no additional guidance on the process that a franchisee should undertake to ensure they are informed about their options for exiting the business.¹³

11.22 It has been suggested that for some franchisees there is a lack of understanding in areas including ownership of the business, the ways a franchisee is able to dispose of the business, how the business is to be valued on sale, and what

10 Mr Angus McKay, Chief Executive Officer, 7-Eleven Stores Pty Ltd, *Committee Hansard*, 14 September 2018, p. 70.

11 Nicholas Argyles & Janet Bercovitz, 'Franchisee Associations as Sources of Bargaining Power? Some evidence', *Journal of Economics and Management Strategy*, vol. 24, no. 4, Winter 2015, p. 820.

12 Sarah Walters & Noah Leszcz, 'Resale Programs for Franchise Systems: A Different Perspective on Franchisees Exiting the System', *Franchise Law Journal*, vol. 37, no. 3, Winter 2018, pp. 421–434.

13 Competition and Consumer (Industry Codes— Franchising) Regulation 2014, cl. 27–28.

conditions need to be satisfied by the franchisee and the prospective purchaser before the business can be sold.¹⁴

11.23 The Australian Small Business and Family Enterprise Ombudsman noted that a number of cases had come to its attention in which franchisees had significant difficulty in exiting without large financial losses.¹⁵

11.24 MST Lawyers argued that the termination provisions of the Franchising Code generally operated fairly and effectively. They suggested that franchisors only used clause 27 (both for the service of breach notices and termination notices) or clause 29 when other, less severe, options such as informal performance management or dispute resolution had failed to resolve the issue.¹⁶

11.25 Franchise Legal (a law firm working in franchising) suggested including a clause in the Franchising Code that a franchisee be able to terminate the franchise agreement by giving the franchisor no less than 90 days' written notice with no pecuniary penalty of any kind to the franchisee for doing so.¹⁷

11.26 Mr Matthew Wheatley, President of the Franchisee Federation of Australia, argued that franchisees should be able to apply for early termination of an agreement as a result of hardship and that an independent tribunal could assess whether franchisees should be allowed to exit an arrangement in cases where a franchisee is suffering substantial and ongoing financial loss.¹⁸

11.27 Similarly, Mr Andrew Hahn (a franchisee) suggested that where disputes arose in relation to franchisee exits, adjudication could be through a franchise ombudsman, with the burden of proof being on the franchisor. Mr Hahn also argued that there should be provisions to exit a franchise if a minimum return is not achieved, stating:

Franchisors cannot continue to ignore this responsibility to ensure their systems and the locations they site their franchises in deliver reasonable returns to their franchisees. Where a franchise location or system is not delivering due to no fault of the franchisee, there needs to be an exit system in place for the franchisee where they can exit the franchise agreement after providing a set period of notice with no further penalty...It is poignant to note that franchisors currently often include minimum performance criteria with regards to total revenue targets in their franchise agreement to protect

14 Mr John Hawkey, *Exit Strategy Planning: Grooming Your Business for Sale or Succession*, Routledge, London, 2017, p. 130.

15 Dr Craig Latham, Deputy Ombudsman, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 21 September 2018, p. 41.

16 MST Lawyers, *Submission 39*, p. 14.

17 Ms Ilya Furman, Principal at Franchise Legal Pty Ltd, additional information, 30 November 2018.

18 Mr Matthew Wheatley, President, Franchisee Federation of Australia, *Committee Hansard*, 29 June 2018, p. 74; see also Association of Croc's Playcentre Franchisees, *Submission 155*, pp. 13–14.

themselves allowing them to breach a franchisee, the same protection needs to be extended to the franchisee.¹⁹

11.28 Dr Courtenay Atwell, an individual who has conducted research on the business format franchise model, argued that there was scope for the inclusion of a component-based break down of the initial purchase price and that it would provide the basis for a more informed discussion on the termination or exit in terms of the expected payout or return.²⁰

11.29 Dr Sudha Mani from Monash University argued that only franchisees that have directly experienced an adverse effect because of the franchisor's action should have the right to exit or terminate their agreements with the franchisor. Dr Mani suggested that franchisees that are indirectly affected due to factors such as poor brand image or change in brand reputation because of the franchisor's detrimental actions should be offered other forms of compensation and not necessarily a right to exit the system.²¹

11.30 McDonald's informed the committee that if a franchisee wished to exit a franchisee agreement early, they would be offered the opportunity to transfer their restaurant at fair market value. McDonald's also noted that:

If a McDonald's franchise was operating an unprofitable restaurant, McDonald's would firstly work closely with the franchisee to improve sales and the operation of their restaurant. Should we not be successful in rectifying the profitability of the franchisee's restaurant, we would work with the franchisee to transfer the restaurant to an existing franchisee, or may buy back the restaurant at fair market value. We work with franchisees to improve their situation for the long term, this may on occasion include the provision of financial support for a short term period.²²

Liability for damages as a result of early exit

11.31 The committee received evidence about the financial consequences faced by franchisees exiting a franchise agreement prior to its expiry. In particular, franchisees drew attention to the damages for which they were liable. In some cases, these damages included what would have been due to the franchisor if the franchise agreement had run its full term.²³

19 Mr Andrew Hahn, *Submission 147*, p. 2; see also Name Withheld, *Submission 199*, p. 2.

20 Dr Courtenay Atwell, Private capacity, *Committee Hansard*, 29 June 2018, p. 6.

21 Dr Sudha Mani, answers to questions on notice, 3 October 2018 (received 19 October 2018).

22 McDonald's Australia, answers to questions on notice, 21 September 2018 (received 22 October 2018).

23 Name Withheld, *Submission 196*, p. 2; Name Withheld, *Submission 174*, p. 1; Mr Don Brown, *Submission 92*, p. 1.

The Civic Video case

11.32 The committee became aware of the Civic Video case, in which a court awarded damages to the franchisor in circumstances where a franchisee who exited early was required to pay all fees due under a franchise agreement as if the agreement had run its full term:

This case involved a franchisee purporting to sell its franchised businesses to a third party (Paterson), and ceasing to operate the businesses without first seeking the franchisor's consent. This was found by the Court to constitute a repudiation of the franchise agreements.

...

The Court of Appeal held that the franchisor was entitled to loss of bargain damages to restore its position to that which it would have been in if the franchisee had performed the franchise agreements.

The Court did not consider it relevant that, as argued at the initial trial, the franchisee had at the time of the repudiation fallen behind in its payment of fees due under the franchise agreements and that the franchisee may not have been financially able to perform the franchise agreements for the balance of their terms.²⁴

Shock events—the impact of changes to a franchisor's business model

11.33 During the inquiry, the committee heard about many franchise systems that had transitioned from the founders of the franchise to new owners and new management. In some cases, these transitions were successful. In other cases, however, the outcomes were devastating for franchisees. Business models that were founded on shared incentives and interdependence between franchisees and franchisors were changed into business models that removed shared incentives, gouged franchisees on fees while at the same time reducing services, and generally exploited franchisees to maximise the profit returned to the franchisor. This often appears to have been associated with franchisor buy outs by private equity or franchisors becoming market listed entities.

11.34 Retail Food Group (discussed in chapter 4) is one of the most obvious examples of such outcomes. Mr Sherlock, the former owner of Brumby's Bakeries which was taken over by RFG, informed the committee about some of the difficulties current franchisees faced in trying to exit the system, stating 'there are so many Brumby's franchisees that contact me: they can't sell their business. They're locked in there. It's modern-day slavery. They've got no exit for the business'.²⁵

24 MST Lawyers, *Franchising cases 2016: Lesson learned*, www.mst.com.au/franchising-cases-2016-lessons-learned/ (accessed 7 December 2018).

25 Mr Michael Sherlock, Private capacity, *Committee Hansard*, 8 June 2018, p. 49.

11.35 The Law Council of Australia suggested that franchisees should have an option to exit a franchise system if there is a substantial change to the operations of a franchise following a change in franchisor ownership.²⁶

11.36 Dr Jenny Buchan, an academic in franchise law, submitted that franchisees should be given a statutory right to exit the system by requiring the franchisor to buy their businesses back at a current market value on the occurrence of any 'shock' event. These events might include, for example, the franchisor changing the focus of its efforts and diluting the value (to franchisees) of their businesses through a public listing.²⁷

11.37 The Franchisee Federation of Australia also supported the need for a mechanism to allow franchisees to exit when the franchisor makes material changes to the franchise system:

The example I'd like to use today is if I'm a Pizza Hut franchisee and tomorrow a new marketing director comes into that organisation, they have every right in the world to say to me the next day—bearing in mind I may have purchased that business seven days ago—I'm sorry. We no longer sell pizzas. We now sell telephones,' and I am not able to exit my franchise agreement. So we believe that we should be able to apply for a hardship early termination of that agreement, meet with an independent tribunal and that tribunal can then make the decision and assess whether we should be allowed to exit that agreement or not. There are situations where franchisees are losing thousands of dollars a week and they've got personal guarantees that are waved at them like a loaded gun. In fact, the franchisors don't necessarily terminate the franchise agreement; they let the franchisee dig a hole deeper and deeper and deeper.²⁸

11.38 By contrast, Mr Stephen Giles, an experienced franchise lawyer, argued that franchisees can cooperate collectively and already have legal rights in the event of a breach of express or implied obligations, or misleading, deceptive or unconscionable conduct. Further, Mr Giles suggested that a right for franchisees to exit with requirements for franchisors to buy back stores would cause accounting problem for franchisors:

The creation of a right of exit on nebulous grounds would from an accounting perspective create an immediate contingent liability that most franchisors would be unable to meet. In other words this change would be likely to be interpreted as a contingent liability to buy back all franchisees. The quantum of that contingent liability would bankrupt many if not most franchise systems.²⁹

26 Mr Hank Spier, Committee Member, Small and Medium Enterprises Committee, Business Law Section, Law Council of Australia, *Committee Hansard*, 21 September 2018, p. 35.

27 Dr Jenny Buchan, *Submission 16*, p. 4.

28 Mr Matthew Wheatley, President, Franchisee Federation of Australia, *Committee Hansard*, 29 June 2018, p. 74.

29 Mr Stephen Giles, *Submission 142*, p. 3.

Committee view

11.39 The committee notes that early exit by a franchisee from a franchise agreement is somewhat akin to the early exit of a head lessor (which could be a franchisor) from a lease agreement. As discussed in chapter 20 on lease arrangements, the Franchise Council of Australia (FCA) noted it is common for landlords to require up to 12 months' rental plus costs from the head lessor in the event of an early exit from a lease agreement. The FCA argued that such arrangements are overly onerous, that landlords should be prevented from extracting these amounts, and that tenants should have express statutory rights to terminate lease agreements.³⁰ As outlined in chapter 20, the committee recognises the concerns raised by franchisors with respect to the power wielded by shopping centre landlords. However, the committee observes that the potential damages that a franchisor can extract from a franchisee for early exit of a franchise agreement appear far greater in scope than the damages that a landlord can extract from a head lessor. Claims for damages are discussed further later in the committee view.

11.40 The committee considers that a central difficulty with franchising is that, in too many cases, exit arrangements do not provide a way for franchisees to exit an unviable franchise that is fair to both parties and in a way that reasonably constrains financial losses. The committee notes that where exit from an unviable franchise occurs in collaboration between the franchisee and franchisor, it is possible to mutually minimise losses. However, as with so many other aspects of franchising, the franchise agreements and the Franchising Code reinforce the asymmetry of power in the franchisor's favour. If this power imbalance is exploited, it can essentially eliminate franchisor losses and bankrupt the franchisee.

11.41 Before setting out some of the options to reduce the scale of franchisee loss on exiting a franchise system before the term of the agreement expires, the committee first considers some issues associated with exits, such as franchisor failure, bad franchisor business models, shock events and franchisor claims for damages.

Franchisor failure

11.42 Paragraph 29(1)(b) of the Franchising Code provides the franchisor with a right to terminate the agreement if the franchisee is bankrupt or insolvent. However, the Code does not afford the franchisee any such rights. This can leave franchisees trapped in a business that is failing, unable to exit, and yet still having to provide substantial cash flow to the franchisor. The only options for franchisees appear to be to sell, go bankrupt, or just walk away and face the substantial risk of liability for damages due to breach of the franchise agreement. A failing business is unlikely to sell except to a naïve prospective franchisee. The other two options destroy most, if not all, of a franchisee's personal wealth and may leave them with massive debts.

30 Franchise Council of Australia, *Supplementary Submission 29.1*, pp. 4 and 21; see also Mr Stephen Giles, *Submission 142*, p. 3; FoodCo Group Ltd, *Submission 217*, p. 7.

Bad franchisor business models and shock events

11.43 During the inquiry, the committee heard about many franchise systems that had transitioned from the foundering franchisors to new ownership arrangements with devastating consequences for franchisees.

11.44 The committee notes that the comments by Mr Giles that the creation of a right for franchisees to exit on nebulous grounds would create an immediate contingent liability that most franchisors would be unable to meet. However, the committee is not proposing to create a right of exit on nebulous grounds. Rather, the committee considers that where bad franchisor business models or shock events push franchisees into a scenario where earnings before interest, tax, depreciation and amortization (EBITDA) is negative, the franchisee should have access to certain termination rights. As noted by Dr Buchan, these shock events might include, for example, the franchisor changing the focus of its efforts and diluting the value (to franchisees) of their businesses through a public listing.

Franchisor claims for damages

11.45 In reaching its conclusions concerning franchisor claims for damages, the committee was informed by arguments put forward by MST Lawyers in the context of the Civic Video case. MST Lawyers noted that courts will enforce franchisor claims for damages, including, for example, requiring a franchisee to pay the franchisor monies the franchisor would have received if the franchise agreement had lasted its full term. Further, the Court in the Civic Video case did not consider the possibility that the franchisee may not have been financially able to meet its obligations for the balance of the contract term to be relevant when the Court reached its conclusions.³¹

11.46 The committee considers that franchisees should fulfil their obligations under a franchise agreement to seek the franchisor's consent prior to any proposed transfer of the business. However, it is unclear to the committee why the franchisee should be liable to pay all the fees that would be due to the franchisor as if the agreement had run its full term in circumstances where the franchisee is choosing to exit early because changes to the franchisor's business model are causing the franchisee to suffer recurring losses in that particular location.

No fault exit path

11.47 The committee considers that there needs to be a no fault exit path for franchisees who find themselves in an unviable business, especially if the situation is a result of exploitation by a franchisor. This would allow the business to be wound up without destroying the franchisee's personal wealth. The committee considers that this could be achieved by introducing provisions into the Franchising Code that would allow a franchisee to seek a no fault termination if the business is unviable. Such a termination should occur before a business becomes technically insolvent and may be triggered by a franchisee when:

- three consecutive quarters of taxable losses were recorded; and

31 MST Lawyers, *Franchising cases 2016: Lesson learned*, www.mst.com.au/franchising-cases-2016-lessons-learned/ (accessed 7 December 2018).

- the cap on the working capital contributed by the franchisee was exceeded. This cap would be agreed by the franchisee and franchisor when the franchise agreement is first signed.

11.48 The committee is therefore recommending that the Franchising Code include a no fault termination provision that prevents the franchisor from pursuing performance of the agreement (such as ongoing royalty payments) other than normal short term liabilities associated with winding up a business, such as de-fitting a retail tenancy and the payment of a certain amount of additional royalties and franchise fees.

11.49 The committee notes that there are varying reason why a franchise may fail and the conditions for exit may need to vary accordingly as set out in the scenarios below.

Franchise scenarios for franchisee triggered exits

11.50 Based on the information considered in this chapter, the committee proposes that future provisions for franchisee triggered exits could be developed as shown in Figure 11.1. The provisions could be based on four scenarios which arise depending on profitability with scenario 1 being the most profitable and scenario 4 the least profitable as determined by:

- Franchisee Net Profit after Tax (NPAT);
- Franchisee Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA); and
- Franchisor Net Profit after Tax (NPAT) for that store.

11.51 While specific reference is made in the report here and below to the franchisee's NPAT and EBITDA with some consideration of cash flow, as well as the franchisor's NPAT, what is important is the concepts that these technical terms encapsulate and the nature of the profits or losses for a business that these reflect when used honestly and accurately. The committee notes that these figures can be manipulated and that, as such, what is important is the concepts reflected by these terms in the scenarios outlined in this report rather than the specific terms themselves.

Scenario 1: Business success

11.52 In this scenario, NPAT is positive for both the franchisee and franchisor. The incentives for the franchisee and the franchisor are aligned in keeping the business running. If the franchisee wishes to leave, there is likely to be a reasonable prospect of another franchisee or the franchisor being willing to take over the store. The committee considers that the current termination arrangements under the Franchising Code would not need adjusting to take into account this scenario, subject to other recommendations made in other chapters of this report.

Scenario 2: Franchisee over-gearred or suffering personal hardship

11.53 The committee is concerned about this scenario because the incentives of the franchisee and franchisor are likely to be misaligned, with the franchisor making a profit from the store and the franchisee making a loss. Given that the franchisee is achieving a positive EBITDA, the committee notes that the business operations are profitable, but either the financial structure is unsustainable (over geared, for example,

due to excessive debt) or the franchisee has suffered some form of personal hardship that is preventing them from operating the business in their normal manner.

11.54 In this scenario, the franchisor is not at fault. However, having encountered such a situation, there should still be a way for a franchisee to exit. Rather than being locked into the franchise agreement for the remainder of the franchise term or subject to a full claim for damages, such an unsustainable franchise business should be allowed to fail with the franchisee terminating the agreement without undue capital destruction.

11.55 One way for a franchisee to remedy this scenario would be to rearrange their finances to allow them to move into scenario one. Another alternative would be for the franchisee to sell the franchise using the transfer provisions in the Franchising Code. For some franchisees, this may not be possible. The committee therefore recommends that the Franchising Code include specific provisions to enable early exit by franchisees in this scenario, which would mean that:

- the franchisee can trigger an early exit;
- protections so that franchisees are not exploited by the franchisor during a buy-back; and
- a cap of the lesser of six months or the remaining term of the franchise agreement on claims for damages by the franchisor (including any related lease or licence costs).

Scenario 3: Franchisor exploitation

11.56 This scenario is the most concerning to the committee. The franchise is performing so poorly that the franchisee's EBITDA is negative, and the prospect of making a profit is highly unlikely. However, because franchisor profits are in most cases based on total sales revenue, rebates and the upfront fee, it is possible for franchisors to be making a profit while the franchisee is making a loss. In this scenario, the incentives for franchisees and franchisors are not aligned and the franchise is very likely operating under a bad business model. The committee was informed about numerous situations where this scenario appeared to be occurring.

11.57 The committee therefore recommends a mechanism for franchisees to trigger a no fault termination of the franchise agreement after three fiscal quarters of franchisee negative EBITDA in which:

- the franchisor is responsible for meeting the terms and conditions of breaking any third party leases and is not allowed to charge the franchisee;
- the franchisor should not be able to seek damages or impose any further costs on the franchisee under the franchise agreement; and
- the franchisor is to repay a pro-rata portion (based on the proportion of the term of the franchise agreement undertaken) of the upfront fees to the franchisee.

Figure 11.1: Franchisee business scenarios

<p><u>Scenario 1: Business success</u></p> <div> <p>Franchisee NPAT > 0</p> <p>Franchisee EBITDA > 0</p> <p>Franchisor NPAT > 0</p> </div> <p>Incentives aligned Both agree to continue</p>	<p>No need for new code provisions, subject to other recommendations in this report</p>
<p><u>Scenario 2: Hardship</u></p> <div> <p>Franchisee NPAT < 0</p> <p>Franchisee EBITDA > 0</p> <p>Franchisor NPAT > 0</p> </div> <p>Incentives misaligned Franchisee may be over geared or suffering personal hardship</p>	<p>Need new code provisions for:</p> <ul style="list-style-type: none"> • Franchisee to use transfer provisions if possible; or • Franchisee triggered early exit with protection from buy-back exploitation • cap on franchisor claims for damages (lessor of 6 months or remaining term)
<p><u>Scenario 3: Exploitation</u></p> <div> <p>Franchisee NPAT < 0</p> <p>Franchisee EBITDA < 0</p> <p>Franchisor NPAT > 0</p> </div> <p>Incentives opposed Bad franchisor business model</p>	<p>Need new code provisions for:</p> <ul style="list-style-type: none"> • franchisee triggered early exit after 9 months • franchisor responsible for lease exit terms • franchisee not required to perform franchise agreement • franchisor to return pro-rata portion of upfront franchise fees
<p><u>Scenario 4: Business failure</u></p> <div> <p>Franchisee NPAT < 0</p> <p>Franchisee EBITDA < 0</p> <p>Franchisor NPAT < 0</p> </div> <p>Incentives aligned Both agree to terminate</p>	<p>Subclause 29(2) provides for agreed termination</p> <p>Need new code provisions for:</p> <ul style="list-style-type: none"> • sharing lease termination costs • no requirement to perform franchise agreement terms

Scenario 4: Business failure

11.58 In this scenario, NPAT is negative for both the franchisee and franchisor. If this situation persists for three financial quarters or more, it is likely that the franchisee's and franchisor's interests would be aligned and there is a reasonable prospect that both would agree to terminate the franchise agreement.

11.59 While subclause 29(2) of the Franchising Code provides for agreed termination, there needs to be a way to fairly:

- share the costs between the franchisee and franchisor associated with breaking leases where there is a third party landlord; and
- manage the termination of the franchise agreement.

11.60 In a business failure scenario where both the franchisor and franchisee are incurring losses at a particular outlet, the committee considers it unacceptable for franchisors to be able to require franchisees to pay the franchisor all the royalties and fees that would have been payable if the agreement had run its full term.

11.61 In this particular scenario, the committee recommends that, aside from a period of no more than 90 days, the franchisor should not be able to seek damages or impose any further costs on the franchisee under the franchise agreement. In other words, the franchisor and franchisee share the costs of a failed business model and there is no requirement for the franchisee to perform the franchise agreement terms because the franchisor's business at that location is also financially unviable.

11.62 An exception to scenarios 3 and 4 may be a greenfield site, where there is an argument that a longer period is needed to establish the new business. In this case, it would be desirable to see an ongoing growth in revenue and decrease in losses each quarter, with a trend that gives a reasonable prospect of profit in the future.

Recommendation 11.1

11.63 The committee recommends that the Australian Government amend the Franchising Code of Conduct to include provisions for franchisee triggered exit from franchise agreements as set out in scenarios 2, 3 and 4 in this chapter.

11.64 The committee notes that the scenarios and recommendations above deal with matters, including shock events, such as franchisor performance and business model changes. Other shock events (special circumstances) could include the franchisor becoming insolvent, bankrupt, placed into liquidation, being convicted of fraud or serious offences, or being deregistered by ASIC. The committee notes that where a franchisee is subject to such special circumstances, clause 29 of the Franchising Code allows for termination by the franchisor if such a right is included in the franchise agreement. The committee considers that rights should also exist for franchisees to terminate franchise agreements where a franchisor is subject to such special circumstances. The committee notes however, that franchisors are unlikely to voluntarily include such rights in franchise agreements. Therefore the franchisee rights to terminate the agreement in special circumstances should be statutory rights.

Recommendation 11.2

11.65 The committee recommends that the Franchising Taskforce consider how to amend the Franchising Code of Conduct to include provision for a franchisee to have a right to terminate the franchise agreement in special circumstances (similar to clause 29), for example, if a liquidator is appointed to the franchisor (or where the franchisor is a natural person, becomes bankrupt).

11.66 The committee agrees with the ACCC's suggestion to align the Oil Code provisions regarding termination in special circumstances with those of the Franchising Code. This amendment would make it clear that subclause 36(1) of the Oil Code does not provide a statutory right to termination.

Recommendation 11.3

11.67 The committee recommends that the Australian Government amend clause 36 of the Oil Code of Conduct for termination in special circumstances to align with clause 29 of the Franchising Code of Conduct, and to include a note that such clauses do not give rise to a statutory right to termination and that such a right must be in the franchise agreement itself.

11.68 The committee also observes that the special termination provisions in both the Franchising and Oil Codes do not have any notice period or provision for pausing the termination process if there is a dispute about whether termination is valid. For example, Caltex franchisee submitters and witness raised concerns about the immediacy and speed of termination processes foreclosing their attempts to dispute the validity of the termination. The committee therefore considers that there should be a seven day notice period for termination in special circumstances during which time a franchisee may lodge a notice of dispute and the termination process must be put on hold until the dispute is resolved through agreement, mediation, arbitration or court action.

Recommendation 11.4

11.69 The committee recommends that for termination in special circumstances under both the Franchising Code of Conduct and Oil Code of Conduct, the franchisor must provide seven days' notice and if the franchisee lodges a notice of dispute with a mediator, arbitrator or court during the seven days, the termination process must be suspended until the dispute is resolved. Action by a franchisor in furtherance of a non-compliant notice (with insufficient notice) should attract a civil penalty of a similar amount to other penalties associated with such further action or termination.

11.70 The committee also notes that paragraphs 29(1)(f) and 29(1)(g) provide for termination in circumstances in which a franchisee may act in a way that endangers public health or safety or act fraudulently. However, unlike other aspects of clause 29, paragraphs 29(1)(f) and 29(1)(g) allow the franchisor discretion as to what constitutes a breach, rather than the determination being made by an independent decision-maker. The committee considers that there are risks that such discretion may be abused by franchisors. The committee is therefore recommending that the matters in paragraphs 29(1)(f) and 29(1)(g) must be determined by a relevant government authority. For example, a franchisee must be convicted of fraud, rather than the franchisor using

their discretion. Similarly, termination for operating in a way that endangers public health or safety must be tied to a 'permanent closure direction' from a government health and safety authority.

Recommendation 11.5

11.71 The committee recommends that the Australian Government amend the termination in special circumstances provisions in both the Franchising Code of Conduct and Oil Code of Conduct such that:

- **termination in relation to fraud can only occur if the franchisee is convicted of fraud in connection with the operation of the franchise; and**
- **termination in relation to public health and safety can only occur if the franchisee is served with a 'permanent closure direction' for the franchise by a relevant government body, or failure to remedy WHS orders or notices.**

Chapter 12

Goodwill

Introduction

12.1 The concept of goodwill does not have a firm legal definition. However, over time courts and parliaments have developed descriptions. In 1901, Lord Macnaghten described goodwill as follows:

It is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old-established business from a new business at its first start... Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in the same trade.¹

12.2 This chapter considers the evidence that the committee has received regarding goodwill issues in relation to franchising. The chapter begins by providing some background on the common law as it applies to goodwill. The evidence in relation to current regulatory arrangements and typical franchise agreements is then discussed.

Background on goodwill in franchising

12.3 Dr Jenny Buchan, a franchise law academic, indicated that in legal terms there are three types of goodwill: business (brand), site, and personal (franchisee). The franchisee pays for brand goodwill and possibly site goodwill when buying into a franchise system. Franchisee goodwill is added by the franchisee. A component of goodwill is usually taken into account when the franchise fee is calculated. Dr Buchan also noted that:

In exchange for the franchise fee (business goodwill), the franchisee has the right to trade using the franchisor's intellectual property and system for the duration of the franchise term. This money is a sunk cost that is paid before the franchisee starts trading and is recouped over time as the franchisee derives value from the franchisor's brand.²

12.4 In an journal article, Terry and Giugni argued that, unless specified in the franchise agreement, a franchisee has no right to a payment for goodwill upon expiry or termination of the franchise:

The franchisee simply acquires the right to participate in a business system for a term specified by the franchise agreement. Absent contractual provisions to the contrary, the franchisee has no right to assign or to have the agreement renewed and on termination or non-renewal has no

1 *Inland Revenue Commissioners v Mull and Co's Margarine Ltd* [1901] AC 217 at 223–224.

2 Dr Jenny Buchan, Economic and Finance Committee, Parliament of South Australia, *Hansard*, 19 March 2008, p. 112; Dr Jenny Buchan, *When the Franchisor Fails*, A research report prepared for CPA Australia by the University of New South Wales, January 2006, p. 23.

entitlement to be compensated by the franchisor despite the franchisee's purchase of, or contribution to, goodwill.³

12.5 A similar view was taken by the Federal Court of Australia in the case of *Ranoa Pty Ltd v BP Oil*:

But where a franchisor elects not to grant a new lease, the franchisee is turned from the site without compensation for any goodwill which it may have developed during its period of occupancy. A franchisee, such as the appellant, may regard this result as harsh, the harshness being exacerbated if it should be the case—we do not know whether it is so—that the franchisors are more likely to decide themselves to operate sites to which substantial goodwill attaches. But if this result is harsh, it is a product of the circumstance that the Act does not require the franchisor who elects not to renew to pay any compensation to the franchisee.⁴

12.6 In 1998, in a case examining whether goodwill attached to a licence to operate a taxi, a High Court judgment set out the nature, sources and value of goodwill. The judgment made the following points, which are relevant to franchising:

- Goodwill is the right or privilege to make use of all that constitutes the attractive force which brings in custom.
- Goodwill is correctly identified as property, therefore, because it is the legal right or privilege to conduct a business in substantially the same manner and by substantially the same means (emphasis added) that have attracted custom to it.
- A person who has sold the goodwill of a business may be restrained by injunction from soliciting business from a customer of the old firm even though the value of that firm is no greater than the value of its identifiable assets.
- If the lease expires and is not renewed and the business ceases to exist, the goodwill comes to an end. A new lease to a person commencing a similar business from the premises may command a premium, but no part of the premium is paid for goodwill.
- The value, as opposed to the existence, of goodwill for legal and commercial purposes is governed by the extent to which the earnings of a business exceed the norm.
- With the possible exception of a licence to conduct a business exclusive of all competition, a licence that authorises the conduct of a business is not a source of goodwill.⁵

3 A. Terry and P. D. Giugni, 'Freedom of Contract, Business Format Franchising and the Problem of Goodwill', *Australian Business Law Review*, vol. 23, no. 4, August 1995, p. 242.

4 *Ranoa Pty Ltd v BP Oil Distribution Ltd and Anor*, [1989] FCA 787; 91 ALR 251.

5 *Commissioner of Taxation (Cth) v Murry* [1998] HCA 42; 193 CLR 605; 155 ALR 67; 72 ALJR 1065 (16 June 1998).

Franchising reviews that considered goodwill

12.7 Since the 1970s, a number of reviews have considered goodwill and its application under Australian law. While some of the reviews made recommendations about providing arrangements for sharing goodwill, none appear to have been put in place.

12.8 In 1976, the Trade Practices Act Review Committee recommended that franchisees be given the right to just and equitable compensation upon termination or non-renewal of their franchise agreement.⁶

12.9 In 1979, the Trade Practices Consultative Committee recommended the apportionment of goodwill on the termination or non-renewal of an agreement by the franchisor.⁷

12.10 In its 2008 inquiry, the Parliamentary Joint Committee on Corporations and Financial Services examined a considerable body of evidence regarding goodwill, and devoted five pages of its report to that evidence. The committee recommended that:

...the Franchising Code of Conduct be amended to require franchisors to disclose to franchisees, before a franchising agreement is entered into, what process will apply in determining end of term arrangements. That process should give due regard to the potential transferability of equity in the value of the business as a going concern.⁸

12.11 The 2013 Wein Review did not make any recommendations regarding goodwill at the end of term of a franchise agreement because the review argued that such a recommendation would interfere with fundamental principles of contract and property law.⁹

12.12 The Franchising Code does not address goodwill, other than to clarify how goodwill may affect restraints of trade under clause 23.

The allocation of goodwill in franchising

12.13 This section summarises evidence that the committee received regarding goodwill in franchise systems.

12.14 Professor Andrew Terry, an academic in the area of business regulation, noted that up until the first Franchising Code in 1998, a franchisee had no right to transfer the business. The 1998 Franchising Code gave franchisees the right to transfer a franchise outlet to another franchisee. Professor Terry pointed out that this change in the Code recognised for the first time that franchisees had some portion of goodwill and were not limited to making money solely from a trading profit.¹⁰

6 Mr Alan Wein, *Review of the Franchising Code of Conduct*, 30 April 2013, p. 1.

7 Mr Alan Wein, *Review of the Franchising Code of Conduct*, 30 April 2013, pp. 1–2.

8 Parliamentary Joint Committee on Corporations and Financial Services, *Opportunity not opportunism – Improving conduct in Australian franchising*, December 2008, pp. 73–82.

9 Mr Alan Wein, *Review of the Franchising Code of Conduct*, 30 April 2013, p. vii.

10 Professor Andrew Terry, Private Capacity, *Committee Hansard*, 24 August 2018, p. 25.

12.15 The Franchise Council of Australia (FCA) noted that up to 10 000 franchise outlets in Australia may be sold by transfer each year. Further, the FCA suggested that when franchises are transferred by selling to another franchisee, franchisees are able to charge for goodwill and they are entitled to that goodwill.¹¹

12.16 McDonald's also noted that franchisees may be able to sell their business as an ongoing cashflow business and receive a payment for the goodwill from the purchaser.¹²

12.17 Dr Courtenay Atwell, an individual who has conducted research on the business format franchise model, argued that goodwill should be jointly owned and that the disclosure document should identify how much the franchisee is paying for goodwill at the start of the franchise agreement:

I don't think it belongs to either party definitively. I think there needs to be a predetermined split in the goodwill value. Obviously the franchisee leverages off the other franchisees in the system. It is not owned by either party; it should be jointly owned.¹³

12.18 ANZ informed the committee that when lending to franchises, it required any goodwill in the purchase price to be amortised over the term of the loan. ANZ also noted that goodwill is not taken into account when assessing security or the capacity to repay a loan.¹⁴

12.19 The Franchisee Federation of Australia argued that franchises should be offered, either on a perpetual ownership basis or a fixed term basis, a clear formula to calculate return on capital and a share of business improvement, including growth in goodwill.¹⁵

12.20 The experience of Mr and Ms Horvath, former franchisees of Wendy's Ice Cream, illustrated a common experience among franchisees who perceive franchising to be a low risk investment that, with enough due diligence, can provide for retirement. Mr and Ms Horvath bought a franchise with the expectation that the sale of the business would finance their retirement. However, the goodwill belonged to the franchisor under the franchise agreement, which reduced the anticipated value of their business.¹⁶

Lease arrangements and goodwill

12.21 Mr Richard Evans, an executive in the franchise industry, submitted that if a small business is reliant upon a tenancy lease, or indeed a franchise agreement, the

11 Mr Stephen Giles, Board Director, Franchise Council of Australia, *Committee Hansard*, 21 September 2018, p. 28.

12 Mr Andrew Gregory, Managing Director and Chief Executive Officer, McDonald's Australia Ltd, *Committee Hansard*, 21 September 2018, p. 10.

13 Dr Courtenay Atwell, Private capacity, *Committee Hansard*, 29 June 2018, p. 6.

14 ANZ, answers to questions on notice, 2 October 2018 (received 22 October 2018).

15 Franchisee Federation of Australia, *Supplementary submission 113.1*, p. 3.

16 Mr Peter and Ms Dianne Horvath, *Submission 189*, pp. 1–2.

operator needs to understand there is no goodwill. If the lease or the agreement is not renewed, then there is no business, let alone goodwill. Mr Evans also argued that all investment outcomes must be calculated against the initial lease term or the agreement term.¹⁷

12.22 Craveable Brands confirmed that under its franchise arrangements, if a lease has expired, there is no goodwill attributable to the franchisee. However, if there is a lease and the business is a going concern, a franchisee may be able to sell the franchise:

You're buying for the term that you're buying for, and you're well aware of that. But if you want to go into a renegotiation for a new lease with us—going to the landlord maybe a year or two out and getting a longer term—then you could potentially sell it to an incoming franchisee at that point of time and achieve some goodwill at that point.¹⁸

12.23 The FCA noted the challenges around goodwill arising from lease expiry in a shopping centre:

The franchising code gives a statutory right of sale of business to a franchisee, and the franchisor must not unreasonably withhold consent to that transfer process. The most challenging situation is the end-of-lease-term issue in major shopping centres, where, because of the way those arrangements are framed, the goodwill is essentially dependent upon the shopping centre proprietor granting a new lease. We've identified... significant concerns around that. This is not a new issue. It's been the subject of various other parliamentary inquiries previously.¹⁹

Franchise systems that attribute goodwill to the franchisee

12.24 Some franchise systems, for example 7-Eleven, include the attribution of goodwill to the franchisee.

12.25 The 7-Eleven Franchisee Association provided information suggesting that in the case of a transfer from one franchisee to another, the value placed on goodwill in the sale contract in the past has ranged from 2.1 to 2.7 times the sum of the previous year's total retail income and miscellaneous non retail income.²⁰ A 7-Eleven franchisee suggested that 7-Eleven did not use the same formula for goodwill when it was considering a buy-back of a franchise outlet.²¹

12.26 The 7-Eleven Franchisee Association submitted that when 7-Eleven does not renew a franchise agreement, the franchisee loses all the goodwill from the business.

17 Mr Richard Evans, *Submission 157*, p. 7.

18 Mr Brett Houldin, Chief Executive Officer, Craveable Brands Pty Ltd, *Committee Hansard*, 14 September 2018, pp. 102–103.

19 Mr Stephen Giles, Board Director, Franchise Council of Australia, *Committee Hansard*, 21 September 2018, p. 28.

20 7-Eleven Franchisee Association, *Submission 114*, p. 9.

21 Name Withheld, *Submission 193*, p. 4.

The Association also argued that 7-Eleven does not have a regular practice of refunding the franchise fee or goodwill if a lease is not renewed.²²

12.27 7-Eleven responded by submitting that during transfers, goodwill is negotiated between the buyer and seller, and 7-Eleven does not exercise control over goodwill prices. 7-Eleven also submitted that its end of term arrangements include the following:

The franchisee is informed a minimum of 18 months out of non-renewal and we then work with them to facilitate a sale of their business. Where a sale isn't made, the franchisee has had 10 years of returns and is refunded their stock investment.

Although there is no obligation on 7-Eleven's part to do so[,] it regularly (on a case-by-case basis) compensates franchisees who, by reason of a non-renewal of a lease (for whatever reason) do not continue for the maximum term of 10 years.²³

12.28 In spite of the recognition of franchisee goodwill by 7-Eleven, the committee heard about disputes about the amount of goodwill and the timeliness of payments when franchise agreements end.²⁴

Franchise systems that do not attribute goodwill to the franchisee

12.29 Some franchise agreements and transfers do not include consideration of the goodwill attribution to franchisees. Auto dealerships and the Caltex franchise agreement are summarised as examples below.

Auto dealerships

12.30 The committee obtained access to a dealer franchise agreement which did not attribute any goodwill to the franchisee. The Federal Chamber of Automotive Industries provided a range of reasons why dealer franchise agreements do not attribute goodwill to the franchisee in the new car industry:

- dealers do not have to pay anything for the enormous value of their manufacturer's brand or for the goodwill that is in that brand;
- dealers do not pay franchise fees to the manufacturers, unlike in most other franchises; and
- the only payment that is made by a dealer to the manufacturer is to buy vehicles and parts at their wholesale price.²⁵

12.31 However, the Australian Automotive Dealer Association (AADA) argued that the termination or non-renewal of a dealership agreement can lead to millions of dollars of goodwill being lost by dealers. The AADA argued for fair and reasonable

22 7-Eleven Franchisee Association, *Submission 114*, p. 20.

23 7-Eleven, *Response to Submission 114*, pp. 11, 14.

24 Mr Jaspal Singh, *Submission 104*, pp. 1, 11.

25 Federal Chamber of Automotive Industries, *Response to Submission 55*, p. 4.

compensation to be paid to franchised new car dealers and franchisees at the end of the term.²⁶

12.32 Similarly, the Motor Trades Association of Australia (MTAA) noted that dealers had been subject to sudden cessation of dealership agreements without regard for goodwill. The MTAA argued for the inclusion of goodwill as a value component of termination arrangements where the agreement is terminated without appropriate notice or good cause.²⁷

12.33 The Victorian Automobile Chamber of Commerce argued that the Franchising Code should include provision for the payment of goodwill generated by the franchisee.²⁸

Caltex

12.34 In 2015, Caltex decided to operate its stores through practices other than franchising.²⁹ Several franchisees have raised concerns that they have not been fairly compensated for the loss of goodwill.³⁰

12.35 ACA Lawyers clarified that the Caltex franchise agreement does not attach any goodwill to the franchisee.³¹ Mr Bruce Hollett confirmed that when Caltex agreements expire the franchisee has no right to goodwill:

Because their franchise agreement has expired, they have essentially no tenure and no goodwill. The balance of the sites have tenure, and Caltex has made an offer based on a formula to buy those sites out. We separately have had an independent valuer who specialises in the sale of oil company franchise sites value those businesses, and there is a substantial, monumental difference between what Caltex has offered to buy back the sites with tenure.³²

Committee view

12.36 The committee notes that there are only two ways in which a franchisee can obtain a financial reward for the franchisee goodwill. One is through the transfer (sale) of the franchise to another franchisee, and the other is if the franchisor is willing to buy back the franchise. Transfers appear, from evidence received by the committee, to be more common than buy-backs. This essentially puts franchisees on a more or less

26 Australian Automotive Dealer Association, *Submission 84*, p. 10.

27 Motor Trades Association of Australia Limited, *Submission 55*, pp. 6, 13, 24; see also Mr Don Brown, *Submission 92*, p. 1.

