McDonald's Australia Limited Submission regarding the 2013 Review of the Franchising Code of Conduct

1. Introduction

McDonald's Australia Limited commends the Discussion Paper on the Review of the Franchising Code of Conduct (the Review) and welcomes the opportunity to make a submission.

McDonald's Australia Limited (McDonald's) operates over 890 quick service restaurants Australia-wide under a franchise system. As at 31 December 2012 McDonald's has 255 franchisees that, between them, operate 669 McDonald's restaurants.

Australia wide, McDonald's restaurants employ approximately 95,000 employees and is one of Australia's largest youth employers. As a leading international franchise brand, McDonald's recognises it has an important role to play in issues relating to franchising and franchising regulation. McDonald's operates in 119 countries and where possible, adopts a franchising model. From this global vantage point, McDonald's believes the Australian franchising regulations to be the most robust worldwide, providing great clarity and protection to franchisees.

The 2012 PwC Franchise Sector Indicator[i] demonstrated that the franchise sector outperformed the general market as a whole in what was and continues to be a tough economic climate. The Franchise Council of Australia ("FCA") estimates the contribution of franchising to the Australian economy at $131 billion. In a report commissioned by McDonald's and prepared by external group AECOM Australia Pty Ltd, the direct and indirect economic contribution of McDonald's to the Australian economy was calculated at more than $13 billion for 2011, representing 0.2 per cent of GDP.

Franchising is the foundation of McDonald's business model and as such we strongly support the regulation of the industry via the Franchising Code of Conduct (the Code) in collaboration with the powers of the regulator, the Australian Competition and Consumer Commission (ACCC). McDonald's embraces ongoing review of the Code to better enhance relationships between franchisor and franchisee. McDonald's is committed to working with government and regulators to ensure that the legislative framework finds a balance between protecting the franchisee and avoiding unnecessary regulation that fails to achieve the intended results and stifles innovation, industry competition and adds unnecessary compliance costs. In this spirit, McDonald's makes the following submission which sets out our contribution towards tackling the issues and demonstrates our commitment to constructive participation in the Review. We would welcome the opportunity, if appropriate, to present our submission in person.

2. General comments

McDonald's notes the terms of reference of the Review are to inquire into:

- The efficacy of the 2008 and 2010 amendments to the Code;
- Good faith in franchising;
- End of term rights of franchisees; and
- The relevant enforcement provisions of the CCA.

McDonald's comments on certain of these matters below and also offers some additional general views on the current regulatory framework.

In considering the issues raised in the terms of reference it is important to bear in mind the relevant policy framework. Prescribed mandatory industry codes including the Code are designed to achieve minimum standards of conduct where there is an identifiable problem to address and as an alternative to primary legislation where market failure has been identified. It follows that before any extension or modification to the Code should be introduced, these basic principles need to be considered and the usual cost/benefit analysis that applies to any Commonwealth regulation also needs to be undertaken.[ii]

It follows that any changes or extensions to the Code should be resisted where these regulatory tests are not satisfied. It also follows that if the current provisions of the Code are not meeting these requirements they should not be maintained or should be appropriately modified. This policy framework calls into focus the need to consider available market evidence and industry experience. In the absence of sufficient evidence of ongoing market failure or a regulatory gap that needs to be filled in primary generic legislation, further specific regulation should be avoided otherwise there is a distinct risk of placing the franchise sector at a competitive disadvantage and stifling investment and growth.

In conducting the Review it would be unwise to make a presumption that a franchise agreement is a unique or unusual business arrangement or that franchisees are fundamentally in a position of relative disadvantage. Where they may be disadvantaged, such as in relation to access to information relating to the franchise, regulatory intervention in the form of disclosure requirements can be justified but generally, empirical evidence should be identified before advocating further regulation.

Mutuality of incentives and rewards is the cornerstone of the franchise relationship and in McDonald's experience, the best regulator of behaviours. A franchisor entrusts to its franchisees its single biggest asset - its brand. This allows the franchisees to be the critical interface between the customers and the brand. This fact is at odds with the view that a franchisee is in a relationship of relative disadvantage to a franchisor. Further in many franchise systems (including McDonald's) franchisees can be large and sophisticated businesses in their own right and it does not make sense to regulate the entire industry on the incorrect premise that all franchisees are small and vulnerable businesses by introducing

base-line regulation that operates indiscriminately in all circumstances or regulates for the infrequent exception rather than for the rule.

It also needs to be borne in mind that the Code operates across the whole industry which is very diverse in its makeup and includes large and small franchisors and franchisees, global and local businesses, highly sophisticated and less sophisticated franchisees. Accordingly, the Code needs to cater for all of these different players and provide appropriate flexibility with opportunities to opt out where there is no practical need or desire for regulation. In these circumstances the general law will apply in any case to provide a default level of protection where needed.

