SUBMISSIONS TO THE FEDERAL GOVERNMENT ENQUIRY INTO THE FRANCHISING CODE OF CONDUCT

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Executive Summary

In too many companies that sell franchises, a failed franchise means a loss of business, home, livelihood, credit rating, relationship, dignity, self-esteem and – in extreme cases – life, ***to the franchisee****. To the* ***franchisor*** *franchise failure represents an opportunity to sell the business again at a large profit. Not only that, if the shop still operates, the business may also be referred to (by the franchisor at least) as a successful franchise, even if the franchisee is bankrupt.*

Until this underlying attitude prevalent in too many franchise systems disappears, you can have all the Codes of Conduct you like, people will still be burned at far too high a rate by the unfulfilled promises of franchising.

To the extent that a Code of Conduct can regulate the franchisor/franchisee relationship, there needs to be far greater disclosure by franchisors of the things that prospective franchisees really need to know in order to fully assess the pros and cons of the franchise they are considering. Bearing in mind the level of investment that people, often ordinary "mums and dads", make when buying a franchise, it is not unreasonable to expect levels of disclosure (and corporate behaviour) equivalent to that of companies listed on the Australian Securities Exchange.

For reasons best known to themselves, franchisors and their advocates have steadfastly resisted the introduction into franchising of the concept of "good faith", despite it being so prevalent in legislation across the broadest range of our laws, and despite it being recommended by Parliamentary enquiries in this country on more than one occasion. Rather than resisting such measures, good franchisors and franchisees should welcome it, and go further – by introducing the concept of a fiduciary duty owed by a franchisor to all of its franchisees. That is, not only a duty of good faith but also one of loyalty and trust.

Franchisees also need improved protection at the end of franchise terms, because at present very few franchisees can walk away at the end of their terms receiving the real value of their businesses. Moreover, when things do go wrong, far too often franchisees have to "go it alone" in pursuing their rights, because the Australian Competition and Consumer Commission (ACCC) either cannot or will not intervene. All this at a time when franchisees are in no financial or emotional position to take action.

Introduction

1. I am a lawyer with more than 20 years' experience in legal practice, both litigious and transactional. I currently practise in a number of different areas of law, including advising franchisees prior to entering a franchise system, as well as representing franchisees that are having difficulties with their franchisor and/or possibly facing franchise termination.

2. I have also been a franchisee. I was a master franchisee with James' Home Services (JHS) in 2009 and 2010. Regrettably, my time with JHS was one of the most disappointing and degrading experiences of my life, and has resulted in litigation which as at the date of this submission remains unresolved. I will mention aspects of my experience in this submission in passing, though my submission is based more on my experience with other franchise systems and my considerable reading on the subject.

3. Prior to entering JHS I had very little experience with franchise law and it has only been in recent times that I have come to realise how little I knew at that time about franchising, despite my experience in the law.

4. My credentials to make submissions to this enquiry about franchising are therefore very sound. There would be few if any people in this country that have:

- Bought a franchise;
- Sold franchises;
- Been a party to franchise mediation and litigation (and the emotional and financial rollercoaster that that brings); and
- Practised in franchising law, including franchising disputes.

5. I am conscious of the terms of reference for the Review and I will attempt to address those terms as closely as possible. However, I will also make some general points about the realities of franchising, particularly from the perspective of franchisees who, according to the *Franchising Australia 2012* report conducted by Griffith University (Franchising Australia 2012), outnumber franchisors by a ratio of somewhere in excess of 60 to 1.

6. Reliable data regarding franchising in Australia is difficult to find, yet pro-franchisor advocates profess that all is well in franchising, failed franchisees are relatively few (and usually the fault of the franchisees themselves), and that those who stand up for franchisees have no idea what they are talking about. Those sentiments were publicly reiterated by a former CEO of the Franchise Council of Australia (FCA) only in the week leading up to the deadline for submissions for this review[1]. The fact is that there is no reliable statistical data to support my claims that not all is well in franchisee world. However, those who speak for franchisors must make the same concession when they claim that franchising is healthy.