28 Victorian Automobile Chamber of Commerce, *Submission 66*, p. 5.

29 Mr Julian Segal, Chief Executive Officer and Managing Director, Caltex Australia, *Committee Hansard*, 14 September 2018, p. 54.

30 Mukarram Khan, *Submission 206*, p. 1; Name Withheld, *Submission 169*, p. 2; Name Withheld, *Submission 185*, p. 2; Franchise Redress, *Submission 85*, p. 5.

31 ACA Lawyers, *Submission 80*, p. 4.

32 Mr Bruce Hollett, Member, Caltex National Franchise Council, *Committee Hansard*, 29 June 2018, p. 31.

equal footing with an independent small business when it comes to assessing the risks associated with their exit strategy. Both franchisees and independent small businesses are entirely dependent on their capacity to find a willing buyer.

12.37 However, if a franchisee leaves with no financial reward for goodwill when a franchise agreement expires or is terminated, the franchise store may be resold by the franchisor to another franchisee. The store may or may not be operated as a corporate store before being resold. If the franchisor is able to receive a payment for goodwill from the new franchisee in this circumstance, the franchisor would have benefited financially because it would have obtained some goodwill for nothing.

12.38 The committee notes from the background and evidence discussed above that there are differing views on whether the goodwill associated with a franchise is divisible or not. The committee is satisfied that the following three significant sources of goodwill exist for a franchise:

- (a) **Brand goodwill** that arises from the franchise brand, reputation and business systems;
- (b) **Site goodwill** that arises from the specific location; and
- (c) **Franchisee goodwill** that a franchisee may generate through their work.

12.39 The extent to which franchisee goodwill exists depends on:

- (a) whether the franchisee has enhanced the goodwill in a way that is additional to the brand goodwill and site goodwill; and
- (b) the extent to which the earnings of a business exceed the norm; and
- (c) whether:
 - (i) the franchise agreement specifies whether any goodwill is attributable to the franchisee; or
 - (ii) there is a secondary market for franchisee goodwill through transfers to new franchisees.

12.40 Figure 12.1 shows four scenarios for goodwill that arise depending on whether the franchise agreement attributes goodwill to franchisees and whether franchisee goodwill is specified in transfer contracts.

12.41 The notion of risk in the four scenarios relates to how great the risk is that a franchisee may lose some or all of the goodwill to which they may be entitled. For example, there is no risk that a franchisee would lose goodwill if they are not entitled to it. The committee does not express a preference for one scenario over another and it should not be inferred that the low risk scenario outlined below is preferable to a higher risk one. Further, as outlined in the conclusions, the committee does not recommend that a franchisee should receive goodwill. Rather, the committee recommends that any entitlement to goodwill should be clearly set out and that the policy and regulatory arrangements may vary for different scenarios. As it is presently unknown to what extent goodwill is set out in franchising contracts, the committee is recommending that some analysis be undertaken (see below).

Figure 12.1: The risk to franchisee goodwill in four scenarios

Risk to franchisee goodwill when a franchise agreement expires or is terminated (excludes franchisor and site goodwill)		Franchisee goodwill specified in franchise agreements	
		No	Yes
Franchisee goodwill specified in transfer contracts	Yes	Scenario 4: High risk: <ul style="list-style-type: none"> • potential incentive to churn • franchisor able to capture franchisee goodwill for nothing and then resell • the existence of a transfer market creates reasonable expectation of valuable franchisee goodwill 	Scenario 3: Moderate risk: <ul style="list-style-type: none"> • potential incentive to churn • franchisor discretion in determining franchisee goodwill value • the existence of a transfer market creates reasonable expectation of valuable franchisee goodwill
	No	Scenario 1: No risk: <ul style="list-style-type: none"> • the franchisee has no goodwill • entire franchisee profit is during contract term 	Scenario 2: Low risk: <ul style="list-style-type: none"> • this scenario may be uncommon • however the franchisor may have discretion in determining the goodwill apportioned to the franchisee

Source: Diagram developed by the committee during the inquiry.

12.42 The committee makes the following observations about the four scenarios, noting that the length of a franchisee's tenure will have a significant effect on whether a franchisee builds any goodwill at all.

Scenario 1—No risk for franchisee

12.43 This scenario is termed low risk for the franchisee because neither the franchise agreement, nor the transfer contract, attributes any goodwill to the franchisee. The scenario appears to be relatively straight forward and is probably common.

12.44 Where this scenario occurs, adequate disclosure and franchisee education should assist in mitigating incorrect expectations by a franchisee that do not align with franchise and transfer contract terms.

12.45 It is important, therefore, for the prospective franchisee to recognise that they must make a profit from operating the business during the franchise term.

Scenario 2—Low risk for franchisee

12.46 With only the franchise agreement specifying franchisee goodwill, this scenario is probably rare, but not without risk, as the franchise agreement may give the franchisor unlimited discretion in determining the value of franchisee goodwill.

12.47 At this point, it is difficult to determine how commonly this scenario occurs. If it is more common than expected, some reforms may be appropriate to ensure the transparency and accountability of franchisors in determining the value of franchisee goodwill.

Scenario 3—Moderate risk for franchisee

12.48 While specifying franchisee goodwill in both franchise agreements and transfer contracts, this scenario potentially leads to increased risks to franchisee goodwill, because:

- the existence of the transfer market creates an expectation of valuable franchisee goodwill; however, at expiry or termination, the franchisor may have unlimited discretion to determine the value of franchisee goodwill; and
- the existence of the transfer market may give the franchisor a financial incentive to churn: that is, to let the franchise agreement or lease expire in order to capture the franchisee goodwill and then resell the franchise.

12.49 This scenario may align with many of the submissions received during the inquiry. The committee is concerned about the incentive for franchisors to capture a windfall gain from the franchisee goodwill by churning.

Scenario 4—High risk for franchisee

12.50 This scenario would appear to be the most risky of all scenarios if franchisees are paying for franchisee goodwill in transfer contracts, but there is no franchisee goodwill specified in the franchise agreement. At expiry or termination there will be no payment for franchisee goodwill. Unfortunately, at present the committee does not have information on how commonly this scenario occurs. If this scenario is common, some policy or regulatory response may be appropriate to avoid inappropriate assignment of goodwill in transfer contracts when there is no goodwill attributable to the franchisee in the franchise agreement.

Conclusions

12.51 The committee concludes that two key issues arise from the consideration of goodwill.

12.52 Firstly, some of the problems in relation to goodwill arise from a lack of clarity on whether there is any goodwill attributable to franchisees, in addition to brand and site goodwill. Even in the scenario that the committee termed no-risk, there is a problem. That problem arises because some franchisees appear to be under a misapprehension that they are entitled to goodwill even though there is no goodwill attributed to the franchisee in either the franchise agreement or transfer contract. As noted above, the committee considers adequate disclosure and franchisee education are essential to minimise incorrect expectations by franchisees that do not align with the franchise and transfer contract terms. In this regard, the committee considers that if the franchisee is not entitled to goodwill, this should be specified in the franchise agreement or transfer contract. This would reduce the number of misunderstandings and disputes.

12.53 Secondly, issues arise in the scenarios where there are varying amounts of risk that the franchisee could lose goodwill, in a situation where they may have been entitled to it. This is particularly the case in a situation where the franchisor has an incentive to operate in a manner that would allow them to capture the franchisee's goodwill through a windfall gain. It is important to recognise that these scenarios present an element of risk for the franchisee because they also offer the franchisee an opportunity to profit from goodwill (and to recoup the element of goodwill attributable to the franchisee for which they paid when purchasing the business).

12.54 The committee considers that some of the issues around goodwill could be mitigated by greater transparency around the calculation and attribution of goodwill. The committee therefore recommends that the Franchising Taskforce examine how the Franchising Code could be amended to require that franchise agreements specify in the end-of-term arrangements whether a franchisee is entitled to any goodwill, including in a situation where no goodwill is attributable to a franchisee. In addition, where applicable, the calculation of franchisee goodwill should be specified.

12.55 The committee also considers that the lack of data on how common the four scenarios are, potentially impedes the setting of appropriate policy and regulation. The committee therefore recommends that the Franchising Taskforce examine how to implement the collection and analysis of data on how goodwill is treated in franchise agreements and transfer contracts.

Recommendation 12.1

12.56 The committee recommends that the Franchising Taskforce examine whether the Franchising Code of Conduct should be amended to include a requirement for franchise agreements and transfer contracts to set out the end-of-term arrangements for franchisee goodwill, including:

- **what financial consideration the franchisee is entitled to (if any) when a franchise agreement expires and the agreement is not renewed, including:**
 - **if the franchise is closed down; or**
 - **if the franchise becomes a corporate store; or**
 - **if the franchise is sold by the franchisor to another party;**
- **what financial consideration the franchisee is entitled to (if any) when a lease between a franchisor and the landlord upon which the franchise is dependent is not renewed; and**
- **how the franchisee goodwill is calculated and determined separately from the site and brand goodwill.**

Recommendation 12.2

12.57 The committee recommends that the Franchising Taskforce examine how to implement the collection and analysis of data on franchise transfers to determine how common it is for franchisee goodwill to be included in transfer contracts and whether or not the corresponding franchise agreements attribute goodwill to franchisees. The Franchising Taskforce should then re-examine whether the policy and regulatory settings are appropriate, particularly if it is common for transfer contracts to include goodwill, but franchise agreements do not.

Chapter 13

Restraint of trade

Introduction

13.1 This chapter considers the evidence the committee received about restraint of trade issues in relation to franchising. The chapter begins by providing some background on restraint of trade law, including the current provisions of the Franchising Code of Conduct (Franchising Code). It then outlines the key concerns raised by submitters about existing conditions. The chapter concludes with the committee view.

Background on restraint of trade

13.2 In the context of franchising, a restraint of trade clause restricts the ways in which a franchisee may engage in certain business activities once the franchise arrangement has ended.¹ One of the most common restraints is to prohibit a franchisee from operating a business similar to the franchise within a certain timeframe after the end of the franchise agreement.²

13.3 The validity of a restraint of trade clause in Australian law is determined on the basis of whether it is justified as reasonable in the interests of both parties.³ Agreements imposing a restraint of trade can be declared void if they infringe public policy, or 'some definite and governing principle which the community as a whole has already adopted either formally by law, or tacitly by its general course of corporate life'.⁴

13.4 Under common law, a franchisee can dispute a restraint of trade term contained in an agreement and a court may consider the term void unless it is considered reasonable and necessary to protect the franchisor's legitimate business interests. However, this requires the franchisee (as the person seeking to dispute the restraint) to take court action. The onus is placed on the party relying on the restraint—the franchisor—to prove the reasonableness of the restraint to ensure its enforceability.⁵

1 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Explanatory Statement, Select Legislative Instrument No. 168, 2014 (see section on clause 23).

2 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 11.

3 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Explanatory Statement, Select Legislative Instrument No. 168, 2014 (see section on clause 23).

4 *Halsbury's Laws of Australia*, Dr Andrew Hemming and Michelle Daniel, '(B) Contracts which Infringe Public Policy', 17 September 2018, [110–7085].

5 *Halsbury's Laws of Australia*, Dr Andrew Hemming and Michelle Daniel, '(B) Contracts which Infringe Public Policy', 17 September 2018, [110–7085].

Previous inquiries and reforms

13.5 When the Parliamentary Joint Committee on Corporations and Financial Services reviewed restraint of trade provisions in its 2008 report, it recognised 'the commercial arguments underlying the application of restraint of trade clauses during the time in which a franchisee and franchisor have a working relationship'. While the committee did not make specific recommendations, it held the view 'that it may not be appropriate in all circumstances for such restraints to apply once the franchise agreement has ended' because of 'the severe restrictions that such restraints might impose on the ability of former franchisees to generate income as independent business people'.⁶

13.6 In 2013, the Wein Review questioned the reasonableness of a franchisor imposing a restraint of trade on an ex-franchisee:

...assuming that all other aspects of the franchise agreement have been complied with, it might be asked whether an ex-franchisee should be prevented from developing their own, similar business in the vicinity of the franchise site or territory. Put another way, should a franchisor be entitled to enforce a non-compete clause against a compliant franchisee when it is the franchisor that has decided not to renew the franchise.

The scenario being contemplated may not be common. It is more than likely that a well-performing franchisee that is not in breach of the agreement will have its franchise renewed, if it wants it renewed. And if the franchisee is not performing well, the franchisor has little to fear from their starting up a competing business.

It should be remembered that competition is an inherently good thing and should be encouraged where possible. It has been argued that the removal of non-compete clauses may, on the other hand, lead to an increase in franchise fees, as the franchisor covers against the former-franchisee going into competition with a new franchisee. However, if it is in fact the case, as argued by some franchisors, that a franchisee has no goodwill in the franchised business, a franchisor could not logically object to a franchisee commencing a similar business in another location, even one that is proximate. At the same time, the franchisee should not be able to engineer the non-renewal of the franchise to avoid a restraint of trade clause.⁷

13.7 The Wein Review consequently recommended that the Franchising Code be amended to provide an exemption to restraint of trade clauses in a franchise agreement for franchisees whose franchisor has opted not to renew the agreement for another term (discussed later in this chapter).⁸

6 Parliamentary Joint Committee on Corporations and Financial Services, *Opportunity not opportunism: Improving conduct in Australian franchising*, 2008, p. 58.

7 Mr Alan Wein, *Review of the Franchising Code of Conduct*, 30 April 2013, p. 108.

8 Mr Alan Wein, *Review of the Franchising Code of Conduct*, 30 April 2013, p. 109.

Evidence received during the inquiry

13.8 This section summarises evidence received by the committee in relation to restraints of trade. It outlines the views expressed in favour of restraints of trade, as well as submitters concerns about restraints of trade.

13.9 The Department of Jobs and Small Business informed the committee that as franchise agreements are common law contracts, they are subject to common law contract rules and principles for matters such as 'the validity of restriction of trade clauses'.⁹

13.10 The Department of Jobs and Small Business submitted that, historically, many franchise agreements have contained restraint of trade clauses. Such clauses place contractual restrictions on franchisees that prohibit them from engaging in a certain business activity once the franchise has ended. One of the most common restraints is to prohibit a franchisee from operating a business similar to the franchise within a certain timeframe after the end of the franchise agreement.¹⁰

13.11 It should be noted that some franchise systems do not contain restraints of trade clauses in their franchise agreements. Tabcorp, for example, indicated that it does not impose restraints of trade conditions following the termination or expiry of franchise agreements.¹¹ Ray White also informed the committee that it does not use restraints of trade, submitting that:

If a franchisee leaves the group, we have no interest in taking their premises, their database, their phone numbers or digital footprint or restraining them from operating in the real estate industry, nor should we.¹²

Views in favour of restraints of trade

13.12 The Franchise Council of Australia (FCA) was in favour of restraints of trade in franchise contracts and suggested that franchisors will only seek to enforce a restraint where the franchisee has sold their business to the franchisor or another franchisee, or where the franchisee seeks to use valuable confidential information or intellectual property after termination. The FCA also suggested that the law in relation to restraints of trade is that restraints are very narrowly interpreted and that a restraint will only be enforced to the extent that it is reasonably necessary to protect the legitimate interest of the party seeking to rely on it.¹³

13.13 Domino's informed the committee that its standard form franchise agreement contains a restraint of trade provision following termination. Domino's noted that in practice, this restraint has not been exercised in the last three years following the

9 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 3.

10 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 11.

11 Tabcorp Holdings Limited, *Submission 30*, p. 3.

12 Ray White, *Submission 31*, p. 3; see also Federal Chamber of Automotive Industries, *Response to Submission 55*, p. 4; Mr Tony Weber, Chief Executive, Federal Chamber of Automotive Industries, *Committee Hansard*, 14 September 2018, p. 84.

13 Franchise Council of Australia, *Submission 29*, p. 29.

termination of a franchise agreement and has only been used on rare occasions in previous years.¹⁴

13.14 Haarsma Lawyers indicated that the current restraint provisions appear to adequately protect the interests of both the franchisor and the franchisee. Haarsma Lawyers suggested that:

- if the franchisor has a legitimate interest to protect and a franchise agreement is properly drafted to protect that interest, then a restraint clause will be enforceable, and the franchisor will be protected;
- if the franchisor is simply using a broad-brush approach and the restraint is unreasonable, the restraint clause set out in the franchise agreement will not be enforceable;
- in relation to clause 23 of the Franchising Code (discussed later in this chapter), given the relatively short time period that the provisions of the current Code have been operational, the real impact of clause 23 may not be apparent yet.¹⁵

Concerns about restraints of trade

13.15 The Australian Competition and Consumer Commission (ACCC) informed the committee that during its review of Unfair Contract Terms, restraints of trade were one of the four most common unfair terms found in franchise agreements. The ACCC noted that some, but not all, franchisors had agreed to amend such terms.¹⁶

13.16 Dr Jenny Buchan, a franchise law academic, argued that there should be no restraints on a former franchisee. Dr Buchan suggested that if franchisees are no longer entitled to be a franchisee because, for example, the term has ended, they should not be prevented from earning a living doing what they have become good at during the term of the franchise.¹⁷

13.17 Mr Andrew Hahn, a current franchisee, argued that if a franchise system is performing well, the franchisee will generally wish to remain. However, Mr Hahn noted that restraint of trade clauses can be used to prevent franchisees from leaving the franchise system:

Non-competition agreements attempt to prevent an existing franchisee from being able to use their industry knowledge gained over several years, and for which they have paid both an upfront fee as well as ongoing fees and generally an exit fee as well, to continue to earn a living in their profession. They are used to prevent franchisees from leaving the franchise system...The power imbalance is again a relevant consideration as the large financial and legal resources of a franchisor are used to overwhelm a

14 Domino's Pizza Enterprises Ltd, *Submission 74*, p. 6.

15 Haarsma Lawyers, *Submission 51*, p. 4.

16 Australian Competition and Consumer Commission, *Submission 45*, p. 6.

17 Dr Jenny Buchan, *Submission 16*, p. 8.

franchisee, who is likely to be leaving in a vulnerable state after already having been financially crippled by a poorly performing franchise system.¹⁸

13.18 Mr John Wood, a former franchisee, submitted that he was subject to a restraint of trade clause due to the franchisor failing to offer a renewal within the mandated timeframe:

When we left the franchise network we did so due to no renewal being offered by the time mandated under the franchise code. Indeed it took our franchisor a month and a half beyond their obligated milestone to offer a renewal by which time we had assumed they were not going to do so and had progressed to a sale of our assets...We were left unable to renew, unable to sell our business as a going concern and due to restraint of trade, unable to operate the business under our own brand — all due to franchisor non-performance.¹⁹

13.19 Ms Carolyn Walshe, a former franchisee, argued that restraints of trade on former franchisees are only appropriate where the franchise has been terminated due to proven misconduct by the franchisee. Ms Walshe submitted that in other circumstances, the imposition of a restraint of trade is patently unfair, and creates the conditions for one or more of the following:

- An inability for the former franchisee to earn an income, especially where the franchise operated within the service sector in a field for which the franchisee was uniquely professionally qualified.
- A high risk of the former franchisee falling into financial stress where mortgages or other personal liabilities are involved.
- A risk of the former franchisee becoming a burden to the state due to a need for income support via Centrelink.²⁰

13.20 Other franchisees raised similar concerns. For example, one submitter argued that the Franchising Code should include a provision that negates a restraint of trade term in a franchise agreement if the franchisor does not purchase the franchise back at the end of the term or make a payment of goodwill to the franchisee.²¹

13.21 Restraint of trade clauses can also cause difficulties for franchisees when the franchisee has time remaining on a retail lease that the franchisee holds independently of the franchisor. Mr Peter and Ms Dianne Horvath, former franchisees of Wendy's Ice Cream, noted that although they had the right to assign their lease agreement to another person who could operate an ice-cream outlet, restraints of trade prevented them from operating their own outlet outside of the Wendy's franchise system.²²

18 Mr Andrew Hahn, *Submission 147*, p. 5.

19 Mr John Wood, *Submission 18*, p. 5.

20 Ms Carolyn Walshe, *Submission 97*, pp. 1–2; see also Dr Jenny Buchan, *Submission 16*, p. 8.

21 Name Withheld, *Submission 180*, p. 5.

22 Mr Peter Horvath, *Submission 119*, p. 5.

13.22 Franchise Right and Legalite noted that the current arrangements can create difficulties for franchisees when the franchisee cannot afford to dispute the restraint through the court.²³ This is because the franchisee would continue to be bound by the restraint of trade terms in the agreement which could be excessively prohibitive:

...restraints of trade in franchise agreements are wide-reaching and go above and beyond what is necessary to protect the franchisor. For example, in some cases, regional franchisees will be subject to a state-wide or even Australia-wide restraint of trade preventing them from continuing their trade.²⁴

Clause 23 of the Franchising Code of Conduct

13.23 In 2015, in response to recommendations from the 2013 Wein Review, the Franchising Code was amended to include the current clause 23 to provide that any restraint of trade clauses in a franchise agreement, or by reference another document, have no effect after the franchise agreement expires, if the following conditions are met:

- the franchisee gives written notice to the franchisor seeking to extend the agreement on similar terms as the existing agreement or agreements held with other franchisees; and
- the franchisee has not breached the agreement or a related agreement; and
- the franchisee has not infringed the intellectual property of, or a confidentiality agreement with, the franchisor during the term of the agreement; and
- the franchisor does not extend the agreement; and
- either the franchisee claims compensation for goodwill because the agreement was not extended (but the compensation given was a nominal amount and did not provide genuine compensation for goodwill) or the agreement did not allow the franchisee to claim compensation for goodwill (in the event that it was not extended).²⁵

13.24 The explanatory statement to the Franchising Code clarifies several important points regarding the operation of clause 23:

- the franchisee must meet a narrow set of conditions (listed above);
- the franchisee must have materially contributed to goodwill and not been compensated for it;

24 Franchise Right & Legalite, *Submission 72*, p. 4.

25 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, cl. 23.

- a franchisee is dependent on the good faith requirement in the Franchising Code to prevent franchisors only offering substantially changed agreements at renewal;
- the provision does not prevent a franchisor from taking action against a franchisee for breaches of restraint of trade terms; and
- the onus is on the franchisee to show that they fall within the exception contained within clause 23.²⁶

13.25 The explanatory statement accompanying the changes provided a case study outlining an example of how clause 23 might apply in practice (see Figure 13.1).

13.26 The Department of Jobs and Small Business indicated that the intended purpose of clause 23 was to protect franchisees from restraint of trade clauses designed to prevent competition by a former franchisee, where the former franchisee has contributed to the goodwill of the franchise (which the franchisor could take advantage of) without being properly compensated.²⁷ In relation to the submission from the Department of Jobs and Small Business, the committee notes that clause 23 refers to franchise agreements (that is, an agreement between a franchisor and a franchisee), and provides some limited protections for former franchisees.

13.27 Despite the existence of clause 23, evidence suggested that it has not yet been used successfully in court by franchisees to avoid a restraint of trade clause. Mr Derek Sutherland, an experienced franchising lawyer, stated that he was unaware of any circumstance where this had occurred. He noted that a franchisee may have relied upon clause 23 but there are no reported court judgements.²⁸ The Queensland Law Society also submitted that it is unaware of any case where clause 23 has been applied or tested by the courts.²⁹

26 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, Explanatory Statement, cl. 23.

27 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 12.

28 Mr Derek Sutherland, *Submission 53*, p. 45.

29 Queensland Law Society, *Submission 48*, p. 11.

Figure 13.1: Example of clause 23 of the Franchising Code in practice³⁰

Example: Capital Lunchvans is a mobile lunch vans franchise system, offering pre-prepared food, drinks and snacks. The lunch vans it uses are standard mobile food vans and do not contain any specialised equipment. The business model Capital Lunchvans uses is not innovative or unique. Its franchise agreement does contain a restraint of trade clause purporting to prevent a franchisee opening a competing lunch van or similar business within 5 kilometres of its original territory for a period of two years.

Glen was one of the first franchisees in the Capital Lunchvans system. He trained his staff and has a large number of regular customers who visit his van each day. He believes he has an excellent rapport with his customers.

In February 2015, seven months before the expiry of the franchising term, Capital Lunchvans advises Glen that it will not be extending his franchise agreement. Glen is not in breach of the franchise agreement at that time, though he has been in breach in the past, but always remedied the breach. He emails Capital Lunchvans advising that he wants to extend the agreement on the terms Capital Lunchvans is offering other franchisees, or if that is not possible then to at least be compensated for the goodwill he believes he has created in the business.

Capital Lunchvans declines to pay Glen goodwill, arguing that it has provided him with the business, training and advertising and that it is largely responsible for any success of the business.

In March 2016, Glen purchases a café in a building within his old Capital Lunchvans territory. He also delivers lunches to offices in the building in which his café is located.

Capital Lunchvans believes Glen's new business competes with the franchisee who has taken over Glen's old territory; however, on these facts, it is unlikely that it would be able to enforce its restraint of trade clause against Glen. While Glen's new business is likely to be considered a similar business to a lunch van, he appears to have satisfied the conditions of clause 23.

Concerns raised about clause 23

13.28 Some submitters held concerns about the operation of clause 23 and argued that the drafting of the clause could be clearer. For example, the Queensland Law Society considered that the drafting of clause 23 of the Franchising Code is poor and could be revisited to address the following matters:

- it applies only if a franchisee requests an extension of their existing agreement;
- the provision does not apply to termination of a franchise agreement (other than expiry where a request for extension has been made); and
- distinctions could be made between franchisee versus franchisor terminations.³¹

30 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, *Explanatory Statement*, cl. 23.

31 Queensland Law Society, *Submission 48*, p. 11.

13.29 However, Mr Sutherland argued that the Franchising Code did not need to be revised because:

There are cases where franchisees deliberately try to avoid their end of term obligations including restraints. If the restraint terms are reasonable, the Code should not be used to allow a franchisee to avoid their existing contractual obligations on termination.³²

13.30 The National Retail Association (NRA) submitted that restraints of trade on former franchisees are already subject to significant legal precedent in addition to the provisions of the Franchising Code. The NRA submitted that any variation to the Franchising Code in this regard may introduce an element of uncertainty in a sector which is already undergoing significant change.³³

13.31 Haarsma Lawyers were of the opinion that because clause 23 has only been operational for a relatively short period of time, its impacts may not yet be apparent.³⁴

Other issues raised

13.32 This section outlines two key issues raised in evidence to the inquiry about restraints of trade:

- the absence of restraint of trade clauses in contracts for transfers of franchises between franchisees; and
- restraint of trade clauses in agreements for automotive dealer franchises.

Restraint of trade and transfers between franchisees

13.33 The inquiry received evidence raising concerns about restraint of trade clauses associated with contracts for the transfer of franchises between franchisees.

13.34 The FCA argued that franchisees obtaining a franchise by transfer should seek additional enforceable restraints of trade against the previous franchisee.³⁵ Mr Sutherland held a similar view and argued that franchisees who purchase a franchise directly from an existing franchisee may not have included contractual restraint against the former franchisee. In some cases, the former franchisee goes on to compete with the new franchisee, with the new franchisee having no recourse other than to implore the franchisor to take action to enforce the restraint covenant that the franchisor has with the former franchisee. Mr Sutherland observed:

That can lead to a dispute where the buyer demands the franchisor take steps to protect them and their investment when they have no contractual restraint to enforce themselves. In that case the buyer paid the seller (not the franchisor) for goodwill, but cannot protect it because a franchisor cannot afford to enforce the restraint.³⁶

32 Mr Derek Sutherland, *Submission 53*, p. 46.

33 National Retail Association, *Submission 52*, p. 3.

34 Haarsma Lawyers, *Submission 51*, p. 4. See also MST Lawyers, *Submission 39*, p. 15.

35 Franchise Council of Australia, *Submission 29*, p. 29.

36 Mr Derek Sutherland, *Submission 53*, p. 5.

13.35 The Queensland Law Society also argued that a contract for a transfer between franchisees should include an appropriate restraint of trade provision to protect the goodwill for which the buyer is paying. The Queensland Law Society suggested it should not be assumed that the franchisor has any obligation to enforce a contractual restraint in its agreement with the former franchisee, when the buyer had an opportunity to obtain its own restraint from the seller which would give it the right to enforce that restraint directly.³⁷

13.36 MST Lawyers were also in favour of the inclusion of restraints of trade clauses when a franchise transfers from one franchisee to another, and submitted that:

...restraints of trade are a common clause in sale of business agreements... From our experience, putting to one side restraints contained in franchise agreements and deeds of surrender of franchise agreements, prospective franchisees who are purchasing an existing franchised business from a vendor franchisee inevitably and reasonably require a restraint of trade to protect the goodwill for which they have agreed to provide valuable consideration.³⁸

Restraint of trade clauses and automotive dealer franchisers

13.37 Among the different industries referred to in evidence, automotive dealership franchise contracts were highlighted as a possible area of concern, in the context of restraint of trade clauses.

13.38 The Victorian Automobile Chamber of Commerce (VACC) submitted that almost 40 per cent of respondents to the Franchising Code and Oil Code of Conduct Survey reported that they were subject to the imposition of restraints of trade following the termination of their agreement.³⁹ VACC submitted that former franchisees have endured acute financial and emotional stresses resulting from the imposition of such restraints of trade upon termination of their agreement:

Many current franchisees have also expressed that they do not know what would happen upon termination of their agreement, but remain fearful of reprisals as such. The fact that such restrictive trade practices by franchisors remain prevalent and are rarely challenged is testament to the high cost of legal action and the comparatively weaker economic position of the franchisee.⁴⁰

13.39 However, the Federal Chamber of Automotive Industries (FCAI) pointed out that new car automotive dealer agreements do not contain restraint of trade provisions. The FCAI argued that if a dealer ceases to represent a manufacturer for whatever reason, there is nothing preventing the dealer from representing another brand and

37 Queensland Law Society, *Submission 48*, p. 7.

38 MST Lawyers, *Submission 39*, p. 16.

39 Victorian Automobile Chamber of Commerce, *Submission 66*, p. 12.

40 Victorian Automobile Chamber of Commerce, *Submission 66*, p. 13.

operating from the same site immediately.⁴¹ Likewise, the Queensland Law Society submitted that automotive dealer agreements do not generally contain a restraint of trade (during or post-term) because the dealer may hold multiple dealerships across a number of brands.⁴²

13.40 The FCAI's legal adviser, Mr Peter George, noted that the FCAI represents new car manufacturers and that the VACC survey potentially included a range of other automotive industry franchisees.⁴³ This difference in representation may account for the different perspectives on whether restraints of trade are applicable.

Committee view

13.41 The committee acknowledges the concerns raised by franchisees that restraint of trade clauses in franchise agreements can negatively impact franchisees after exiting the franchise agreement (particularly in circumstances where the franchisee has developed experience or a specialisation in the industry of the franchise system). Franchisees can also be left in a precarious position if the franchised business fails, or is terminated or not renewed, while the franchisee is still committed to other costly arrangements such as retail lease agreements. In this situation, the franchisee may find that they are unable to run the type of business that the lease agreement prescribes for that particular location, either as an independent business or by joining a different franchise system.

13.42 However, the committee considers that, in a number of cases in which franchisees submitted that they were bound by restraints of trade, it was likely these restraints could be contested in court and potentially found void. The committee notes that the enforceability of restraint of trade clauses takes into consideration:

- whether the franchisee has been paid for goodwill (as opposed to the tangible assets of the business) in which case, the franchisor should be able to protect the goodwill it has purchased from the franchisee; and
- whether the franchisee's new business has infringed the intellectual property of the franchisor, for example the brand name or public image.

13.43 The committee notes that some franchisees appeared to be under the impression that the restraints placed upon them could not be contested, or that opening a business that operates in the same industry in a nearby location would constitute an unchallengeable breach of restraint of trade provisions. The committee suggests that franchisees who wish to start their own business in the same industry as the former franchise system, seek legal advice about the franchisor's ability to enforce any restraint of trade provisions in the franchise agreement, and the likelihood of such provisions being considered void under common law.

41 Federal Chamber of Automotive Industries, *Response to Submission 55*, p. 4; Mr Tony Weber, Chief Executive, Federal Chamber of Automotive Industries, *Committee Hansard*, 14 September 2018, p. 84.

42 Queensland Law Society, *Submission 48*, p. 12.

43 Mr Peter George, Partner, CIE Legal; and Advisor to the Federal Chamber of Automotive Industries, CIE Legal, *Committee Hansard*, 14 September 2018, p. 87.

13.44 The committee also considered the operation of clause 23 of the Franchising Code and notes the submissions from Mr Sutherland and the Queensland Law Society in which they state that they are not aware of any circumstances where a franchisee has successfully used clause 23 to avoid a restraint of trade clause. The committee notes that the clause is intended to protect a franchisee who meets the criteria contained in clause 23, by providing an exemption from restraint of trade clauses in the franchise agreement. However, franchisees should ensure that they can demonstrate they have met the criteria if the franchisor challenges the franchisee's exemption in court.

13.45 The committee notes, however, that the clause has only been operational for four years. As a result, it is difficult to determine whether the clause is fit for purpose, or whether it unfairly impacts franchisees because of the onus of proof placed on them to demonstrate that they meet the exemption. Therefore, the committee is of the view that the Australian Government, through the ACCC, or another agency as appropriate, commission a five-year review in 2020 to determine whether clause 23 of the Franchising Code is meeting its objectives, is fit for purpose and/or needs revising. In particular, the committee suggests that the ACCC conduct this review with a mind to whether it provides a remedy to unfair contract terms, or whether further changes to the Franchising Code are necessary.

13.46 Notwithstanding the above, the committee is concerned that paragraph 23(1)(b) which provides that a franchisee was not in breach of the franchise agreement or any related agreement, may cause unnecessary confusion because it is not clear whether 'breach' constitutes a serious or minor breach. The committee is of the view that paragraph 23(1)(b) should be amended to clarify what constitutes a breach. The committee also understands that the assessment of any breaches outstanding at the expiry of the franchise agreement would require franchisees to have remedied any breaches accordingly, in order for the exemption to apply.

13.47 The committee considers that the unfair contract terms provisions which now apply to small business are likely to benefit franchisees that wish to open their own business after exiting a franchise system and that do not meet the criteria specified in clause 23. The ACCC has engaged with the franchise sector regarding the implementation of the new provisions. The ACCC informed the committee that it has worked with several franchisors to amend restraint of trade provisions in standard form franchise agreements in order to limit the provisions, so that they only seek to protect the franchisor's business to the extent that it is reasonable. The committee considers that its recommendation to make unfair contract terms illegal, and to apply penalties, will assist in preventing franchisees from being subject to unreasonable restraint of trade provisions.

13.48 The committee also notes the questions raised about whether contracts for transfers between franchisees should include restraint of trade provisions, so that franchisees are not reliant on franchisors to take action on potential breaches of restraint of trade clauses. At this stage, the committee does not recommend action in this area, given that evidence about this issue was limited. However, the committee suggests that the ACCC could consider this issue in the future, should it be flagged as systemic across the sector.

13.49 The committee acknowledges evidence put forward by the Victorian Automobile Chamber of Commerce (VACC) that former franchisees in the automotive industry may be subject to restraint of trade clauses which can be costly for former franchisees to challenge in court, and subsequent evidence provided by the Federal Chamber of Automotive Industries (FCAI) that new car dealer agreements do not contain restraint of trade provisions. The committee notes that the absence of goodwill attributed to the franchisee in new car dealer franchise agreements would correspond with the possible unenforceability of restraint of trade clauses as whether or not a payment for goodwill has been made by the franchisor or franchisee in the purchase or sale of the franchise business is a key consideration as to whether a restraint of trade clause is enforceable.

13.50 The committee notes that while goodwill does not appear to be part of new car dealer agreements, it may be included in service and repair agreements, and therefore, restraints of trade may apply to service and repair agreements.

Recommendation 13.1

13.51 The committee recommends that the Australian Government, through the Australian Competition and Consumer Commission (or another agency as appropriate) commission a review of clause 23 of the Franchising Code of Conduct to determine whether it is fit for purpose and whether any changes are required.

Recommendation 13.2

13.52 The committee recommends that the Australian Government amend the Franchising Code of Conduct to incorporate into the disclosure document an explanation that clauses (or part thereof) of a franchise agreement that are not in compliance with clause 23 of the Franchising Code are of no effect and not enforceable by the franchisor.

Recommendation 13.3

13.53 The committee recommends that the Australian Government amend the Franchising Code of Conduct to:

- **clarify what constitutes a 'breach' for the purposes of paragraph 23(1)(b) with particular regard to the concept of a "related agreement" within the clause; and**
- **insert "at the time of expiry" at the beginning of paragraph 23(1)(b).**

Chapter 14

Collective action

Introduction

14.1 This chapter considers regulatory arrangements for collective action in franchising. The chapter begins by describing the provisions relating to collective bargaining in the Franchising Code of Conduct (Franchising Code) and the *Competition and Consumer Act 2010* (CCA). A class exemption for collective bargaining in franchising, proposed by the Australian Competition and Consumer Commission (ACCC), is then discussed.

Existing provisions

14.2 Both the Franchising Code and Oil Code of Conduct (Oil Code) have provisions enabling collective action by franchisees. However, provisions regarding collective bargaining in the CCA have led to uncertainty about whether franchisees are legally able to participate in collective bargaining in some circumstances. The relevant provisions are set out below, followed by the ACCC proposal for a class exemption that seeks to remove this uncertainty.

Franchisee associations under the codes

14.3 Clause 33 of the Franchising Code gives franchisees and prospective franchisees the freedom to form associations. Clause 33 also includes a civil penalty for franchisors that engage in conduct that restricts or impairs franchisees forming an association. Clause 33 specifies that:

A franchisor must not engage in conduct that would restrict or impair:

- (a) a franchisee or prospective franchisee's freedom to form an association; or
- (b) a franchisee or prospective franchisee's ability to associate with other franchisees or prospective franchisees for a lawful purpose.

Civil penalty: 300 penalty units.¹

14.4 Clause 26 of the Oil Code includes a similar provision; however, it does not have a civil penalty.²

Collective bargaining under the Competition and Consumer Act

14.5 Collective bargaining occurs where two or more small businesses form a group to jointly negotiate with a supplier or a customer about terms and conditions. The group may choose to appoint a representative, such as an industry association, to negotiate on their behalf. Collective boycotts occur when bargaining groups want to be able to refuse to supply to, or buy from, a particular customer or supplier, unless or

1 Competition and Consumer (Industry Codes— Franchising) Regulation 2014, cl. 33.

2 Competition and Consumer (Industry Codes—Oil) Regulations 2017, cl. 26.

until they reach agreement on terms and conditions. Collective bargaining and collective boycotts may involve agreements between businesses that would otherwise be competitors. Doing so may breach competition laws, unless they lodge a notification or authorisation with the ACCC. The following conditions apply:

- A collective bargaining notification can only be lodged if each member of the group reasonably expects that it will make a contract with the target or targets, and that the value of its transactions under the collective bargaining arrangement will not exceed \$3 million in any 12-month period.
- The legal protection provided by a collective bargaining notification commences 14 days after the notification is validly lodged, unless the ACCC objects within this period. The legal protection provided by a notification for collective boycott conduct commences 60 days after the notification is validly lodged, unless the ACCC objects within this period.³

14.6 The NSW Small Business Commissioner argued that the existing provisions have had limited use. Over the last three years, the ACCC issued an average of 13 authorisations for collective bargaining, and just three collective bargaining notifications, per annum. Two factors that may contribute are the complexity of the process and the costs (\$1000 for the notification form and \$7500 for an authorisation form). The NSW Small Business Commissioner stated that:

Particularly concerning is that, despite the typically inferior bargaining power held by small business in dealing with larger businesses, small businesses 'continually fail' to take advantage of the collective bargaining scheme. While franchisees are placed in a particularly disadvantageous position when bargaining with franchisors, this cohort appears least likely to access collective bargaining provisions. The ACCC's collective bargaining notifications register appears to indicate that no such applications have been lodged by franchisees in the last five years.⁴

14.7 The ACCC has allowed collective bargaining by other groups, including:

- newsagents or other retailers negotiating with their suppliers and post office owners negotiating with Australia Post;
- lottery agents negotiating with lottery operators;
- primary producers, such as dairy farmers, chicken growers and vegetable growers, negotiating with processors they supply; and
- truck owner-drivers negotiating with transport companies.⁵

3 Australian Competition and Consumer Commission, *Small Business Collective Bargaining Notifications and the Competition and Consumer Act*, November 2017, pp. 1–2.

4 NSW Small Business Commissioner, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 21 September 2018, p. 4.

5 Australian Competition and Consumer Commission, *Potential ACCC class Exemption for Collective Bargaining*, discussion paper, 23 August 2018, pp. 1, 3.

14.8 In November 2017, the Australian Parliament amended Australia's competition law following a comprehensive review in 2015. One of the changes made the collective bargaining notification process easier and more flexible for small businesses.⁶ Another significant change provided the ACCC with the power to make class exemptions for specific types of business conduct under Part IV of the CCA that may carry a risk of breaching the law but:

- do not substantially lessen competition; and/or
- are likely to result in overall public benefits.⁷

Collective bargaining in franchising—ACCC proposal

14.9 In December 2018,⁸ the ACCC proposed a class exemption to provide legal protection for the following:

- businesses with an annual turnover of less than \$10 million in the preceding financial year to collectively bargain with customers or suppliers, and
- all franchisees to collectively bargain with their franchisor regardless of their size or other characteristics.⁹

14.10 A class exemption for collective bargaining would remove the need for businesses that meet eligibility criteria to seek authorisation or lodge a notification. This would allow businesses to access the exemption without delay or additional cost, and realise the benefits of collective bargaining.¹⁰

14.11 However, a class exemption would not force a target to deal with the bargaining group if it does not wish to. It simply means that the group is able to collectively negotiate with the target on a voluntary basis without breaching the competition law.¹¹

14.12 The ACCC also proposed that all groups of franchisees and fuel retailers governed by either the Franchising Code or Oil Code would be eligible for the class exemption in relation to negotiations with their franchisor or fuel supplier, including

6 Australian Competition and Consumer Commission, *Submission 45*, p. 43.

7 Australian Competition and Consumer Commission, *Potential ACCC Class Exemption for Collective Bargaining*, discussion paper, 23 August 2018, p. 1; Australian Competition and Consumer Commission, *Class exemptions*, www.accc.gov.au/business/exemptions/class-exemptions (accessed 7 January 2019).

8 The ACCC released a discussion paper for consultation in August 2018 and released an update on the class exemption in December 2018.

9 Australian Competition and Consumer Commission, *ACCC Class Exemption for Collective Bargaining – Update*, 19 December 2018, p. 1.

10 Australian Competition and Consumer Commission, *Potential ACCC Class Exemption for Collective Bargaining*, discussion paper, 23 August 2018, p. 3.

11 Australian Competition and Consumer Commission, *Potential ACCC Class Exemption for Collective Bargaining*, discussion paper, 23 August 2018, pp. 3–4.

group mediation, regardless of franchisee size and without any other limitations on membership of the bargaining group. The ACCC noted that:

Many, but not all, franchisees would have annual turnover of less than \$10 million. However, allowing all franchisees to collectively bargain with their franchisor or fuel supplier regardless of their size would provide certainty that all franchisees who have contracts with the same franchisor or fuel supplier are able to form a single group, with no franchisees excluded.¹²

14.13 In its discussion paper, the ACCC indicated that the proposed no limits on franchisee size in the class exemption would only apply to negotiations with franchisors and not to other suppliers. For negotiations with other suppliers, franchisees would be subject to the same eligibility criteria as any other collective bargaining group.¹³

Responses to the ACCC's collective bargaining proposal for franchisees

14.14 Most responses to the exemption proposed by the ACCC offered strong support for the proposal, with some groups suggesting further refinements.¹⁴

14.15 The Department of Jobs and Small Business supported the ACCC proposal, observing that the reform would reduce red tape and may assist in reducing the power imbalance between franchisors and franchisees.¹⁵

14.16 Likewise, the Victorian Small Business Commission (VSBC) supported the ACCC proposal and noted that it would reduce administrative burdens on small business:

The VSBC supports the class exemption allowing collective bargaining by all franchisees with their franchisor, regardless of their size. It is agreed that the exemption should apply only to negotiations between franchisees and their franchisors.

...this would also allow for more efficient mediation processes where multiple franchisees are in dispute with their franchisor regarding common issues.¹⁶

12 Australian Competition and Consumer Commission, *ACCC Class Exemption for Collective Bargaining – Update*, 19 December 2018, p. 4.

13 Australian Competition and Consumer Commission, *Potential ACCC Class Exemption for Collective Bargaining*, discussion paper, 23 August 2018, pp. 8, 9; Australian Competition and Consumer Commission, *ACCC Class Exemption for Collective Bargaining – Update*, 19 December 2018, p. 4.

14 Australian Competition and Consumer Commission, *ACCC Class Exemption for Collective Bargaining – Update*, 19 December 2018, p. 1.

15 Department of Jobs and Small Business, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 2 October 2018, pp. 2, 6.

16 Victorian Small Business Commission, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 21 September 2018, p. 2.

14.17 The Australian Automotive Dealer Association supported the ACCC proposal, submitting that:

...all franchisees should be able to bargain collectively with their franchisor, regardless of the size or corporate structure.

...collective bargaining should be part of the standard arrangements for interactions between franchisees and their franchisor rather than an extraordinary recourse when relationships turn bad.¹⁷

14.18 A number of submitters suggested further refinements to the changes suggested by the ACCC. For example, the NSW Small Business Commissioner argued that the class exemption should include dispute resolution and allow groups of franchisees to bargain collectively with a common franchisor (or their subsidiaries), irrespective of the size of the businesses within the group. It was noted that franchisees are likely to have common grievances and that they are often unlikely to be in competition with each other. The NSW Small Business Commissioner also drew attention to international research on the positive effects of collective action:

One quantitative study analysed franchise agreements across 154 US franchise networks trading in the hospitality, automotive service, and home maintenance industries. The study identified a correlation between franchisee networks employing collective bargaining and positive outcomes for franchisees. Those outcomes were longer franchise agreements (21% longer on average); fewer terminations and non-renewals of an agreement by the franchisor (one per year per network on average); and shorter non-compete terms for exiting franchisees (29% on average).¹⁸

14.19 The Queensland Law Society supported the ACCC proposal, including the use of a collective bargaining class exemption for mediation with franchisors, where it was optional for franchisees to join the collective bargaining. However, the Queensland Law Society identified the need to put appropriate arrangements in place for situations where a small number of multi-unit franchisees may hold a majority of the number of franchises and therefore potentially the majority of the votes. As a result the views of other franchisees may not receive due consideration.¹⁹

14.20 The Business Law Section of the Law Council of Australia (the Law Council) noted that a class exemption would provide a safe harbour for eligible businesses to collectively bargain without breaching the competition law. However, the Law Council expressed concern with the self-assessment process and demands by targets to prove the exemption. For example, the class exemption would not assist where a

17 Australian Automotive Dealer Association, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 21 September 2018, p. 3.

18 NSW Small Business Commissioner, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 21 September 2018, pp. 2, 3, 9, 10.

19 Queensland Law Society, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 21 September 2018, pp. 3–4.

contract stated that a party is not to be part of a collective bargaining arrangement unless authorised by the ACCC.²⁰

14.21 Legal academics Dr Tess Hardy and Professor Shae McCrystal supported collective bargaining, but considered that the ACCC proposal requires further examination. They suggested the scope of the proposal should be expanded beyond contract terms and conditions to include franchise business models, dispute resolution, boycotts and sharing of information. Dr Hardy and Professor McCrystal noted that while franchisees have the freedom to form associations under the Franchising Code, they may still be subject to the franchising contract and risks of retaliatory action from franchisors.²¹

14.22 Dr Hardy and Professor McCrystal were particularly concerned that the ACCC proposal did not include a class exemption for collective boycott conduct and that franchisors would not be required to negotiate with a collective bargaining group, explaining that:

This is critical omission. A fundamental element of any collective bargaining regime is the ability to pursue bargaining against unwilling targets. If negotiations can only take place on a voluntary and consensual basis, there is arguably no recognisable form of bargaining. Indeed, it is not uncommon, and not surprising, that powerful firms refuse to engage in collective negotiations with subordinate businesses (or their group representative). For example, in its submission to the Franchising Inquiry, the Motor Trades Association of Australia, observed that on a number of occasions where a dealer council [an association made up of dealer representatives of a particular brand of vehicle] has suggested that the discussions take place under collective negotiation under the [Competition and Consumer Act], that approach, or process, has been rejected by the manufacturer franchisor...[E]vidence before the [Parliamentary Joint Committee on Corporations and Financial Services] Franchising Inquiry suggests that the Caltex franchisor has ultimately "refused franchisees' requests to renegotiate the terms of the Franchise Agreements and has also refused to provide franchisees with a copy of the independent review".²²

Other evidence on collective action

14.23 The committee received other evidence in relation to collective bargaining, which did not relate directly to the ACCC proposal.

20 Small and Medium Enterprise Committee of the Business Law Section of the Law Council of Australia, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 5 October 2018, pp. 1–2.

21 Dr Tess Hardy, Melbourne Law School and Professor Shae McCrystal, University of Sydney Law School, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 21 September 2018, pp. 2–4.

22 Dr Tess Hardy, Melbourne Law School and Professor Shae McCrystal, University of Sydney Law School, *Submission on Potential ACCC Class Exemption for Collective Bargaining*, 21 September 2018, pp. 4–5.

14.24 Dr Tess Hardy, from the University of Melbourne Law School, noted that the uncertainty over the possibility of collective action extends to a question of whether groups of franchisees are entitled to participate in collective mediation under clause 33 of the Franchising Code. Although franchisees have a right to freely associate under the Franchising Code, it is unclear what actions (if any) franchisees may legitimately take in pursuit of their freedom of association.²³

14.25 The Office of the Franchising Mediation Adviser (OFMA) argued for a general exemption to allow franchisees to engage in group mediation with their franchisor, noting that:

...groups of disgruntled franchisees from the same system are banding together to seek support and share the costs of dispute resolution by participating in a single mediation. If those franchisees are deemed to be competitors, and during the mediation they are engaging in conduct that could be an anti-competitive arrangement (such as collective boycott or cartel conduct) then they would need to seek an approval from the ACCC to avoid the risk of legal action before using the mediation process.²⁴

14.26 The Franchisee Federation Australia (FFA) submitted that the Franchising Code does not expressly allow for multi-party mediations whereby multiple franchisees affected by the same or similar issues could jointly seek mediation. The FFA suggested that rather than the current 'divide and conquer' approach taken by many franchisors, this inclusion would improve efficiencies and allow for outcomes to improve matters across a franchise. The FFA also suggested amending legislation and/or the Franchising Code to ensure franchise agreements cannot contractually exclude multiple franchisees (or a representative) from negotiating changes of terms that may affect them all.²⁵

14.27 Franchising lawyers Mr Sean O'Donnell and Mr Derek Sutherland submitted that an express exclusion from the obligation for franchisees or the franchisor to lodge a collective bargaining notification under the CCA to facilitate group mediation could be beneficial for disputes relating to marketing funds or changes to the franchise system that affect all franchisees.²⁶

14.28 The NSW Small Business Commissioner drew attention to an example of a franchisee suffering retribution for speaking out about problems in the franchise industry. The NSW Small Business Commissioner suggested that a collective complaint model can be successful where a group of people who fear retribution can work together to raise issues.²⁷

23 Dr Tess Hardy, *Submission 91*, p. 4.

24 Office of the Franchising Mediation Adviser, *Submission 37*, p. 20.

25 Franchisee Federation Australia, *Submission 113.1*, p. 4.

26 Mr Sean O'Donnell and Mr Derek Sutherland, *Submission 111*, p. 1; Mr Derek Sutherland, *Submission 53*, p. 38; see also Mr Hendrik Grebe, *Submission 200*, p. 11.

27 Ms Robyn Hobbs OAM, NSW Small Business Commissioner, Office of the New South Wales Small Business Commissioner, *Committee Hansard*, 16 October 2018, p. 11.

14.29 The Motor Trades Association of Australia noted that even though there are associations in the automotive industry, members are reluctant to participate in actions due to threats and intimidation by the franchisor. Although dealer associations acknowledged that removing impediments to collective bargaining would assist dealers, many dealers may be above the financial thresholds.²⁸

14.30 Mr Peter Bain supported the class exemption because it would help address the power imbalance between franchisees and franchisors. He also suggested other options including representation on a board for franchisees.²⁹

Committee view

14.31 The committee notes that both the Franchising and Oil Codes have provisions enabling collective action by franchisees. However, provisions regarding collective bargaining in the *Competition and Consumer Act 2001* have led to uncertainty about whether it is lawful for franchisees to participate in collective bargaining in some circumstances. The Australian Competition and Consumer Commission (ACCC) proposal for a class exemption would remove this uncertainty. The committee supports the ACCC proposal for a class exemption to ensure it is lawful for franchisees to collectively bargain with their franchisor regardless of their size or other characteristics.

14.32 The committee observes that submissions on the ACCC proposal by Dr Hardy and Professor McCrystal and others advocated for the collective bargaining proposal to also cover franchise business models, dispute resolution, and sharing of information. The committee agrees that these would be worthwhile additions.

14.33 Nevertheless, the ACCC has indicated that the class exemption would not force a target to deal with the bargaining group if the target does not wish to.

14.34 The committee notes that Dr Hardy and Professor McCrystal also suggested that the class exemption be extended to cover boycotts. The committee appreciates the point that such an exemption would increase the bargaining power of franchisees. However, the committee considers that it is appropriate for a coercive action such as a collective boycott to have a greater degree of oversight. The committee is therefore satisfied that the existing notification and approval process through the ACCC for franchisees to undertake a boycott is appropriate. Nonetheless, the committee considers that the current costs of \$1000 for a notification and \$7500 for an authorisation are a significant impediment for franchisees considering this action.³⁰

28 Mr Richard Dudley, Chief Executive Officer, Motor Trades Association of Australia, *Committee Hansard*, 22 June 2018, p. 18; Mr Peter Roberts, Member and SA Executive Board Member, Motor Trades Association of Australia, *Committee Hansard*, 22 June 2018, p. 18; Mr James Voortman, Executive Director, Communications and Policy, Australian Automotive Dealer Association, *Committee Hansard*, 22 June 2018, p. 21.

29 Mr Peter Bain, Private capacity, *Committee Hansard*, 24 August 2018, p. 7.

30 Australian Competition and Consumer Commission, *Small Business Collective Bargaining: Notification and Authorisation Guidelines*, December 2018, p. 5.

14.35 The committee notes the point raised by the Law Council of Australia, the Franchise Federation of Australia, and Dr Hardy and Professor McCrystal that the proposed class exemption would not assist where the contract states that a party is not to be part of a collective bargaining arrangement unless authorised by the ACCC. The committee considers that the franchise agreement/contract should not be able to supersede an explicit regulatory class exemption and that any such terms should be declared void under Unfair Contract Terms laws.

14.36 The committee notes that the ACCC proposal and the additions proposed by the committee would reduce red tape and regulatory fees for small businesses in Australia.

14.37 A substantial number of submitters and witnesses expressed fears of intimidation and retribution by franchisors for pursuing issues individually and collectively (see chapter 3). The committee notes that the ACCC does not appear to have conducted any enforcement action in relation to clause 33 of the Franchising Code.³¹ The committee recommends that the ACCC continually monitor this situation and conduct an investigation into whether franchisors have taken action to impede franchisees who have attempted to pursue issues collectively, and to take action based on the findings of this investigation, as appropriate.

14.38 The committee notes that clause 33 of the Franchising Code refers to 'a franchisee or prospective franchisee's ability to associate with other franchisees or prospective franchisees for a lawful purpose'. The committee considers that if franchisees are inclined to associate with each other for a potentially unlawful purpose:

- it is a matter for the regulators or police to assess whether the purpose is unlawful and to take any relevant enforcement action;
- the only role for franchisors would be to report the matter to the relevant authorities; and
- there are no circumstances in which it would be appropriate for a franchisor to take on the role of the authorities and engage in conduct to restrict or impede franchisees from forming an association.

31 Australian Competition and Consumer Commission, *Franchising investigations*, www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/franchising-code/franchising-investigations (accessed 11 January 2019).

Recommendation 14.1

14.39 The committee recommends that the Australian Government implement the Australian Competition and Consumer Commission's proposal for a class exemption to make it lawful for all franchisees to collectively bargain with their franchisor regardless of their size or other characteristics. The committee recommends that the following additions be made to the reform:

- the proposal be extended to also cover collective action regarding franchise business models, dispute resolution, and sharing of information;
- the fees for the notification and authorisation process should be reduced so that they are not an impediment to franchisees and other small businesses; and
- any contract terms that seek to supersede or restrict the effect of the class exemption for collective bargaining be declared illegal under Unfair Contract Terms laws.

Recommendation 14.2

14.40 The committee recommends that the Australian Competition and Consumer Commission conduct an investigation into whether franchisors have taken action to impede franchisees who have attempted to pursue issues collectively, and to take action based on the findings of this investigation, as appropriate.

Chapter 15

Dispute resolution

Introduction

15.1 Accessible, affordable and effective dispute resolution under the Franchising Code of Conduct (the Franchising Code) is of fundamental importance to franchisors and franchisees, particularly given the power imbalance between the respective parties. An effective dispute resolution process should have a sufficient range of mechanisms in place to enable the parties to resolve disputes in the most timely, cost-effective, flexible and fair way, without the need to resort to the court system except in rare cases.¹

15.2 Evidence from a range of submitters and witnesses to this inquiry, including franchisees, franchisors, mediators, ombudsmen, academics, and regulators, highlighted the need for changes to the current dispute resolution arrangements in the franchising sector.

15.3 This chapter sets out the dispute resolution arrangements currently available under the Franchising Code and the issues identified during the inquiry. This is followed by a comparison of the dispute resolution arrangements for franchising with the dispute resolution arrangements for small business generally, as well as for the food and grocery supply sector and the financial services sector.

15.4 At the outset, however, the committee points out that not all disagreements between franchisors and franchisees proceed to formal dispute resolution. For example, Mr Andrew Gregory, Chief Executive Officer of McDonald's Australia, acknowledged that the franchisor has 'robust discussions debating the importance and priorities of our plans, and we disagree with our franchisees regularly'. Mr Gregory pointed out that McDonald's 'engage our franchisees through a range of committees and decision-making bodies that cover nearly every aspect of our business'. According to Mr Gregory, this collaborative approach meant that even serious disagreements about major business decisions were typically resolved in discussions between the franchisor and its franchisees.²

Current arrangements and outcomes

15.5 The Franchising Code provides for parties to a franchise agreement to resolve disputes through two mechanisms: mediation and legal action through the court system. Part 4 of the Franchising Code outlines the procedures to be followed for disputes between parties to a franchise agreement. Parties are required to resolve a

1 See Office of the NSW Small Business Commissioner, *Submission 49*, pp. 12–14; Office of the Franchising Mediation Adviser, *Submission 37*, pp. 17–18; Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, pp. 13–21.

2 Mr Andrew Gregory, Managing Director and Chief Executive Officer, McDonald's Australia Ltd, *Committee Hansard*, 21 September 2018, pp. 1 and 6.

dispute in a 'reconciliatory manner'. If the parties are unable to agree how to resolve a dispute within three weeks, either party may refer the matter for mediation.³

Mediation

15.6 Once the mediation process begins, 'the parties must attend the mediation'.⁴ Should the parties be unable to agree on a mediator, either party may approach the Office of the Franchising Mediation Adviser (OFMA) and request the appointment of a mediator.⁵

15.7 OFMA informed the committee that for the 21 month period from 1 January 2017 to 30 September 2018, it referred 477 disputes to panel mediators. These disputes involved 202 different franchisors.⁶

15.8 OFMA also reported:

- four per cent of franchise systems generated 10 or more disputes (representing 45 per cent of all matters lodged);
- 27 per cent of franchise systems were reported as having 2 or more but less than 10 disputes (representing 29 per cent of all matters lodged); and
- 69 per cent of franchise systems had only 1 dispute with a franchisee that was mediated (representing 26 per cent of all matters lodged).⁷

15.9 OFMA cautioned that the results set out above may not necessarily represent the complete picture of franchising in Australia, as the records only include disputes referred to OFMA. Further, the statistics do not include 70 separate disputes relating to franchising operations lodged separately under the Oil Code of Conduct with the Office of the Oil Code Dispute Resolution Adviser.⁸

Multi-party mediation

15.10 Multi-party mediation in the context of franchising would generally involve a number of franchisees with similar issues all mediating with the franchisor at the same time. The ACCC observed that multi-party mediation has benefits such as:

- assisting to shift the imbalance of bargaining power that exists between the franchisor and franchisee when resolving disputes; and
- creating a more efficient process and use of resources.⁹

3 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, cl. 34–45.

4 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, sub cl. 39(3).

5 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, sub cl. 38(4).

6 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 9.

7 Office of the Franchising Mediation Adviser, *Submission 37*, p. 8.

8 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 9.

9 Australian Competition and Consumer Commission, *Submission 45*, p. 15.

15.11 However, the Franchising Code 'does not expressly state that mediators may undertake multi-franchisee mediation when disputes of a similar nature arise within a franchise system'.¹⁰

15.12 More problematically, the ACCC 'is aware of franchisors refusing to attend multi-party mediation on this basis and insisting on addressing disputes on an individual basis'.¹¹

15.13 OFMA has been involved in trying to assist multiple franchisees from the same franchise network who have similar complaints about the franchise system or the franchisor. OFMA noted that multi-party mediations have successfully resolved disputes that have involved over 20 franchisees.¹²

Relative success and outcomes of mediation

15.14 OFMA noted that the settlement rate for mediations conducted by OFMA in 2017 was 80 per cent, and in the first quarter of 2018 it was reported as 85 per cent. While these results appear to indicate a high level of success, OFMA advised circumspection in interpreting the success through these statistics alone. Rather, OFMA preferred to delve deeper and obtain information about the extent to which settled matters were in fact 'totally resolved'. Viewed through this lens, about 68 per cent of matters are 'totally resolved' to the satisfaction of both parties.¹³

15.15 The statistics show that while about two thirds of all disputes referred to mediation have a successful outcome, about one third do not. This means a substantial proportion of disputes do not reach a mutually satisfactory outcome. Indeed, OFMA notes that while successful mediation does not rely on the collaboration and cooperation of the parties because a skilled mediator can help achieve an agreed outcome, it does require mutual good faith on behalf of the participants:

...a necessary condition is that the parties be willing to negotiate in good faith and try to achieve an outcome. Where this condition is missing the mediation process will fail by design.¹⁴

15.16 Evidence to the committee from a range of submitters and witnesses appeared to bear out OFMA's conclusions about the relative success of mediation and the reasons for that. For example, Professor Andrew Terry noted that even though there is 'a very high settlement rate at very low cost and in a very short time, a lot of those settlements are reluctant settlements on the part of a franchisee, whose only alternative at present is to go to court'.¹⁵

10 Australian Competition and Consumer Commission, *Submission 45*, p. 15.

11 Australian Competition and Consumer Commission, *Submission 45*, p. 15.

12 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 11.

13 Office of the Franchising Mediation Adviser, *Submission 37*, p. 9.

14 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 20.

15 Professor Andrew Terry, Private capacity, *Committee Hansard*, 24 August 2018, p. 18.

15.17 The Australian Small Business and Family Enterprise Ombudsman (ASBFEO) noted that one of the challenges for franchisees in going to court is the way cost orders operate. If a franchisee pursues litigation, but runs out of money to continue, it is possible for courts to order the franchisee to pay the franchisor's costs.¹⁶

15.18 Mr Faheem Mirza, a franchisee, noted that his mediation was counted as successfully resolved in the mediation statistics. From his perspective, however, it was not at all successful:

I took this dispute to the OFMA... However, OFMA could not even get enough money out of Foodco to enable me to pay their [Foodco's] fee. I signed a deed. I walked out with \$100. I was in debt with CBA and I had to fail my ATO liabilities to pay for my living costs. For the record, OFMA marks this result as a successful outcome.¹⁷

15.19 Another franchisee, Mr Anthony McVilly, described the challenges of mediation when there is an imbalance of power:

So we went to mediation. That is a total waste of time, effort, money—whatever you want to call it—because they hold the gun at your head. They say what you're going to do. And if they don't like it—and they keep changing the goalposts—it gets too hard. You can't go anywhere else because they are a multinational company.¹⁸

15.20 Franchisee Mr Sanjeev Bajaj relayed his experience of mediation under the Oil Code of Conduct (Oil Code):

We had a mediation under the Oil Code. We walked in there and they told us what we'd done wrong. We said, 'No problem; how can we fix it? We'll fix it.' They gave us 30 days to sell the site. We said, 'We can't sell it in 30 days. It's a freehold business. We'll do our best and we will change the colours and put your colours in.' We would take their card and their fees and put their branding in tomorrow morning and paint it all over. They went out of the room and didn't come back for five hours. Then they said, 'There is no deal.' So we had to go to court. We lost about five or six hundred thousand dollars in the court case. In the end the court appointed a mediation.¹⁹

15.21 Likewise, another franchisee, Mr Robert Whittet, highlighted the problems of the current situation where mediation or court are the only options:

We spent well over \$5000 on going to mediation. After our spending \$5000, the other side got up from the table and walked away and said: 'We're not doing anything. We're too big. Take us to court.' We outlaid what

16 Dr Craig Latham, Deputy Ombudsman, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 21 September 2018, p. 41.

17 Mr Faheem Mirza, Private capacity, *Committee Hansard*, 29 June 2018, p. 39.

18 Mt Anthony McVilly, Member, Victorian Automobile Chamber of Commerce, *Committee Hansard*, 22 June 2018, p. 10.

19 Mr Sanjeev Bajaj, Private capacity, *Committee Hansard*, 22 June 2018, p. 15.

we had left to try to go through the mediation process, and then you end up at the point where you've spent so much money—in our case, it's basically cost us over \$2½ million to fight, which we have lost, over seven years. This is where they pull you. Even in the last few days, they've said to us: 'Sell what you've got. Try and go another week.'²⁰

15.22 The Franchisee Federation of Australia (FFA) summed up the position of many franchisees by submitting that the mediation process under the Franchising Code is ineffective because it allows franchisors to just go through the motions or, on occasion, to actively impede it. The FFA argued that the current dispute resolution process via the OFMA has been useful in minor disputes but does not have the requisite authority to bring about the resolution of disputes arising from the power imbalances identified during the inquiry.²¹

Arbitration as an addition to the dispute resolution process

15.23 As noted above, in many cases mediation is a desirable and effective dispute resolution mechanism. However, the absence of a determinative mechanism as another constituent part of the dispute resolution process is a serious shortcoming. Several submitters and witnesses supported the addition of a determinative system to the current dispute resolution process under the Franchising Code. Many of these submitters drew the committee's attention to the existence of such a mechanism under other codes, such as the Food and Grocery Code of Conduct.

15.24 In explaining the difference between mediation, conciliation and arbitration, ASBFEO noted:

- A mediator is more like a facilitator and will raise questions that lead people to consider the range of options.
- A conciliator will guide and direct the parties, while acknowledging that the parties need to agree on an answer.
- An arbitrator can act much like a conciliator, but has the capacity to make a contractually binding ruling on the parties.²²

15.25 The arguments set out in favour of some form of mandatory determination in circumstances where a resolution is not reached through mediation included:

- the lower cost of arbitration compared to a court process;²³ and

20 Mr Robert Whittet, Private capacity, *Committee Hansard*, 8 June 2018, p. 69.

21 Franchise Federation of Australia, *Supplementary Submission 113.1*, p. 4; see also Mrs Maria Varkevisser, Private capacity, *Committee Hansard*, 8 June 2018, pp. 42–43.

22 Dr Craig Latham, Deputy Ombudsman, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 21 September 2018, p. 41.

23 Professor Andrew Terry, *Submission 108*, p. 8; Mr Brian Keen, Founder and Chief Executive, Franchise Simply, *Committee Hansard*, 8 June 2018, p. 62; Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 21.

- the ability to secure a determination in circumstances where one party has declined to participate in mediation in good faith.²⁴

15.26 The committee's 2008 report, *Opportunity not opportunism: improving conduct in Australian franchising*, concluded that a Commonwealth tribunal for the franchising sector would most likely add another layer of complexity and expense to the process without achieving improved outcomes. In addition, the committee argued that many of the issues which lead to franchising disputes might be mitigated by the introduction of an explicit obligation into the Franchising Code for all parties to a franchise agreement to act in, and approach mediation in, good faith.²⁵

15.27 However, the committee acknowledges that much has changed over the last ten years. As the evidence on mediation in the previous section attests, the shortcomings of the processes currently available under the Franchising Code (including the good faith provisions) have become much more apparent. As the evidence below shows, substantial progress in arbitration has occurred since 2008.

15.28 OFMA drew attention to significant changes in dispute resolution procedures. OFMA pointed out that since the committee's 2008 inquiry into franchising, the state based Commercial Arbitration Act has been completely revised and updated in line with an amended International Arbitration Act and has been adopted nationally as a uniform Act in all states. OFMA also drew the committee's attention to the use of arbitration in every administrative tribunal in Australia.²⁶

15.29 Further, OFMA also noted that the Franchising Code lacks the range of determinative dispute resolution procedures, such as arbitration, used in more recent codes such as the Food and Grocery Code of Conduct introduced in 2015.²⁷

15.30 Likewise, Professor Andrew Terry commented on the growing trend towards establishing tribunals and ombudsmen as an avenue for consumers to invoke legal rights, thereby avoiding costly and time consuming court action.²⁸ He also drew the committee's attention to various industry ombudsman schemes which showed a precedent for ombudsmen making binding decisions. One example, the Financial Ombudsman Service, provided a range of remedies including the '...payment of money, compensation for financial or non-financial loss, and in some cases variation of contract terms'.²⁹

24 See, for example, Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, pp. 13–21; Australian Small Business and Family Enterprise Ombudsman, *Submission 130*, p. 2; Dr Craig Latham, Deputy Ombudsman, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 21 September 2018, p. 39; Franchisee Federation of Australia, *Supplementary Submission 113.1*, p. 4.

25 Parliamentary Joint Committee on Corporations and Financial Services, *Opportunity not opportunism: improving conduct in Australian franchising*, 2008, p. 99.

26 Office of the Franchising Mediation Adviser, *Submission 37*, pp. 14, 18.

27 Office of the Franchising Mediation Adviser, *Submission 37*, pp. 14, 16, 17.

28 Professor Andrew Terry, *Submission 108*, p. 8;

29 Professor Andrew Terry, *Submission 108*, p. 8.

15.31 OFMA drew a further distinction between the conduct and functions of a court and arbitration, namely the ability to undertake an investigation in the arbitration process followed by the determination of the dispute by an expert or arbitrator:

...courts are umpires, and what's really required by small businesspeople is a determination by an expert or an arbitrator—by somebody who can actually do more than simply be an umpire, by somebody who can investigate. In other words, they can call for the records, they can see the prices that were paid, they can see the amount of the discount and they can calculate what a fair outcome should be.³⁰

15.32 Several submitters highlighted the importance of arbitration as a backstop to the mediation process. Both Dr Tess Hardy and the ASBFEO argued that the ability to direct parties to arbitration where a resolution is not reached through mediation would level the playing field between franchisors and franchisees in the dispute resolution process.³¹

Differing perspectives on arbitration

15.33 Despite widespread support for the inclusion of a determinative process in the dispute resolution process for franchising, there was opposition to the proposal including from the Franchise Council of Australia (FCA). This section sets out the FCA's six key reasons why it did not support suggestions to supplement mediation with any form of arbitration or any new Tribunal, and OFMA's responses to those views.

15.34 First, the FCA argued that arbitration would immediately create an adversarial environment, which runs entirely contrary to the principles of mediation. Fewer disputes would proceed to mediation, the parties would be less open to negotiated settlements and access to justice would be significantly reduced.³²

15.35 With respect to the FCA's concern that arbitration would create an adversarial environment, OFMA responded:

Mediation processes are born out of the adversarial litigation environment and were originally described as forms of 'alternative' dispute resolution. Therefore, mediation does not need collaborative, cooperating parties to be successful. A skilful and experienced mediator does make a difference in achieving an agreed outcome.

However, a necessary condition is that the parties be willing to negotiate in good faith and try to achieve an outcome. Where this condition is missing

30 Mr Derek Minus, Franchising Code Mediation Adviser, Office of the Franchising Code Mediation Adviser; Oilcode Dispute Resolution Adviser, Office of the Oilcode Dispute Resolution Adviser, *Committee Hansard*, 8 June 2018, pp. 3–4; see also Dr Tess Hardy, Private capacity, *Committee Hansard*, 22 June 2018, p. 4.

31 Dr Tess Hardy, Private capacity, *Committee Hansard*, 22 June 2018, p. 4; Australian Small Business and Family Enterprise Ombudsman, *Submission 130*, p. 2.

32 Franchise Council of Australia, *Supplementary Submission 29.1*, Part B: Issue 10—Dispute Resolution Mechanisms, p. 11.

the mediation process will fail by design. A determinative procedure is then required.³³

15.36 Second, the FCA argued that mediation is well suited to franchising, where both parties are typically small businesses and their assets are essentially intangible. The FCA suggested that neither party can typically afford for a dispute to continue. The FCA argued that as a consequence both parties have a genuine vested interest in achieving a negotiated outcome, as they know an early compromise solution will usually yield the best net outcome.³⁴

15.37 Similarly, the National Retail Association (NRA) was not in favour of adding arbitration as a dispute resolution option, informing the committee that, in its view, the current focus on mediation is more conducive to building and restoring effective working relationships between franchisees and franchisors.³⁵

15.38 OFMA noted that the above proposition has significant limitations, arguing that:

Mediation is well suited to the resolution of franchising disputes if the parties are acting in good faith to resolve the conflict. But where a party is using the process to avoid an outcome (e.g. repayment of the franchise fee as they have failed to complete the agreement) then there is no impetus to resolution. In fact the party with the superior economic power can just refuse to agree, safe in the knowledge that the franchisee is unable to afford to take the matter to litigation.³⁶

15.39 Third, with respect to the FCA's claim that 'arbitration would almost certainly lead to higher costs of dispute resolution and delayed resolution of disputes',³⁷ OFMA pointed out that in the majority of cases, mediation is the cheapest and most effective option and will therefore remain the resolution process of choice on most occasions. Accordingly, it is incorrect to compare the costs of mediation with those of arbitration. Rather, for the minority of disputes that do not achieve a satisfactory resolution at mediation, the correct comparison is the price of 'justice' through the courts versus a fixed price arbitration process.³⁸

33 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 20.

34 Franchise Council of Australia, *Supplementary Submission 29.1*, Part B: Issue 10—Dispute Resolution Mechanisms.

35 National Retail Association, answers to questions on notice, 16 October 2018 (received 31 October 2018).

36 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 20.

37 Franchise Council of Australia, *Supplementary Submission 29.1*, Part B: Issue 10—Dispute Resolution Mechanisms, p. 12.

38 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 20.

15.40 Fourth, OFMA and the ACCC³⁹ rebutted the FCA's claim that 'there are few if any arbitrators in Australia who would have the requisite experience to act in a franchise arbitration'.⁴⁰ OFMA observed that:

There are hundreds of trained and experienced private arbitrators (most of them with legal qualifications as it is the state law societies and bar associations that have kept the process alive) in Australia and professional associations that train and maintain their standards.

Arbitrators are empowered under many legislative schemes to act as experts and conduct the resolution of the dispute first by attempting conciliation and then if that fails, determining the matter as an 'expert'. That is, the arbitrator is empowered to conduct an 'inquisitorial process' to use their business and technical expertise and call for evidence in order to determine a matter.⁴¹

Of the 100 mediators appointed to the Franchising Mediator List there are already 12 people who are qualified, experienced and available as arbitrators.⁴²

15.41 Fifth, the FCA argued that 'the courts have been effective in enforcing franchisee rights, with most franchising cases yielding favourable results to franchisees'.⁴³

15.42 However, the committee received evidence that contradicted the proposition that franchisees are generally successful in court. OFMA noted that matters that go to trial usually result in a loss for the franchisees (see chapter 7 for evidence the committee received regarding the Pizza Hut cases: *Virk Pty Ltd (In Liquidation) v. Yum! Restaurants Australia Pty Ltd* and related cases).⁴⁴

15.43 Further, OFMA submitted that even though beneficial legislation does exist to assist franchisees, most cannot avail themselves of it because of the crippling cost of the litigation system and the economic imbalance between the parties, particularly in respect to their ability to absorb the costs of, and delays in, litigation.⁴⁵

39 Dr Craig Latham, Deputy Ombudsman, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 21 September 2018, p. 41.

40 Franchise Council of Australia, *Supplementary Submission 29.1*, Part B: Issue 10—Dispute Resolution Mechanisms, p. 12.

41 Office of the Franchising Mediator, *Submission 37*, p. 18.

42 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 21.

43 Franchise Council of Australia, *Supplementary Submission 29.1*, Part B: Issue 10—Dispute Resolution Mechanisms, p. 12.

44 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 21.

45 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 21.

15.44 Sixth, the FCA submitted that 'there is no need for arbitration in place of litigation'.⁴⁶ OFMA pointed out that arbitration 'is not a one-size fits all scheme but can be tailored to the particular nature and type of disputes'.⁴⁷ OFMA argued that it should be possible to design a process for the resolution of non-complex matters that parties want to refer to arbitration:

Such a system would provide access to justice for small business franchise owners and franchisees, which have failed to reach agreement at a mediation.

In this way, a quick decision by an experienced industry 'expert', using a flexible determination process, can deliver a binding decision at much less cost than attempting to conduct litigation in a Federal Court.⁴⁸

Comparison of dispute resolution systems

15.45 This section compares dispute resolution arrangements for a range of sectors:

- franchising under the Franchising Code;
- small business and family enterprises under ASBFEO;
- the grocery supply chain under the Food and Grocery Code of Conduct; and
- financial services under the newly established Australian Financial Complaints Authority (AFCA).

15.46 The dispute resolution schemes under AFCA and the Food and Grocery Code of Conduct are both newer and more comprehensive than the franchising and ASBFEO dispute resolution schemes.

15.47 Appendix 4 compares the dispute resolution schemes under the Franchising Code, ASBFEO, the Food and Grocery Code of Conduct, and AFCA.

15.48 Although not included in Appendix 4, the committee notes the Oil Code of Conduct has a determinative process and allows the Oil Code Dispute Resolution Adviser to act as an expert in making a non-binding determination. Similarly, under the Horticultural Code of Conduct, a horticultural assessor is able to make an assessment.⁴⁹

46 Franchise Council of Australia, *Supplementary Submission 29.1*, Part B: Issue 10—Dispute Resolution Mechanisms, p. 12; see also Mr Derek Sutherland, Private capacity, *Committee Hansard*, 8 June 2018, pp. 11–12.

47 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 21.

48 Office of the Franchising Mediation Adviser, *Supplementary Submission 37.1*, p. 21.

49 Mr Derek Minus, Franchising Code Mediation Adviser, Office of the Franchising Code Mediation Adviser; Oilcode Dispute Resolution Adviser, Office of the Oilcode Dispute Resolution Adviser, *Committee Hansard*, 8 June 2018, p. 5.

15.49 A key difference between the dispute resolution schemes compared in Appendix 4 is that, unlike the Franchising Code, the AFCA and the Food and Grocery Code of Conduct schemes include binding arbitration and the capacity to award remedies, compensation, interest and costs.

15.50 The Food and Grocery Code of Conduct also has time limits for starting investigations, resolving complaints and for appointing a mediator. The ACCC recommended that the Franchising Code and Oil Code be amended to require that mediation commence within a specific period once a mediator has been appointed. The ACCC argued for the change because in its view:

Currently, parties can conceivably delay mediation by consistently claiming they are unavailable to attend on certain dates. While the obligation to mediate in good faith is relevant in the event a party vexatiously seeks to delay mediation, this provides no recourse at the time for the affected party who is seeking to address the cause of their initial dispute.⁵⁰

15.51 The FCA submitted that it did not object to the ACCC's proposed amendment, but indicated that, in the FCA's view, the lack of a time limit was not a problem.⁵¹

15.52 The AFCA model has further additional features including:

- restrictions on either party taking legal action until alternative dispute resolution is complete; and
- the capacity to refer systemic or serious matters to regulators.

Structure of the mediation and ombudsman roles in the franchising sector

15.53 One of the issues that arose in consideration of dispute resolution in franchising was the respective roles and functions of OFMA and ASBFEO.

15.54 The ACCC submitted that duplication exists in the current mediation arrangements for franchising, and consideration should be given to consolidating the mediation advisory services within ASBFEO.⁵² The ACCC explained that, in their view, the consolidation of services within a single entity would simplify the system and help increase franchisee awareness of mediation services.⁵³

15.55 The ACCC acknowledged that when it considered a dispute could be resolved by mediation, it referred parties to not just OFMA, but also ASBFEO and the various small business commissioners because they all offer similar services.⁵⁴

50 Australian Competition and Consumer Commission. *Submission 45*, p. 15.

51 Franchise Council of Australia, *Supplementary submission 29.1*, p. 22.

52 Australian Competition and Consumer Commission, *Submission 45*, p. 13.

53 Ms Kristie Piniuta, Director, Small Business and Industry Codes, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 56.

54 Ms Kristie Piniuta, Director, Small Business and Industry Codes, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 56.

15.56 Noting that ASBFEO also provides case management and referral to specialist mediators, the Small Business Development Corporation (SBDC) suggested merging OFMA into ASBFEO. The SBDC noted that this approach would avoid the duplication of services, reduce the length of time to resolve disputes, and increase the Ombudsman's ability to detect trends.⁵⁵

15.57 ASBFEO advised that such an arbitration scheme would provide a referral or direction service to arbitration in the same way that it currently does for mediation or conciliation.⁵⁶

Committee view

15.58 Negotiation between franchisors and franchisees is the cheapest and most flexible process for resolving disputes and different perspectives within a franchise relationship. Disputes can range from the relatively minor through to substantial changes in the way that the franchise operates. Indeed, the committee received evidence from a major franchisor that they have robust negotiations with their franchisees and franchisee association where differing perspectives and disagreements are put on the table and worked through. To a great extent, this approach presupposes a willingness on behalf of both parties to engage in good faith about the future of the business relationship between them, as well as recognition by both parties that the continued existence of a mutually beneficial and profitable relationship underpins the negotiations. Negotiation between the parties is the first step in any healthy business relationship and, given good intentions on all sides, it has the potential to resolve many disputes. Unfortunately, the committee received evidence that a mutually agreed understanding arising from constructive approaches to negotiation is absent in particular franchise operations. Additionally, the committee was made aware of negotiations that were tokenistic in manner, such that the franchisees' concerns or views were rarely attended to.