7. The only Australian survey that goes close to being a systematic survey of franchising, Franchising Australia 2012 (and earlier versions) has its merits, but the capacity to draw any real conclusions on the health of franchising from it is not one of them. For example:

   - Only franchisors were surveyed.
   - Of the 1,137 franchisors identified in Australia, 126 responded to the survey, a response rate of only 11.6 percent – hardly a representative sample.
   - The survey found that there were an estimated 65,000 business format franchised units in Australia.

   Accordingly, the report is based on the responses of 126 out of over 66,000 Australian franchisees and franchisors – less than one fifth of one percent.

8. Hence conclusions that are made in Franchising Australia 2012 (and relied on by those seeking to assure us that all is well) like "*across the sector the proportion of franchisees in dispute with their franchisor was estimated at 1.5 percent*" are difficult to justify. I am not criticising the authors of the report – it is commendable that someone is at least looking in to the franchising sector, and the more research carried out the better. I am simply cautioning against drawing significant conclusions as to the state of franchising in Australia from its results.

[1] Richard Evans, Smart Company 12 February 2013

Good franchising should be encouraged

9. Unlike, I suspect, some people who will make submissions as existing former franchisees or on their behalf, I actually am personally a fan of franchising. Let me rephrase that – I am a fan of ***good*** and ***fair*** franchising.

10. Franchising at its best reflects the best aspects of capitalism. That is, a willing buyer and a willing seller negotiating for a product or service with each other in good faith from equal or near equal bargaining positions in a mutually beneficial transaction. Sadly, this ideal does not reflect the reality of franchising in Australia in a lot of franchising systems, in particular equality of bargaining power. There are few areas of commerce in Australia in which the odds are so squarely stacked against one party.

11. I note from the Discussion Paper that was published in relation to this Review the purpose of industry codes under the *Competition and Consumer Act 2010*, namely that they are "*co-regulatory measures, designed to achieve minimum standards of conduct in any industry whether is an identifiable problem to address. Industry codes can be used as an alternative to primary legalisation in incidences where market failure has been identified*".

12. In many ways it would be preferable if the Franchising Code of Conduct (the Code) was not necessary and that the market would take care of any inequities in the relationship and respective bargaining powers. Given the reality of the relationship between and respective bargaining powers of franchisors and franchisees, I cannot see that happening any time soon.

13. In Australia the franchising environment has evolved in a particular manner, initially with little or no regulation, then voluntary codes of practice, then the Code, which has been amended a couple of times. I do not believe it is evitable that franchising is best served by incremental amendments to the Code. Unlike the USA, whose franchising industry is subject to state by state regulation, making it extremely difficult to regulate business across state borders, in Australia franchising is governed by a federal system, so it would be remiss of the Federal Government not to take the lead in Australia and aim to develop best practice, not incremental changes to the minimal standards of an imperfect system.

14. A number of worthwhile amendments to the Code have been recommended in previous Federal and State enquires into franchising. The franchisor lobby headed by the FCA has done its job very well in ensuring the Government puts the kybosh on a lot of those very worthy efforts and recommendations, and as a result States like Western Australia, Queensland, New South Wales and my own State of South Australia are looking at State-based regulation. Honourable politicians like Joanna Gash, Peter Abetz and Tony Piccolo have heard first-hand numerous horror stories of franchising (many of which have been retold in submissions to previous franchising enquiries), and have led these pushes because of the inadequacy of the Federal Government in regulating this important area of business. I have seen the perils that the lack of uniformity across State laws has produced in many areas of law. State by State regulation in an activity as important as franchising is something that ought to be avoided if at all possible, but certainly not at all costs. If the Federal Government will not provide adequately protection to franchisees, the States can hardly be blamed for stepping in.

The stark reality of franchising for many

15. It is difficult for me to make any meaningful comparison between the conduct of the participants in franchising before and after the various amendments to the Code, as my personal involvement in franchising has been relatively recent. What I can say however that it is one thing to have a code of conduct, but for many franchisees the ***reality*** of franchising lives very much outside the Code and from what I have read and experienced, has changed little over many years. Those realities include:

    - The attitudes of franchisors and indeed the franchising community generally promoting the supposed safety of franchises compared to other forms of business ownership – something that is demonstrably false;

- False claims in marketing material that franchisees will "own" their businesses, when the plain fact is that they are often left with a next to worthless "asset" at the end of the franchise term;

- Bullying and public vilification of franchisees by the franchisor (which I can tell you from personal experience does not always cease when the franchise does);

- Lack of good faith;

- Control of leases by franchisors in retail and other sectors in which a physical locality of the franchise business is a factor, enabling the franchisor to exert almost total control over a franchisee's business;

- Franchise churning; and

- Lack of obligation and will on the part of franchisors to train franchisees and to assist in the development of the franchisees' businesses, despite lofty claims in marketing material that "*you are in business for yourself but not by yourself*".

Misleading claims on franchise success rates

16. It has long been claimed by what I will term the "*franchising industry*" that franchises are much safer business investments than other forms of going into business. Despite the significant amount of empirical evidence to the contrary, many of the "*players*" in the franchising industry still promote franchising in such a way. For example:

    - The website of the FCA, which claims to represent all sectors of the franchising industry (but which in reality does not and in my view cannot) states that "*franchising is by far the most successful form of small business*", while pointing out correctly that there are "*many of the same risks inherent to any other business venture*".

    - In JHS, I was a master franchisee and therefore part of my role (and that of my sales consultants) was to sell franchises. To do so I was required to follow a sales presentation script that suggested to prospective franchisees that the chances of success to the franchise were 95% as opposed to 35% in other forms of business.

    - A Melbourne firm of franchise consultants[2] states on its website "*with such astronomical growth in the industry* ***and a touted 90% success rate for established franchise systems****, it's little wonder that when you are thinking about starting a business, franchises appear to be an attractive option*".

    - Even Franchising Australia 2012 states that "*90% of franchisees were operating profitably*". The problem with that survey as indicated above is that only franchisors were surveyed (and to that question only 39 responded). I suspect that many of those franchisees have a very different perspective on their profitability. Apart from anything, my experience is that most franchisors derive their royalties from a franchisee's turnover, not profit, so in many cases they would have no idea whether their franchisees were profitable.

17. Given the paucity of methodical research into the success or otherwise of franchise businesses, it is difficult to avoid the conclusion that these percentages have been plucked from thin air. Apparently the US Department of Commerce in a study about 30 years ago reported that 95% of all franchisees were still in business after 5 years. That "*statistic*" has been discredited so many times, particularly in the United States, that it is hardly worth addressing any further, but percentages in that order are still spewed out by those representing franchisors when trying to recruit franchisees. Recently the US Small Business Administration (an arm of the US Federal

[2] McDonnell, McPhee & Associates, quote accessed on 6 February 2013

Government), declared, not for the first time, that "***survival among independent businesses and franchises appears to be similar***".[3]

18. I am not aware of any systematic research in Australia on this topic, but it would surprise me if the position were any different here. In any event, the claims set out above are based on opinion, not empirical evidence.

19. What is evident in Australia is that ***entire franchise systems*** have disappeared or faced insolvency, leaving misery and despair in their wake. Consider the following well-known franchise brands in a wide range of industry sectors that have either disappeared or had what might neutrally be called "insolvency events" over the past decade or so:

Kleenmaid	Baskin Robbins	Klein's	Angus & Robertson
Traveland	Borders	Midas	Kenny's Cardiology
Bean Bar	Souvlaki Hut	Cookie Man	David Reid Homes
MyATM	EzyDVD	Strathfield Audio	Refund Home Loans
Pets Paradise	Cut Price Deli	Darrell Lea	Go Gecko

and others have disappeared or gone into administration, with dire consequences (financial and otherwise) for their many franchisees and staff. Only in the past week a relatively new franchise (in Australia at least), Secret Recipes, has been placed into administration. Entire franchise system failure in well-known brands makes a lie of the oft-quoted supremacy of franchises over other forms of business. The sheer weight of numbers of businesses associated with these recent failures points to a failure rate in the franchising industry of far more than the low numbers being touted by advocates of franchising, especially when compounded with failures and churning within those franchise systems still operating.