15.59 It is also apparent that not all disputes can be resolved without outside intervention. Mediation should be the next step in the process because it allows the parties to engage in negotiation with a trained and experienced facilitator. It appears from the evidence provided to the committee that mediation is well-suited to franchising and may achieve a satisfactory resolution in up to two thirds of cases.

15.60 Nevertheless, the committee affirms the recommendation put forward by the ACCC that the Franchising Code be amended to expressly allow a mediator to undertake multi-franchisee mediations when disputes with similar issues arise. Such an amendment would improve efficiency as well as ameliorating the power imbalance that exists between franchisor and franchisee in dispute resolution.

15.61 The ACCC did not provide further information on what may constitute a 'similar issue' in its submission. The committee considers that the notion of a similar issue needs to be sufficiently broad to allow franchisees to bargain collectively on a

55 Small Business Development Corporation, *Submission 76*, pp. 4–5.

56 Dr Craig Latham, Deputy Ombudsman, Australian Small Business and Family Enterprise Ombudsman, *Committee Hansard*, 21 September 2018, pp. 40–41.

dispute even though the disputed issue may have had a varying impact on franchisees (that is, some may have been severely impacted and others less so; or the impact may not affect all franchisees simultaneously). The committee also considers that a mediator or arbitrator should be able to make decisions for each individual franchisee's circumstances, or a decision that applies to all franchisees involved in the dispute.

15.62 However, the committee agrees with the view put forward by OFMA, namely that a necessary condition of mediation is that the parties be willing to negotiate in good faith and try to achieve an outcome. Where this condition is missing, the mediation process will fail by design. Indeed, the evidence to this inquiry included a litany of instances where one party alleged the other party failed to engage in good faith in the mediation process, knowing that the only alternative was court action which was prohibitively expensive for one of the parties. In effect, the party in the stronger position had no incentive to reach a negotiated settlement and could effectively say to the weaker party, 'take it or leave it', or 'take it to court'. To be clear, most of the allegations put to the committee alleged that the franchisor refused to negotiate in good faith with the franchisee. In other words, the franchisor had a vested interest in impeding mediation because they knew the franchisee could not afford to take them to court.

15.63 It is in these circumstances, where all the issues are unable to be resolved satisfactorily through mediation, that a determinative procedure such as arbitration is required. Arbitration works in those situations where a party wants an investigation of the facts and a determination on the evidence.

15.64 The committee accepts that arbitration is more expensive than mediation because of the time and expertise required. But, it can deliver finality to parties who want to resolve a matter and move on. And arbitration is far cheaper and more flexible than pursuing court action, and this is the critical cost comparison in any attempt to deliver justice in a timely fashion at a reasonable price. Indeed, many of the concerns raised in the committee's 2008 report have now been addressed by a number of developments in arbitration during the ensuing decade.

15.65 Furthermore, the addition of arbitration within the overall dispute resolution framework for franchising would, in all likelihood, increase the number of satisfactory outcomes achieved through mediation. In addition, referral to arbitration would help level the current uneven playing field where many franchisees cannot afford to take franchisors to court, or defend themselves, when franchisors take them court. To prevent this scenario, the committee considers that the Franchising Code should include a requirement that franchisors should have to demonstrate to the court's satisfaction that the matter could not be resolved through mediation or arbitration. If the franchisor is not able to do that, the court should direct the parties to mediation or arbitration. In this regard, the committee suggests that similar to mediation, arbitration must be conducted in Australia⁵⁷ and should only be conducted in the state or territory

57 Competition and Consumer (Industry Codes— Franchising) Regulation 2014, sub cl. 41(2).

in which the franchisee's business is based to be consistent with existing Franchising Code provisions on the jurisdiction for settling disputes.⁵⁸

15.66 The committee also acknowledges that there may be certain types of dispute that can only, or should only, be determined or enforced through the courts. However, acknowledging this proposition does not detract from the overall argument that the inclusion of binding arbitration would be a valuable addition to the current dispute resolution system for franchising.

15.67 In terms of how the dispute resolution scheme for franchising could be enhanced, the overwhelming bulk of the evidence from a range of stakeholders strongly argued the Franchising Code be amended to include provision for binding arbitration. In this regard, the committee notes that more modern dispute resolution schemes under the Food and Grocery Code of Conduct and the AFCA both provide for binding arbitration.

15.68 The committee notes the ACCC recommendation to amend the Franchising Code and Oil Code to require that mediation commence within a specified time period once a mediator has been appointed. The committee notes that the FCA has indicated that it does not object to the proposed amendment. The committee is satisfied by the ACCC's argument that the absence of a time limit in the past has allowed parties to frustrate dispute resolution processes. The committee therefore recommends that the ACCC recommendation be implemented for both mediation and arbitration.

15.69 Further, the committee considers that certain features of the AFCA scheme referred to earlier would be valuable additions to the dispute resolution scheme under the Franchising Code. These features are:

- the capacity to refer systemic or serious matters to regulators; and
- the restrictions on taking legal action until the dispute resolution process is complete.

15.70 While membership of the food and grocery disputes resolution process is voluntary, the committee is firmly of the view that the mandatory nature of the franchising scheme should be maintained.

15.71 Finally, the committee notes that there is the potential for the duplication of services offered by ASBFEO and OFMA. The committee recommends that the Franchising Taskforce consider the appropriateness of merging the two bodies to improve efficiency and reduce complexity for franchisees seeking to use dispute resolution. While the committee notes the evidence it received that proposed OFMA be merged into ASBFEO, the committee does not have a firm view on what the best outcome would be.

58 Competition and Consumer (Industry Codes— Franchising) Regulation 2014, cl. 21.

Recommendation 15.1

15.72 The committee recommends that the Franchising Taskforce consider the appropriateness of:

- merging the Office of the Franchising Mediation Adviser with the Australian Small Business and Family Enterprise Ombudsman, and that franchising be included in the name of any combined body;
- funding any combined small business and franchising ombudsman through an industry levy based on numbers of complaints;
- all franchisees under the Franchising Code of Conduct falling within the jurisdiction of the combined body if established;
- enhancing the powers of any combined body so that it may refer and direct parties to binding arbitration under the Franchising Code of Conduct; and;
- the appointment of a combined small business and franchising ombudsman as an independent assessor with the ability to review handling of disputes and the capacity to refer systemic or serious matters to regulators.

Recommendation 15.2

15.73 The committee recommends that the dispute resolution scheme under the Franchising Code of Conduct remain mandatory and be enhanced to include:

- the option of binding arbitration with the capacity to award remedies, compensation, interest and costs, if mediation is unsuccessful (does not exclude court action);
- require that mediation and then arbitration commence within a specified time period once a mediator or arbitrator has been appointed;
- restrictions on taking legal action until alternative dispute resolution is complete (along similar lines to those used by the Australian Financial Complaints Authority);
- immunity from liability for the dispute resolution body;
- to include a requirement that if a franchisor takes a matter straight to court, the franchisor must demonstrate to the court's satisfaction that the matter cannot be resolved through mediation, and if not the court should order the parties to mediation;
- the capacity for a mediator or arbitrator to undertake multi-franchisee resolutions when disputes relating to similar issues arise (as determined by the mediator or arbitrator).

Chapter 16

Comparison of industry codes

Introduction

16.1 The terms of reference for the inquiry require the committee to consider whether the provisions of other mandatory industry codes of conduct, such as the Oil Code of Conduct (Oil Code), contain advantages or disadvantages relevant to franchising relationships in comparison with terms of the Franchising Code of Conduct (Franchising Code).

16.2 Certain franchise outlets, for example, those that contain a fuel outlet, are regulated under the Oil Code. It is important to ascertain the relevant advantages or disadvantages of the respective codes because the Franchising Code does not apply to franchise agreements to which another mandatory industry code (such as the Oil Code) applies.¹

16.3 This chapter summarises the comparison undertaken by the committee, which includes consideration of the provisions of the following codes:

- The Franchising Code as set out in the Competition and Consumer (Industry Codes—Franchising) Regulation 2014;
- The Oil Code as set out in Competition and Consumer (Industry Codes—Oil) Regulations 2017; and
- The Food and Grocery Code of Conduct (Food and Grocery Code) as set out in Competition and Consumer (Industry Codes—Food and Grocery) Regulation 2015.

16.4 The Food and Grocery Code is of relevance because certain factors are present in both the food and grocery industry and the franchising industry. Specifically, the significant power imbalance in the relationship between franchisees and franchisors is similar to the power imbalance between small suppliers and big supermarket retailers regulated by the Food and Grocery Code.

16.5 The differences between the codes in relation to dispute resolution were discussed in chapter 15.

Differences between the Franchising and Oil Codes

16.6 This section summarises the evidence received during the inquiry that identified and commented on differences between the Franchising and Oil Codes.

16.7 In its submission, the Australian Competition and Consumer Commission (ACCC) provided a detailed comparison of the Oil and Franchising Codes, which is reproduced in Appendix 5. The ACCC advised that the definition of a fuel re-selling agreement in the Oil Code largely mirrors the definition of a franchise agreement under the Franchising Code. However, some fuel re-selling agreements (for example,

1 Department of Jobs and Small Business, *Supplementary submission 20.2*, p. 6.

some commission agent agreements) do not satisfy the criteria of a franchise agreement under the Franchising Code.²

16.8 The Department of the Environment and Energy noted that the Oil Code has provisions for reseller agreements that have similarities to those of the Franchising Code (including termination and dispute resolution), but also include additional industry-specific requirements. Other differences include that the Oil Code:

- does not include good faith provisions; and
- does not contain civil penalties for breaches.³

16.9 The Franchise Council of Australia (FCA) also pointed out that the Oil Code has slightly broader grounds for termination and statutory rights to terminate for legal non-compliance.⁴

16.10 The Queensland Law Society was concerned that the Franchising and Oil Codes were inconsistent and that similar provisions were drafted differently. The Queensland Law Society therefore recommended that the Franchising and Oil Codes be brought into alignment through a comprehensive comparison.⁵

16.11 The Department of the Environment and Energy also observed that:

The current situation of petroleum retailers only being covered by the Oil Code has the benefit of avoiding the complexity caused by multiple codes applying to a single wholesaler or retailer.⁶

16.12 However, it stated that the downside of decoupling the Oil and Franchising Codes is that:

...the two codes have evolved independently of each other and now offer different levels of protection based on the balance of needs in different industry areas.⁷

16.13 The FCA supported harmonisation of the Oil and Franchising Codes to make it less confusing for franchisees and franchisors. However, they submitted that significant differences exist between oil industry franchises and other franchises, including that:

- oil businesses are often operated 24 hours each day, and from standalone premises owned or leased by the franchisor;
- the franchisors are typically very large corporations; and

2 Australian Competition and Consumer Commission, *Submission 45*, p. 23.

3 Department of the Environment and Energy, *Submission 61*, p. 4; see also Queensland Law Society, *Submission 48*, p. 10; Franchise Council of Australia, *Submission 29*, p. 27.

4 Franchise Council of Australia, *Submission 29*, p. 27.

5 Queensland Law Society, *Submission 48*, p. 10; see also Franchise Advisory Centre, *Submission 138*, p. 4.

6 Department of the Environment and Energy, *Submission 61*, p. 4.

7 Department of the Environment and Energy, *Submission 61*, p. 4.

- there are usually higher levels of day to day control exercised by franchisors over the businesses in the oil industry.⁸

16.14 7-Eleven supported the harmonisation of the relevant termination provisions in the Franchising and Oil Codes, arguing that there is no reason why fuel and non-fuel stores should be subject to different termination provisions and standards of acceptable behaviour.⁹

16.15 The Australasian Convenience and Petroleum Marketers Association (ACPMA) noted that the Oil Code makes provision for commission agent agreements. ACPMA suggested that those agreements provide a means of low cost market entry for new participants. ACPMA argued that if the provisions in the Franchising Code replaced those in the Oil Code, it would likely result in the loss of this business model with consequent negative impact on the ability of the industry to attract new market participants.¹⁰

16.16 The Coffee Club drew attention to the enhanced disclosure provisions under the Oil Code during franchise transfers:

One aspect of the Oil Code that is significantly different is Annexure 3, where it provides a standard form of disclosure for the transfer of a fuel re-selling business by its owner. There is no equivalent disclosure under the Franchising Code for a transfer [of] an existing franchised business by its owner. At present, when the owner of a franchise business wishes to sell the business, no disclosure obligations from the seller to the buyer apply other than that negotiated by the parties.¹¹

16.17 The Coffee Club noted that if something similar to Annexure 3 of the Oil Code was introduced into the Franchising Code, there would be more consistency in the information provided to prospective franchisees upon the re-sale of existing businesses. However, they acknowledged that business brokers, who deal with both franchised and non-franchised businesses, would need to understand any new requirements under the Franchising Code.¹² These matters have been addressed by recommendations in chapter 6.

Relevant clauses in the Food and Grocery Code

16.18 The Food and Grocery Code contains several additional clauses that constrain the more powerful party in the relationship. These clauses are not present in either the Franchising or Oil Codes, and include:

- a ban on unilateral variation of the contract (clause 9);
- a ban on retrospective variation of the contract (clause 10);

8 Franchise Council of Australia, *Submission 29*, p. 27.

9 Mr Angus McKay, Chief Executive Officer, 7-Eleven Stores Pty Ltd, *Committee Hansard*, 14 September 2018, p. 70.

10 Australasian Convenience and Petroleum Marketers Association, *Submission 71*, p. 2.

11 The Coffee Club, *Submission 77*, p. 5.

12 The Coffee Club, *Submission 77*, p. 5.

- a ban on supplier rebates (clause 15);
- a ban on wastage and shrinkage payments (clauses 13 and 14); and
- a ban on payments for the activities of other parties (clause 17).

16.19 In addition, the Food and Grocery Code also provides a duty on the stronger party to conduct training with respect to the Code (clause 40).

ACCC recommendations on penalties and legal costs

16.20 As noted throughout the report, the ACCC submission argued for several amendments to the Franchising and Oil Codes to improve their effectiveness. This section covers matters that have not been considered elsewhere, in particular the ACCC's overarching recommendations on penalties, and also franchisors seeking reimbursement of their legal costs from prospective franchisees.

Penalties

16.21 In relation to penalties, the ACCC submitted that the ability to seek civil pecuniary penalties and issue infringement notices is a fundamental part of the ACCC's enforcement toolkit. Further, the lack of consequences for breaching the Franchising and Oil Codes undermines the ACCC's ability to ensure compliance with the codes. Where penalties are insufficient, franchisors are likely to factor the risk of a penalty into the cost of doing business. Where penalties are unavailable, there is no incentive for a franchisor to comply with the codes. The ACCC noted that the penalties currently available under the Franchising Code were small in comparison to the Australian Consumer Law (ACL):

...the current maximum penalty available for a breach of a civil pecuniary penalty provision in an industry code is 300 penalty units (currently \$63 000). By comparison, maximum penalties available under the ACL are \$1.1 million (for companies).¹³

16.22 In its submission, the ACCC drew attention to the Treasury Laws Amendment (2018 Measures No. 3) Bill 2018, which was subsequently passed by Parliament in August 2018. The Bill increased the maximum penalty for a breach of the ACL by a corporation to the greater of:

- \$10 million; or
- three times the value of the benefit obtained from the offence (where the court can determine this value); or
- 10 per cent of the annual turnover of the business.¹⁴

16.23 As a result, the ACCC recommended that:

- civil pecuniary penalties (and, thereby, infringement notices) be made available for all breaches of the Codes; and

13 Australian Competition and Consumer Commission, *Submission 45*, p. 4.

14 Treasury Laws Amendment (2018 Measures No. 3) Bill 2018, *Explanatory Memorandum*, p. 9.

- the quantum of penalties available for breach of an industry Code be significantly increased to ensure that penalties are a meaningful deterrent, such as to at least reflect the penalties currently available under the Australian Consumer Law.¹⁵

16.24 The FCA supported the introduction of penalties to the Oil Code to match those in the current Franchising Code. However, the FCA opposed the ACCC's recommendations on increasing the number and level of penalties in the Franchising Code. The FCA argued that the current penalty regime is correctly tailored in terms of the Franchising Code provisions and the quantum of penalties. The FCA observed that it was not aware of any instances where the ACCC's compliance activities had been inhibited by the current penalty regime under the Franchising Code.¹⁶

Franchisors seeking reimbursement of their legal costs from prospective franchisees

16.25 The ACCC recommended that the Franchising Code be amended to prohibit franchisors from passing on to a prospective franchisee the legal costs of preparing, negotiating and executing documents. The ACCC argued that:

Many franchisors include a term in their agreements that require the prospective franchisee to reimburse the franchisor for the franchisor's costs for preparing, negotiating and executing the agreement.

The ACCC considers that the ability for franchisors to pass on their initial legal costs to a prospective franchisee may disincentivise many prospective franchisees from:

- seeking their own independent advice
- attempting to negotiate the terms of the arrangement, since doing so will increase the franchisor's costs of negotiating and drafting any changes.¹⁷

16.26 The FCA responded to the ACCC recommendation by arguing that if this change is made, franchisors will simply seek to recover this cost by increasing the initial franchise fee. The FCA indicated that it would support a prohibition on charging additional fees above the standard fixed fee for costs of negotiations.¹⁸

Committee view

16.27 The committee notes the views of stakeholders proposing a comprehensive review to harmonise the Oil and Franchising Codes to reduce confusion for franchisees and franchisors. In particular, the committee considers that the Oil Code should be amended to align with the Franchising Code by providing penalties for breaches of the same provisions. Importantly, subject to any recommendations for reform of the Franchising Code made in this report, all existing features of the Franchising Code should be retained.

15 Australian Competition and Consumer Commission, *Submission 45*, pp. 4, 5.

16 Franchise Council of Australia, *Supplementary submission 29.1*, p. 18.

17 Australian Competition and Consumer Commission, *Submission 45*, p. 10.

18 Franchise Council of Australia, *Supplementary submission 29.1*, p. 21.

16.28 The committee observes that the Food and Grocery Code has many useful features that constrain the discretion of the more powerful party. As noted in chapters 4 and 9, the committee received evidence about the ability of franchisors to unilaterally vary terms and conditions. As discussed in chapter 8, the committee recommends that conflicts of interest associated with supplier rebates and third line forcing are investigated. Further, the committee considers that a ban on unilateral as well as retrospective variations to terms and conditions and a ban on franchisors charging wastage and shrinkage payments could be usefully added to the Franchising and Oil Codes.

16.29 The committee also considers that there should be a duty on the franchisor to provide franchisees with training on the obligations and rights of franchisees and franchisors under the Franchising Code, and where applicable, the Oil Code.

16.30 The committee supports the ACCC recommendations on penalties and is firmly of the view that civil pecuniary penalties should apply to all breaches of the Franchising and Oil Codes. The committee agrees with the ACCC that the penalties are manifestly inadequate and fail to provide any meaningful deterrent to large franchisors. The committee supports the ACCC's arguments that penalties could be set at a multiple of three times the value of the benefit obtained from the offence, so that there is an effective deterrent that correlates with the size of the offence and the size of the franchisor. The FCA's arguments against the ACCC recommendations were unconvincing. Therefore, the committee recommends that the ACCC's recommendations on penalties be implemented, following consideration by the Franchising Taskforce.

16.31 However, the committee notes that subsection 51AE(2) of the *Competition and Consumer Act 2010* constrains the size of the penalties that can be set under an industry code to 300 penalty points. Therefore, in order for the ACCC's recommendation to be implemented, the penalty amounts for a breach of the Franchising Code would need to be prescribed in legislation so that the limit on penalties under industry codes in subsection 51AE(2) does not apply to franchising.

16.32 The committee also supports the ACCC's recommendation that the Franchising Code be amended to prohibit franchisors from passing on to the prospective franchisee the legal costs of preparing, negotiating and executing documents. The committee is disappointed by the response from the FCA suggesting that franchisors could seek to increase upfront fees to circumvent the intent of such a law should it be passed by the Parliament. The committee considers that this further demonstrates how out of touch the FCA is with the franchisees who it claims to be an advocate for (see chapter 5 for the committee's consideration of the FCA).

16.33 Therefore, in addition to recommending that the ACCC's proposal be implemented, the committee recommends that the amendment include a civil penalty for any franchisor found to be deliberately attempting to put up franchise fees to circumvent a regulation to prevent the passing on of legal costs.

Recommendation 16.1

16.34 The committee recommends that the Franchising Taskforce consider amendments to the *Competition and Consumer Act 2010* and the Franchising Code of Conduct to implement the penalty regime recommended by the Australian Competition and Consumer Commission, including:

- civil pecuniary penalties (and, thereby, infringement notices) be made available for all breaches of the Franchising Code of Conduct and Oil Code of Conduct;
- the quantum of penalties available for breach of the Franchising Code of Conduct and Oil Code of Conduct be significantly increased to ensure that penalties are a meaningful deterrent, such as to at least reflect the penalties currently available under the Australian Consumer Law; and
- ensuring that the penalties for a breach of the Franchising Code of Conduct are prescribed in legislation, so that the limit on penalties under industry codes in subsection 51AE(2) does not apply to franchising.

Recommendation 16.2

16.35 The committee recommends that the Australian Government amend the Franchising Code of Conduct to include the following provisions:

- except where already incorporated into a joining fee, a prohibition on passing on to the prospective franchisee the legal costs of preparing, negotiating and executing documents, including a civil penalty for any franchisor found to be deliberately attempting to increase franchise fees to circumvent a regulation to prevent the passing on of legal costs;
- a ban on unilateral variations to terms and conditions;
- a ban on retrospective variations to terms and conditions;
- a ban on franchisors charging wastage and shrinkage payments; and
- a duty on franchisors to provide franchisees with training on the requirements of the Code.

Recommendation 16.3

16.36 The committee recommends that, subject to any recommendations for reform of the Franchising Code made in this report, the Australian Government amend the Oil Code of Conduct to align with the Franchising Code of Conduct.

Chapter 17

Automotive industry code

Introduction

17.1 This chapter considers a proposal put to the committee for a separate automotive industry code of conduct to address issues specific to the automotive sales and service industry. The chapter provides a summary of the issues and proposals put forward by car dealer industry associations, as well as the views of automotive manufacturers and the Australian Competition and Consumer Commission (ACCC).

Issues identified by dealer associations

17.2 The Motor Trades Association of Australia (MTAA) argued that the Franchising Code of Conduct (Franchising Code) does not adequately incorporate unique characteristics specific to the automotive sector, such as high capital investment costs, the complexity of modern automotive vehicles and systems, and the power of manufacturers to impose unfair franchising arrangements on dealers.¹

17.3 The MTAA argued that the Franchising Code is only able to deal with the headline agreement, but not necessarily the underlying policy and procedure documents that substantially influence and control the relationship.² The MTAA suggested that this allowed:

...unfair and unreasonable behaviours and actions in the automotive sector including unreasonable timeframes for return on considerable capital investment, sudden, unexplained and in the view of some members, arbitrary cessation of dealership and franchising agreements, without regard for reasonable timeframes, goodwill, performance, or potential proven future profitability. Dealer and franchise agreements are being terminated through questionable changes to designated market areas, backed with sometimes less than robust market analysis.³

17.4 The MTAA noted that the Franchising Code does not provide the degree of protections it was intended to. The MTAA submitted that automotive sector franchisees are vulnerable to retaliation from the more powerful player in the relationship:

The fear of retribution, repercussion or retaliation from some franchisor manufacturers and/or their distributors/representatives/agents, is a constant and ongoing concern of automotive sector franchisees. Vehicle dealers for example may have millions of dollars at risk at any given time and the potential of losing this investment and their entire business for speaking out against unfair practices is real.⁴

1 Motor Trades Association of Australia Limited, *Submission 55*, p. 1.

2 Motor Trades Association of Australia Limited, *Submission 55*, p. 6.

3 Motor Trades Association of Australia Limited, *Submission 55*, p. 6.

4 Motor Trades Association of Australia Limited, *Submission 55*, p. 1.

17.5 Mr Richard Dudley, Chief Executive Officer of the MTAA, emphasised the degree of concern among dealers, informing the committee that:

...this is the first time in an unprecedented manner that we have actually had member businesses from our constituency nationwide appear before any committee with regard to the franchising code such is the fear of reprisal, retribution and intimidation. But, with our member businesses that have elected to come here today, I think it's a reasonably good indication that something's not quite right with this regulatory instrument.⁵

The MTAA proposals

17.6 The MTAA identified options for establishing an automotive code of conduct:

a) Seize the opportunity presented by the potential creation of a Code of Conduct for Access to Automotive Service and Repair Information...The recommendation could include widening the remit of such a regulatory instrument to create an 'Automotive Code of Conduct' centred on access to service and repair information and automotive retailing agreements;

Or

b) Incorporate changes including a schedule and/or provisions within the current Franchising Code of Conduct to deal with the complexities and nuances of Automotive retailing in all of its guises;

Or

c) Develop a separate Franchising Code of Conduct based on monetary thresholds to cater for larger businesses;

Or

d) A combination of a) & b) with retention of relevant and appropriate provisions of the Franchising Code of Conduct, and the excising out of the Franchising Code other provisions to be re-scoped and included in a potential Automotive Code of Conduct, through a schedule and parts.⁶

17.7 The MTAA submitted that an automotive code should include the following features:

- clarity on the size of dealer operations;
- a variation of agreements provision to limit unilateral changes by franchisors;
- stronger termination provisions regarding notice periods, requirements to provide information on remedying breaches, and timeframes for remedying breaches;
- stronger post-termination provisions on the provision of information, negotiation of arrangements, access to independent advice and prorata refunds for early termination;

5 Mr Richard Dudley, Chief Executive Officer, Motor Trades Association of Australia Limited, *Committee Hansard*, 22 June 2018, pp. 8, 13.

6 Motor Trades Association of Australia Limited, *Submission 55*, p. 4.

- independent valuations for buybacks;
- stronger good faith provisions; and
- penalties for breaches.⁷

Other industry stakeholders in support of an automotive industry code

17.8 The Australian Automotive Dealer Association (AADA) was also concerned about the power imbalance between manufacturers as franchisors and dealers as franchisees. It submitted that while many dealers enjoy good relations with their respective manufacturers and work in a mutually beneficial partnership, there remain many instances where dealers are subjected to treatment resembling a master/servant relationship.⁸

17.9 The AADA argued that the Franchising Code has not protected franchised new car dealers, submitting that car dealers are entering agreements which contain oppressive contractual clauses and unfavourable termination, non-renewal and end-of-term arrangements. Further, the AADA noted that franchised new car dealers are very different from typical franchisees in terms of the scale of their investments and nature of their business. Similarly, car manufacturers are also very different from typical franchisors in terms of scale, as they are all powerful off-shore multinational corporations.⁹

17.10 The AADA submitted that dealers are subject to a range of unfair practices and conditions including:

- no security of tenure;
- limited notice on non-renewal;
- inadequate capital expenditure protections;
- end of agreement terms that leave dealers with vehicle stock and parts; and
- constraints on addressing consumer complaints.¹⁰

17.11 Further, due to the large capital investments in sites and stock, dealers may not qualify for protections associated with unfair contract term legislation.¹¹

17.12 The AADA argued that, for these reasons, a specific automotive industry code of conduct is required to protect franchised new car dealers in Australia.¹²

17.13 The Victorian Automobile Chamber of Commerce (VACC) agreed, submitting that a new automotive industry code of conduct is required. The VACC

7 Motor Trades Association of Australia Limited, *Submission 55*, Appendix B Potential options for resolving motor vehicle franchised dealer agreements, pp. 2–3.

8 Australian Automotive Dealer Association, *Submission 84*, p. 3.

9 Australian Automotive Dealer Association, *Submission 84*, p. 3.

10 Australian Automotive Dealer Association, *Submission 84*, pp. 6, 8.

11 Australian Automotive Dealer Association, *Submission 84*, pp. 6, 8.

12 Australian Automotive Dealer Association, *Submission 84*, p. 3.

cited the complexity and substantial investment levels that characterise the automotive industry and the systemic failures of the Franchising and Oil Codes to support this position.¹³

17.14 The VACC argued that a dedicated code should:

- include cars, motorcycles, commercial vehicles, and farm machinery;
- acknowledge rapid technological change including electric and autonomous vehicles;
- acknowledge the large financial expenditure required by automotive franchisees;
- require full disclosure of audited financials, including cash flow projections, return on investments and operating costs of the business;
- require the term of the lease for an automotive franchise premises to correspond with the term of the franchise agreement, and provide that the franchisor is not to be unfairly evicted off the premises should the agreement be terminated prior to the expiry of the lease;
- require geographical exclusivity to be made explicit in the agreement and provide that it cannot be changed without the consent of both parties. There needs to be the option of being able to negotiate an exclusive Primary Market Area (PMA) territory for the term of the agreement;
- provide that the franchisee has the option of using a range of suppliers (not limited by the franchisor), without associated financial penalties;
- require that the termination provisions are clearly stated in the agreement, including that the franchisor be required to buy stock and equipment back at a fair price; and
- deal with goodwill, restraint of trade, and dispute resolution.¹⁴

Manufacturer views

17.15 The Federal Chamber of Automotive Industries (FCAI) is the peak industry body in Australia for automotive manufacturers. Its members include all of the major importers and distributors of new vehicles in Australia. The FCAI expressed support for the existing approach in which the Franchising Code applies to the automotive industry, notwithstanding that the automotive sector differs from other franchise models in key respects. The FCAI explained:

Motor vehicles dealerships are...included within the definitions of what constitutes a franchise in section 5(2) of the Code. Distributors have accepted the applicability of the Code and have incorporated the requirements outlined in the Code, into their contractual dealings and day to day operations.

13 Victorian Automobile Chamber of Commerce, *Submission 66*, p. 5.

14 Victorian Automobile Chamber of Commerce, *Submission 66*, p. 5.

The fact that the automotive industry is not a 'true' franchise is recognised in the Code itself. The general definition of 'franchise agreement' in the Code (which sets out the 4 indicia of a 'franchise agreement') does not apply to the automotive industry. It is only because a 'motor vehicle dealership agreement' is expressly deemed to be a franchise agreement that the Code applies.¹⁵

17.16 The FCAI responded to the dealer associations' views and proposals through submissions and at a public hearing. It argued that:

- the MTAA were not able to demonstrate why the issues raised cannot be dealt with under the existing legislative regime;
- the imbalance of power is not as great as suggested by dealer groups, citing the example of Automotive Holdings Limited, an automotive retailing and logistics group with 183 franchises at 113 locations and a turnover of more than \$6.5 billion;
- manufacturers have significantly less control over dealers than other franchisors have over their franchisees;
- dealers often operate multiple franchise brands;
- dealers can exercise significant power through their control or ownership of lucrative sites; and
- it is not in the interests of the manufacturer to antagonise dealers, so manufacturers only take action for good reasons.¹⁶

17.17 The FCAI submitted that the existing regime is more than adequate because the Franchising Code and the Australian Consumer Law (ACL) provide:

- protection from unfair termination;
- protection from requirements to undertake significant capital expenditure; and
- protection from unilateral changes to contracts, policies and manuals (through the unconscionable conduct provisions in the ACL).¹⁷

17.18 In relation to dealer concerns about not being paid for goodwill when franchises are terminated (see first page of this chapter), the FCAI made two points. Firstly, dealers do not pay franchise fees for access to the goodwill associated with the manufacturer's brand, and secondly, dealer agreements do not contain restraint of trade provisions.¹⁸ The issues around goodwill and restraint of trade provisions were discussed in greater detail in chapters 12 and 13 respectively.

17.19 The FCAI also submitted that automotive manufacturers encourage dealer councils and sometimes pay for travel costs for dealers to attend meetings. The FCAI

15 Federal Chamber of Automotive Industries, *Submission 58*, pp. 2, 3.

16 Federal Chamber of Automotive Industries, *Response to Submission 55*, p. 2; Federal Chamber of Automotive Industries, *Submission 58*, p. 4.

17 Federal Chamber of Automotive Industries, *Response to Submission 55*, p. 3.

18 Federal Chamber of Automotive Industries, *Response to Submission 55*, p. 4.

argued that manufacturers generally seek advice and comment from dealer councils when considering making amendments to dealer agreements.¹⁹

ACCC views

17.20 The committee sought the ACCC's view on the MTAA proposal. The ACCC acknowledged that there were issues with thresholds for unfair contract terms, imbalance of power, and capital investments associated with establishing dealerships. The ACCC indicated that it was aware of the MTAA proposals, but had not reached a view on whether there should be a separate code.²⁰ Further, Mr Timothy Grimwade, Executive General Manager, stated that:

When we conducted our investigation or market study into new-car retailing, we did look at some of the agreements between manufacturers and dealers and did identify some imbalance of power, so we do understand where the MTAA are coming from in their submission. We have recommended a regulatory response to deal with access to data to improve competition within independent repairers and car dealers.²¹

17.21 The ACCC also noted that it had made recommendations to this committee in relation to unfair contract terms (discussed in chapter 9). The ACCC indicated that it was aware that the definition of 'small business' might not capture car dealers.²² Mr Grimwade advised the committee that:

While we haven't come to a landing recognising that there's going to be a review of the unfair contract terms legislation, I think, at least from November this year [2018], we have indicated that our view is that thresholds should be increased, but we haven't formed a view yet on how much they should be increased by.²³

The Treasury Regulation Impact Statement

17.22 In December 2018, Treasury released a Regulation Impact Statement (RIS) canvassing possible responses to address new car dealers' franchising concerns for comment by mid-February 2019. It was noted in the RIS that if a separate Automotive Code is implemented to govern franchising relationships between car manufacturers and new car dealers, then the Franchising Code would cease to apply to dealings

19 Federal Chamber of Automotive Industries, *Response to Submission 55*, pp. 4–5.

20 Mr Mick Keogh, Deputy Chair, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 57.

21 Mr Timothy Grimwade, Executive General Manager, Consumer, Small Business and Product Safety Division, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 57.

22 Mr Timothy Grimwade, Executive General Manager, Consumer, Small Business and Product Safety Division, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 57.

23 Mr Timothy Grimwade, Executive General Manager, Consumer, Small Business and Product Safety Division, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 57.

between car manufacturers and new car dealers, since the Franchising Code only operates where an industry-specific mandatory code does not exist.²⁴

17.23 The RIS identifies four options as having a positive net benefit, which together are likely to address the identified problems in the new car retailing sector:

- Option 2A—requiring manufacturers to provide at least 12 months' notice when not renewing a dealer agreement.
- Option 2B—requiring manufacturers to provide a statement to a dealer whose agreement is not being renewed outlining why the agreement is not being renewed.
- Option 2D—requiring pre-contractual disclosure of significant capital expenditure to have a greater degree of specificity.
- Option 2F—enabling multi franchise mediation.²⁵

17.24 Other options which are also canvassed in developing the RIS included:

- Option 2C—mandating that manufacturers buy back stock when an agreement is not renewed.
- Option 3B—minimum five year terms with right of renewal.²⁶

Committee view

17.25 The committee notes the evidence from the FCAI that automotive dealers do not pay franchise fees for access to the goodwill associated with the manufacturer's brand, and that dealer agreements do not contain restraint of trade provisions.

17.26 The committee considers that the franchising issues raised by dealers and their industry associations overlap with many of the issues identified by other sectors of the franchising industry. The committee is mindful of disadvantages that arise with the fragmentation of codes into multiple codes. The committee therefore considers that the franchise-specific concerns raised by dealers can be addressed by the recommendations that the committee is making for franchising and the Franchising Code.

17.27 The committee notes that options 2A, 2B, 2D and 2F of the Treasury RIS deal with issues that are not unique to franchising relationships between car manufacturers and new car dealers. Those issues are of concern across franchising more generally. Therefore the committee considers that addressing those issues in the Franchising Code is appropriate.

17.28 The committee notes that the Treasury RIS also considered what happens to stock when an agreement is not renewed. While this applies to many franchise

24 Treasury, Regulation Impact Statement, *Franchise relationships between car manufacturers and new car dealers*, December 2018, p. 6.

25 Treasury, Regulation Impact Statement, *Franchise relationships between car manufacturers and new car dealers*, December 2018, p. 6.

26 Treasury, Regulation Impact Statement, *Franchise relationships between car manufacturers and new car dealers*, December 2018, p. 7.

systems, the capital costs associated with cars is very significant. The committee notes that option 2C to mandate that manufacturers buy back stock if an agreement is not renewed was considered by the RIS, but not included in the list of options having a positive net benefit.

17.29 However, the committee received a lot of evidence, including on a confidential basis, that:

- dealers have suffered large losses on stock when an agreement has not been renewed and the franchisor has offered a nominal price for stock well below the cost price; and
- dealers have been required to spend substantial sums of money upgrading a showroom only to have the franchise agreement not renewed by the franchisor less than a year later.

17.30 The committee considers that reform may be needed to ensure fair arrangements exist for capital intensive stock when franchise agreements are not renewed. The committee is of the view that further consideration should be given to requiring franchise agreements in the automotive sector to include a provision mandating that a franchisor be required to buy back at cost price all vehicles and parts up to three years old in the event of the non-renewal of a lease. The committee recognises that this may require an independent valuation of all stock at the time of non-renewal, and that the cost of the valuation should be split evenly between the franchisor and franchisee.

17.31 The committee also considers that manufacturers should be required to provide at least 12 months' notice when not renewing a dealer agreement and that a dealer should not be compelled to upgrade the dealership after notice of non-renewal or termination has been given to the dealer.

Recommendation 17.1

17.32 The committee recommends that the Department of the Treasury and the Department of Jobs and Small Business give further consideration to identifying reforms that would support the fair handling of capital intensive stock when franchise agreements between car manufacturers and new car dealers are not renewed, including, but not limited to:

- **manufacturers being required to provide at least 12 months' notice when not renewing a dealer agreement;**
- **dealers not being compelled to upgrade the dealership after notice of non-renewal or termination has been given to the dealer; and**
- **in the event of the non-renewal of a lease, mandating that the franchisor buy back at cost price all vehicle parts up to three years old, with the cost of any independent valuation of stock to be split evenly between the franchisor and franchisee.**

17.33 The committee notes that dealers have raised a range of issues for industry codes that are not specific to franchising, but may be significant issues for the automotive industry. The committee therefore considers that as long as it does not impede the other recommendations of this inquiry, the committee does not have any

objection to a separate automotive industry code that deals with non-franchising matters, such as the access to service and repair information code proposed by the MTAA.

17.34 The committee notes that the RIS indicates that if a separate code is established for the automotive industry, the Franchising Code would not apply to franchises operating under the automotive code. The committee appreciates that such an approach limits red tape and reduces confusion. However, the committee notes that a downside of that approach is that codes may evolve separately over time and become inconsistent, as has occurred with the Oil Code of Conduct and the Franchising Code.

17.35 In the case of a system such as 7-Eleven, this has led to stores in the 7-Eleven network operating under different and inconsistent codes, depending on whether or not they sell petrol.

17.36 The committee considers that Treasury should consider ways to ensure that multiple codes remain aligned over time, or establish a core franchising code that applies generally, with industry-specific aspects in schedules or sub-codes that apply in addition to the core franchising code for relevant industries.

Recommendation 17.2

17.37 The committee recommends that the Department of the Treasury and the Department of Jobs and Small Business ensure that multiple codes remain aligned over time, noting that options may include establishing a core franchising code that applies generally, with industry-specific aspects in schedules or sub-codes that apply in addition to the core franchising code for relevant industries.

Chapter 18

Pre-entry education and access to advice

Introduction

18.1 Chapter 6 considered the disclosure requirements under the Franchising Code of Conduct (Franchising Code) and the extent to which they can help to address the profound asymmetry of information that exists between a franchisor and a prospective franchisee.

18.2 This chapter also considers information. However, the focus here is on the role of education in assisting prospective franchisees to be better informed about the risks and responsibilities entailed in becoming a franchisee prior to signing a franchise agreement. The stage in the process prior to the signing of the franchise agreement is typically referred to as either the 'pre-entry' or 'pre-contractual' period. For consistency, this chapter uses the 'pre-entry' period.

18.3 This chapter examines the educational strategies and material provided by the Australian Competition and Consumer Commission (ACCC), independent organisations and industry representatives for the purposes of educating prospective franchisees. The chapter then explores franchisees' access to legal advice prior to entering a franchise network and whether utilising advisory resources provided adequate awareness about potential risks and the contractual obligations owed by the franchisee. This is followed by consideration of whether prospective franchisees should be required to obtain legal and accounting advice prior to signing a franchise agreement.

Education programs for franchisees

18.4 Franchisees and prospective franchisees can readily access pre-entry education on the ACCC website. A number of other organisations also provide educational courses through a range of modes including:

- university courses;
- one day seminars; and
- online courses.