20. The issue also arises as to what "*success*" in franchising actually means. That relates to large extent to the concept of franchise churning, of which much has been written. What a successful business is to a franchisor does not necessarily mean the same thing as it does to a franchisee. I am aware of franchises in quite large, well-known franchise chains in which there have been several different franchisees in the same shop space over a relatively short period of time, all or most of whom have "*gone broke*" well before the scheduled end of the franchise term, but the business itself continues to run (at times run by the franchisor as a company store) and is therefore considered by the franchisor to be "*a success*" because the store itself has remained in business. One suspects that none of the franchisees in question considered their businesses to have been a success, at least not at the end of it. It is also a practice of some franchisors to hide failures, closures and churning through "transfers" back to the franchisor or a "friendly" franchisee or Master Franchisee, thereby creating a misleading representation of the true state of affairs. I am aware of this conduct from personal experience.

Disclosure – the reality

21. The Code places a lot of emphasis on pre-purchase disclosure. True, the disclosure document provisions appear on their face to be quite extensive and anyone with a passing knowledge of franchising would agree that there is a lot of disclosure required and such a disclosure ought to give perspective franchisees a pretty good insight into the company. However, those of us with a bit more (possibly bitter) experience in the industry understand the many shortcomings of the Code's disclosure provisions.

22. One thing that ought to be said about disclosure is that those who represent franchisors concede that more and more matters ought to be disclosed. Disclosure can be seen as the franchisor's insurance policy against later claims of misrepresentation, misleading and deceptive conduct and the like. A disclosure document can be as thick as a bestselling book and full of jargon and legalese that would put most prospective franchisees off. In truth, franchisees who sign franchise agreements without fully reading or understanding what they are getting into may be to blame for their own problems, but they should be doing anything but

[3] In its August/September 2012 periodical *The Small Business Advocate*.

cutting corners, and seeking counsel from a lawyer well educated and experienced in franchising law and practice, a good business accountant and even a business advisor.

23. It must be remembered that franchising is nothing more than a method by which a business owner may grow their business. It is not a business in itself. There are other ways in which a business may grow, including a public share float, obtaining venture capital or other finance, going into partnership, entering a joint venture, or simply employing more staff and opening more stores, particularly in the sales and business development area.

24. Franchisors may complain about the red tape associated with franchising, the disclosure requirements and the like, but they must remember that the current disclosure requirements pale into insignificance compared to the disclosure and other requirements necessary for a public share float[4]. A quick look at the ASX Listing Rules confirms this. While I profess no expertise in initial public offerings, consider the following examples:

- ASX has to admit the company to the Official List;
- A Product Disclosure Statement, Prospectus or Information Memorandum has to be lodged with and approved by ASIC;
- Each officer of the company has to be of good character and approved by ASX;
- ASX has to be provided with audited accounts for the previous 3 years or for as long as the company has been traded if it is less than 3 years;
- There are thresholds of levels of profit, net tangible assets and/or market capitalisation, as well as a requirement of significant amount of cash based assets and working capital;
- There are significant fees payable to ASX and significant ongoing disclosure and notification obligations.

25. As an example I have attached a prospectus I discovered in relation to a recent IPO for a company called Indoor Skydiving Limited. It was admitted to the official ASX list in January 2013. The prospectus was designed to raise a maximum of $12,000,000.00. To put that into a franchising perspective, a national retail franchisor in the food industry might be able to raise that amount of money in a year or less by selling franchises. I am not suggesting you read the prospectus from cover to cover, but it is worth looking at some of the salient categories of information in the prospectus, namely:

- Overview of the investment opportunity;
- Risk Factors (3 pages setting out the risks associated with the investment);
- Industry Overview;
- Opportunities;
- Overview of the Business;
- Details of Corporate Governance;
- Detailed financial statements;
- A lot of detail regarding its current projects and how it intends to make a profit;
- Details of the remuneration and shareholdings of the company's directors.