18.5 The ACCC provides information and education resources, including webpages on the industry codes, for both franchisees and franchisors through their website. A team is tasked with developing resources and information to educate and provide guidance to franchisees, franchisors and other small business operators.¹ The ACCC also maintains publications on franchising including:

1 Australian Competition and Consumer Commission, *Submission 45*, p. 20.

- a franchisee manual;
- a Franchisor Compliance Manual; and
- Franchising: what you need to know factsheet.²

18.6 The ACCC's franchisee manual is intended to 'help franchisees and prospective franchisees to understand their rights and responsibilities under the Franchising Code of Conduct'.³ The franchisee manual encourages prospective franchisees to review:

- the disclosure document, earnings information, the franchisor's position, and to speak with current franchisees about their experiences;⁴
- the franchise agreement, including ongoing rights and obligations, and end of term arrangements;⁵ and
- internal and Franchising Code complaint handling procedures and the ACCC's recommended approach to dispute resolution.⁶

18.7 The franchisee manual also provides a 10-step checklist that the ACCC recommends prospective franchisees should undertake before committing to a franchise opportunity.⁷

18.8 A number of courses provide a preliminary overview of franchising that prospective franchisees can take before entering a franchise agreement. Prominent pre-entry education programs include:

- An ACCC sponsored pre-entry education course for prospective franchisees provided by FranchiseED, a not-for-profit organisation that provides education and consultancy services as well as access to franchise sector-specific research.⁸ FranchiseED offers both free and pay to access franchise education courses targeted primarily at prospective or existing

2 Australian Competition and Consumer Commission, *Submission 45*, p. 20.

3 Australian Competition and Consumer Commission, *The franchisee manual*, December 2014, Cover page.

4 Australian Competition and Consumer Commission, *The franchisee manual*, December 2014, pp. 7–9.

5 Australian Competition and Consumer Commission, *The franchisee manual*, December 2014, pp. 11–15.

6 Australian Competition and Consumer Commission, *The franchisee manual*, December 2014, pp. 16–17.

7 Australian Competition and Consumer Commission, *The franchisee manual*, December 2014, p. 2.

8 FranchiseED, *About Us*, www.franchise-ed.org.au/about-us/ (accessed 17 December 2018).

franchisees. A link to this course is provided in Annexure 2 of the Franchising Code.⁹ The FranchiseED pre-entry course consists of five modules:

- Module One: the Franchising Code of Conduct and role of the ACCC;
- Module Two: disclosure, finance, fees and the franchise agreement;
- Module Three: franchisor support, site and territory selection, retail leasing and marketing funds;
- Module Four: franchise intellectual property, the operations manual, the franchisor/franchisee relationship and dispute resolution; and
- Module Five: due diligence, business skills, franchisee suitability and questions to pose to franchisors, franchisees and ex-franchisees.¹⁰
- Commercially available franchise education services include:
 - The Franchise Advisory Centre, a for-profit educational, consulting and coaching organisation for franchisors and franchisees that offers an introduction to franchising one day seminar.¹¹
 - The Franchise Council of Australia (FCA) provides a 2 hour, 13 module online course called 'Welcome to Franchising' designed for franchisors and franchisees.¹²
- Prospective franchisees are also able to gain some insight into the franchising model by undertaking business related degrees at universities such as the University of Sydney or Griffith University.¹³

Views on mandatory pre-entry education

18.9 It is not compulsory for prospective franchisees to undertake education or training in relation to purchasing a franchise prior to signing a franchise agreement. However, some inquiry participants recommended pre-entry education be made compulsory for prospective franchisees to ensure that prospective franchisees are familiar with their rights and obligations under the contract.

9 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, *Annexure 2*.

10 FranchiseED, *Pre-Entry Franchise Education Program*, www.franchise-ed.org.au/pre-entry-franchise-education-program-introduction/ (accessed 19 December 2018).

11 Franchise Advisory Centre, *Introduction to Franchising*, www.franchiseadvice.com.au/introduction-to-franchising/ (accessed 17 December 2018).

12 Franchise Council of Australia, *Welcome to Franchising*, www.franchise.org.au/welcome-to-franchising.html (accessed 17 December 2018).

13 University of Sydney, *Unit of study: Franchising—CLAW2212*, <https://sydney.edu.au/courses/units-of-study/2018/claw/claw2212.html>, accessed 17 December 2018; Griffith University, *Bachelor of Business*, <https://degrees.griffith.edu.au/Program/2088/Courses/Domestic#course-list>, (accessed 17 December 2018).

18.10 For example, the Office of the New South Wales (NSW) Small Business Commissioner observed that a majority of prospective franchisees do not have the necessary skills to comprehend the documentation provided to them:

...irrespective of the accuracy or detail of the documentation prescribed by the Code, the majority of prospective franchisees lack the business and educational background necessary to properly appraise it, or to conduct adequate due diligence. In many franchise networks, 25% or more of all franchisees are of a culturally and linguistically diverse background suggesting a fundamental linguistic barrier to comprehending the prescribed documentation may also apply in many cases.¹⁴

18.11 The Office of the NSW Small Business Commissioner therefore argued that education and training should be developed and provided by the ACCC and be made mandatory under the Code:

The Code should require prospective franchisees that have not previously entered into a franchise agreement to undertake education on the risks of franchising, the nature of franchise agreements, and basic due diligence and financial literacy. The ACCC should develop this training and offer it at no or low cost, on an ongoing basis.¹⁵

18.12 Dr Jenny Buchan, an academic in franchise law, noted that before entering a franchise, franchisees are not required to consider how a franchisor's decisions can impact upon their business, which can be particularly damaging if the franchisee is bound by multiple long term contracts, such as leases and supply agreements:

Thus, there is no requirement for a franchisor (or franchisee) to consider the impact of strategic decisions on its franchisees. Franchisees are expected to trust that the franchisor will act in such a way as to enhance the brand and enable franchisees to prosper. This trust can be misplaced.

A current franchisee could do nothing about any risky strategic decision taken by their franchisor, even if they became aware of it. They are locked into a long-term franchise agreement, and to consequential leases, supply agreements and other contracts.¹⁶

18.13 Ms Nicole Simmons, a former franchisee, suggested a pre-entry education course should be mandatory if the franchisee signed a document acknowledging their right to seek legal advice and declined to get that advice:

A short course regarding your rights and obligation under the Code should be offered...to franchisees prior to purchase. The outline and other details of the short course should be provided to franchisees with the disclosure document. This course should be mandatory for prospective franchisees if

14 Office of the NSW Small Business Commissioner, *Submission 49*, p. 5.

15 Office of the NSW Small Business Commissioner, *Submission 49*, pp. 1, 6.

16 Dr Jenny Buchan, *Submission 16*, p. 5.

they waived their right to legal advice regarding disclosure documents or the contract.¹⁷

18.14 Kentucky Fried Chicken offered general support for the development of policies which required new franchisees to undertake education relating to the risks associated with franchising:

We will support in principle further regulation, policies and initiatives that...require new and inexperienced franchisees to receive proper professional advice and education on the risks associated with franchising before purchasing a franchise for the first time.¹⁸

18.15 While the FCA did not recommend mandating pre-entry education, it observed that completing the course may reduce the incidence of disputes:

Although the FCA stops short of recommending mandatory pre-entry education, it should be noted that franchisors who voluntarily require completion of such courses as a pre-requisite anecdotally report lower instances of disputation.¹⁹

18.16 Other submitters favoured proposals which drew prospective franchisees' attention to education material. For example, the Franchise Advisory Centre argued that the URL to the FranchiseED pre-entry program ought to be displayed on each page of the disclosure document provided by the franchisor, and that the program be referenced in the mandatory risk statement:

It is recommended that a few words encouraging people to undertak[e] the program and its URL be required to be displayed at the bottom of each page of a franchise disclosure document, in addition to its very small reference in the Mandatory Risk Statement currently outlined in the Code. Franchisors should also be required to include a link from their websites to the program.²⁰

18.17 The Franchise Relationships Institute argued that educational resources focusing on how franchisors and franchisees can improve the management of their relationship would be useful:

An online education program on franchise relationship management would be a useful addendum to the current educational tools that are available through the ACCC website.²¹

18.18 Mr Martin Hasselbacher, Director, Policy and Advocacy at the Small Business Development Corporation, argued that the promotion of the currently

17 Ms Nicole Simmons, *Submission 134*, p. 5.

18 Kentucky Fried Chicken Pty Limited, *Submission 60*, p. 4.

19 Franchise Council of Australia, *Supplementary Submission 29.1*, p. 9.

20 Franchise Advisory Centre, *Submission 138*, p. 5.

21 Franchise Relationships Institute, *Submission 47*, p. 4.

available education programs combined with current disclosure provisions is sufficient and that additional mandatory requirements would be a compliance burden for experienced franchisees.²²

18.19 The committee also heard from Professor Elizabeth Spencer, who argued that information depicting the differences between 'good' and 'bad' franchisors would be an important step towards franchisees identifying whether a franchise is a good investment. In addition to advocating the Australian Securities and Investments Commission (ASIC) MoneySmart initiative as an example of a website which provides important consumer information, Professor Spencer suggested running an annual hackathon which identifies problems in franchising and seeks development in the digital space to create a repository of information for people interested in franchising as a business opportunity.²³ Professor Spencer argued that with digital developments, mandated education for prospective franchisees could be done more automatically, including taking the franchisees through potentially unfair contract terms step-by-step.²⁴

Views on mandatory legal and accounting advice

18.20 The committee heard that one way of ensuring prospective franchisees are more informed about the franchise opportunity they have chosen to buy into is to mandate legal and accounting advice for prospective franchisees prior to the signing of a franchise agreement.

18.21 The Queensland Law Society argued that legal and accounting advice should be mandatory for prospective franchisees so that:

- an accountant can evaluate and consider the characteristics of the actual franchised business; and
- a lawyer can ensure an understanding of the end of term arrangements, payment requirements under the franchise agreement, and the consequences of a failure to comply with the terms of the franchise agreement.²⁵

18.22 In contrast, Professor Andrew Terry, an academic in the area of business regulation, argued that it was futile to mandate legal advice because the broad discretionary powers given to the franchisor in the franchise agreement limited the extent to which useful advice could be provided:

...the utility of legal advice is compromised by the existence of broad discretionary powers in the franchise agreement which limit the advising lawyer's ability to advise other than in unhelpfully general terms...In the

22 Mr Martin Hasselbacher, Director, Policy and Advocacy, Small Business Development Corporation, *Committee Hansard*, 16 October 2018, p. 13.

23 Professor Elizabeth Spencer, Private capacity, *Committee Hansard*, 16 October 2018, p. 7.

24 Professor Elizabeth Spencer, Private capacity, *Committee Hansard*, 16 October 2018, p. 8.

25 Queensland Law Society, *Submission 48*, p. 4.

face of such 'broad discretionary powers' there is little the advising lawyer can do apart from advising prospective franchisees that there are broad discretionary powers which the franchisor may exercise. Whether these powers will be exercised wisely or unwisely is beyond the jurisdiction of the lawyer.²⁶

18.23 Dr Alex Malik, a former Senior Investigator with the ACCC who worked on several complex franchise investigations, contended that it would be difficult to force prospective franchisees to seek advice:

In the case of a would-be franchisee who expresses a refusal to seek out qualified, competent and independent advice, it is unlikely that any additional Government regulations could have forced them to seek out such advice and implement such advice.²⁷

18.24 Ray White, a real estate franchisor, took the view that legislating to require franchisees to obtain mandatory pre-entry legal advice was not justified:

Information statements provided to franchisees already warn them to take appropriate legal, accounting and business advice. This same warning is prudent for anyone intending to commence business. As it is, the standard in the franchise sector is currently higher.²⁸

Standards for legal and financial expertise in franchising

18.25 Some submitters to the inquiry were concerned about legal practitioners, accountants and financial advisers who lack sufficient knowledge and experience in franchising, providing advice to franchisees and prospective franchisees.

18.26 The Business Law Section of the Law Council of Australia (Law Council) advised the committee that it was concerned franchisees were getting advice from advisors with limited experience in franchising matters:

An issue of concern to Committee [Small and Medium Enterprise Committee, Business Law Section] members is the high incidence of franchisees obtaining franchising advice from advisors with limited or in some cases no experience in franchising matters. As a result, the advice received by many franchisees has been of limited value in terms of the franchisee being able to make an informed decision about whether to enter into the franchise agreement.²⁹

26 Professor Andrew Terry, *Submission 108*, p. 6.

27 Dr Alex Malik, *Submission 103*, p. 4.

28 Ray White, *Submission 31*, p. 6.

29 Law Council of Australia, Small and Medium Enterprise Committee, Business Law Section, *Submission 59*, pp. 5–6.

18.27 Mr Derek Sutherland, a lawyer with long experience in the franchise sector, also observed that inexperienced lawyers and accountants can misinterpret disclosure requirements:

In my view franchisors, lawyers and accountants who are inexperienced are more likely to misinterpret disclosure items and what information they are required to give and their code compliance obligations.³⁰

18.28 The Law Council also noted franchisees were sometimes reluctant to heed the advice provided to them:

Unfortunately, it is also our member's experience that many franchisees who do receive appropriate independent advice, do not heed that advice if it conflicts [with] their pre-existing desire to enter into the particular franchise agreement.³¹

18.29 Dr Courtenay Atwell, an individual who has conducted research on the business format franchise model, proposed that each state and territory law society and all professional accounting bodies in Australia 'establish an accredited specialist status that recognises members who have a requisite level of expertise in the franchise business model'.³²

18.30 Dr Atwell also recommended prospective franchisees be required to obtain advice from an accredited professional and suggested the Code be amended so that:

Section 10 of the Franchising Code of Conduct establishes compulsory advisory provisions that require franchisees to consult with legal practitioners or accountants who are accredited specialists in the business model.³³

18.31 Similarly, the Victorian Small Business Commission submitted that:

- the franchisee be obliged to provide a certificate that legal advice has been sought prior to entering an agreement; and
- a process of specialist accreditation be developed with regulation on who can provide advice.³⁴

Committee view

18.32 Evidence to the inquiry from a range of stakeholders highlighted the important role of education in equipping prospective franchisees with the knowledge and skills to better inform themselves about the risks and responsibilities inherent in

30 Mr Derek Sutherland, *Submission 53*, p. 14.

31 Law Council of Australia, Business Law Section, *Submission 59*, pp. 5–6.

32 Dr Courtenay Atwell, *Submission 1*, pp. 3–4.

33 Dr Courtenay Atwell, *Submission 1*, pp. 3–4.

34 Victorian Small Business Commission, *Submission 38*, p. 4.

becoming a franchisee. It is apparent that many prospective franchisees lack the skills and experience to understand those risks. Further, the committee is concerned that some franchisees have not applied the necessary scepticism to a franchise opportunity and have not undertaken sufficient due diligence or sought sufficient and appropriate legal or accounting/business advice. Indeed, several submissions showed that prior to entering a network, many franchisees were not aware of the level of risk to which they would become exposed after signing the franchise agreement.

18.33 During the inquiry, the committee became aware that a small number of individuals appeared to exercise significant influence over the franchising sector in areas that included the provision of education to franchisees and the ACCC consultative committees. There is a risk, therefore, that the franchisors' perspectives and interests as espoused by this group, have overly influenced not only the educational material provided to franchisees but also the construction of the Franchising Code, research studies of the sector, and the past regulatory approach to the sector. For these reasons, the committee recommends below that the educational resources accessed through the ACCC website are both comprehensive and independent.

ACCC franchisee manual

18.34 The committee notes the ACCC's franchisee manual provides foundational material for prospective franchisees looking to purchase a franchise. That said, the franchisee manual only goes a small way towards warning franchisees about the risks of entering a franchise. Nevertheless, the committee considers that the ACCC franchisee manual should be provided to prospective franchisees by the franchisor at the time the disclosure document is first provided to the franchisee. To this end, the committee recommends that the Franchising Code be amended to make this a requirement.

FranchiseSmart website

18.35 The committee considers that the material made available to prospective franchisees should be far more comprehensive and cover the risks, rewards, and responsibilities of being a franchisee. Such material should aim to improve the business literacy of prospective franchisees.

18.36 In this context, it is useful to consider an analogous problem from the financial services sector where part of ASIC's role has been to improve financial literacy. ASIC's MoneySmart website is central to this task. ASIC's MoneySmart website has a series of categories for different products. Typically, the product is described, and how it works is explained, usually with an example. Then the risks are explained, often followed by a case study of where something went wrong. There may also be advice from a respected and independent expert. This is usually followed by some tips on what to check, what to do, and what to avoid.

18.37 The committee considers that ASIC's MoneySmart website could serve as a useful template for the development of a more comprehensive guide to franchising.

The committee considers it particularly important that case studies form part of the website, including examples of franchisee failure. The committee does not view the items listed in the dot points below as exhaustive. However, based on the issues that have arisen during this inquiry, many of which are covered in various chapters of this report, the committee considers that the website should include examples covering contract items and the associated detrimental effects that could result for the franchisee if the franchisor exercised their contractual rights, including:

- the franchisee's right to exclusive territory and the potential effect of territory splitting by the franchisor;
- franchisor restrictions on the choice of suppliers the franchisee may use and how this may financially impact franchisees, in particular regional franchisees;
- franchisor competition with the franchisee through corporate stores, and online sales in the franchisees' geographical area;
- the various fee structures franchisors may utilise and the potential impact of multiple fees owed to the franchisor or third parties such as royalties, rebates and separate operational fees on a franchisee's business, particularly during an economic downturn;
- common oversights made by franchisees associated with retail leases, including not accounting for the significant mid- or end-of-lease capital expenditure, and franchisee detriment when the franchisor withholds franchisee lease payments from the lessor;
- financial impacts on the franchisee when a franchisor considers significant and immediate capital expenditure by the franchisee necessary for the franchised business, including how such decisions may financially impact a new business that already has substantial start-up debt, or a franchisee's financial position approaching the end of the term of the franchise agreement;
- liabilities for franchisees if multiple contract terms exist but have separate end of term dates with no guarantees of renewal;
- identifying if and how a franchisor may churn unprofitable sites in its network;
- how changes to franchisor ownership and control can affect franchisees, including through public listing, private equity buy out, or administrator involvement;
- liabilities for different franchisee businesses, such as for a sole trader, partnership or company; and
- the extent to which restraints of trade could be applied after the conclusion of the franchise agreement.

18.38 The committee recommends the ACCC develop a FranchiseSmart type website with a similar design and purpose to ASIC's MoneySmart website to address issues that franchisees may encounter within the franchise sector. To be clear, the

committee is firmly of the view that, in order to display the requisite independence from industry, the website should be developed and administered by the ACCC.

Legal and accounting advice

18.39 The committee considers it vital that prospective franchisees obtain professional and informed legal and accounting advice before entering into a franchise agreement or contracts related to a franchise opportunity. The committee recognises the concerns raised by the Law Council of Australia that some prospective franchisees appear to be obtaining advice from advisers who have little knowledge or experience in franchising and that this may influence the quality of advice received. The committee considers that when seeking legal advice, a prospective franchisee should engage a lawyer with relevant expertise in the area, such as a contract lawyer.

18.40 The committee acknowledges that prospective franchisees hopeful about a new franchise opportunity are more likely to ignore advice which conflicts with their pre-existing desire to enter into a franchise agreement. However, the committee is conscious of the arguments advanced by some submitters that the utility of legal advice may be compromised by the existence of broad discretionary powers in the franchise agreement which in turn limit the advising lawyer's ability to advise other than in general terms. Lawyers have a professional duty to act in the best interest of their clients. Given that the fee for service would increase considerably if lawyers negotiated terms in a franchise agreement at length, it appears likely that a client's instructions would generally be restricted to explaining the impact only. As pointed out in chapter 9, this underscores the importance of the new provisions regarding unfair contract terms. For these reasons, while the committee considers that informed legal and accounting advice is vitally important, it is not persuaded that mandating pre-entry legal and accounting advice would necessarily improve outcomes for franchisees.

Recommendation 18.1

18.41 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require the franchisor to provide a prospective franchisee with the Australian Competition and Consumer Commission franchisee manual at the time the franchisor first provides the disclosure document to the prospective franchisee.

Recommendation 18.2

18.42 The committee recommends that the Australian Competition and Consumer Commission develop a FranchiseSmart type website with a similar design and purpose to the Australian Securities and Investments Commission MoneySmart website to address issues that franchisees may encounter within the franchise sector, including examples of detrimental outcomes experienced by franchisees, information on Australian Fair Work rights, minimum wage laws and Awards, and provisions that apply to migrant workers.

18.43 The committee considers that the Australian Government amend should amend the Franchising Code of Conduct to provide that a reasonable estimate of the personal workload, in term of hours worked, required by the franchisee (or their nominee or manager) to ensure the business' performance, is disclosed to prospective franchisees in the disclosure documents.

Recommendation 18.3

18.44 The committee recommends that the Australian Government amend the Franchising Code of Conduct to require, as part of mandatory disclosure, a reasonable estimate of the personal workload to be undertaken by the franchisee (or their nominee or manager) in running and operating the franchise business).

Chapter 19

Financing and lending

Introduction

19.1 This chapter focuses on the lending practices of banks and other financial intermediaries. A franchise system typically relies on capital input from prospective franchisees to grow the overall business. When a new franchisee purchases the license to operate a brand for a defined period of time, the growth of the overall system is, to a large extent, funded by the franchisee. In this funding scenario, the franchisee takes on most of the financial risk.

19.2 Further, franchisors receive additional revenue from the increase in royalties that accrue when they assist franchisees to grow already existing franchises within the system. However, franchisors may receive more revenue and derive greater profits by collecting the additional start-up and other fees paid as a consequence of growing the total number of outlets within the system. This situation creates an incentive for the franchisor to devote resources to increasing the number of outlets rather than employing sufficiently experienced area managers to assist existing franchisees to grow their businesses. Listed public company franchisors have an added incentive to grow outlet numbers and maximise profits in order to increase shareholder returns.

19.3 Against this background of financial risk accruing largely to the franchisee, the committee sought to understand the role played by banks and financiers in the franchise sector. The committee notes that the role of banks in the franchise sector has received little examination in previous reviews of the sector. In particular, the committee examined allegations made by some submitters that banks had not conducted comprehensive assessments before approving business loans for franchised businesses. The potential lack of rigor in assessing a business loan to a prospective franchisee is particularly concerning given the Australian Competition and Consumer Commission (ACCC) observation that, if a prospective franchisee gets approval for a loan, they may take the approval as an indication that the business is indeed sound and the franchisee is therefore far more willing to proceed with a franchise agreement.¹

19.4 In light of the above, the committee also sought information on the delinquency rates (in excess of 90 days overdue) for different small business bank lending portfolios. Data from the ANZ Bank indicated that the delinquency rate for franchisees was nearly identical to the delinquency rates for non-franchised businesses.² In terms of business failure rates, entering a franchise would appear to be no safer than investing in a non-franchised small business.

1 Mr Scott Gregson, Executive General Manager, Merger and Authorisation Review Division, Australian Competition and Consumer Commission, *Committee Hansard*, 21 September 2018, p. 55.

2 ANZ Bank, Answer to question on notice, 14 September 2018 (received 1 November 2018).

19.5 This chapter begins by examining the assessment of loan applications, including the valuation process, non-bank lending, exit arrangements and loan assessments. The integrity of financial statements is then considered, followed by the nature of franchisor accreditation by lenders. Finally, the chapter examines the issue of responsible lending in franchising.

Assessment of loan applications

19.6 A fundamental element of business borrowing is the proportion of the total purchase price that a lender is willing to loan to the applicant. Evidence to the committee indicated that banks applied a maximum lending ceiling of 50 per cent of the purchase price of a franchise.³

19.7 However, other evidence indicated that the full amount of a franchise purchase price could be borrowed if the prospective franchisee provides equity for the balance. For example, Mr John and Mrs Julia Banks submitted that they were able to obtain a loan for the full price of the franchised business (plus an additional amount to cover unforeseen costs) by securing the loan to their property:

We signed a contract and purchased the store for \$230 000. We had to take out a loan from Westpac for the full amount plus a further \$20 000 for working capital to sustain us through the first couple of months in case we had other required expenditure. We secured this loan with a mortgage over our only asset—a property which we owned outright.⁴

19.8 ANZ Bank informed the committee that while franchisees were provided with unsecured or partially secured term loans amounting to approximately half the value of the franchise, franchisees were also able to raise the equity contribution required by borrowing against other assets, such as investment or residential property, in the form of a business mortgage loan.⁵

Ability to repay a loan and the consequences of using the family home as security

19.9 Significant differences exist between a term and a business mortgage loan. A term loan is typically approved on the basis that the franchisee will have the capacity to repay the loan within the term of the franchise agreement or lease tenure. By contrast, the business mortgage loan can extend beyond the franchise agreement or lease tenure.⁶

19.10 The capacity for a business mortgage loan to extend beyond the term of the franchise or lease agreement can create difficulties because most franchisees spend the term of the initial franchise agreement repaying the term loan. However, the future value of the franchise is largely dependent on the franchisor renewing the franchise agreement for an additional term. If the franchisor does not renew the agreement, the

3 See for example, Mr Rod Nuttall, Answers to questions on notice, 30 August 2018 (received 10 September 2018), p. 3.

4 Mr John and Mrs Julia Banks, *Submission 100*, p. 1.

5 ANZ Bank, Answers to questions on notice, 2 October 2018 (received 22 October 2018), p. 4.

6 ANZ Bank, Answers to questions on notice, 2 October 2018 (received 22 October 2018), p. 4.

franchisee may be left with little, if any, value to sell.⁷ In this scenario, the former franchisee still has a business mortgage loan to repay without the income stream derived from the franchise outlet.

19.11 The criteria that lenders use in order to assess the ability of a prospective franchisee to repay a loan varied, with projected turnover being the most commonly cited criterion. In the event that they have accredited a franchise system, ANZ indicated that it took into account average performance indicators such as gross sales, and variable and fixed expenses.⁸ The National Australia Bank (NAB) stated that its repayment calculations 'are restricted to the proposed turnover during the term of the contract'.⁹

19.12 Mr Rod Nuttall, a former banker with experience in franchise lending, indicated that some franchisees were at significant risk of losing their homes either as a result of loans being tied to homes, or offered on the basis of future cash flow from the business.¹⁰

19.13 For example, Ms Fran Forde, an Endota franchisee, explained that after the relationship with her franchisor broke down, she needed to sell the family home to pay her 'modest' business loan.¹¹

19.14 Similarly, a Gloria Jeans franchisee submitted that the family home was sold following the establishment of a new store which required significant injections of personal funds to continue trading. In addition, the franchisee needed to keep up the loan repayments for the duration of the five year franchise agreement, and was unable to draw a wage for three years. Ultimately, over the five year period, the franchisee incurred a loss of over \$270 000.¹²

19.15 As noted above, banks typically provide a loan based on the capacity of the business to repay it within the term of the franchise or lease agreement. However, one submitter pointed out that in cases where the franchisor was the head lessor, if the franchisor terminated the lease agreement part way through the term, the franchisee would lose both the business and income stream, and be left with the balance of the loan to repay:

7-Eleven has the head lease and provides the bank a deed/assurance about the franchisees continuity in [the] operating the store. Based on this deed, the banks fund the loans for the term of the store agreement and the store lease. This is a risk if 7-Eleven terminates the lease through variation

7 See, for example, Levitt Robinson, *Submission 143*, pp. 4–5.

8 ANZ Bank, Answer to questions on notice, 2 October 2018 (received 22 October 2018), p. 4.

9 National Australia Bank, Answer to questions on notice, 26 September 2018 (received 29 November 2018), p. 3.

10 Mr Rod Nuttall, Private capacity, *Committee Hansard*, 24 August 2018, p. 10; Mr Rod Nuttall, Answer to questions on notice, 30 August 2018 (received 10 September 2018), p. 3.

11 Ms Fran Forde, *Submission 15*, p. 9.

12 Name Withheld, *Submission 160*, p. 1.

clauses applied as and when 7-Eleven thinks fit for their commercial interest...¹³

19.16 A different perspective on loan repayment was put forward by Mr Derek Sutherland, a lawyer with long experience in the franchise sector. He contended that some franchisees may have excessive debt burdens and engage in irresponsible borrowing and dubious repayment practices:

In some cases franchisees deliberately do not pay down business debt, they may borrow from family and friends (and not disclose this to a franchisor) or prefer to use their money from the business to reduce non deductible house mortgage debt and other non-deductable debt before repaying business debt. As a consequence it may still have a significant business debt to repay at end of term for the business. This can mean that they are not in a financial position to be able to fund a fit out or refurbishment at the time of renewal. It can often lead to disputation and non-renewal...Excessive borrowings and poor repayment practices can also lead to a higher risk of failure and insolvency.¹⁴

Valuations of prospective franchise businesses

19.17 Another issue that arose during the inquiry is the extent to which lenders conduct an evaluation of a prospective franchise business and, by extension, the ability of a prospective franchisee to repay a loan. The committee notes that similar issues have arisen at the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) with respect to small business lending.

19.18 Valuation processes for prospective franchisees' businesses differed between banks. ANZ indicated that valuations are only conducted for businesses valued above \$1 million:

ANZ utilises the actual contract of sale price as the indicative valuation up to \$1m, again noting that credit approvers may require an external valuation.¹⁵

19.19 NAB confirmed that it obtains independent valuations for franchise units over \$500 000.¹⁶ The Commonwealth Bank of Australia (CBA) stated that it completes an internal assessment of the franchise unit value as part of the credit assessment process.¹⁷

13 Name Withheld, *Submission 193*, p. 2.

14 Mr Derek Sutherland, *Submission 53*, p. 6.

15 ANZ Bank, Answer to questions on notice, 2 October 2018 (received 22 October 2018), p. 3.

16 National Australia Bank, Answer to questions on notice, 26 September 2018 (received 29 November 2018), p. 4.

17 Commonwealth Bank of Australia, Answer to questions on notice, 26 September 2018 (received 25 October 2018), p. 2.

Non-bank lending and broker-facilitated lending

19.20 The committee received evidence that raised concerns about loans arranged by franchisors. Some submitters described instances where a bank, having conducted the necessary due diligence, refused to grant a loan to a franchisee, particularly with respect to expenses incurred during the term of the franchise agreement. In these instances, the franchisor recommended alternative lenders where franchisees could source funds.

19.21 For example, Mr Santoshkumar Rajput, a Retail Food Group (RFG) franchisee, submitted that when he wanted to purchase a second Michel's Patisserie outlet, the loan application was declined by ANZ because they did not consider the new business would support the required loan repayments. And yet the franchisor referred Mr Rajput to an alternative lender who approved the loan with minimal due diligence:

When we [applied] for another business loan from ANZ we got rejection straight away as ANZ found the new business [had] no potential to pay off the loan but RFG was very desperate to [sell] that store so when I informed them they straight away suggest me private financial lender AXESSTODAY and informed me that they have lots of tax advantage loans available and easy to get those loan as they tied up with RFG and they literally approved my loan of 200k in just few days without much documents at all. After purchasing that store I came to know that previous owner was about to close that shop as his shop was very [quiet] and he was getting financial [assistance] from RFG.¹⁸

19.22 Another submitter recounted an experience with finance arrangements when Domino's Pizza Enterprises required franchisees to upgrade ovens. The franchisee was told that failure to upgrade could constitute an operational breach. The franchisee's loan application was declined by the bank but approved by an alternative lender without conducting any due diligence:

For all the upgrade, bank would not fund anything & rightly so to my store. As business would not be able to meet the monthly installments. But Dominos have companies such as Rentmax—who would fund anything—without any diligence/reasonable care that store has capacity to payback or not. Dominos may fund for 6.9% per annum plus fees.¹⁹

19.23 Mr Jaspal Singh stated that his loan applications to purchase a 7-Eleven outlet were unsuccessful until 7-Eleven management referred him to a broker:

Loan broker provided to me by 7-Eleven head office and he got loan approval from ANZ bank within one week, I tried other banks before but they were not approving my business loan due to lack of sufficient information on store...financials by 7-Eleven head office and concerned about serviceability of loan.²⁰

18 Mr Santoshkumar Rajput, *Submission 106*, p. 4.

19 Name Withheld, *Submission 176*, p. 3.

20 Mr Jaspal Singh, *Submission 104*, p. 2.

19.24 Alternatively, the franchisor may choose to finance the loan where a bank has refused. This arrangement could also include charging higher than market interest rates and requiring guarantors to the loan.

19.25 For example, Mr Robert Verni, another RFG franchisee, described his experience when RFG required him to refurbish his site in line with obligations under the franchise agreement. When the bank declined the loan due to the store's low turnover, the franchisor financed the loan instead, on condition that it was guaranteed by a third party. The committee was told that:

I think it's important to note that the banks would not lend us monies for the refurbishment as our turnover and EBITDA [earnings before interest, tax, depreciation and amortization] were not strong enough. RFG models were not well accepted in the market to lend. As a result, RFG financed the refurbishment at their interest rate and costs, loaning us \$125k. My parents, who were 75 to 80-year-old pensioners at the time and were already guarantors for the business but otherwise had nothing to do with the business, had to be placed on the loan as guarantors. Or RFG would not finance it...My parents...put a \$350k debt against their house...Altogether, my family lost in excess of \$800k+. ²¹

Exit arrangements as part of the loan assessment

19.26 A major difference between franchised and non-franchised business is the exit arrangements embodied in franchising. As noted in chapter 11, exit arrangements represent a significant, but not necessarily well-understood, strategic risk for franchisees. Franchisees can experience significant difficulties when they try to exit a franchise system prior to the expiry of the franchise agreement.

19.27 The committee sought to understand the extent to which banks examine the exit arrangements in franchise and lease agreements when deciding whether to grant loans to prospective franchisees.

19.28 The committee heard that NAB 'considers both primary and secondary exits when assessing the loan applications for franchisees'. ²² The CBA considers exit arrangements for franchisees in accredited and non-accredited systems in the structure of the loan provided. However, CBA does not require prospective franchisees to provide an exit strategy as part of their proposed business plan because 'in the majority of franchisee contracts, the debt amortizes to nil within five to seven years'. ²³ Likewise, ANZ does not require an exit strategy as part of their loan applications. ²⁴ CBA indicated that it dealt with the possibility of non-renewal of the franchise or

21 Mr Robert Verni, *Submission 102*, pp. 3, 5.

22 National Australia Bank, Answer to questions on notice, 26 September 2018 (received 29 November 2018), p. 3.

23 Commonwealth Bank of Australia, Answer to questions on notice, 26 September 2018 (received 25 October 2018), p. 2.

24 ANZ Bank, Answers to questions on notice, 2 October 2018 (received 22 October 2018), p. 5.

lease agreements by structuring the loan so that repayments are aligned to the term of whichever agreement is expected to conclude first.²⁵

19.29 Mr Rod Nuttall stated that lenders did not account for exit arrangements or require franchisees to incorporate an exit strategy into the business plan:

The market forces for resale of the business are not understood in any accurate depth as there is little consistent robust data kept on the matter. To consider exit arrangements system-kept data on resale, including failure, walkout or resale to franchise need to be kept. The most informed party would be the franchisor however there is no requirement, and potentially no incentive to them to keep such records. In any case that is generally something not disclosed even if kept by the franchisor. Some franchisors will suggest that they attempt to remain neutral with the resale market however they remain highly influential with the fact they must still approve the incoming franchisee. This is a significant imbalance of risk that franchisee business has with non-franchise businesses.²⁶

Integrity of financial statements and information

19.30 The committee heard concerns about the accuracy and reliability of financial information provided in disclosure documents and agreements related to the purchase of a franchise. Some submitters attested to the difficulty that lenders face when assessing financial information provided to them, because clauses in the disclosure document or franchise agreement state that none of the financial information can be relied upon. As discussed in chapter 6, such clauses are used by franchisors to effectively release them from liability in the event that financial figures are discovered to be inaccurate.²⁷

19.31 Franchisees are often surprised by the cost associated with purchasing a franchise. The ACCC stated that 'it is not uncommon for franchisees to raise concerns about higher than expected costs' and that some franchisors provide very broad cost ranges in their disclosure documents.²⁸ The ACCC observed that:

The effect of this practice is that prospective Franchisees end up receiving 'almost meaningless' information, with costs able to vary by hundreds of thousands of dollars.²⁹

19.32 Some submitters also pointed out that a lack of adequate recordkeeping processes could have an impact on a lender's decision. Mr Rod Nuttall observed that both the bank and the franchisee rely on meaningful and accurate data being provided by the franchisor. However, the level of accuracy and disclosure can vary

25 Commonwealth Bank of Australia, Answer to questions on notice, 26 September 2018 (received 25 October 2018), p. 3–4.

26 Mr Rod Nuttall, Answer to questions, 30 August 2018 (received 10 September 2018), p. 5.

27 See, for example, Franchise Advisory Centre, *Submission 138*, p. 1; Mr Emmanuel Martin, *Submission 118*, p. 3; Mr Michael Terceiro, *Submission 124*, p. 2.

28 Australian Competition and Consumer Commission, *Submission, 45*, p. 9.

29 Australian Competition and Consumer Commission, *Submission, 45*, p. 9.

considerably. Mr Nuttall also observed that franchisees experiencing financial difficulty are unlikely to provide accurate financial information for assessment.³⁰

Franchisor accreditation with lenders

19.33 During the inquiry, the committee heard that some lenders provide accreditation to a number of franchise systems. Lenders may decide to accredit a franchise system if the franchisor has undertaken an in depth review process and provided the lender with confidence in the reliability of the franchise system.

19.34 Mr Darryn McAuliffe, Chief Executive Officer of FRANdata Australia, provided insight into what banks look for in the accreditation process, stating:

The four major banks will typically look for a couple of hurdles to be met. Generally, they're looking for five years of operation, 50 outlets, a minimum business-lending amount that's there and then they will review probably 10 different components to decide whether they think that brand is an acceptable risk profile or someone they would like perhaps to write more transactions to than brands they don't know—things like how they recruit franchisees; how they pick their sites; how they train their franchisees; how they support them; what the strength of the franchisor is like; what the unit performance looks like; what the secondary market is, if it's available—those types of things that suggest a better risk profile. Compliance is important now, as well...³¹

19.35 However, Mr McAuliffe also informed the committee that franchisors could lose their accreditation status under the following circumstances:

- when the bank does not write enough business;
- when the bank encounters poor loan performance; or
- when the bank encounters poor behaviour by the franchisor in supporting new franchisees.³²

19.36 The CBA informed the committee it considers the following information prior to making a decision about accreditation:

- business model;
- business growth plan including key statistics on number of stores, stores per operator;
- key competitors, substitutes, product maturity, legal and regulatory environment;
- management structure and capability;
- strategic, financial and operational objectives;

30 Mr Rod Nuttall, Answer to questions, 30 August 2018 (received 10 September 2018), p. 4.

31 Mr Darryn McAuliffe, CEO, FRANdata Australia Pty Ltd, 29 June 2018, *Committee Hansard*, p. 67.

32 Mr Darryn McAuliffe, CEO, FRANdata Australia Pty Ltd, 29 June 2018, *Committee Hansard*, p. 65.

- general financial performance of system—last three years including underperformance of stores;
- non-performing stores and treatment;
- financial and operational risk management and reporting back to franchisor;
- corporate governance; and
- recruitment and onboarding/selection criteria.³³

19.37 CBA informed the committee that, in the past 5 years, the bank had de-accredited 13 franchise systems for various reasons including:

- changes in key management;
- corporate and support structure concerns;
- concerns over management;
- decrease in assessed credit quality; and
- low rate and/or quality of applications.

19.38 ANZ confirmed it has 70 franchise systems either accredited or ranked as 'preferred' on its panel.³⁴ Within its accredited franchise systems, ANZ approved 452 out of a total 593 franchisee loan applications in 2017, a 76 per cent approval rate.³⁵

19.39 ANZ has not removed accreditation from a franchise system in the last five years. Instead, where concerns were raised about a system, the bank changes its lending policy in relation to that system. This practice, ANZ argued, 'allows us to continue to obtain information about the overall performance of the franchise system which our existing customers may be part of.'³⁶

19.40 NAB noted that an assessment of whether the franchise system provides assistance to underperforming franchisees was a key factor in the accreditation process.³⁷ NAB stated that in the previous three years, the bank had reduced the number of accredited brands from approximately 35 down to 12 brands, primarily in food retail.³⁸ NAB also indicated that in recent years, it had only approved about half

33 Commonwealth Bank of Australia, Answer to questions on notice, 26 September 2018 (received 25 October 2018), p. 1.

34 Mr Mark Lang, General Manager, ANZ Bank, *Committee Hansard*, 14 September 2018, p. 1.

35 Mr Mark Lang, General Manager, ANZ Bank, *Committee Hansard*, 14 September 2018, p. 2.

36 ANZ Bank, Answers to questions on notice, 2 October 2018 (received 22 October 2018), p. 2.

37 National Bank of Australia, Answer to questions on notice, 26 September 2018 (received 29 November 2018), p. 4.

38 National Bank of Australia, Answer to questions on notice, 26 September 2018 (received 29 November 2018), p. 1.

the prospective franchisee loan applications with these accredited brands as a result of the bank's assessment of the franchisee's ability to repay the loan.³⁹

Efficiencies derived from accreditation

19.41 The committee heard that accreditation of franchise systems provides benefits for both lenders and franchisors.

19.42 Accreditation of franchise systems is cost effective for lenders. This is because a large portion of the information relating to the franchise system banks require when assessing loans to franchisees can be accessed internally by bank managers. This limits the need for additional work on behalf of the bank manager and the franchisee. Mr Mark Lang, General Manager of Business and Private Banking at ANZ Bank, set out the benefits of processing a franchisee's loan application when the franchise system is accredited:

Where we have accredited or panel systems, it's a repository of information. If one of our managers is talking to somebody in a panel system, they can go online and access the sort of information...so they start off with a good information base as they start to put together the loan application. And...if it's non-panel, we literally have to start from ground zero and build up that level of information.⁴⁰

19.43 Accreditation also benefits franchisors. RFG stated it was a 'fair representation' to characterise the accreditation process as making sure that one or more banks have a good understanding of how the franchise system works in advance so that the bank is best able to make a whole assessment.⁴¹

19.44 The Foodco Group acknowledged accreditation assisted the lending process, noting that it 'facilitates a smoother lending process in a franchise relationship'.⁴²

19.45 CBA held the view that accreditation provides efficiency to the lending process. However, CBA acknowledged that accreditation did not necessarily provide a financial benefit to the franchisee:

Accreditation itself does not give a customer preferential pricing treatment. However, through familiarity with the system there may be time efficiencies and improved pricing of risk, which could result in a more cost-effective outcome for the customer.⁴³

39 National Bank of Australia, Answer to questions on notice, 26 September 2018 (received 29 November 2018), p. 4.

40 Mr Mark Lang, General Manager, ANZ Bank, *Committee Hansard*, 14 September 2018, p. 10.

41 See the exchange between Mr Matt Keogh MP and Mr Richard Hinson, CEO, Retail Food Group, *Committee Hansard*, 11 September 2018, p. 12.