[4] The FCA has made a submission to this enquiry that the Code disclosure obligations are now arguably more extensive and prescriptive than those that apply to corporate fundraising under the *Corporations Act 2001*. The paragraphs in this submission that follow should dispel that myth.

26. Bear in mind that a start-up publicly listed company such as this would probably only expect to attract "*mums and dads*" willing to invest maybe $5,000.00 - $10,000.00 at most. In contrast, many franchisors, particularly those whose franchises carry significant levels of plant and equipment and/or inventory, are looking for "*mum and dad*" investors often in the hundreds of thousands of dollars.

27. Many franchisees are going in to business for the first time. Often they don't know what they know, let alone what they don't know.

28. With all of this in mind, my view is that the disclosures that ought to be made in order to give a prospective franchisee a ***real*** perspective on the franchise, and additional to those already set out in the Code, are as follows:

- All of the foreseeable risks, including:
  - The potential for failure of the franchisor, and the catastrophic impact that can have on a franchisee's business;
  - The risk that the business will not be as profitable as it was stated to be in pre-contractual negotiations (for example the recent Billy Baxter's decision in the Supreme Court of Victoria);
  - The risk that the franchise "*system*" will not work in the franchisee's locality due to climatic, economic, demographic or other circumstances;
  - The risk that the franchisor will compete with the franchisee (for example by way of e-commerce or direct mail, or by opening another store (company or franchisee operated) in the vicinity of the franchisee's store;
  - The risk of the franchisor not providing adequate training, and how that might impact on the profitability of a franchisee's business;
  - The risk that the franchisee may not (consciously or unconsciously) follow the system of the franchisor;
  - The risk of *force majeure* events;
  - The risks associated with business generally.

- Over the period of, say, 3 years prior to the Disclosure Document's publication:
  - The number and nature of disputes lodged by franchisees and the names and contact details of all franchisees involved in such disputes.
  - The number of mediations between franchisees and the franchisor and the names and contact details of all franchisees involved such mediations. Given the almost prohibitive cost of litigation to the average franchisee, mediation levels provide a much more reliable measure of the level of disputation within a franchise system.
  - The amounts paid, goods-in-kind, rebates or benefits of whatsoever nature provided by suppliers, landlords and the like to the franchisor, and full details of the application of such amounts by the franchisor.
  - The number of franchisees sold year by year, and the number of franchises (including company stores) as at 30 June in each of those 3 years. This will enable a franchisee or prospective franchisee to monitor the overall growth (or decline) of the business.
  - Detailed financial statements of the franchisor, distinguishing between the sales of product/service as opposed to sales of franchises. This will give franchisees an idea whether the franchisor is in the business of selling their product or service as opposed to selling franchises.
  - The number, names and contact details of all people involved in the administration and management of the franchisor (whether employees or consultants/contractors) that have left the franchisor.

- Whether the franchisor or an associated company holds the head lease if the franchise is to operate from leased premises and if so, whether the franchisee pays more to lease the premises than the franchisor does.

- Consequences of a breach of the lease on the franchisee's obligations under the franchise agreement.

- The franchisor's plans for growth of the business, and if they exist, copies of the franchisor's business and marketing plans. This will allow the prospective franchisee to consider if they share the same vision as the franchisor, consider if the franchisor's core business is growing its brand by developing franchisees to sell its products and services, or if it is just in the business of selling franchises, and have the plan considered by a business adviser.

- All operations manuals and any other material that governs the relationship between the franchisor and the franchisee. As many franchise agreements require compliance with all operations manuals (with failure to do so being a breach of the agreement), it is imperative that the franchisee is aware of their contents before they sign the franchise agreement, not after.

- A complete history of those involved in the management of the franchisor including where they previously worked, which will enable reference checking by the franchisee.

- In the case of a franchise business situated in or referable to a particular location (eg a shopping centre), disclosure of the entire history of that store while it has been in the franchise network including the names and last known contact details of all previous owners.

- The existence, contact details and length of time of existence of any franchisees' association or franchisee advisory council within the franchise network. This will allow a prospective franchisee to assess the relationship and level and quality of communication between the franchisor and its franchisees.