42 Foodco Group Pty Ltd, Answers to questions on notice, 14 September 2018 (received 15 October 2018, p. 6.

43 Commonwealth Bank of Australia, Answer to questions on notice, 26 September 2018 (received 25 October 2018), p. 2.

Understanding the significance of accreditation

19.46 The committee heard that there is the potential for prospective franchisees to misunderstand the significance of accreditation. In some instances, franchisees interpreted accreditation to mean that the bank has verified and endorsed the franchise opportunity. This in turn raised concerns that accreditation may be being used by franchisors to sell the franchise to prospective franchisees. Mr Rod Nuttall explained:

The franchisor receives a significant endorsement of that brand because a major bank has apparently performed a rigorous examination of the success factors of acquiring a franchise unit. This is quite a powerful endorsement for the franchise, and a significant one...that is potentially underestimated.⁴⁴

19.47 For example, a submission on behalf of a number of Australia Post franchisees stated:

Franchisees report that they attended meetings with various Australia Post Franchise managers where the bank accreditation was highly promoted. Some attended meetings accompanied by accountants, business advisors and the representation was repeated in their presence.⁴⁵

19.48 Australia Post has confirmed they have accreditation with at least one of the four major banks.⁴⁶ The committee was unable to draw a conclusion on whether Australia Post had misrepresented its accreditation status to prospective franchisees at the time of selling the franchises.

Potential conflicts of interest between banks and franchisors

19.49 The committee sought to understand how the banks deal with any potential conflicts that may arise, given that the bank may be providing loans to both the franchisor and its franchisees.

19.50 ANZ explained that potential conflicts of interest are mitigated by the separation of the divisions that work with franchisors and franchisees:

Different areas of ANZ deal with franchisors and franchisee relationship and activities. The national franchising unit manages panel franchise systems, but not the banking relationship. Small business banking manages banking relationships with individual franchisees under \$1 million. ANZ Institutional and corporate bank or business bank units generally manage banking relationships with franchisors, as these are usually large business clients. Separate credit arrangements evaluate small business, business banking or institutional credit in accordance with group credit policies.⁴⁷

19.51 CBA informed the committee that the bank manages potential conflicts of interest in three ways:

44 Mr Rod Nuttall, Answer to questions, 30 August 2018 (received 10 September 2018), p. 3.

45 Mr John Christensen, *Submission 78*, p. 12.

46 Mr David McNamara, Australia Post, *Committee Hansard*, 14 September 2018, p. 26.

47 Mr Mark Lang, General Manager, Business and Private Banking, ANZ Bank, *Committee Hansard*, 14 September 2018, p. 2.

CBA maintains a personal conflicts register and different staff manage relationships between franchisors and franchisees.

CBA requires staff to complete training to understand conflict of interest, including both actual and perceived. The training makes clear that it is incumbent on leadership to identify instances of conflict of interest and the ways staff can mitigate and/or remove/remedy the conflict.

CBA also maintain[s] an independent credit risk function with industry sector specialization.⁴⁸

19.52 Foodco Group informed the committee that there are no commissions or other payments to the franchisor as a result of accreditation and that 'irrespective of the accreditation arrangement, the decision to lend rests solely with the bank'.⁴⁹

Responsible lending

19.53 In the committee's 2015 report on its inquiry into the impairment of customer loans, the committee recommended that:

...responsible lending provisions, including ASIC's [Australian Securities and Investments Commission] monitoring under the National Consumer Credit Protection Act 2009, be extended to small business loans.⁵⁰

19.54 The committee's view at the time was that small business borrowers ought to receive responsible lending protections insofar as 'the protections do not impede businesses that are well informed, have a strong business case and are prepared to back themselves in taking on a venture'.⁵¹ As a result, the committee suggested a threshold test whereby banks would not allow a borrower to exceed an amount unless:

- the borrower is able to demonstrate that they have sought independent advice as to their capacity to manage the extra debt; and
- the borrower is willing to sign a clearly documented front page to the loan contract that informs them of the conditions to which they will be subject if they do not meet the terms of the contract.⁵²

19.55 The committee's recommendation to extend responsible lending provisions to small business has not been adopted. As at 1 February 2019, the government had not responded to the recommendations made by the committee in its 2015 report.

48 Commonwealth Bank of Australia, Answer to questions on notice, 26 September 2018 (received 25 October 2018), p. 4.

49 Foodco Group Pty Ltd, Answer to questions on notice, 14 September 2018 (received 15 October 2018), p. 6.

50 Parliamentary Joint Committee on Corporations and Financial Services, *Impairment of customer loans*, 2016, p. 30.

51 Parliamentary Joint Committee on Corporations and Financial Services, *Impairment of customer loans*, 2016, p. 30.

52 Parliamentary Joint Committee on Corporations and Financial Services, *Impairment of customer loans*, 2016, p. 30.

19.56 The committee's recommendation was examined by Mr Phil Khoury in his report on the *Independent Review of the Code of Banking Practice 2017* commissioned by the Australian Banking Association (formerly the Australian Bankers' Association). Mr Khoury considered that amending the Code of Banking Practice to include responsible lending requirements as prescribed in the *National Consumer Credit Protection Act 2009* (NCCP Act) would 'restrict flexibility in a way that I think would be undesirable'.⁵³

19.57 Accordingly, the draft of 'The Banking Code of Practice' prepared by the Australian Banking Association, which was approved by ASIC and will commence in July 2019, provides that signatories lending to small business adhere to the following commitment:

If we are considering providing you with a new loan, or an increase in a loan limit, we will exercise the care and skill of a diligent and prudent banker.⁵⁴

19.58 The new Banking Code of Practice requires signatories to assess whether a small business can repay the loan by 'considering the appropriate circumstances reasonably known [to the bank] about the applicant's financial position or account conduct'.⁵⁵

19.59 However, the Banking Code of Practice does not place conditions on a bank to form an opinion about the applicant's ability to repay the credit facility. Nor does it require a bank to refuse a loan in the event a loan assessment has concluded that the applicant does not have the ability to repay the loan. This position is in contrast to the requirements that apply to consumer loans under the NCCP Act.⁵⁶

19.60 The views of the Royal Commission are relevant to this discussion. Commissioner Kenneth Hayne stated in his Interim Report that he 'did not understand there to be substantial support for changing the legal framework in ways that would bring some or all SMEs [small and medium enterprises] within the application of the NCCP Act'.⁵⁷ The Commissioner summarised the reasons put as to why relevant statutory regimes have remained limited in application for small business lending:

The policy choices that have been made to limit the application of these statutory regimes reflect recognition of the need to ensure small businesses have access to reasonably affordable and available credit. The extension of protections has been judged likely to restrict the circumstances in which banks may lend and likely to limit the banks' capacity to reduce credit risk when they do lend, thus restricting the supply of credit and increasing its cost. This has been seen as especially the case where credit is sought for a new business (for which there can be no trading records) and the lender

53 Mr Phil Khoury, *Independent Review—Code of Banking Practice*, 2017, p. 50.

54 Australian Banking Association, *Banking Code of Practice*, p. 25.

55 Australian Banking Association, *Banking Code of Practice*, p. 25.

56 *National Consumer Credit Protection Act 2009*, ss. 123(2), s. 128–133.

57 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, vol. 1, pp. 164, 180.

seeks security for the loan either from the principals of the business or from a third party guarantor, or, often enough, both. There has been reluctance, therefore, not least on the part of small business owners themselves, to take up proposals for increased protections. And the small business representatives consulted in the course of the Khoury Review of the Code of Banking Practice...said that they did not have concerns about irresponsible lending to small businesses.⁵⁸

19.61 However, during this inquiry, the committee was informed that some banks are applying certain responsible lending principles to small business lending despite the lack of a legislative requirement to do so. In answers to questions on notice, the CBA stated:

Whilst lending to small business currently falls outside the *National Consumer Credit Protection Act 2009* (NCCP), CBA still considers relevant responsible lending principles including:

- (a) the customer's requirements and objectives;
- (b) the customer's financial situation; and
- (c) whether the loan is suitable for the customer's needs.⁵⁹

19.62 The CBA's response raises questions about whether, and if so to what extent, responsible lending provisions should be formally extended to cover small business.

Committee view

Asymmetry of financial risk

19.63 As noted in other chapters, there are inherent asymmetries within franchising. Other chapters have considered the power imbalance between franchisor and franchisee, particularly as manifested through the franchise agreement and the entry and exit arrangements in franchising.

19.64 However, franchising also embodies an asymmetry in financial risk between franchisor and franchisee. Franchise systems typically rely on capital input from prospective franchisees to fund the growth of the overall business. While the committee acknowledges that a franchisor can suffer brand damage and loss of expected income as a result of franchisee underperformance, the franchisee currently takes on most of the financial risk and it appears the franchisor bears little accountability for franchisee failure.

19.65 Further, as noted earlier, the failure rates of franchised and non-franchised businesses are similar. Yet, the funding model of franchising does not adequately connect the franchisor to the financial risks, meaning the franchisor may have little accountability for franchisee failure, and by extension, insufficient incentive to support franchisees in its network or act promptly on franchisee underperformance. Additionally, the franchisor is often able to recoup any losses it has suffered, such as

58 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report*, vol. 1, p. 163.

59 Commonwealth Bank of Australia, Answer to questions on notice, 26 September 2018 (received 25 October 2018), p. 3.

the loss of expected royalties over the term of the franchise agreement, through the pursuit of damages in court.

19.66 Having said that, the committee acknowledges that in many franchise systems, franchisors and franchisees exist in a mutually beneficial relationship. However, as in any asymmetrical relationship, the risk is that the more powerful party may exploit the arrangement. The committee heard a great deal of evidence supporting this.

19.67 Further, evidence during the course of the inquiry indicates that the franchisor derives greater profits from growing the number of outlets than from growing the size of the existing franchises within the system. In this sense, franchising can be seen as an expansion model where the franchisor is incentivised to grow the number of outlets, and has a correspondingly lesser incentive to assist franchisees to grow their businesses.

19.68 A fundamental question therefore arises from the issues set out above: do prospective franchisees really understand the nature of the business they are entering into and, in particular, the financial risks associated with franchising? And flowing on from that, who should bear responsibility, and to what extent, for ensuring that a prospective franchisee assesses the franchise system and the attendant financial risks accurately and borrows accordingly?

19.69 Given the financial risk in franchising typically falls mainly on the franchisee, the committee considers that the role of lenders in the franchise sector and the rules around business lending should receive examination.

Responsible lending

19.70 The Royal Commission considered whether there was substantial support for bringing small and medium enterprises (SMEs) within the application of the National Consumer Credit Protection Act. In particular, the Royal Commission *Interim Report* set out some of the reasons why responsible lending laws had remained limited in application for small business lending, including the view that the extension of protections would likely restrict the supply of credit and increase its cost.

19.71 While the committee is wary of drawing conclusions before the Royal Commission has reported, evidence received during the inquiry is pertinent to this discussion. Firstly, the committee received evidence from the CBA that they already adopt certain responsible lending criteria when assessing a prospective franchisee's ability to repay a business loan. Secondly, the committee received evidence about instances where the major banks declined to provide a loan based on their assessment that the business did not have the capacity to repay the loan within either the term of the franchise or lease agreement. However, in some of these instances, the prospective franchisee still managed to secure a loan, often arranged with the assistance of the franchisor, and often with minimal due diligence. This raises questions about the extent to which irresponsible lending by non-bank lenders to prospective franchisees is occurring.

19.72 In the committee's view, responsible lending sits somewhere between two extremes: overly risk-averse lending and irresponsible lending. To be clear, the

committee does not view responsible lending as risk-averse lending. For example, a lender could make loans to potentially risky businesses, but would still need to satisfy certain criteria regarding the capacity of the business to cover the loan repayments within a defined timeframe. Indeed, on the evidence received, it appears that at least some of the major banks already go through this process. However, the lack of rigor in assessing a business loan to a prospective franchisee by some non-bank lenders is concerning, particularly if a prospective franchisee takes the approval as an indication that the business is indeed sound and signs a franchise agreement on that basis.

19.73 Nevertheless, it would be unreasonable to attribute all the responsibility in these circumstances to the lender. As set out in chapter 18, a prospective franchisee must be responsible for doing its due diligence, including sourcing appropriate legal and financial advice. If the major banks have declined to provide a loan, this is a clear warning to a prospective franchisee that thorough business and financial advice should be sought about the realistic prospects of the intended franchise outlet. It is fanciful for a franchisee to simply accept that a franchisor's offer to help arrange the required finance is always done with the franchisee's best interests at heart. In these instances, some prospective franchisees have acted with a naïve disregard for their own interests.

19.74 However, as some of the evidence examined in the chapter on RFG sets out, particularly with respect to the allegations that RFG churned and burned a certain number of franchisees, a question arises about the extent to which franchisor-assisted lending can be deliberately exploitative. The committee is unable to reach definitive answers on these questions. Yet, given the wider debate about lending to SMEs, the committee considers it important that such questions remain part of the broader discussion, and that serious consideration is given to what appears to be laxer lending standards applied by certain non-bank lenders. Further, if, for arguments sake, the major banks were lending responsibly to prospective franchisees, and effectively acting as gatekeepers, this should help to reduce the incidence of unnecessary franchisee failure and churning in a handful of franchise chains. However, this positive development would be undercut if that same handful of franchisors is able to persuade a franchisee to get a loan through another source.

19.75 In the context of broader debate about responsible lending requirements and the availability of credit to the small business sector, the committee considers it useful to canvas a further related matter. If irresponsible lending is occurring, it risks artificially inflating the value of franchise outlets because a franchise outlet is only worth what a prospective franchisee is willing and able to pay, or borrow, to buy it. If credit standards are too loose, a prospective franchisee may be able to borrow more than would be appropriate based on the business fundamentals. Hence, the value of the franchise outlet could be overvalued. By contrast, responsible lending standards would help prevent unrealistic prices being paid for certain outlets. The committee is aware that a market correction may disadvantage those existing franchisees who borrowed and paid too much for their outlet.

19.76 The committee notes that it has previously recommended that the responsible lending standards in the National Consumer Credit Protection Act be extended to cover small business. Given the matter is currently being considered elsewhere, the committee refrains from making recommendations on this matter at this time.

However, the committee strongly urges policy makers and the broader business community to consider the issues set out here and heed the detrimental consequences, (both on an individual and industry-wide level) of a failure to appropriately apply responsible lending standards to small businesses. Further, the committee notes that because responsible lending provisions do not apply to small business, the regulators do not have a basis on which to take any action in relation to the conduct of those franchisors and certain sections of the lending industry which are engaged in irresponsible lending.

Reliability of financial statements

19.77 The committee is disturbed by evidence from franchisees that the financial information they received prior to signing the franchise agreement was incomplete and/or misleading. The committee notes the view expressed by the ACCC that some of the financial information provided to franchisees with respect to costs is essentially meaningless. The committee is concerned that many franchise agreements and disclosure documents include clauses which provide that profit and loss statements and other financial information cannot be relied upon.

19.78 In the committee's view, a franchisee must have access to accurate financial information prior to signing a franchise agreement. Further, the integrity of financial information and financial statements was a significant issue raised in numerous confidential submissions to the inquiry.

19.79 In this regard, the committee notes that all businesses are required to lodge business activity statements (BAS) with the Australian Tax Office. The committee considers that a BAS is likely to provide a true and accurate picture of a business including revenues, costs, and gross profits. The committee considers that any prospective purchaser of an existing franchise outlet should be given at least the previous two years' BAS as well as the books of the business. Without access to the BAS, a franchisee has no reasonable basis to assess the viability of the business (see recommendation in chapter 6).

19.80 The committee recognises that it is difficult to objectively assess the business prospects for a new franchise outlet because there is no historical financial information. In this case, a prospective franchisee must carefully assess figures provided by a franchisor for purportedly equivalent sites. This is particularly important given the franchise agreements that the committee has seen exclude the franchisor from any liability regarding the accuracy of the figures in relation to the new site (see recommendation in chapter 6).

Loan approvals and exit arrangements

19.81 In this chapter, the committee has discussed the evidence provided by the major banks about loan approvals and the typical expenses incurred when a franchisee exits a franchise system. This evidence raises questions about whether expenditure that is required as part of the end of term arrangements for the franchise or lease is being adequately accounted for when lenders assess the profitability of the business. The committee considers it reasonable for banks to take such expenses (which are significant and usually mandatory) into account alongside start-up and operational

expenses in order to more accurately determine the viability of the business and the franchisee's capacity to repay the loans within the term of the franchise agreement.

Accreditation

19.82 The committee understands that out of the total number of franchise systems operating in Australia, a relatively small proportion are accredited with banks. Further, the banks adopt different business strategies with respect to the accreditation process, including in relation to decisions about whether to maintain the accreditation of a franchise system.

19.83 Evidence to the committee highlighted the advantages to both banks and franchisors of accreditation. However, the committee is aware of the potential for both misunderstanding by prospective franchisees, and misrepresentation by franchisors, of the significance of bank accreditation. The committee would be very concerned if a franchisor was misusing accreditation to market the franchise to prospective franchisees. The committee believes that franchisees should be aware that accreditation does not mean that a bank has verified and endorsed the business model.

Chapter 20

Retail lease arrangements

Introduction

20.1 This chapter examines the impact of increased rental costs, provisions for the disclosure of lease arrangements to franchisees, and franchisee rights as a sub-lessee or licensee of the franchisor. The assessment process conducted by the franchisor to determine whether a franchisee's business can afford rental costs is also considered.

20.2 Retail lease arrangements have a significant impact upon the financial performance of a franchised business. There are different kinds of lease arrangement scenarios, including where:

- the franchisor owns the premises and leases or licences it to the franchisee;
- the franchisor leases the premises from a third party and sub-leases or licences it to the franchisee;
- the franchisee leases the premises directly from a third party without franchisor involvement;
- the franchisee owns the premises; or
- the franchisee owns the building and the franchisor owns the land or leases the land from a third party.

Retail lease arrangements—industry view

20.3 Some franchisors expressed concern that retail lease arrangements had a negative impact on franchised businesses, particularly in major shopping centres. Relevant factors included high rent price increases, large penalties for early termination of the contract, and the refusal of landlords to include exclusivity rights in contracts.¹

20.4 The Franchise Council of Australia (FCA) informed the committee that it held significant concerns around retail lease arrangements, noting the following issues in particular:

- anti-competitive conduct by major shopping centre landlords, who introduce new competitors after agreeing on rental and lease terms without giving the affected tenants the ability to re-negotiate terms or to exit the leases;
- length of lease terms typically limited to five to six years;
- price increases; and

1 Mr Richard Hinson, Chief Executive Officer, Retail Food Group, *Committee Hansard*, 11 September 2018, p. 2; Mr Serge Infanti, Managing Director of Foodco Group Pty Ltd, *Committee Hansard*, 14 September 2018, p. 27; Craveable Brands Pty Ltd, Answer to questions on notice, 14 September 2018 (received 12 October 2018), p. 1.

- the absence of a legal right to terminate the lease leading to penalties of 12 months' rent plus costs or higher following termination.²

20.5 Mr Richard Hinson, Chief Executive Officer of Retail Food Group (RFG), explained the key issues facing franchisee businesses within the RFG network, which were identified from the company's whole-of-business review commissioned in June 2017:

The whole-of-business review highlighted that issues within shopping centres were having a profound impact on our franchisees. Roughly 50 per cent of RFG's franchisee businesses are located in major shopping centres. The issues impacting on franchisees include rapidly increasing operational costs disproportionate to sales. These include rents, utility costs, skyrocketing electricity costs, regulatory and compliance requirements, insurance and staff wages. Additionally, there are unprotected lease terms. Our franchisees commit, in good faith, to a lease and rental and then often find, over the term of the agreement, that new competitors are added to their immediate trading area. This change in tenancy mix is clearly to maintain shopping centre rental yields and their shareholder returns. Overcompetition impacts on the profitability of long-term tenants.³

20.6 Some franchisors noted that significant loss could be incurred by the franchisor when it is a party to the lease if the lease is breached or terminated early as a result of a franchisee's inability to cover costs.⁴ Mr Serge Infanti, Managing Director of Foodco Group, highlighted the material impact of high penalties incurred by the franchisor due to early termination of the contract:

A franchise business that is unable to pay rent creates an immediate liability for us as the head lessee. Failure to pay rent can result in the lessor terminating the lease and recovering unpaid rent and damages from us...Where a franchisee is facing financial challenges due to events outside of their control, we endeavour to assist by way of proactively approaching lessors for rent abatement and offering reduced royalties, increasing operational support and offering rental assistance. In the event a lease is terminated either by mutual consent or by the lessor terminating, then it is Foodco—not the franchisee—that pays the surrender fee, which could be upwards of \$250,000 depending on the remaining term of the lease. Foodco often does not pursue the franchisees for these fees.⁵

20.7 Craveable Brands agreed that significant losses can be incurred by the franchisor when a franchisee requires rent assistance, observing that:

2 Franchise Council of Australia, *Supplementary submission 29*, p. 4.

3 Mr Richard Hinson, Chief Executive Officer, Retail Food Group, *Committee Hansard*, 11 September 2018, p. 2.

4 Mr Richard Hinson, Chief Executive Officer, Retail Food Group, *Committee Hansard*, 11 September 2018, p. 2; Mr Serge Infanti, Managing Director of Foodco Group Pty Ltd, *Committee Hansard*, 14 September 2018, p. 27; Craveable Brands Pty Ltd, Answer to questions on notice, 14 September 2018 (received 12 October 2018), p. 1.

5 Mr Serge Infanti, Managing Director of Foodco Group Pty Ltd, *Committee Hansard*, 14 September 2018, p. 27.

...we generally take on the head lease of the store and then grant our franchisees a licence to occupy the store on the same terms and conditions as to rent etc. In those instances where we provide rent relief to a franchisee we continue to pay our landlord the full rental payable under our head lease but only recoup part of the rental from our franchisee (meaning Craveable Brands is directly out of pocket).⁶

20.8 Mr Andrew Gregory, Managing Director and Chief Executive Officer of McDonald's Australia (McDonald's), noted that in cases where increases in rent are considered too high, the franchisor and franchisee have made a joint decision to close the store. Mr Gregory stated:

...sometimes we agree with the franchisee to close a restaurant as a result because either the rent increase is too high or the level of competition in the shopping centre has become so great that sales have deteriorated. We make the shared decision with the franchisee to close that particular restaurant.⁷

20.9 Mr Gregory also acknowledged that the level of investment required for a McDonald's restaurant, including the input of significant upfront capital, meant that a short term lease would not be successful for the system, with McDonald's instead preferring 15 to 30 year leases. The franchise therefore 'just wouldn't open a restaurant in a three- to five-year lease situation' with the risk of price increases and non-renewal.⁸

20.10 Dymocks Franchise Systems (NSW) (Dymocks) warned that landlords may be churning tenants, stating:

Landlords appear increasingly less concerned with maintaining an appropriate retail mix in a centre to ensure that all tenants are viable. The endless churning of similar and competing offers mean that the sales of all retailers are diluted and the viability of many small businesses prejudiced. No retailer expects a monopoly on their use within a centre. However, when significant economic decisions are being made based on a current state of affairs (the landlord's current retail mix) there is an expectation that the landlords will not adversely affect the trading mix without some allowance to existing tenants. At present this is not the case.⁹

20.11 Dymocks argued that the Franchising Code of Conduct (Franchising Code) was not the appropriate place to deal with leasing regulation however:

...improved regulation of retail leases would assist to protect franchisees against the churning of retail tenancies, dilution of retail mix and the lack of

6 Craveable Brands Pty Ltd, Answer to questions on notice, 14 September 2018 (received 12 October 2018), p. 1.

7 Mr Andrew Gregory, Managing Director and Chief Executive Officer, McDonald's Australia, *Committee Hansard*, 21 September 2018, p. 8.

8 Mr Andrew Gregory, Managing Director and Chief Executive Officer, McDonald's Australia, *Committee Hansard*, 21 September 2018, pp. 3, 8.

9 Dymocks Franchise Systems (NSW) Pty Ltd, *Submission 67*, p. 8.

material information disclosed by landlords prior to entering into a lease agreement.¹⁰

20.12 The Coffee Club Franchising Company (The Coffee Club) identified a trend in recent years for shopping centres to expand the number of food retailers as non-food retailers leave shopping centres. This can have an impact on food franchisees, particularly as it is 'extremely rare' for landlords to agree to exclusivity rights as part of a lease agreement:

Rather, retail leases ordinarily contain provisions that make it clear that the landlord may lease other premises in the building for the same or similar purposes.¹¹

20.13 The FCA noted that rent and unfair conduct by major shopping centres have caused significant damage to many retail businesses, many of which are franchised businesses. The FCA argued that franchisors and franchisees are vulnerable to unfair conduct by landlords because of their access to tenants' sales data and high competition for locations in major shopping centres:

Tenants are particularly vulnerable towards the end of their term, which is usually unnecessarily short, as they are faced with having to accept a significant rental increase or depart, and lose the value of fixtures and fittings that are often bespoke to that particular location. Landlords not only are fully informed as to the tenant's sales and financial position, but they know the performance of the same business at other locations and the likely performance of competitors at that site. If the tenant leaves, a competitor will be keen to take the site, as by doing so the competitor essentially benefits from the residual goodwill of the departing tenant. So the competitor may happily pay above fair market rental. This is a market distortion that unfairly prejudices sitting tenants, and creates an ongoing churn of small businesses in major shopping centres.¹²

Rent increases

20.14 The committee heard that the rents associated with retail leases are increasing substantially and to the detriment of franchised businesses.

20.15 State and territory laws prohibit the inclusion of clauses which prevent rent decreases below the rate of the previous year or otherwise limit the amount of a decrease ('ratchet clauses'). However, all states and territories allow for the use of either specified amounts or percentage increases to be included in the contract.¹³

20.16 Evidence received in 2014 by the Senate Economics References Committee during its inquiry into the need for a national approach to retail leasing arrangements indicated that rental increases of five per cent per annum are common in shopping centre leases, and this has been a consistent rate applied in lease contracts for some

10 Dymocks Franchise Systems (NSW) Pty Ltd, *Submission 67*, pp. 1–2.

11 The Coffee Club Franchising Company Pty Ltd, *Submission 77*, pp. 6–7.

12 Franchise Council of Australia, *Submission 29*, pp. 31–32.

13 Clayton Utz, *Retail Leases Comparative Analysis 2017*, pp. 42–43.

time, despite the fact that it is substantially above the annual increase in the consumer price index (CPI).¹⁴

20.17 The Franchise Relationships Institute provided evidence that this trend had continued, observing that:

Rental costs are particularly problematic with a significant number of retailers facing rental increases of 5% to 10% per year. This means most businesses are now going backwards in their profitability with declines of around four to six percentage points a year.¹⁵

20.18 The Franchise Relationships Institute advised that this trend is 'unsustainable':

In this hostile trading environment, we have noticed a tendency of landlords to use their position of market power to unfairly increase rentals, while the benefits they offer their tenants, such as exclusivity to sell certain products or services, and access to a strong customer base, is declining. In many cases tenants are paying significantly higher rentals while facing significantly higher competition and having access to a significantly lower number of customers in the centres they occupy.¹⁶

20.19 RFG confirmed that within its network, occupancy costs for shopping centre based outlets are generally 70 per cent higher than the occupancy costs applicable to non-shopping centre based outlets and are a key contributor to the reduced operating performance of shopping centre outlets.¹⁷

Disclosure of lease information

20.20 The Franchising Code provides for the circumstances in which the franchisor must disclose leasing information to a prospective franchisee. The committee heard that disclosure of lease terms is not always timely and that reform is necessary.

20.21 Clause 13 of the Franchising Code provides that the franchisor is to give the franchisee information relating to the occupation of a premises where a franchisee leases a premises directly from the franchisor or an associate, or where the franchisee occupies a premises that is leased by the franchisor or an associate of the franchisor. When the franchisee leases the premises directly from the franchisor, the franchisor is required to provide the franchisee with a copy of the lease or agreement to lease.¹⁸ In instances where the franchisor leases the premises and gives the franchisee the right to occupy the premises, the franchisor must provide the franchisee with either:

- a copy of the franchisor's lease or agreement to lease; or

14 See Senate Economics References Committee, *Need for a national approach to retail leasing arrangements*, 18 March 2015, p. 44.

15 Franchise Relationships Institute, *Submission 47*, p. 5.

16 Franchise Relationships Institute, *Submission 47*, p. 5.

17 Retail Food Group Limited, *Submission 32*, p. 3.

18 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, c. 13.

- documents giving the franchisee the right to occupy a premises and written details of any associated conditions of occupation.¹⁹

20.22 In either instance, the required documents must be provided to the franchisee within one month after:

- the lease has been signed by the landlord and franchisee, if the franchisee leases the premises from the franchisor or associate directly; or
- the occupation of the premises, or the signing of an agreement by both parties, for the franchisee's right to occupy a premises that is leased by the franchisor.²⁰

20.23 The franchisor is also required to disclose to the franchisee details of any incentive or financial benefit that the franchisor or an associate is entitled to receive as a result of the lease or the franchisee's right to occupy the lease.

20.24 The franchisor is therefore not required to give franchisees a copy of the lease, or documents providing the right to occupy a premises, at the time when the franchisor provides copies of the Franchising Code, disclosure document and franchise agreement, which must be provided at least 14 days prior to a franchisee entering into the franchise agreement.

20.25 Franchise Right and Legalite, in a joint submission to the inquiry, conveyed how some franchisors have utilised clause 13 by withholding information about the lease from franchisees in order to secure the sale of a franchise and that, in some cases, a site may not have been identified at the time the franchise agreement is entered into:

In our experience, some franchisors have knowingly withheld or omitted key leasing information in order to secure the franchise sale. In some cases, franchise sales occur long before a site has been identified. Whilst in some cases this may be acceptable, in others, franchisees find themselves investing huge sums of money only to find that they ultimately cannot secure a site and must walk away at a loss.²¹

20.26 In this respect, certain franchise agreements that the committee received on a confidential basis indicated that some agreements provide that the franchisor is not liable to the franchisee for any loss incurred if the franchised operation fails to commence trade on the date nominated for any reason, and is not liable for the franchisee's breach of the franchise agreement or other contracts in this event. The committee also notes that, unless an obligation in the franchise agreement provides that the franchisor is required to provide a premises within a specified time frame, the franchisor is not restricted in delaying the commencement of the operation of the franchisee's business.

19 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, c. 13.

20 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, c. 13.

21 Franchise Right Pty Ltd and Legalite, *Submission* 72, p. 2.

20.27 Mr Heath Adams, a lawyer that has worked with franchisees, noted that the degree of disclosure to franchisees around lease terms that have been negotiated by the franchisor is inadequate and the input, or ability of franchisees to have an input, on those terms is limited.²²

20.28 MST Lawyers observed that some franchisees may not fully understand the implications of various head lessor arrangements. For example, the franchisee will typically be bound to the franchisor 'to observe and perform all the terms and conditions of the head lease as if the franchisee was named as the tenant'. However, the franchisee will not necessarily have any rights as a tenant against the landlord. MST Lawyers pointed out that franchisees may be limited in their ability to enforce the head lease, or their full rights under the head lease.²³

20.29 MST Lawyers therefore recommended improved disclosure in the Franchising Code to set out the nature of the franchisee's right to occupy the premises. To this end, they proposed that Annexure 1, item 9 of the Code be amended to include the following:

9.3 Whether the site to be occupied for the purposes of the franchised business is to be occupied by the franchisee:

- (a) as owner of the site; or
- (b) as lessee under a lease or agreement to lease granted by the franchisor, an associate of the franchisor or a third party; or
- (c) as sublessee under a sublease granted by the franchisor, an associate of the franchisor or a third party; or
- (d) as licensee under a licence granted by the franchisor, an associate of the franchisor or a third party; or
- (e) pursuant to any other occupancy right and, if so, the details of the conditions of such occupancy right.²⁴

20.30 Dymocks noted that, while franchisors have significant disclosure obligations to franchisees under the Franchising Code, there are no requirements for landlords to provide the same level of disclosure to either the franchisor or franchisee:

...prior to entering into a lease agreement, landlords are not required to disclose the proportion of failed tenancies, tenancies in arrears, rent relief or future business plans to dilute the competitive mix to the detriment of the proposed retailer/franchisee.²⁵

20.31 Different provisions in relation to leases are provided for by each state and territory. Disclosure to sub-lessees appears inconsistent with only some states and territories providing that a lease disclosure statement is to be given by a landlord or tenant to a sub-lessee, while Queensland legislation accounts specifically for

22 Mr Heath Adams, *Submission 81*, p. 3.

23 MST Lawyers, *Submission 39*, p. 9.

24 MST Lawyers, *Submission 39*, p. 10.

25 Dymocks Franchise Systems (NSW) Pty Ltd, *Submission 67*, p. 8.

disclosure to franchisees.²⁶ Bakers Delight Holdings (Bakers Delight) informed the committee that in most cases, retail lease laws in each state and territory apply to sub-leases, occupancy licences and other agreements to occupy a premises. However, there are specific provisions in some states that require disclosure to franchisees:

In the case of Victoria and Queensland, there are specific provisions in the retail lease legislation that require specific disclosure to be made to Franchisees. In addition, there are monetary penalties and other consequences for failure to comply with retail lease legislation.²⁷

20.32 In both Queensland and New South Wales, the landlord must comply with their disclosure obligations, and failure to comply could result in the lessee exercising the right to terminate the lease by giving written notice to the landlord within six months after the lessee enters into the lease.²⁸ The tenant is generally able to exercise this right if the lessor:

- has not provided a current disclosure statement and the lessee has not provided the lessor with a waiver notice;²⁹ or
- the disclosure statement is a defective statement, i.e. it is materially incomplete, or contains information that is false or misleading in a material manner.³⁰

20.33 In some states and territories, lessees may also be entitled to compensation for damages although in some instances this is not available where the lessor acted honestly and reasonably, and the tenant is in a similar position as it otherwise would have been if the disclosure document was not defective.³¹

Assessment of the viability of a franchise outlet prior to lease renewal

20.34 It is important that the franchisor properly assess the viability of a franchise business before a lease is renewed.³² This is because the business might fail if it is unable to absorb the costs associated with lease renewal.

20.35 Mr Derek Sutherland, a lawyer with long experience in the franchise sector, observed that when a franchisor is aware that their business model will not work at a particular location, the franchisor should close the outlet and incur the loss rather than opportunistically offloading the outlet onto another unsuspecting franchisee.³³

26 See, for example, *Retail Shop Leases Act 1994* (QLD), s. 21(C) and s. 21(E); *Retail Leases Act 2003* (VIC), s.17.

27 Bakers Delight Holdings, *Submission 41*, p. 4.

28 *Retail Shop Leases Act 1994* (QLD), s. 21(F); *Retail Leases Act 1994* (NSW), s. 11(2).

29 *Retail Shop Leases Act 1994* (QLD), s. 21B.

30 *Retail Leases Act 1994* (NSW), s. 10.

31 See, for example, *Retail Shop Leases Act 1994* (QLD), s. 21(F).

32 The committee notes that a landlord has the right to refuse to renew a lease.

33 Mr Derek Sutherland, *Submission 53*, p. 4.

20.36 Mr Emmanuel Martin, former senior manager at Gloria Jeans prior to the RFG takeover, observed that lease renewals could occur close to the renewal period where the franchisee's business had not been assessed or, in several cases, where it was already known that the lease terms were unsustainable for the business:

From my experience, there have been several cases of retail leases being renewed even though past and current franchise trading numbers will not commercially and financially sustain the terms of the new lease renewal.

It is also common that lease renewals are undertaken very close to the lease renewal period and that the trading financials of the franchisee's business [are] not analysed effectively so that an informed decision can be made.³⁴

20.37 To address this oversight, Mr Martin argued that franchisors should be required to 'implement a thorough and professional due-diligence process at least 12 months before lease renewals', including ascertaining whether the financial performance of the franchisee's business makes the renewal of the lease agreement unviable.³⁵

20.38 The experience of Mr Peter and Ms Dianne Horvath, owners of a Wendy's Ice Cream franchise, showed that franchisors may be making false assurances to franchisees as to the viability of lease arrangements for the franchisee's business without actually conducting an assessment, or that franchisors may be more interested in securing the sale of a business to improve the perceived performance of the company by external stakeholders:

Under the Wendy's franchise model, Wendy's hold the leased premises and the franchisee receives a licence to operate a business from Wendy's leased premises. As the franchisee, we had no involvement or seat at the table on the negotiation of leasing terms. During their negotiation process, we were provided 3 different leasing rates to apply to our budget. Each time that rent increased, we sought assurances from Wendy's leasing agent that we could still turn a profit at that rate and we were verbally assured we could.

It did not become obvious to us until much later that the franchisor's business model had different drivers than the franchisee. The franchisor's performance indicators were number of stores opened, not number of profitable stores. Profit to the franchisee is irrelevant as Wendy's earnings are derived from turnover, not surplus profits.