- Disclosure that at the conclusion of the franchise agreement for whatever cause, the franchisee may have a worthless asset (unless laws are changed relating to end of term requirements, discussed below). Very few franchisees realise this, until they get to the end of the franchise term and find they walk away with practically nothing.

- The number and identity of all company-owned businesses within the franchise system.

- Whether the franchisor offers a product or services that can be purchased online, mail order or in such a way that bypasses the franchisee, and if so, whether and how the franchisees are compensated in the event of a customer living in their area buying by this means. This is especially relevant in respect of items that can be easily purchased via the internet such as books, music, DVDs and the like.

29. As in many areas of business and other life, we can learn a lot (good and bad) from the United States of America in the area of franchising[5]. I have attached a copy of the Universal Franchisee Bill of Rights and the American Association of Franchisees and Dealers' (AAFD) Fair Franchising Standards, that have been in place and evolving for a number of years. While by no means reflecting the reality of franchising in America, the Fair Franchising Standards (which have been formulated by stakeholders in all parts of the franchising industry, not only franchisees) set a benchmark in franchising that is fair for both franchisors and franchisees – something that quite frankly we in Australia can only dream about at present.

[5] Business format franchising is generally accepted to have started in the USA in the 1850's with the Singer sewing machine company.

Good Faith

30. The terms of reference include an enquiry into good faith in franchising. Franchisors and their advocates have steadfastly resisted the introduction into franchising of the concept of "*good faith*". The standard argument from the franchisor lobby is that "*good faith*" is very hard to define and that creates a lot of extra uncertainty into the franchise relationship. I suggest that someone who should tell that to the people who prepared the 643 provisions in Commonwealth legislation[6] where the term "*good faith*" appears. Some of these provisions create criminal liability. The duty of utmost good faith has been pivotal to the *Insurance Contracts Act* for nearly 30 years. Acts by members of the Future Fund Board of Guardians that are not made in good faith expose board members to the risk of 5 years in prison. That is just an example that I found by looking on the Australasian Legal Information Institute (AustLII) website. If the Commonwealth Parliament believes that a person can go to prison for up to 5 years for failing to act in good faith, it obviously believes that the concept of "*good faith*" is unambiguous.

31. Even more relevantly, section 181(1) of the *Corporations Act 2001* requires a company director or officer to exercise their powers and discharge their duties in "*good faith*" and in the best interests of the corporation. Failure to do so exposes them to a civil penalty.

32. The Joint Commonwealth Committee in 2008 considered many submissions in relation to good faith, and recommended that "*Franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement*". That recommendation was rejected. It is only one of many recommendations arising from Parliamentary enquiries into franchising that have not been implemented. What did happen was an amendment to the Code made in 2010[7] which in my view is meaningless as it does create an enforceable obligation. It might as well say that the parties to a franchise agreement should not steal from each other. It is true but it adds nothing.

33. A lot of franchise agreements I have read already impose an obligation on *franchisees* to act in good faith in all aspects of the franchise relationship. If those agreements routinely imposed reciprocal obligations on franchisors, no amendment to the law would be necessary. However, they do not.

34. As a very minimum, the law should change to reflect the recommendation of the Joint Commonwealth Committee. However, I believe the law should go further.

Fiduciary duty in franchising

35. Rather than resisting measures relating to good faith in franchising, good franchisors and franchisees should welcome them, and go further – by introducing the concept of a ***fiduciary duty*** owed by a franchisor to all of its franchisees. That is, the parties to a franchise agreement should not only display good faith but also loyalty and trust. Franchisors are held out by the industry as supportive benefactors and guardians of their franchise systems and their franchisees. They talk about being partners in growing their businesses.[8] Business partners owe fiduciary duties to each other. Franchisees rely on their franchisors to help in building their businesses, just as franchisors rely on their franchisees to build theirs – only the franchisees' duties of good faith, loyalty and trust are usually express terms of the franchise agreement, whereas in most franchise agreements positive duties on the franchisor to do anything are few and far between.