Rental/leasing occupancy cost is the single most contributing factor to our losses. Budgeted at circa 23% of sales, our occupancy rate is 31.5% on average, approaching 42% during the winter months. The lessor enjoys an annual increase in rent and sundries of 5% year-on-year regardless of declining foot-traffic and resultant drop in sales. We expected Wendy's to be experts in their field and negotiate better terms than they did. However, we were later to learn that Wendy's were trying to sell the franchise and it

34 Mr Emmanuel Martin, *Submission 118*, p. 8.

35 Mr Emmanuel Martin, *Submission 118*, p. 8.

was critical they opened new stores without considering the interest of the franchisee.³⁶

20.39 The Coffee Club observed that landlords were not normally required to assess an incoming franchisee where the franchisor holds the head lease. The Coffee Club advised that the lack of assessment required by the landlord made it easier for franchisees to sell their business:

...where The Coffee Club is on the head lease this makes it much easier for existing franchisees to sell their store, as the landlord will normally not be required to undertake their own independent assessment of the incoming buyer before consenting to the sale.³⁷

20.40 Mr Alan Evans and Ms Michelle Wolstenholme, franchisees of Caffissimo, a Western Australia-based café chain, argued that landlords and leasing agents played a role in facilitating the reselling of unprofitable businesses by approving lease agreements for a site to new franchisees in the same franchise system:

If a previous franchisee has been unable to pay the rent, it is a fair indication that future franchisees will experience the same difficulties. It is often said that it's the operator. This may be true in a stand-alone business. However, in these cases, the Franchisor has selected, trained and supported the operator (or should have) in a site that they claimed to be profitable.³⁸

20.41 According to the FCA, both franchisors and landlords are usually fully informed of the franchisee's sales and financial position.³⁹ Some submitters pointed out that, if both franchisors and landlords have access to the franchisee's sales data, then whether or not a franchisee's business can sustainably pay the rent should be easily determined and provide the basis for rent reviews:

Landlords are provided with our sales figures on [a] monthly basis. They know exactly how we are trading and yet when we ask them for rent reviews, they plain and simply refuse.⁴⁰

Non-renewal of the lease

20.42 The committee heard that the franchisees may suffer significant detriment when either the franchisor or the lessor decides not to renew the lease part-way through the term of a franchise agreement.⁴¹

20.43 Upon the closure of the franchised business, a franchisor that holds the head lease may negotiate the cessation of the lease without the input of the franchisee. The franchisor is then able to recoup the costs of the negotiation as well as any end of

36 Mr Peter Horvath, *Submission 119*, p. 3.

37 The Coffee Club Franchising Company Pty Ltd, *Submission 77*, p. 4.

38 Mr Alan Evans and Michelle Wolstenholme, *Submission 137*, p. 3.

39 See Franchise Council of Australia, *Submission 29*, pp. 14, 31.

40 Name Withheld, *Submission 190*, p. 1.

41 Belperio Clark Lawyers, *Submission 87*, p. 4; Pole Position MC, *Submission 75*, pp. 2–3; Ms Maggie Xu, *Committee Hansard*, 29 June 2018, p. 39.

lease costs as part of fulfilling the contract from the franchisee. The experience of Mrs Julia Banks, a Donut King franchisee, part of the RFG franchise network, shows what may occur when a franchisor negotiates the cessation of the lease:

Once we closed the store down, they were pretty quick to negotiate a cessation of the lease, and then they said that, as part of that and the clear-out of the store, we owed them \$70,000. We had a meeting with them, and they said, 'Well, if you want to do an arrangement, you can just pay us \$20,000 and pay it off.' We didn't come to any agreement at that meeting—(1) we don't have \$20,000 that we are able to give them, and (2) we, again, would say that they had sold us the business without making any level of real disclosure, which I think amounts to a complete misrepresentation as to the state of the business. So us paying them after we have already lost everything that we own is completely out of the question.⁴²

20.44 The Queensland Law Society argued that where a landlord does not renew the lease of a tenant currently occupying the premises in order to conduct refurbishments, or because the landlord has received a 'better offer' to lease the premises, 'it seems unreasonable that a franchisee should bear the cost of the de-fit and make good of the premises.' The Queensland Law Society suggested that these costs should be borne by the landlord, although such a change 'may also require changes to retail shop lease legislation'.⁴³

20.45 The Victorian Automobile Chamber of Commerce (VACC) argued that franchisees should have protections similar to residential tenants so that landlords cannot evict franchisees from the premises if the franchisor has terminated the franchise agreement prior to the conclusion of the lease term.⁴⁴

20.46 The committee also heard that some franchisors are arranging franchise agreements that do not have the same end date as the lease agreement. This practice can cause serious loss to the franchisee if the lease agreement is due to conclude before the conclusion of the franchise agreement. Ms Maggie Xu, a former Foodco franchisee, informed the committee that when the lease agreement was up for renewal three years into the term of her franchise, the franchisor decided not to renew the agreement, resulting in reduced return on the investment and the cost of de-fitting the site.⁴⁵

20.47 Mr Don Brown, a Yamaha motorcycle franchisee for 44 years, submitted that the franchise agreement and lease agreement should have corresponding end dates:

...this is another area that is not clearly defined. If I am required by the franchisor to lease a premises to operate the franchise or part of the franchise in, I want the franchise term to correspond with the term of the

42 Mrs Julia Banks, Franchisee, Donut King, *Committee Hansard*, 29 June 2018, p. 19.

43 Queensland Law Society, *Submission 48*, p. 7.

44 Victorian Automobile Chamber of Commerce, *Submission 66*, pp. 8–9.

45 Ms Maggie Xu, Private capacity, *Committee Hansard*, 29 June 2018, p. 39.

lease. I do not want to be in the position of having a franchise non-renewed prior to the lease term ending.⁴⁶

20.48 Mr Derek Minus, the Franchising Code Mediation Adviser at the Office of the Franchising Mediation Adviser (OFMA), and the Oilcode Dispute Resolution Adviser at the Office of the Oilcode Dispute Resolution Adviser, informed the committee that disputes related to lease arrangements frequently appeared before OFMA. He provided the following example:

It's very common for franchisors, particularly with shops in shopping malls, to hold a head lease and for the franchisee to be a licensee. But where the problems are occurring—and these are significant problems and frequent problems—is where the franchisor says, 'The lease is coming up for renewal; don't talk to the shopping mall; we'll talk to the landlord on your behalf; leave it to us,' and then they make a determination not to renew the lease because they say that it's too expensive. It's \$10,000 more than they believe that the franchisee could pay, so they don't renew the lease. As a result, the franchisee loses his business. He may have spent five or 10 or 15 years building that business and suddenly finds that, because the franchisor has refused to renew the lease, which they hold, the business is lost. I've probably got about five or six matters that are like that, and there was one I did last week. They are simply dreadful matters, particularly where the franchisor doesn't tell the franchisee that they are not going to renew the lease or doesn't tell them that they don't want to renew it because it's too high a price...In fact, in the mediation I did last week, the franchisor suggested to the franchisee, who lost his house and his business, that they had told the landlord that they could deal directly with the franchisee and that absolved them of all responsibility. It's a big problem.⁴⁷

20.49 The approach taken by some franchisors may address some of the concerns outlined. For example, Bakers Delight informed the committee that it provides 18 months' notice to franchisees before their lease expires and meets with franchisees 15 months out to discuss any site specific changes and to request franchisees' information pertaining to the shop, shopping precinct or centre to inform the franchisor in the negotiation process.⁴⁸

Lessor refusal to approve transfer of lease

20.50 The committee heard that landlords may have an interest in refusing to approve lease transfers where the franchisee's business is not being transferred simultaneously because the landlord may wish to retain the business of a well-known brand.

20.51 Mr Peter and Ms Dianne Horvath indicated they were unable to sell their lease agreement to anyone who wished to operate a non-aligned, independent business as

46 Mr Don Brown, *Submission 92*, p. 1.

47 Mr Derek Minus, Franchising Code Mediation Adviser, Office of the Franchising Mediation Adviser; Oilcode Dispute Resolution Adviser, Office of the Oilcode Dispute Resolution Adviser, *Committee Hansard*, 8 June 2018, p. 7.

48 Bakers Delight Holdings, *Submission 41*, p. 4.

the lessor was opposed to a buyer that did not wish to operate under a nationally recognised brand. Mr Horvath stated in his submission:

We almost secured a buyer who wanted to run his own branding, but the shopping centre did not want to lose a national brand, so they curtailed the sale as they would rather see a branded business go into liquidation. As Wendy's no longer have a right to our leasing arrangement, we can assign our lease to other non-Wendy's buyers who could operate an ice-cream outlet, but we are prevented from operating a non-Wendy's outlet ourselves due to the restraint provisions. Although, all the 15 plus prospective buyers of our store agree the rent is untenable.⁴⁹

Issues related to the franchisor holding the head lease

20.52 The committee received evidence about a range of issues related to the franchisor holding the head lease. These are covered in the following sections:

- franchisee rights under head leases;
- negotiation of rent; and
- lease incentives and rebates.

Franchisee rights under franchisor head leases

20.53 Some submitters expressed concern about a lack of protections for franchisees when the franchisor holds the head lease.⁵⁰

20.54 Mr Mark Scramm, Acting Commissioner for the Victorian Small Business Commission, explained that difficulties can arise when the franchisor holds the head lease and the franchisee is the licensee because there is no legal relationship between the franchisee as licensee and the landlord.⁵¹

20.55 Professor Jenny Buchan noted that when the franchisor holds the head lease and the franchisee is the licensee, the franchisee will pay their rent to the franchisor. However, if the franchisor is experiencing financial difficulty, the franchisor may choose to use that money to pay other creditors rather than pass the rental payment on to the landlords. Professor Buchan observed that there is currently no requirement that the rental money be held in trust by the franchisor and used for the purposes for which it was received.⁵²

20.56 The committee also heard that some franchisors pass the costs of administering the head lease onto franchisees in addition to the rent. Mr Craig Ryan, General Counsel and Company Secretary of Domino's Pizza Enterprises, confirmed it

49 Mr Peter Horvath, *Submission 119*, p. 5.

50 Mr Mark Scramm, Acting Commissioner for the Victorian Small Business Commission, *Committee Hansard*, 22 June 2018, p. 76; Professor Jenny Buchan, *Committee Hansard*, 29 June 2018, p. 9; Name Withheld, *Submission 193*, p. 2; Belperio Clark Lawyers, *Submission 87*, pp. 4–5.

51 Mr Mark Scramm, Acting Commissioner for the Victorian Small Business Commission, *Committee Hansard*, 22 June 2018, p. 76.

52 Professor Jenny Buchan, Private capacity, *Committee Hansard*, 29 June 2018, p. 9.

charged franchisees a percentage of the rent and outgoings as an administration fee for handling the lease called a Lease Liability Fee.⁵³

Negotiation of rent

20.57 The committee heard that some franchisors that hold head leases make no effort to negotiate lower rent to assist franchisees, and may merely be accepting prices offered by the landlord and presenting these offers to the franchisee without negotiation.⁵⁴ Concerns were also raised by various inquiry participants about the restrictions on franchisee involvement and the lack of transparency around the negotiation process.⁵⁵

20.58 Mr Derek Sutherland noted that where the franchisor held the head lease, circumstances where the franchisor may exclude the franchisee from direct negotiations and contact with the lessor include:

- rent reviews;
- end of term lease negotiations for renewal or a new lease;
- tenancy disputes;
- relocation; and
- negotiations and disputes.⁵⁶

20.59 The Franchise Advisory Centre submitted that franchisors often prefer to hold the head lease and sub-lease to franchisees because it allows them to control the site in order to keep competitors from gaining the location. As head lessee, the franchisor negotiates the lease and any fit-out requirements in its own right and does not act as agent for the franchisee, thereby not necessarily making decisions in the franchisee's best interest:

This can result in franchisees paying higher than necessary rents or outgoings, failing to receive the flow-on benefit of a landlord contribution to fitout costs, or being located in a sub-optimal location as a concession to the landlord if the franchisor is negotiating on multiple locations simultaneously.⁵⁷

53 Mr Craig Ryan, General Counsel and Company Secretary, Domino's Pizza Enterprises, *Committee Hansard*, 22 June 2018, p. 51; Domino's Pizza Enterprises Limited, *Submission 74*, p. 17.

54 Queensland Law Society, *Submission 48*, p. 6; Mr Brett Roveda, *Submission 131*, p. 4; Ms Devi Trimuryani, *Submission 116*, p. 4–5; Mr Sasanka Kolli, *Submission 152*, p. 3.

55 Queensland Law Society, *Submission 48*, p. 6; Mr Brett Roveda, *Submission 131*, p. 4.

56 Mr Derek Sutherland, *Submission 53*, pp. 32–33.

57 Franchise Advisory Centre, *Submission 138*, p. 2; see also Queensland Law Society, *Submission 48*, p. 6.

20.60 Mr Jason Gehrke, Director of the Franchise Advisory Centre, also advised the committee that landlords may require the franchisor to agree to lease a suboptimal outlet in order to lease preferred outlets in larger shopping centres.⁵⁸

20.61 One franchisee indicated that their franchisor made no effort to negotiate lower rent on their lease when it came time for renewal, instead presenting the lessor's offer on a 'take it or leave it' basis. In this instance, the franchisee was able to secure a better rate by continuing negotiations directly and without the involvement of the franchisor:

When we were acquiring the second (established) store, we sought an extension on the existing lease which the franchisor presented to the landlord. They were agreeable to the extension but in the middle of the Global Financial Crisis felt it appropriate to seek a 15–20% 'market review' increase. When I questioned whether the franchisor legal/leasing representative had negotiated with the landlord the response was 'that is what they've offered, you can take it or leave it'. I informed them they were benched and negotiated directly with the landlord, achieving a more acceptable outcome. I engaged legal counsel and paid far more than I should have in order to compensate for the shortcomings of the franchisor legal and leasing teams to bring the transaction to a close.⁵⁹

20.62 Mr Robert Verni, a former Brumby's Bakery and Michel's Patisserie franchisee for over 10 years, both part of the RFG franchise network, argued that when the franchisor is the head lessee, franchisees should have a role in the negotiation of rent because franchisees have invested in the brand and are responsible for the operation of the outlet.⁶⁰

20.63 Mr Brian Keen, Founder and Chief Executive Officer of Franchise Simply, noted that new franchisors often fail to understand and execute franchise systems effectively, culminating in inadequate site selection and lease arrangements. Mr Keen argued:

Poorly informed site selection is a very serious issue and always has been. That results when sites are inadequately researched and leases are poorly negotiated, often by franchisors, in fact, on behalf of franchisees. With new franchise groups the problem predominantly is that they don't understand franchising. They have a failure to build a comprehensive, simple franchise system and they don't use suitable—what I would term franchise-savvy—advisers, and that includes lawyers, accountants and consultants generally.⁶¹

58 Mr Jason Gehrke, Director, Franchise Advisory Centre, *Committee Hansard*, 24 August 2018, p. 31.

59 Mr Brett Roveda, *Submission 131*, p. 4; see also Ms Maddison Johnstone, Director, Franchise Redress, *Committee Hansard*, 8 June 2018, p. 27.

60 Mr Robert Verni, *Submission 102*, p. 1; see also Ms Maddison Johnstone, Director, Franchise Redress, *Committee Hansard*, 8 June 2018, p. 27.

61 Mr Brian Keen, Founder and Chief Executive Officer of Franchise Simply, *Committee Hansard*, 8 June 2018, p. 61.

20.64 In order to ensure that landlords and franchisors do not terminate leases without franchisee input, the Queensland Law Society submitted that the Franchising Code should be amended 'to give franchisees the opportunity to make submissions to landlords and for franchisors to be compelled to keep franchisees informed regarding negotiations with landlords'.⁶²

Lease incentives and rebates

20.65 Lessors often provide lease incentives or rebates to induce businesses to enter into leases of the premises. Incentives may be cash or non-cash and may take the form of rent-free or rent-discounted periods for the leased premises, free fit-outs of the premises, as well as many other forms.⁶³

20.66 However, the committee was informed that fit-out incentives or rent reductions provided by landlords are sometimes kept by the franchisor.⁶⁴ Mr Jason Gehrke, Director of the Franchise Advisory Centre, agreed that fit-out incentives may not be passed onto the franchisee.⁶⁵

20.67 As discussed earlier, the Franchising Code stipulates that where a franchisee leases or sub-leases a premise from the franchisor, the franchisor must disclose the details of any incentive or financial benefit that the franchisor or an associate is entitled to receive as a result of the lease or agreement to lease.⁶⁶

20.68 Mr Derek Sutherland acknowledged that where the landlord offers the franchisor an incentive, the rent would increase to enable the landlord to recoup their incentive.⁶⁷

20.69 The Franchisee Association of Craveable argued that in instances where the franchisor does not provide copies of the lease arrangement between the franchisor and lessor to the franchisee, the franchisee could believe that the franchisor is receiving an undisclosed rebate:

The Franchisor holds the majority of leases in their name and has not disclosed the original rent in the form of a direct invoice from the landlord. This has led Franchisees to believe that the Franchisor may be obtaining [an] undisclosed rebate from landlords.⁶⁸

62 Queensland Law Society, *Submission 48*, p. 7.

63 Australian Taxation Office, *Income tax: Lease incentives*, www.ato.gov.au/law/view/document?DocID=ITR/IT2631/NAT/ATO/00001&PiT=99991231235958 (accessed 15 January 2019).

64 Mr Rod Nuttall, Private capacity, *Committee Hansard*, 24 August 2018, p. 15.

65 Mr Jason Gehrke, Director, Franchise Advisory Centre, *Committee Hansard*, 24 August 2018, p. 31.

66 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, c. 13.

67 Mr Derek Sutherland, Private capacity, *Committee Hansard*, 8 June 2018, p. 11.

68 Franchisee Association of Craveable, *Submission 10*, p. 8.

20.70 The Franchisee Association of Craveable also raised concerns about the franchisor using lease obligations, such as the requirement to hold building insurance, to secretly receive payments by charging above the insurance premium rate:

The Franchisor forces the Franchisee to pay building insurance under an umbrella insurance package which covers the whole brand. The logic behind this is to ensure all parties are covered correctly, as a requirement of the lease. However, Franchisees have evidence which confirms that the same level of cover is available for 35% less premium, with 20 times less excess in play...in this instance...they have failed to provide original invoices for the insurance.⁶⁹

Resolving lease disputes

20.71 Lease disputes are currently overseen by state Small Business Commissioners. Belperio Clark Lawyers argued that a specific obligation could be inserted into the Franchising Code to manage disputes in leases where the franchisee or franchisor could refer matters to an independent lease expert and jointly share costs. It also suggested that the Commonwealth, state and territory governments could work in conjunction to expand present commercial leasing legislation across each state and territory to specifically cover obligations in relation to franchises.⁷⁰

Option for reform: Retail Tenancy Code of Conduct

20.72 At present there is no code for retail tenancies. However, since 2007, the Shopping Centre Council of Australia has maintained a voluntary Casual Mall Licensing Code of Practice, which the ACCC re-authorised in 2017.⁷¹ The code is limited and does not contain penalties. It regulates the terms on which shopping centres offer licences to temporary retailers such as 'pop up' shops to prevent shops that may be in competition with permanent tenants from setting up too close to these tenants in such a way that it may negatively affect the sales of the permanent tenants.⁷² The code stipulates that a person is a competitor of another person if:

- more than 50 per cent of goods displayed by the person are the same general kind as more than 20 per cent of the goods displayed for sale by the other person; or
- by offering substantially the same services.⁷³

69 Franchisee Association of Craveable, *Submission 10*, p. 9.

70 Belperio Clark Lawyers, *Submission 87*, p. 5; see also Mr Mark Scramm, Acting Commissioner for the Victorian Small Business Commission, *Committee Hansard*, 22 June 2018, p. 76.

71 Australian Competition and Consumer Commission, *ACCC re-authorises voluntary code for pop-up shops*, 20 December 2017, www.accc.gov.au/media-release/accc-re-authorises-voluntary-code-for-pop-up-shops (accessed 12 November 2018).

72 Australian Competition and Consumer Commission, *ACCC re-authorises voluntary code for pop-up shops*, 20 December 2017, (accessed 12 November 2018).

73 Shopping Centre Council of Australia, *Casual Mall Licensing Code of Practice*, March 2018, p. 2, www.scca.org.au/wp-content/uploads/2017/11/CasualMallLicencingCode_January-2013.pdf (accessed 16 January 2019).

20.73 In March 2018, the FCA was one of five retailer representatives on the Code Administration Committee administering the Casual Mall Licensing Code of Practice.⁷⁴

20.74 In its submission to the inquiry, the FCA argued that there should be provisions to allow franchisors to exit lease agreements without penalty where landlords introduce a new tenant who competes with the existing franchisee if the person is defined as a competitor according to the definition prescribed in the Casual Mall Licensing Code.⁷⁵

20.75 The committee heard that the relationship between franchisors and landlords could be improved by establishing a retail tenancy code of conduct. Currently Tasmania is the only state to have a code of practice for retail tenancies.⁷⁶

20.76 In its submission, Foodco Group argued in favour of establishing a retail tenancy code of conduct 'to address the imbalance of power between the lessor and lessee' to:

- allow tenants to exit the lease at no cost or to seek compensation for declined profitability as a result of a lessor's actions;
- prohibit a lessor from requiring a tenant to provide sales figures to the lessor;
- require lessors to demonstrate how market value is calculated and provide the information to tenants at the time of renewals;
- provide the existing tenant with a right of refusal on the same commercial terms as the lessor has extracted from the market; and
- require lessors to include franchisees in all discussions regarding the tenancy.⁷⁷

20.77 The committee noted that Tasmanian law provides that tenants are not required to disclose turnover figures unless a part of the rent is calculated on the basis of the turnover of the tenant's business.⁷⁸

20.78 The dissenting report by the then Senator Nick Xenophon to the March 2015 Senate Economics References Committee inquiry into the need for a national approach to retail leasing arrangements recommended the development of a code to prohibit tenants being required to provide specific commercial-in-confidence sales and

74 Shopping Centre Council of Australia, *Casual Mall Licensing Code of Practice*, March 2018, www.scca.org.au/wp-content/uploads/2017/11/CasualMallLicencingCode_January-2013.pdf (accessed 16 January 2019).

75 Franchise Council of Australia, *Submission 29*, p. 21.

76 *Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998*.

77 Foodco Group Pty Ltd, *Submission 217*, pp. 8–9.

78 *Fair Trading (Code of Practice for Retail Tenancies) Regulations 1998* (Tas), c. 10(6).

occupancy data to Australian shopping centres.⁷⁹ The government agreed in part to the recommendation, noting that the development of a code should be led by industry.⁸⁰

Committee view

20.79 The interaction between shopping centre landlords, franchisors and franchisees is both complex and fraught. Further, given the high concentration of franchised outlets within shopping centres, the issues arising from retail lease agreements are of central importance to the franchise industry. Franchisors argue that major shopping centre landlords engage in anti-competitive conduct and impose restrictive lease terms, excessive price increases, and onerous conditions around lease termination. However, when franchisors take on the role of head lessor, franchisees can experience a range of negative impacts.

20.80 The committee acknowledges the concerns put forward by the FCA about the impact of high rents and the challenges presented by market rivals. However, the committee notes that the FCA has also acknowledged franchisors have an incentive to continue entering shopping centre lease contracts, irrespective of high rent prices or unfavourable terms, because of the possibility that competitors will obtain the lease for the premises if the franchisor vacates, and that competitors may pay above fair market prices if they can benefit from the outgoing tenants' residual goodwill. The committee accepts the FCA's argument that this produces a market distortion that unfairly prejudices sitting tenants, and creates ongoing churn of small businesses in major shopping centres.

20.81 The committee is also concerned about the negotiating strategies used by some landlords who require franchisors to negotiate the leases for multiple locations simultaneously. This can pressure franchisors into accepting leases for sub-optimal locations in order to be granted the leases for other preferred locations.

20.82 The committee acknowledges the challenges faced by franchisors. However, the committee does not accept that the fear of a competitor occupying a premise justifies the franchisor offering franchise agreements to prospective franchisees where there is a high probability that the business model will fail in that particular location. The franchisor has the option to run the store as a company managed store at these locations and does not need to sub-let or franchise these locations. Some arguments put forward by franchisors during the inquiry indicated a resistance to running company stores because of a lack of expertise or capital (see chapter 4). The committee considers that these reasons do not justify franchisors churning franchisees in shopping centres in order to retain their position in a coveted location. Instead, the franchisor should properly examine a franchisee's ability to meet the costs of the lease and, if a lease arrangement is likely to cause a franchisee's business to fail, the franchisor should run the store under company management or surrender the lease.

79 Senate Economics References Committee, *Need for a national approach to retail leasing arrangements*, March 2015, p. 50.

80 Australian Government response to the Senate Economics Committee Report: *Need for a national approach to retail leasing arrangements*, February 2016, p. 7.

20.83 Clause 9 of the Franchising Code requires a franchisor to give franchisees copies of the Franchising Code, disclosure document and franchise agreement at least 14 days prior to a franchisee entering into the franchise agreement. However, lease agreements are not required to be provided as part of this process. Clause 13 of the Code means that the franchisee may not receive a copy of the lease agreement before entering into the franchise agreement, and may not be entitled to receive a copy prior to the time of signing the lease or occupying the premises, except where provided for by state and territory legislation. While some state and territory legislation may provide that disclosure statements regarding a lease are to be given to prospective sub-lessees prior to the signing of a lease, the provisions can be inconsistent and may not align with the provisions of the franchise disclosure document and agreement.

20.84 The committee considers that the provision to a franchisee of a copy of the agreement to lease alone is inadequate. The committee acknowledges that the conditions in the lease agreement between the landlord and the franchisor might overlap with the conditions in the documents that give the franchisee the right to occupy the premises. The committee therefore considers that a franchisee should be given a copy of the lease agreement between the landlord and the franchisor and the documents that give the franchisee the right to occupy the premises before entering the franchise agreement. This would require a change to subclause 13(3) after subparagraph 13(3)(a)(ii) to remove the word 'or' and replace it with the word 'and'.

20.85 The committee is concerned that franchisors are able to secure the sale of a franchise without having selected a site or provided leasing information to the franchisee. As explained in chapter 10, the franchisee may only terminate the franchise agreement and obtain a refund of any payments made to the franchisor within seven days of entering the agreement. After seven days have elapsed, the only redress currently available to a franchisee would be to prove in court that the agreement has not been satisfactorily executed. A franchisee could therefore be locked into a franchise agreement while the franchisor continues lengthy negotiations with landlords or remains undecided on a location. Further, the franchisee may also incur significant loss if they chose to walk away from the agreement or if they were forced to accept a less than ideal location and higher than expected rent costs.

20.86 The committee acknowledges the difficulties experienced by prospective franchisees, and existing franchisees who occupy leases that are up for renewal, in making an assessment of the viability of their business if they are not able to assess proposed lease agreements, including rent increases, refurbishment requirements and end of lease arrangements prior to the time of signing the lease agreement.

20.87 In cases where total expenses over the term of the franchise agreement are more than the starting working capital, as may be the case when the rent is too high, continued operation of the franchise could result in the business becoming insolvent quite quickly. Without proper accounting processes, greater awareness, and franchisor accountability, insolvency may be difficult to recognise for franchisees who are focused on meeting their day-to-day obligations under the franchise agreement and not on the projected financial health of the business.

20.88 The committee considers that franchisors should conduct an assessment of the prospective or existing franchisee's business to provide reasonable assurance of viability prior to the franchisor signing or renewing a lease arrangement or right to occupy the premises for which the franchisee is liable. Additionally, the term of a franchise agreement should line up with the term of the lease agreement or documents providing the franchisee the right to occupy the premises.

20.89 For the above reasons, the committee considers that the franchisor should be required to provide leasing information alongside the disclosure document and franchise agreement 14 days prior to the signing of the franchise agreement and that the franchise agreement should remain conditional if:

- a site is required for the operation of the franchise agreement; and
- a location has not been identified or finalised prior to the signing of the franchise agreement.

20.90 Further, the committee considers that if the lease agreement has not been signed alongside the franchise agreement, then the cooling off period that applies to the franchise agreement should begin after the franchisee has signed the lease and a copy of the lease agreement has been provided to the franchisee (see chapter 10).

20.91 The committee also notes that termination rights afforded to lessees under various state and territory legislation are often more generous than those afforded to franchisees under the Code. For instance, under the *Retail Shop Leases Act 1994* (QLD), the lessee may terminate a retail shop lease within six months after the lessee enters into the lease if the lessor has failed to comply with certain disclosure obligations, and may be entitled to compensation on account of loss or damage suffered as a result of the non-compliance.

20.92 The committee considers that franchisees should be entitled to terminate agreements to sub-let or occupy a premises provided by the franchisor as head lessee in certain circumstances, including where either:

- the franchisor has failed to provide a copy of the lease agreement within a reasonable time period; or
- the franchisor has withheld, omitted or provided false key information to the franchisee prior to the signing of the lease agreement;
- and this has led to the franchisee being placed in a substantially worse position than the franchisee would be in if appropriate disclosure had occurred.

20.93 It is important to note, however, that these changes as applied through the Franchising Code would not provide additional protection for franchisees that hold leases directly with landlords.

20.94 The committee notes that retail lease arrangements are not currently subject to a national code of practice. The committee is encouraged by the Shopping Centre Council of Australia and the cooperation of various retailers to expand the Code Administration Committee for the updated Casual Mall Licensing Code of Practice.

The committee encourages the appropriate ministerial council to examine ways of harmonizing and enhancing existing retail shops legislation.

Recommendation 20.1

20.95 The committee recommends that the Franchising Taskforce examine the appropriateness of amending clause 13 of the Franchising Code of Conduct to:

- remove the word 'or' after subparagraph 13(3)(a)(ii) and replace it with the word 'and';
- require that a copy of the head lessor disclosure statement and final lease agreement be provided to the franchisee or prospective franchisee no less than 14 days prior to the franchisee entering into the franchise agreement;
- remove any references to 'a copy of the agreement to lease' within clause 13;
- require that the franchisor must, upon request by a franchisee or prospective franchisee, provide the head lessor disclosure statement that is currently in effect within 7 days of the request;
- remove any inconsistencies in subclause 13(4) with respect to the above;
- provide that, notwithstanding any terms of a franchise agreement or related documents including the lease agreement or other agreements or documents providing the franchisee with the right to occupy a premise, a franchisee may terminate without penalty the franchise agreement and any agreement to the sub-lease of a premises by providing written notice to the franchisor within six months of the franchisee occupying the premises if:
 - the franchisor does not comply with the obligation to provide the head lessor disclosure statement; or
 - a head lessor disclosure statement when given to a franchisee is:
 - materially incomplete; or
 - omits information, including key financial information; or
 - contains false or misleading information;
 - and the franchisee is in a substantially worse position than the franchisee would be if the head lessor disclosure document were not subject to the above.

20.96 The committee acknowledges the view that some franchisees may not fully understand the implications of various head lessor and sub-letting arrangements. The committee considers it important that there be improved disclosure in the Franchising Code to set out the nature of the franchisee's right to occupy the premises. To this end, the committee recommends the Franchising Taskforce examine the appropriateness of making the following amendment to Annexure 1 of the Franchising Code.

Recommendation 20.2

20.97 The committee recommends that the Franchising Taskforce examine the appropriateness of amending Annexure 1 of the Franchising Code of Conduct to insert a new item 9.3 in Annexure 1 of the Code to read as follows:

- whether the site to be occupied for the purposes of the franchised business is to be occupied by the franchisee:
 - as owner of the site; or
 - as lessee under a lease or agreement to lease granted by the franchisor, an associate of the franchisor or a third party; or
 - as sublessee under a sublease granted by the franchisor, an associate of the franchisor or a third party; or
 - as licensee under a licence granted by the franchisor, an associate of the franchisor or a third party; or
 - pursuant to any other occupancy right and, if so, the details of the conditions of such occupancy right; and
- whether the term of the relevant lease or licence aligns with the term or period of the franchise agreement.

20.98 The committee notes that when the franchisor holds the head lease and the franchisee is the licensee, there is no legal relationship between the franchisee as licensee and the landlord. In these circumstances, the franchisee will pay their rent to the franchisor. However, if the franchisor is experiencing financial difficulty, the franchisor may choose to use that money to pay other creditors rather than pass the rental payment on to the landlords. This would lead to franchisees being liable to the landlord for non-payment of rent. For these reasons, the committee considers that there should be a requirement in the Franchising Code that rental money paid by the franchisee to the franchisor for the purposes of paying rent to a landlord must be held in trust and only used to pay the franchisee's rental expenses with franchisors being liable like real estate agents.

Recommendation 20.3

20.99 The committee recommends that the Franchising Taskforce examine the appropriateness of amending the Franchising Code of Conduct to provide that, notwithstanding any terms of a franchise agreement, when the franchisor holds the head lease and the franchisee is the licensee, money paid by the franchisee to the franchisor for the purposes of paying rent to a landlord must be held in trust and only used to pay the franchisee's rental expenses, with franchisors being liable. Further, in the event of the franchisor winding up, the money held in trust must be used to pay the rent owed to the landlord.

Chapter 21

Capital expenditure

Introduction

21.1 This chapter considers the nature and scope of capital expenditure that a franchisor can require a franchisee to undertake during the term of the franchise agreement, and the adequacy of the provisions in the Franchising Code of Conduct (Franchising Code) that deal with capital expenditure requirements.

Background

21.2 In 2010, an Expert Panel (the panel) commissioned by the Australian Government examined the requirement to undertake capital expenditure. The panel was of the view that there may be circumstances where it was 'sensible business practice' for a franchisor to require unforeseen capital expenditure by the franchisee, and other circumstances where it represented 'inappropriate conduct'.¹

21.3 The panel therefore broadly supported a requirement in the Franchising Code for greater disclosure in relation to 'the possibility of unforeseen capital expenditure by the franchisee, particularly as a result of a franchisor amending the operations manual'.² The panel further considered that the Franchising Code 'could also require disclosure of whether significant capital expenditure would be a factor to be considered in deciding to renew the franchise agreement'.³

21.4 This resulted in the government amending the disclosure provisions of item 13A of Annexure 1 of the then Trade Practices (Industry Codes—Franchising) Regulations 1998 to require franchisors to disclose:

Whether the franchisor will require the franchisee, through the franchise agreement, the operations manual (or equivalent), or any other means, to undertake unforeseen significant capital expenditure that was not disclosed by the franchisor before the franchisee entered into the franchise agreement.⁴

21.5 The then Franchising Code also required details of the process that would apply in determining the end of term arrangements. This included:

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- 1 Australian Government, Report by the Expert Panel, *Strengthening statutory unconscionable conduct and the Franchising Code of Conduct*, February 2010, p. 58, http://archive.treasury.gov.au/documents/1744/PDF/unconscionable_conduct_report.pdf (accessed 6 March 2019).
 - 2 Australian Government, Report by the Expert Panel, *Strengthening statutory unconscionable conduct and the Franchising Code of Conduct*, February 2010, p. 58.
 - 3 Australian Government, Report by the Expert Panel, *Strengthening statutory unconscionable conduct and the Franchising Code of Conduct*, February 2010, p. 81
 - 4 Trade Practices (Industry Codes—Franchising) Regulations 1998, s. 13A, <https://www.legislation.gov.au/Details/F2010C00457> (accessed 6 March 2019).

...whether the franchisor will consider any significant capital expenditure undertaken by the franchisee during the franchise agreement, in determining the arrangements to apply at the end of the franchise agreement.⁵

21.6 In 2013, the Wein Review of the Franchising Code revisited the issue of capital expenditure. The Review noted concerns about the impracticality of the term 'unforeseen' which required the franchisor to disclose expenses that are by definition unforeseen. It also identified that franchisors were often responding to the requirement in one of two ways:

- merely stating 'yes' under this item in the disclosure document without elaboration; or
- providing a long list of expenses in broad terms, many of which were unlikely to occur.⁶

21.7 A key observation made by the Review was that while capital expenditure benefited franchisors, and regularly benefited franchisees, only franchisees were subject to direct costs. The Review recommended that:

The Code be amended to prohibit franchisors from imposing unreasonable significant unforeseen expenditure. 'Unforeseen' and 'significant' should be defined, with a view to a franchisor being able to demonstrate a business case for capital investment in the franchised business.⁷

21.8 In 2014, the government amended the Franchising Code to provide in clause 30(1) that 'a franchisor must not require a franchisee to undertake significant capital expenditure in relation to a franchised business during the term of the franchise agreement' except in cases which satisfy one of the following under subclause 30(2):

- it has been disclosed to the franchisee in the disclosure document that is given to a franchisee before entering into or renewing the franchise agreement or extending the term or the scope of the agreement;
- it is to be incurred by all or a majority of franchisees and has been approved by a majority of those franchisees;
- it is incurred by the franchisee to comply with legislative obligations;
- it is agreed by the franchisee;
- the franchisor considers it is necessary as capital investment in the franchised business and this is justified by a written statement given to each affected franchisee addressing the following:
 - the rationale for making the investment;

5 Trade Practices (Industry Codes—Franchising) Regulations 1998, para. 17C(1)(f), <https://www.legislation.gov.au/Details/F2010C00457> (accessed 6 March 2019).

6 Mr Alan Wein, *Review of the Franchising Code of Conduct 2013*, pp. 50–51.

7 Mr Alan Wein, *Review of the Franchising Code of Conduct 2013*, p. 53.

- the amount of capital expenditure required;
- the anticipated outcomes and benefits;
- the expected risks associated with making the investment.⁸

Evidence to the inquiry

21.9 Evidence received by the committee indicated deficiencies in the current requirements for significant capital expenditure in the Franchising Code. The ACCC noted that the Franchising Code does not define 'significant capital expenditure'.⁹

21.10 Other participants were concerned that the exemptions were too easily fulfilled by the franchisor, particularly in relation to paragraph 30(2)(e) which provides that a written statement be provided by the franchisor to its franchisees justifying the proposed expenditure. Mr Mark Schramm, Acting Victorian Small Business Commissioner, identified several issues that required consideration including:

- the lack of a definition for significant capital expenditure;
- the lack of parameters around the timing for which capital expenditure can be imposed in the disclosure document;
- the lack of provisions in the disclosure document to disclose paragraph 30(2)(e) of the Franchising Code which deals with the amount of capital expenditure that a franchisee can agree to in the franchise agreement;
- the lack of any requirement to disclose refurbishment cost (noting that disclosure documents must disclose establishment costs);
- the apparent contradiction between item 14.10 of Annexure 1 regarding payments which states 'to avoid doubt, this item covers a payment of significant capital expenditure', and the prohibition on franchisors to require capital expenditure in clause 30.¹⁰

21.11 The NSW Small Business Commissioner identified similar issues:

The provision of documents justifying such expenditure does serve a useful disclosure function. However, the fact that expenditure is defined with reference to the franchisor's own assessment affords the franchisor near-absolute discretion to dictate what constitutes necessary spending. The clause [clause 30] thus allows for both unjustified spending and outright franchisor abuse.¹¹

8 Competition and Consumer (Industry Codes—Franchising) Regulation 2014, s. 30.

9 Australian Competition and Consumer Commission, Submission 45, p. 29. See also Mr Mark Connors, Director Corporate Services and Company Secretary, Retail Food Group, *Committee Hansard*, 11 September 2018, pp. 19–20.

10 Mr Mark Schramm, Acting Victorian Small Business Commissioner, *Committee Hansard*, 22 June 2018, p. 77.

11 NSW Small Business Commissioner, *Submission 49*, p. 11.

21.12 To combat this issue, the NSW Small Business Commissioner submitted that paragraph 30(2)(e) should be made a separate requirement in the Franchising Code:

The obligation to disclose documents justifying the expenditure sought should be removed from the definition of what constitutes 'significant capital expenditure', to instead function as a standalone requirement. This would allow for the possibility that the franchisee may dispute the need for significant capital expenditure when the documents disclosed suggest otherwise.¹²

21.13 The Queensland Law Society argued that the imposition of capital expenditure should be dependent upon the duration of the franchise agreement:

A decision by a franchisor to require an existing franchisee to spend significant capital expenditure to upgrade facilities or refresh the brand should in good faith be linked to the duration of the term offered to the franchisee. The term should reflect a reasonable opportunity for the franchisee to recoup the investment they are making.¹³

21.14 The Australian Automotive Dealers Association (AADA) also argued that a loophole existed in the Franchising Code provisions for significant capital expenditure whereby the franchisor may require a previously undisclosed expenditure, such as a renovation or relocation, in order to renew the franchise agreement:

...the behaviour did not technically contravene the Code because [the] manufacturer avoided the section by taking the position that the expenditure is only required for the 'next agreement' after the expiry of the term of the initial agreement. On that basis, it is not 'undisclosed expenditure' for the purposes of the initial term.¹⁴

21.15 The AADA argued that recuperation of capital expenditure, particularly in relation to a greenfield site, is not always recoverable for the franchisee during the initial term of the franchise agreement, and this places significant pressure on the franchisee to obtain a renewal. However, a franchisor may require subsequent capital expenditure as a condition of renewal without the requirement for disclosure under the Franchising Code.

21.16 The Motor Trades Association of Australia (MTAA) held a similar view, stating in its submission that the high capital investment costs of motor vehicle dealers, which can be in the tens of millions of dollars, is often unrecoverable within the term of the franchise agreement. The MTAA noted this term was usually an initial minimum term of 5 years with renewal options of 3 to 5 years dependent on additional capital expenditure being made.¹⁵

12 NSW Small Business Commissioner, *Submission 49*, p. 11.

13 Queensland Law Society, *Submission 48*, p. 7.

14 Australian Automotive Dealers Association, *Submission 84*, p. 13.

15 Motor Trades Association of Australia, *Submission 55*, pp. 8, 11, 15, 21, 24.

21.17 Mr Andrew Gregory, CEO of McDonald's Australia, considered that a short-term franchise agreement where significant capital expenditure is required would be detrimental to a franchise such as McDonald's where the start-up costs can be in excess of \$1.6 million¹⁶ and further upgrades are expected every 7 to 10 years.¹⁷ The committee heard that McDonald's uses a longer term franchise agreement of around 20 years.¹⁸

21.18 The Caltex National Franchise Council observed that franchisees may not fully appreciate how franchise agreements deal with capital expenditure requirements:

Recent experience of franchisees suggests that there is a marked lack of clarity surrounding how the franchise system operates with respect to, amongst other things, capital expenditure, capital growth, and the ability to realise capital on exiting the system.¹⁹

21.19 However, some franchisors pointed out that the largest capital expenditure can be incurred through conditions imposed by a lease. Foodco submitted that one of the major causes of financial hardship for the franchisor and its franchisees is the fit-out required on commencement of the lease and as a condition of lease renewal:

...[it] often requires a capital expenditure so great that the franchisee might not achieve a satisfactory return of their investment during the term of the lease.²⁰

21.20 Foodco observed that it was common for disputes between a franchisor and franchisee to be caused by the conduct of lessors in retail shopping centres.²¹

Committee view

21.21 The committee recognises that franchisors may deem certain capital expenditure by its franchisees necessary in order for a franchise system to remain competitive and respond to changing market conditions. Further, the sometimes rapid nature of market change means that, by definition, some capital expenditure requirements may be unforeseen.

21.22 The committee acknowledges the evidence from McDonald's about the robust but collaborative process that the organisation went through with their franchisees regarding the substantial capital expenditure required of franchisees associated with the introduction of barista coffee into the McDonald's franchise network in

16 McDonald's Australia, *Franchising Overview*, July 2014, p. 11, https://mcdonalds.com.au/sites/mcdonalds.com.au/files/mcdonalds_australia_franchising_overview.pdf (accessed 6 March 2019).

17 Mr Andrew Gregory, CEO, McDonald's Australia, *Committee Hansard*, 21 September 2018, p. 7.

18 Mr Andrew Gregory, CEO, McDonald's Australia, *Committee Hansard*, 21 September 2018, p. 4.

19 Caltex National Franchise Council, *Submission 110*, p. 25.

20 Foodco Group Pty Ltd, *Submission 217*, p. 7.

21 Foodco Group Pty Ltd, *Submission 217*, p. 7.

Australia.²² The committee also notes that McDonald's uses franchise agreements that are significantly longer in duration than the industry norm, and that this arrangement would typically allow a McDonald's franchisee a longer period over which to recoup their capital expenditure.