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[6] I looked at the AustLII website and searched the phrase "good faith" in the field "All Legislation Databases", and found it appears 18,063 times. I am not saying there are that many laws that impose a duty to act in good faith, but even if 10% of that figure (1,806) represents the number of laws relating to the duty to act in good faith, that is a lot of laws in anyone's language.

[7] Clause 23A: Nothing in this code limits any obligation imposed by the common law, applicable in a State or Territory, on the parties to a franchise agreement to act in good faith.

[8] Though franchise agreements often specifically state that they are not partners.

36. In my view a fiduciary duty should be imposed on a franchisor in all areas in which the franchisor has the ability to act in a way so as to impact on a franchisee's business either positively or negatively. A good example is by not competing with the franchisee. Competition can take place by way of online sales, mail order or other means by which products and services can be ordered online or otherwise bypassing the local franchisee. It also can occur where a franchisor can open a company store or set up a new franchise in an area within or close to the franchisee's location. A lot of location-based franchises have no exclusivity or at least are exclusive only to the shopping centre in which are located (and sometimes not even then). Blind Freddy can see that by opening a store nearby and saturating the market, it is going to impact negatively on the franchisee's business.

37. Competition by franchisors against its franchisees is only one area in which a fiduciary duty impacts on franchisor behaviour. Others include the franchisor's dealings with suppliers and landlords, which must be for the benefit of the franchisees, not an opportunity for the franchisor to profiteer, dealing with the franchisees at the end of their terms, and dealing with issues that adversely affect the franchisor's brand (which is one of the few things a franchisee actually can count on receiving when he or she invests in a franchise).

Consequences at End of Term

38. One of the great myths of franchising, the "*franchise fraud*" as Robert Purvin Jr of the AAFD puts it, is that a franchisee has a business he or she can call his or her own. With franchising, nothing could be further from the truth. Many franchise agreements provide that at the end of the franchise agreement (and any extended terms) for whatever cause, the franchisee must vacate the premises, deliver up the business to the franchisor, return all operations manuals and marketing material, transfer business names and trademarks where applicable and get on with their lives, usually with a restraint from working in the same industry for up to 2 or more years afterwards. This is certainly not made clear in the current disclosure document provisions.

39. When a franchisee leaves the business, particularly at the end of a reasonably long franchise agreement, with the only reason for termination being effluxion of time, I have no issue with the franchisor taking back the business and doing what it likes with it – a franchise is after all a licence to operate for a limited time. However, the franchisee should be given fair compensation for the franchise if the franchisor wishes to take it back. That should be at an agreed value or in default of agreement at a fair market value as determined by a valuer with experience in valuing businesses in the particular industry in which the franchise operates. It should not be an opportunity for a franchisor to take back the plant and equipment at "fire sale" value, and pay no goodwill – something the franchisee has worked very hard to build up – as I have seen in agreements (and rigidly enforced by franchisors in practice).

40. If the franchisor buys back the business at fair market value, then the draconian restraint of trade clauses that I see in many franchise agreements could be justified and enforceable, but my view few such clauses are enforceable because, apart from anything else, they lack consideration. The franchisee agrees to leave the area and/or the industry and receives nothing in return.

41. Moreover, if a franchisor has to pay fair market value to a franchisee upon termination (for whatever reason), that might reduce the incidence of franchise churning that exists in many franchise systems.

42. A lot of franchise agreements I see require the franchisee to litigate any proceedings arising in the home state of the franchisor. I advise the prospective franchisee to negotiate an amendment to terms to allow them to litigate in their home territory, but again these matters are rarely negotiated. In most circumstances it is probably necessary to enact amendment legalisation or regulation to give franchisees the right to litigate and bring alternative dispute resolution proceedings in their home State, and that the laws of their home State govern the franchise. There is a simple justification for this, namely, if a franchisor chooses to do business in a particular State, they should abide by that State's laws and submit to the jurisdiction of its courts.

43. On a related topic, the law needs to deal with the tension between franchising law and insolvency law a lot better than it currently does. When a franchisor is placed into liquidation, receivership or has an administrator appointed, the liquidator, receiver or administrator is usually not well equipped to deal with a network of franchisees. Certainly the RED Group collapse in 2011 (Borders/Angus & Robertson) showed the uncertainty and potential for disaster that franchisees face and the total inadequacy of Australian franchising law to deal with the nightmare scenario of when the franchisor collapses through no fault of their own.[9]

44. Dr Jenny Buchan from the University of NSW has written a number of excellent relevant papers and articles and she should be consulted at length on this topic. Not only will reform in this area protect franchisees, it can also give some much-needed guidance for insolvency practitioners.

Enforcement – Competition and Consumer Act 2010

45. Before I address this topic, I must admit to be alarmed by one of the quotations in the Discussion Paper, namely "*the imposition of large penalties on a franchisor may have the potential to affect the viability of the franchisor's business. While this may be a reasonable repercussion insofar as the franchisor is concerned, there is potential for flow on effect to the franchisees. For example, support from the franchisor might be reduced, or the franchisor might increase franchise fees to accommodate the extra risk associated with the possible position of the pecuniary penalties*". With respect, this will not happen with ***good*** franchisors. The quote above reflects an attitude of "*too big to fail*" which prevails in the United States and to a large extent in this country about the banking sector, and has resulted in many despicable acts by bankers in the United States and Europe, particularly in the context of the 2008 GFC, going unpunished. If franchisors know that they can get away with bad behaviour, bad ones will keep doing it. Deterrence is a key factor in any penal code.

46. When franchise abuses occur, franchisees have little choice but to look to organisations such as the ACCC to protect their rights. However, the ACCC has a poor reputation for enforcing what little franchise regulation there is in Australia. The fact is that all of the remedies that a private litigant can seek from a court are fine, but if you cannot afford to see a lawyer let alone issue court proceedings, it is pretty pointless.

47. Unfortunately, statistics are not available in terms of ACCC powers in relation to franchising. Indeed, reliable statistics in relation to anything in franchising in Australia are hard to find. The latest ACCC "Small Business in Focus" publication (31 January 2013) indicates that the number of complaints lodged with the ACCC about franchises had increased about 67% for the 6 months ending 31 December 2012 from the previous 6 months. This might reflect an increase in poor franchisor behaviour, or perhaps more confidence that the current Chairman will do something about it, or a combination of both. What is not clear, and I would be very interested to know answers to the following questions, namely how many:

    - substantiation notices
    - random audits
    - applications for civil penalties
    - applications to the court for compensation
    - public warning notices

    have been issued by the ACCC since those powers were granted to it? "Small Business in Focus" indicates that 13 franchisors were audited in the 6 months to 31 December 2012, but little other information of any real value was provided.

[9] With the list of franchisor collapses in paragraph 19 one suspects that scenario has been repeated numerous times.

48. On a related topic, in my view a fundamental breach of the Code by the franchisor should allow the franchisee, at his or her option, to terminate the franchise forthwith (without resorting to usually out of reach court remedies) and recover damages. One of the practical problems with a franchisee terminating a franchise is that, in particular if the franchisor holds the head lease as is often the case in retail franchises, the franchisee effectively has to leave the store and therefore the business behind. Accordingly, terminating the franchise agreement is not necessarily a good option in practice.

Conclusion

49. I advocate much greater franchise regulation than that which currently exists, while at the same time comment that, in an ideal world, such regulations should not be necessary. I stand by that submission. Unfortunately, the world is not ideal. I have seen so much abuse of franchisees due to the incredibly one-sided nature of the franchising relationship that it is hard to avoid the conclusion that only legal reform can fix it. The playing field has to be levelled. Many good recommendations from Federal and State enquiries in recent years have been ignored or watered-down seemingly for political reasons at the expense of fair franchising. If the Federal Government does not act, the States will. State by State regulation of anything is anything but ideal.

50. Significant changes of attitude, particularly from franchisors in their treatment of franchisees and franchising generally, but also from franchisees in their expectations from the franchise relationship (which should follow once the franchising sector stops its misleading line on the safety of franchises), needs to take place to enable franchising to reach the lofty heights in terms of business ownership that it aspires to in this country.

15 February 2013

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