21.23 Nonetheless, the bulk of the evidence received by the committee indicated that capital expenditure requirements can have significant impacts on the franchisee. This impact may vary depending on the length of the term left on the franchisee's franchise agreement, lease or licence because the franchisee may require a certain period of time in which to recoup their investment. Indeed, for substantial capital expenditure, a franchisee may need an additional term on the franchise agreement to make an appropriate return on investment.

21.24 Evidence from the AADA and MTAA highlighted the high levels of capital expenditure associated with motor vehicle dealerships. The committee received a raft of evidence asserting that it is currently possible for franchisors to impose capital expenditure requirements on franchisees even in circumstances where the franchisee has no prospect of making a return on that expenditure.

21.25 The committee also notes the concerns raised by both the NSW and Victorian Small Business Commissioners about the current wide discretion permitted to franchisors under the Franchising Code, including with respect to both the timing and scope of required capital expenditure and the potential for unjustified spending and even outright abuse by the franchisor.

21.26 While clause 30 of the Franchising Code deals with 'significant capital expenditure', the committee notes a lack of clarity about what constitutes 'significant capital expenditure'. Further, the committee is of the view that a franchisor should not be able to impose a requirement for capital expenditure in a situation where the franchisee has no prospect of making a return on that investment within the remaining term of the franchise agreement, lease or licence.

21.27 The committee therefore considers that the Franchising Taskforce should examine how clause 30 of the Franchising Code could be amended so that 'significant capital expenditure' is clearly defined, and that there are appropriate constraints around the requirements for franchisees to undertake capital expenditure to ensure franchisees are able to make a return on any investment within the term of the agreement, lease or license.

21.28 Where that is not possible, the committee considers that the franchisee should only be required to fund a pro-rata portion of the capital investment that would allow an appropriate return on investment within the term of the agreement, lease or license, and that the franchisor should be required to fund the remaining portion. In the implementation of any such constraints, the onus should be on the franchisor to demonstrate that a return on investment can be made, based on the last two years of franchisee's financial statements.

22 Mr Andrew Gregory, CEO, McDonald's Australia, *Committee Hansard*, 21 September 2018, p. 9.

21.29 The committee notes that situations may arise in which a franchisor terminates a franchise agreement earlier. In such circumstances, the committee considers that the franchisor should be required to compensate the franchisee for the capital expenditure based on the pro-rata portion of the term that was left when the agreement was terminated.

21.30 The committee also notes that unconscionable conduct laws and unfair contract laws may be relevant to capital expenditure requirements. Therefore, any reforms examined by the Franchising Taskforce in relation to capital expenditure should be considered in the context of unconscionable conduct and unfair contract laws and should consider whether those laws may provide practical and accessible alternative approaches to implementing appropriate protections for franchisees.

Recommendation 21.1

21.31 The committee recommends that the Franchising Taskforce examine how clause 30 of the Franchising Code of Conduct should be amended:

- **to include a clear definition of 'significant capital expenditure'; and**
- **so that there are appropriate constraints on the ability of franchisors to impose capital expenditure requirements on franchisees to ensure that franchisees:**
 - **are able to make an appropriate return on investment within the remaining franchise agreement, lease or licence terms; or**
 - **only have to pay for a pro-rata portion of the capital expenditure that would allow an appropriate return on investment within the franchise, lease or licence terms, with the franchisor to fund the rest of the capital expenditure; or**
 - **are paid appropriate compensation by the franchisor if the franchisor subsequently terminates the franchise agreement.**

Recommendation 21.2

21.32 The committee recommends that the Franchising Taskforce consider updating Item 18 of Annexure 1 of the Franchising Code of Conduct to reflect any changes made to clause 30 of the Franchising Code of Conduct.

Recommendation 21.3

21.33 The committee recommends that the Australian Government amend Schedule 2 of the Franchising Code of Conduct to explain the effect of an amended clause 30 and any interaction with the law of unconscionability and unfair contract terms.

Chapter 22

Franchisees as a potential source of capital for franchisors

Introduction

22.1 This chapter considers the extent to which franchisees may be used as a source of capital by franchisors, and whether the application of investor/owner protections in such circumstances would be appropriate.

Background

22.2 Prior to 1981, franchising was only regulated by the general laws governing commercial relationships. In 1981, however, the Supreme Court of Western Australia held in *Commissioner for Corporate Affairs v Casnot Pty Ltd* (1981) ACLC 40-704 that an advertisement for a cleaning franchise was subject to regulation under the 'prescribed interest' provisions of the then *Companies Act 1981*. That decision meant that franchising was subject to the regulatory regime for company securities and shares under the jurisdiction of the National Companies and Securities Commission (NCSC) (now known as the Australian Securities and Investments Commission (ASIC)).¹

22.3 The regulatory regime for company securities and shares imposed some costs on franchisors, including licencing, disclosure rules, protections for the investor, and penalties for breaches. The NCSC subsequently used its power to offer regulatory relief that exempted franchisors from most of the regulatory requirements. A feature of this exemption was that franchisors were required to seek NCSC approval of the franchise agreement and the disclosure document in order for the exemption to apply.²

22.4 A subsequent legislative amendment in 1987 exempted franchising from the *Companies Act 1981*.³ Section 9 of the *Corporations Act 2001* retains an exemption that excludes franchising from the definition of a managed investment scheme.⁴

22.5 In some franchise systems, the franchisor may use franchisees as a source of capital to grow the franchise network.⁵ In 2018, an empirical analysis of

1 Franchise Council of Australia, *Submission 103* to the 2008 Inquiry into the Franchising Code of Conduct, Parliamentary Joint Committee on Corporations and Financial Services, pp. 67–68.

2 Franchise Council of Australia, *Submission 103* to the 2008 Inquiry into the Franchising Code of Conduct, Parliamentary Joint Committee on Corporations and Financial Services, pp. 67–68.

3 Franchise Council of Australia, *Submission 103* to the 2008 Inquiry into the Franchising Code of Conduct, Parliamentary Joint Committee on Corporations and Financial Services, pp. 67–68.

4 Franchise Council of Australia, *Submission 103* to the 2008 Inquiry into the Franchising Code of Conduct, Parliamentary Joint Committee on Corporations and Financial Services, pp. 67–68.

5 N. J. MacDonald and D. C. B. Cheng, *Basic finance for marketers*, 1997, chapter 7; see also Growthink, *Alternative Source of Financing: Franchising Your Business*, https://www.growthink.com/capital-raising/creative-alternative/Alternative_Source_Financing_Franchising_Your_Business, (accessed 7 March 2019).

191 restaurant chains (including both franchised and non-franchised chains) between 1981 and 2015 found that franchising played an important role as an additional source of long-term capital, and that franchising had a statistically significant effect on decreasing long-term debts.⁶

Evidence to the inquiry

22.6 Dr Tess Hardy from the Melbourne University Law School noted that, from a franchisor's perspective, one of the purposes of franchising can be to provide the franchisor with investment capital to grow the franchise network with minimal risk.⁷

22.7 Dr Courtenay Atwell, an individual who has conducted research on the business format franchise model, reflected on franchisors' motivations in relation to capital provided by franchisees:

In my opinion, a lot of franchisors just want the initial payment. They want the initial inflow of capital from the franchisee signing up to the system; whether they succeed or fail is neither here nor there. A lot of franchisors will buy back a franchise system, for next to nothing, after it fails; and then they may run it as a wholly owned system. They will run it as a franchisor operated outlet. I'd say the reason that happens is that they just want the initial inflow of capital.⁸

22.8 The Franchisee Federation of Australia (FFA) argued that 'franchising is a means of capitalisation' whereby the franchisor uses franchisee capital to grow the business 'rather than raising equity or debt'⁹. The FFA argued that under such circumstances, the franchisee's capital contribution 'is a form of investment that should be afforded some rights, obligations and protections'.¹⁰ The FFA suggested that franchising:

...should be regulated in a similar way to other investments, such as unlisted debt securities. The investment should carry a clear, redeemable value should the investment have either an agreed end date or is mutually brought to an end. A franchise investment agreement should include a formula for calculating how any increase in value is calculated that cannot be eroded by the actions of one party.¹¹

6 Kwanmin Park and SooCheong Jang, 'Is franchising an additional financing source for franchisors? A Blinder-Oaxaca decomposition analysis', *Journal of Tourism Economics*, 13 February 2018, p. 1; see also Manuel Gonzalez-Diaz and Vanesa Solis-Rodriguez, 'Why do entrepreneurs use franchising as a financial tool? An agency explanation', *Journal of Business Venturing*, volume 27, issue 3, May 2012, p. 325.

7 Dr Tess Hardy, *Submission 91*, p. 2.

8 Dr Courtenay Atwell, Private capacity, *Committee Hansard*, 29 June 2018, p. 5.

9 Franchisee Federation of Australia, *Supplementary submission 113.1*, p. 3.

10 Franchisee Federation of Australia, *Supplementary submission 113.1*, p. 3.

11 Franchisee Federation of Australia, *Supplementary submission 113.1*, p. 3.

22.9 The FFA recommended that the Law Reform Commission (or similar authority) review the relevant law and make recommendations on how to ensure franchising has similar protections to other investment schemes.¹²

Committee view

22.10 A franchisee effectively rents the brand, goodwill and systems of the franchisor for the term of the franchise agreement. The question of whether a franchise system also involves investment by franchisees effectively hinges on whether the franchisor is using the franchisees as a source of capital to grow the franchise network above and beyond the 'rent' paid for the brand, goodwill and business systems.

22.11 To the extent that a franchise system uses the franchisee as a source of capital, it may represent a form of capital funding in which the franchisor is not required to give up ownership in its company. As a result, the franchisees in those systems may be exposed to the risks to capital typically associated with ownership without the rewards or protections typically associated with ownership or investor rights.

22.12 The committee therefore considers that the Franchising Taskforce should examine the extent to which franchisees are used as a source of capital by the franchisor, and the extent to which the current regulations are appropriate.

22.13 The committee observes that the Franchising Taskforce may find it useful to undertake some preliminary analysis to identify:

- the extent to which franchisors in Australia use franchisees as a source of capital;
- whether accounting standards appropriately treat capital received from franchisees as capital; and
- whether the capital provided by franchisees is appropriately treated as capital in the audited accounts of franchisors, and the extent to which it is, or has been, redirected to profits or dividends.

Recommendation 22.1

22.14 The committee recommends that the Franchising Taskforce examine the extent to which franchise systems and their agreements involve sufficient co-investment and risk sharing in an enterprise such that they should be regulated in a similar nature to financial products under the *Corporations Act 2001*.

The Hon Mr Michael Sukkar MP
Chair

12 Franchisee Federation of Australia, *Supplementary submission 113.1*, p. 3.

Appendix 1

Submissions and additional information

Submissions

- 1 Dr Courtenay Atwell
- 2 Jim's Group
- 3 Mr Michael Sherlock
- 4 Ms Elke Meyer
- 5 Mr Brian Potts
- 6 Mr Bryan Kelly
- 7 Mr Graham Evans
- 8 Mr Leon Azlin
- 9 Mr Scott Cooper
- 10 Franchisee Association of Craveable
- 11 Swaab Attorneys
- 12 (no submission)
- 13 Mrs Lynette Bayakly
- 14 Mpower Franchising Pty Ltd
- 15 Mrs Fran Forde
- 16 Dr Jenny Buchan
- 17 Mr Kamran Keshavarz Talebi
- 18 Mr John Wood
- 19 Spectrum Analysis Australia Pty Ltd
- 20 Department of Jobs and Small Business
- 21 Mr Stephen Balla
- 22 Mr Vikram Sandhu
- 23 Mr Daniel Mckenzie
- 24 Craveable Brands Pty Ltd
- 25 Mr Patrik & Ms Jana Vereb
- 26 SDA National
- 27 Mr Alan Pearson
- 28 Mrs Abi & Mr Trenton Scaf
- 29 Franchise Council of Australia
- 30 Tabcorp Holdings Limited
- 31 Ray White

- 32 Retail Food Group Limited
- 33 Battery World Australia Pty Ltd
- 34 Mr Kyle Hudspeth
- 35 Mr Hiren Panchal
- 36 Mr Faheem Mirza
- 37 Office of the Franchising Mediation Adviser
- 38 Victorian Small Business Commission
- 39 MST Lawyers
- 40 Spindletop Strategists, Advisers & Mentors
- 41 Bakers Delight Holdings
- 42 Post Office Agents Association Limited (POAAL)
- 43 FC Business Solutions
- 44 Mr Brian Keen, Franchise Simply
- 45 Australian Competition & Consumer Commission
- 46 FRANdata Australia Pty Ltd
- 47 Franchise Relationships Institute
- 48 Queensland Law Society
- 49 Office of the NSW Small Business Commissioner
- 50 Maurice Blackburn Lawyers
- 51 Haarsma Lawyers
- 52 National Retail Association
- 53 Mr Derek Sutherland
- 54 KordaMentha
- 55 Motor Trades Association of Australia Limited
- 56 Independent Hardware Group Pty Ltd
- 57 Australian Industry Group
- 58 Federal Chamber of Automotive Industries
- 59 Law Council of Australia
- 60 Kentucky Fried Chicken Pty Limited
- 61 Department of the Environment and Energy
- 62 Business Council of Co-operatives and Mutuals
- 63 Caltex Australia
- 64 7-Eleven Stores
- 65 Australia Post
- 66 Victorian Automobile Chamber of Commerce

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- 67 Dymocks Franchise Systems (NSW) Pty Ltd
 - 68 Australian Lottery and Newsagents Association & Lottery Retailers Association
 - 69 Motor Trades Association Queensland
 - 70 FranchiseED Ltd
 - 71 Australasian Convenience and Petroleum Marketers Association
 - 72 Franchise Right Pty Ltd & Legalite
 - 73 Licensed Post Office Group Limited
 - 74 Domino's Pizza Enterprises Limited
 - 75 Pole Position Motorcycles
 - 76 Small Business Development Corporation
 - 77 The Coffee Club Franchising Company Pty Ltd
 - 78 Mr John Christensen
 - 79 Mrs Maria Varkevisser
 - 80 Mr Steven Lewis
 - 81 Mr Heath Adams
 - 82 Mr Mark Skews
 - 83 Mr Peter Sanfilippo
 - 84 Australian Automotive Dealer Association
 - 85 Franchise Redress
 - 86 Mr Robert Whittet & Ms Emma Forsyth
 - 87 Belperio Clark Lawyers
 - 88 Ms Narelle Walter
 - 89 Mr Glen Pauline
 - 90 Mr Daniel Sommer
 - 91 Dr Tess Hardy
 - 92 Mr Don Brown
 - 93 Mr Pavel Cherniakov
 - 94 Mr Adam Gordon
 - 95 Mr Jim Kelly & Ms Crystal Petzer
 - 96 Mr Charles Amos
 - 97 Ms Carolyn Walshe
 - 98 Cycam Pty Ltd
 - 99 Mrs Danuta Dwornik
 - 100 Mr John & Mrs Julia Banks
 - 101 Mr Anthony Rachelle

- 102 Mr Robert Verni
- 103 Dr Alex Malik
- 104 Mr Jaspal Singh
- 105 Mr Vincent Le
- 106 Mr Santoshkumar Rajput
- 107 Dr. Sudha Mani
- 108 Professor Andrew Terry
- 109 Mr Joseph Street
- 110 Caltex National Franchise Council
- 111 Mr Sean O'Donnell & Mr Derek Sutherland
- 112 Mr Terence O'Brien
- 113 Franchisee Federation of Australia
- 114 7-Eleven Franchisee Association
- 115 Mr Aurelio Tenaglia
- 116 Ms Devi Trimuryani
- 117 Ms Devanshi Panchal
- 118 Mr Emmanuel Martin
- 119 Mr Peter Horvath
- 120 Ms Pearl Desai
- 121 Mrs Yvonne Ly
- 122 Mr Jasesh Bhatt
- 123 Mr Eric Murphy
- 124 Terceiro Legal Consulting
- 125 Mr Wayne Hong
- 126 Mr Joel Peterson, Mr Daniel McDouall, Mr Mark Bawden & Mr Keegan Scott
- 127 Ms Glenda Lane
- 128 Mr & Mrs Rob & Fiona Bellian
- 129 Mr Geoff Morrisey
- 130 Australian Small Business and Family Enterprise Ombudsman
- 131 Mr Brett Roveda
- 132 Mr & Mrs Stefan and Rowena Graff
- 133 Mr Thushan Parana Gedara
- 134 Ms Nicole Simmons
- 135 Mr Stephen Russell
- 136 Mr Paul Green

172	Name Withheld
173	Name Withheld
174	Name Withheld
175	Name Withheld
176	Name Withheld
177	Name Withheld
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181	Name Withheld
182	Name Withheld
183	Name Withheld
184	Name Withheld
185	Name Withheld
186	Name Withheld
187	Name Withheld
188	Name Withheld
189	Name Withheld
190	Name Withheld
191	Name Withheld
192	Name Withheld
193	Name Withheld
194	Name Withheld
195	Name Withheld
196	Name Withheld
197	Name Withheld
198	Name Withheld
199	Ms Tracey Leggett
200	Mr Hendrik Grebe
201	Mr Ian O'Loughlin
202	Mr Isaac Chalik
203	Mr Ramaswamy Raveindran
204	Name Withheld
205	Mr Manisha Desai
206	Mr Mukarram Khan

207	Mr Mohammad Khan
208	Mr Peter Lynch
209	Mr Robert Toth
210	Mr Martin de Haas
211	Mr Gary & Ms Janet Brennan
212	Mr Omar Alarcon
213	Name Withheld
214	Name Withheld
215	Name Withheld
216	Name Withheld
217	Foodco Group Pty Ltd

The committee also received 190 confidential submissions.

Additional information

1. Australian Automotive Dealer Association: Fact sheet on franchise bill (AB17) sponsored by the California New Car Dealers Association (public hearing, Melbourne, 22 June 2018).
2. Australian Automotive Dealer Association: AADA Automotive Code of Conduct Principles (public hearing, Melbourne, 22 June 2018).
3. Mr Jason Gehrke: Franchise royalties vs franchise behaviour model (public hearing, Canberra, 24 August 2018).
4. Back in Motion franchisees: Letters to the Committee (received between 3 and 17 September 2018).

Tabled documents

1. Mr Derek Sutherland: Summary of recommendations (public hearing, Brisbane, 8 June 2018).
2. Mr Derek Sutherland: Comparative disclosure obligations in a disclosure document - Australia to USA 2018 (public hearing, Brisbane, 8 June 2018).
3. Dr Jenny Buchan: Proposed changes to existing laws regulating the franchising sector (public hearing, Sydney, 29 June 2018).
4. Mr Rod Nuttall: Franchise finance and funding models (public hearing, Canberra, 24 August 2018).
5. ANZ Bank: (1) Opening Statement; (2) ANZ response to letter of 16 August 2018; (3) Example of ANZ brochure provided to prospective franchisees (public hearing, Canberra, 14 September 2018).

Answers to questions on notice

1. Domino's Pizza Enterprises Ltd: Answer to questions taken on notice from a public hearing on 22 June 2018 (received 13 July 2018).

2. Queensland Law Society: Answer to questions taken on notice from a public hearing on 8 June 2018 (received 12 July 2018).
3. Victorian Small Business Commission: Answer to questions taken on notice from a public hearing on 22 June 2018 (received 12 July 2018).
4. Business Council of Co-operatives and Mutuals: Answer to questions taken on notice from a public hearing on 29 June 2018 (received 20 July 2018).
5. Australian Competition & Consumer Commission: Answer to questions posed 3 August 2018 (received 28 August 2018).
6. Mr Rod Nuttall: Answer to questions posed 30 August 2018 (received 10 September 2018).
7. Craveable Brands Pty Ltd: Answer to questions taken on notice from a public hearing on 14 September 2018 (received 12 October 2018).
8. Australia Post: Answer to questions taken on notice from a public hearing on 14 September 2018 (received 12 October 2018).
9. Australia Post: Answer to questions posed 28 September 2018 (received 12 October 2018).
10. Caltex Australia: Answer to questions taken on notice from a public hearing on 14 September 2018 (received 12 October 2018).
11. ANZ Bank: Answer to questions taken on notice from a public hearing on 14 September 2018 (received 12 October 2018).
12. Australian Small Business and Family Enterprise Ombudsman: Answer to questions taken on notice from a public hearing on 21 September 2018 (received 18 October 2018).
13. McDonald's Australia Ltd: Answer to questions taken on notice from a public hearing on 21 September 2018 (received 22 October 2018).
14. Australian Competition & Consumer Commission: Answer to questions taken on notice from a public hearing on 21 September 2018 (received 19 October 2018).
15. Dr Sudha Mani: Answer to questions posed 3 October 2018 (received 19 October 2018).
16. Dr Tess Hardy: Answer to questions posed 3 October 2018 (received 19 October 2018).
17. ANZ Bank: Answer to questions posed 2 October 2018 (received 22 October 2018).
18. Commonwealth Bank of Australia: Answer to questions posed 26 September 2018 (received 25 October 2018).
19. ANZ Bank: Answer to questions taken on notice from a public hearing on 14 September 2018 (received 1 November 2018).
20. Foodco Group Pty Ltd: Answer to questions taken on notice from a public hearing on 14 September 2018 (received 15 October 2018).
21. National Retail Association: Answer to questions taken on notice from a public hearing on 16 October 2018 (received 31 October 2018).

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22. Small Business Development Corporation: Answer to questions taken on notice from a public hearing on 16 October 2018 (received 1 November 2018).
 23. NSW Small Business Commissioner: Answer to questions taken on notice from a public hearing on 16 October 2018 (received 31 October 2018).
 24. Australian Small Business and Family Enterprise Ombudsman: Answer to questions taken on notice from a public hearing on 16 October 2018 (received 7 November 2018).
 25. 7-Eleven Stores Pty Ltd: Answer to questions taken on notice from a public hearing on 14 September 2018 (received 12 October 2018).
 26. Ms Alicia Atkinson: Answer to questions posed 3 October 2018 (received 26 November 2018).
 27. Mr Tony Alford: Answer to questions posed 3 October 2018 (received 26 November 2018).
 28. Caltex Australia: Answer to questions posed 2 October 2018 (received 19 and 23 October 2018).
 29. Department of Jobs and Small Business: Answer to questions taken on notice from a public hearing on 21 September 2018 (received 19 October 2018).
 30. Franchise Council of Australia: Answer to questions taken on notice from a public hearing on 21 September 2018 (received 22 October 2018).
 31. 7-Eleven Stores Pty Ltd: Answer to questions posed 2 October 2018 (received 19 and 25 October 2018).
 32. Australian Competition & Consumer Commission: Answer to questions posed 8 November 2018 (received 22 November 2018).
 33. Mr Tony Alford and Ms Alicia Atkinson: Answer to questions taken on notice from a public hearing on 26 November 2018 (received 4 December 2018).
 34. National Australia Bank: Answer to questions posed 26 September 2018 (received 29 November 2018).

Appendix 2

Public hearings and witnesses

Friday, 8 June 2018 – Brisbane

Mr Mark William Bailey – Private capacity

Mr John Christensen – Private capacity

Queensland Law Society

Ms Simone Pentis, Member, QLS Franchising Law Committee

Mr Matt Dunn, General Manager Policy, Public Affairs and Governance

Shop Distributive and Allied Employees Association

Mr Gerard Andrew Dwyer, National Secretary-Treasurer

Mrs Emma Forsyth – Private capacity

Franchise Redress

Mr Michael Fraser, Director

Ms Maddison Johnstone, Director

Franchise Simply

Mr Brian Keen, Founder and Chief Executive Officer

Office of the Franchising Code Mediation Adviser

Office of the Oilcode Dispute Resolution Adviser

Mr Derek Minus, Franchising Code Mediation Adviser; Oilcode Dispute Solution Adviser

Mr Narashima Rao – Private capacity

Mr Robert Rippin – Private capacity

Mr Michael Andrew Sherlock – Private capacity

Maurice Blackburn Lawyers

Mr Giridharan Sivaraman, Principal

Mr Derek Charles Sutherland – Private capacity

Mrs Maria Varkevisser – Private capacity

Mr Robert Whittet – Private capacity

Friday, 22 June 2018 – Melbourne

Mr Sanjeev Bajaj – Private capacity

Australian Automotive Dealer Association

Mr David Blackhall, Chief Executive Officer

Mr Brian Savage, Director, Operations

Mr James Voortman, Executive Director, Communications and Policy

Victorian Automobile Chamber of Commerce

Mr Steve Bletsos, Senior Research Analyst

Mr Stuart Strickland, Industry Policy Adviser

Mr Anthony McVilly, Member

Victorian Small Business Commission

Ms Alice Bradshaw, Senior Advocacy Officer

Mr Mark Schramm, Acting Commissioner

Mr Daniel Shepherdson, Senior Manager, Advocacy and Monitoring Services

Mr Don Brown – Private capacity

Franchise Right Pty Ltd

Mrs Sussan Campbell, Director

D'Alberto Motors

Mr Clare D'Alberto, General Manager

7-Eleven Franchisee Association

Mr Paresh Davaria, Association Member

Mr Bikramjit Singh, Association Member

Motor Trades Association of Australia Ltd

Mr Richard Dudley, Chief Executive Officer

Mr Adam Gordon – Private capacity

Mr Chris Hackett – Private capacity

Dr Tess Hardy – Private capacity

Domino's Pizza Enterprises

Mr Nick Knight, Australia New Zealand Chief Executive Officer

Mr Don Meij, Group Chief Executive Officer and Managing Director

Mr Craig Ryan, General Counsel and Company Secretary

Legalite

Mrs Marianne Marchesi, Principal Lawyer

Franchise Relationships Institute

Mr Greg Nathan, Founder

Ms Devanshi Panchal – Private capacity

Jim's Group Pty Ltd

Dr Jim Penman, Managing Director

Motor Trades Association of Australia Ltd

Mr Peter Owen Roberts, Member and SA Executive Board Member

Mr Kamran Keshavarz Talebi – Private capacity

Friday, 29 June 2018 – Sydney

Dr Courtenay Atwell – Private capacity

Donut King, Marsden, Queensland

Mr John Banks, Owner

Mrs Julia Banks, Owner

Professor Jenny Buchan – Private capacity

Licensed Post Office Group Ltd

Mr Paul Desteno, Director/Secretary

Mr Graeme Obrien, Director/Secretary

Caltex National Franchise Council

Mr Bruce Hollett, Member

Lander & Rogers

Mr Tean Kerr, Partner

Australasian Convenience and Petroleum Marketers Association

Mr Mark Graham McKenzie, Chief Executive Officer

Mr Faheem Mirza – Private capacity

Mr Alan Ross Pearson – Private Capacity

Business Council of Co-operatives and Mutuals

Mr Anthony Taylor, Policy Officer

Michel's Patisserie, Charlestown, New South Wales

Ms Devi Trimuryani, Franchisee

Franchisee Federation of Australia

Mr Matthew Wheatley, President

Ms Maggie Xu – Private capacity

Friday, 24 August 2018 – Canberra

Mr Peter Bain – Private capacity

Franchise Advisory Centre

Mr Jason Gehrke, Director

Mr Rod Nuttall – Private capacity

Professor Andrew Terry – Private capacity

Tuesday, 11 September 2018 – Canberra

Retail Food Group Limited

Mr Colin Archer, Chairman of the Board

Mr Anthony (Mark) Connors, Director Corporate Services and company Secretary

Mr Richard Hinson, Director of Franchisor and Chief Executive Officer

Mr Peter McGettigan, Chief Financial Office

Friday, 14 September 2018 – Canberra

Foodco Group Pty Ltd

Mr Robert Henry Fitzgerald, Executive Director

Mr Serge Infanti, Managing Director

CIE Legal

Mr Peter George, Partner and Advisor to the Federal Chamber of Automotive Industries

Caltex Australia

Mr Steven Gregg, Chairman

Mr Julian Segal, Chief Executive Officer and Managing Director

Craveable Brands Pty Ltd

Mr Brett Houldin, Chief Executive Officer

ANZ Bank

Mr Mark Lang, General Manager, Business and Private Banking

Ms Claire Tinsley, Risk Engagement Lead, Business and Private Banking

7-Eleven Stores Pty Ltd

Mr Braeden Lord, General Manager, Retail Operations

Mr Angus McKay, Chief Executive Officer

Mr Michael Smith, Chairman

Federal Chamber of Automotive Industries

Mr Tony McDonald, Director, Industry Operations, Federal Chamber of Automotive Industries

Mr Tony Weber, Chief Executive

Australia Post

Mr David McNamara, General Manager, Post Office Network

Friday, 21 September 2018 – Canberra

Franchise Council of Australia

Ms Mary Aldred, Chief Executive Officer

Mr Stephen Giles, Board Director

Department of Jobs and Small Business

Mr Peter Cully, Group Manager, Small Business and Economic Strategy Group

Ms Andrea Stone, Acting Director, Small Business Policy, Deregulation and Small Business Branch

Ms Rose Verspaandonk, Branch Head, Deregulation and Small Business Branch

McDonald's Australia Ltd

Mr Andrew Gregory, Managing Director and Chief Executive Officer

Australian Competition and Consumer Commission

Mr Scott Gregson, Executive General Manager, Merger and Authorisation Review Division

Mr Timothy Grimwade, Executive General Manager, Consumer, Small Business and Product Safety Division

Mr Mick Keogh, Deputy Chair

Ms Kristie Piniuta, Director, Small Business and Industry Codes

Law Council of Australia

Mr Hank Spier, Committee Member, Small and Medium Enterprises Committee, Business Law Section

Tuesday, 16 October 2018 – Canberra

Mr Baden Burke – Private capacity

National Retail Association Ltd, Union of Employers

Ms Lindsay Carroll, Deputy Chief Executive Officer

Small Business Development Corporation

Mr David Eaton, Western Australian Small Business Commissioner

Mr Martin Hasselbacher, Director, Policy and Advocacy

Office of the New South Wales Small Business Commissioner

Ms Robyn Hobbs, OAM, New South Wales Small Business Commissioner

Mr Steven Mason – Private capacity

Professor Elizabeth Spencer – Private capacity

Tuesday, 26 November 2018 – Canberra

Mr Anthony James Alford – Private capacity

Ms Alicia Jayne Atkinson – Private capacity

Mr Andre Nell – Private capacity

Appendix 3

Previous inquiries, reviews and reforms

Year	Reviews and reforms
1976	<p>Trade Practices Act Review Committee Report (the Swanson Committee)</p> <ul style="list-style-type: none"> - Considered compensation to franchisees for loss of goodwill upon the termination of a franchise agreement by the franchisor. - Recommended franchisees be given the right to just and equitable compensation (Recommendation not enacted).
1979	<p>Trade Practices Consultative Committee report (the Blunt Review)</p> <ul style="list-style-type: none"> - Recommended changes to <i>Trade Practices Act 1974</i> to include franchise specific provisions: - Disclosure - Termination conditions - Transferring franchises to another person - Goodwill upon termination or non-renewal - Pecuniary penalties for breaching disclosure provisions.
1990	<p>House of Representatives Standing Committee on Industry, Science and Technology (Beddall Committee) report <i>Small business in Australia: Challenges, problems and opportunities</i></p> <ul style="list-style-type: none"> - Recommended re-examination of the case for specific franchise agreement legislation containing: - Prior disclosure documents - Cooling off period - Conditions for altering an agreement - Conditions for termination/renewal or transfer of franchises
1993	<p>Voluntary Franchising Code of Practice introduced containing provisions on:</p> <ul style="list-style-type: none"> - Disclosure - Cooling off period - Standards of conduct based on unconscionability - Dispute resolution procedures
1994	<p>Review of voluntary code of practice by Robert Gardini</p> <ul style="list-style-type: none"> - Found the Code lacked coverage (40–50 per cent of franchises registered) - Recommended a system of self-regulation or co-regulation to provide universal coverage for franchise systems
1997	<p>House of Representatives Standing Committee on Industry, Science and Technology (Reid Committee) report <i>Finding a balance: Towards fair trading in Australia</i></p> <ul style="list-style-type: none"> - Concluded that self-regulation did not work due to the lack of a viable regulatory strategy to account for the disparity in power between parties - Recommended specific legislation providing compulsory registration of franchisors and compliance with the code - Recommended that this legislation provide for the establishment of independent code administration bodies and dispute resolution procedures funded through compulsory registration fees

1998	<p>Mandatory industry code introduced in <i>Trade Practices Act 1974</i></p> <ul style="list-style-type: none"> - Advisory board established (the Franchising Policy Council) comprising three franchisors, three franchisees, two advisers and an independent Chair
2000	<p>First Council Review of the Franchising Code of Conduct, Report of the Franchising Policy Council</p> <ul style="list-style-type: none"> - Suggested that a short-form disclosure document for franchises with turnover of less than \$50,000 be considered - Concluded that pecuniary penalties should not be introduced for a breach of the Code. - Proposed that termination at the will of the franchisor should be monitored and procedural steps should be inserted in the Code to cover termination by the franchisee.
2001	<p><i>Trade Practices (Industry Codes-Franchising) Regulation 2001 (No. 1)</i> enacted the Franchising Policy Council's report's recommended amendments.</p>
2006	<p>Department of Industry, Tourism and Resources <i>Review of the Disclosure Provisions of the Franchising Code of Conduct</i> report (Matthews Review)</p>
2007	<p>Government response to the 2006 review</p>
2007	<p><i>Trade Practices (Industry Codes—Franchising) Amendment Regulations 2007 (No 1)</i></p>
2008	<p>Parliamentary Joint Committee on Corporations and Financial Services report, <i>Opportunity not opportunism: improving conduct in Australian franchising</i></p>
2009	<p>Government response to Parliamentary Joint Committee report</p>
2010	<p>Expert Panel's report <i>Strengthening Statutory Unconscionable Conduct and the Franchising Code of Conduct</i></p>
2010	<p><i>Competition and Consumer Act 2010 (Cth)</i></p> <ul style="list-style-type: none"> - Australian Consumer Law commenced 1 January 2011
2011	<p>Treasury's <i>Policy guidelines for prescribing industry codes under Part IVB of the Competition and Consumer Act 2010</i></p> <ul style="list-style-type: none"> - Set out types of considerations that may be taken into account by government when deciding whether to prescribe an industry code under the Competition and Consumer Act

Appendix 4

Comparison of dispute resolution systems

Section/Clause numbers are in brackets where appropriate	Franchising Code of Conduct	ASBFEO	Food & Grocery Code of Conduct	AFCA
Internal dispute resolution stage	Yes (34–39)	No requirement	Requirement to appoint code compliance managers (32)	Yes (E.1)
Mediation / negotiation	Yes (40–45)	Can recommend parties to alternative dispute resolution (4, 71, 73)	Yes (38)	Yes (A.8)
Conciliation	No	Can recommend parties to alternative dispute resolution (4, 71, 73)	No	Yes (A.8)
Arbitration	No	No (4)	Yes (38)	Yes (A.8)
Thresholds and eligibility criteria	No	Yes (4–6)	No	Individuals and organisations with less than 100 employees (C.1)
Cost	Each party pays (43)	Free	Each party pays (39)	Free
Independent review	No	Ombudsman may publish failure to participate (74)	No	Yes for AFCA handling of a matter only (A.15–16)
Dispute resolution body has immunity from liability	Not specified	Not known	Yes for mediation and conciliation	Yes (A.22)

Structure	Office of the Franchising Mediation Adviser provides advice and appoints independent mediators if requested by either party (40)	Statutory body recommending commercial services	The Resolution Institute is a commercial provider of mediation, conciliation and arbitration services	Not-for-profit company with board (equal representation from industry and consumers) that appoints Ombudsmen, adjudicators and panel members
Funding	OFMA funded by Commonwealth	ASBFEO funded by the Commonwealth	Commercial	Industry funded through levies based on level of complaints
Time limits	Terminate after 30 days if no action (42)	Yes if the person became aware of the issue more than 12 months before requesting assistance (68)	Yes for starting investigations, resolving complaints (34) and for appointing the mediator or conciliator (39)	Yes for lodging complaints
Remedies Compensation Award Interest Award Costs	Not specified	Not specified	Yes (31)	Yes (D) Yes (D.3–4) Yes (D.6) Yes (D.5)
Able to impose fine or penalties	Civil penalties for failing to attend (39, 41)	No – however the ASBFEO may publicise failure to participate (74)	No	No
Operational rules and guidelines	Clauses (39–45)	<i>Australian Small Business and Family Enterprise Ombudsman Act 2015</i> and rule prescribed by the Minister (72)	Rules of the Institute of Arbitrators and Mediators Australia	AFCA Complaint Resolution Scheme Rules
Representation allowed	Yes (39, 41)	Not specified	Yes (39)	Yes (A.16)
Mandatory	The Code is mandatory	No	No	Yes - AFS Licensees are required to join

Restrictions on stronger party during dispute resolution	No	Not specified	No	Yes, constraints on legal action, debt recovery and defamation action (A.7)
Powers to gather information	No	Yes (75–78)	No	Yes (A.9)
Matters referable to regulators	No	Yes (15)	No	Yes (11.5) For serious breaches AFCA must refer
Regulatory oversight	ACCC	Minister (20, 24– 33)	ACCC conducts audits	By ASIC under <i>Corporations Act 2001</i>
Review by a court of other body	Yes (37)	Yes (92)	No	The complainant is not bound by the determination and may seek court action (A.15)

Notes: Grey shading indicates features of the AFCA scheme that are not in the Food and Grocery Code of Conduct.

Sources: Competition and Consumer (Industry Codes— Franchising) Regulation 2014; *Australian Small Business and Family Enterprise Ombudsman Act 2015*; Australian Financial Complaints Authority, *Operational Guidelines to the Rules*, 1 November 2018; Australian Financial Complaints Authority, *AFCA Funding Model Overview*, July 2018, p. 4; Australian Securities and Investments Commission, *Regulatory Guide 165 Licensing: Internal and external dispute resolution*, p. 4; The Institute of Arbitrators and Mediators Australia, *Mediation and Conciliation Rules*, November 2001, p. 3; Resolution Institute, *Mediation Rules*, 8 September 2016; Resolution Institute, *Arbitration Rules*, 3 August 2016; Office of the Franchising Mediation Adviser, *Franchising Mediation Adviser*, <https://franchisingcode.com.au/about-franchising-code/> (accessed 25 October 2018); Australian Competition & Consumer Commission, *Resolving franchising disputes*, www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/resolving-franchising-disputes (accessed 25 October 2018); Australian Competition & Consumer Commission, *Food and Grocery Code of Conduct*, Complaints & Disputes, www.accc.gov.au/business/industry-codes/food-and-grocery-code-of-conduct/complaints-disputes (accessed 25 October 2018).

Appendix 5

Comparison of Industry Codes of Conduct

Clause numbers are in brackets where appropriate	Franchising Code	Oil Code	Food & Grocery Code
Mandatory	Yes	Yes	No
Transitional application	Yes (5, 6)	Yes (6)	Yes (5, 6)
Written agreement / contract	Yes	Yes	Yes (8)
Unilateral variation ban	No	No	Yes (9)
Retrospective variation ban	No	No	Yes (10)
Ban on wastage and shrinkage payments	No	No	Yes (13, 14)
Supplier rebates ban	No	No	Yes (15)
Payments for other party's activities ban	No	No	Yes (17)
Business disruption grounds	No	No	Yes (23) must be reasonable
Freedom of association	Yes (33)	Yes (26)	Yes (29)
Duty to train with respect to code	No	No	Yes (40)
Pre-entry disclosure by franchisors: <ul style="list-style-type: none"> • Information statement • Disclosure document • Code • Final franchise agreement 	Yes Yes Yes Yes	No Yes Yes No	(8) Matters to be covered by the agreement
Minimum duration for agreement	No	Yes—5 years (subject to exceptions)	No

	Franchising Code	Oil Code	Food & Grocery
Cooling-off period	Yes	Yes	No
General obligation for parties to act in good faith	Yes	No—limited to mediating and changes to renewed franchise agreements	Yes (28)
Record keeping obligation	Yes	No	Yes (42)
Prohibition against significant capital expenditure	Yes	No	No
Prohibition on general release from liability	Yes	Yes	No
Prohibition against waivers clause	Yes	No	No
Marketing fund provisions	Yes—Annual financial statement required 4 months from end of financial year, copy to franchisees in 30 days	Yes—Annual financial statement, required 3 months from end of financial year, copy to franchisees in 30 days	Conditions for compulsory and optional funding of promotions (18, 20)
Requirement to audit annual financial statement	Yes unless 75% of contributing franchisees vote not to	Yes unless 75% of contributing franchisees vote not to	No
Availability of mediation	Yes if unresolved after 3 weeks	Yes	Yes (38)
Parties must pay own mediation costs	Yes	Yes	Yes (39)
Exit (termination) arrangements for the weaker party	No	Yes (38)—Franchisor required to pay proportion of costs for agreed terminations	(19) some conditions on delisting
Financial penalties available for breaches	Yes—some civil pecuniary penalties	No	No

Source: Australian Competition and Consumer Commission, *Submission 45*, p. 24; Competition and Consumer (Industry Codes—Food and Grocery) Regulation 2015; Competition and Consumer (Industry Codes—Franchising) Regulation 2014; Competition and Consumer (Industry Codes—Oil) Regulations 2017.