3. Executive Summary

A. McDonald's is keen to reduce complexity in franchising. Recent changes to the disclosure requirements of Franchisors under the Code designed to help franchisees understand the contracts they are about to enter have in some respects been counter-productive. Franchisor disclosure documents now number in the hundreds of pages and many franchisees are overwhelmed upon receipt of the documentation. While franchisors are in position of great knowledge over the businesses they grant to franchisees, the information disclosed should be carefully scrutinised with a view to cutting down on some of the more irrelevant or unnecessary disclosure requirements. Changes to disclosure requirements which increase the page count of already lengthy disclosure documents do not always add reciprocal value to franchisee understanding. It is McDonald's view that while the disclosure obligations in the Code assist franchisee understanding, overall this goal has not been enhanced through the 2010 amendments.

B. At a state and federal level there has been much contention over the obligations of parties to a franchise agreement to act in good faith in their dealings with one another and the arrangements to apply at the end of a franchise term. McDonald's strongly opposes any change to the Code in relation to either: good faith obligations; or end of term arrangements. Industry codes are implemented in only limited circumstances to mitigate instances of bad/opportunistic conduct in an industry where a specific need has arisen, they are not implemented to regulate normal, proper conduct or to establish "best practice". Amendments to the Code placing obligations on Franchisors to act in good faith or to follow a prescribed course of action at the end of a franchise term would be at odds with the policy and legislative underpinnings of mandatory industry Codes and also result in unintended consequences detrimental to franchisees. McDonald's also opposes the movement of some states towards supplemental franchising laws to operate alongside the federal Code. This will create unworkable disconformity in the law for an industry that operates on a national basis.

C. On any statistical measure, franchisee failure in Australia is low and no matter how robust, regulation will never be able to absolutely prevent franchisee failure (or

franchisor failure for that matter). There is no cause for regulatory intervention where there is a lack of evidence of overwhelming franchising disputes in the areas of good faith or end of term arrangements.

From this review of the Code, McDonald's would like to see:

i. a contraction of some of the document disclosure requirements to produce a more meaningful disclosure and focused regime;
ii. further clarification of, and for certain exemptions to apply to, the disclosure period;
iii. an exemption to the foreign franchisor disclosure requirements where there is only one large master franchisee;
iv. no further changes to the concept of good faith provided for in 2010 amendments; and
v. no changes to the end of term arrangements provided for in the 2010 amendments regarding increased disclosure.

4. Trade Practices (Industry Codes – Franchising) Amendment Regulation 2007 (No 1)

The 2013 Code Review discussion paper has called for comment on the efficacy of the changes to the disclosure requirements under the Code implemented after the 2008 Code review.

McDonald's fully supports detailed disclosure to franchisees prior to entering into a franchise agreement. The 2008 and 2010 amendments have added significantly to the material provided to Franchisees. However, McDonald's believes the sheer volume of disclosure materials now required makes close scrutiny of that information by potential Franchisees less likely and some of the most important information to a franchisee is inevitably lost in a sea of information.

McDonald's comments on each of the 2008 and 2010 amendments, where it considers relevant, using the headings from Appendix A of the Discussion Paper.

Franchise Agreement

One of the amendments which effects day-to-day franchise transactions is the requirement for franchisors to provide franchisees with a copy of the franchise agreement "in the form it is intended to be executed". Given the requirement for Disclosure to be made at least 14 days prior to entry into the franchise agreement, McDonald's believes this provision needs further clarification. On a strict reading of the Code, *any* amendments to the franchise agreement after disclosure is first made (for example, due to mistake, or negotiation on the part of the franchisee and its advisers) requires re-disclosure of all documents and a re-setting of the 14 day disclosure period as the franchise agreement, as it is intended to be signed, has changed. This causes unnecessary delays, increased costs and frustration of

franchisees (particularly sophisticated franchisees who wish to "waive" their disclosure period & cooling-off, but are not permitted under the Code). In summary, McDonald's submits that the franchise agreement attached to the Disclosure Document should be substantially in the form proposed / intended by the Franchisor and no re-disclosure should be needed for minor amendments or amendments made as a result of a request by the Franchisee.

Time for provision of documents

McDonald's supports the 14 day disclosure period and 7 day cooling-off provided to prospective franchisees. This allows sufficient time for a prospective franchisee to read the relevant documents, ask any questions and seek proper advice.

However, McDonald's would support some exemptions to the 14 day disclosure period, including allowing franchisees to choose to opt out of the disclosure period. In the alternative, an exemption could apply to existing franchisees that choose to enter into an additional franchise agreement. By way of example, McDonald's has many long-term franchisees that operate more than one McDonald's restaurant. In McDonald's experience, when entering into a franchise agreement for say, their third restaurant, these franchisees are frustrated by the statutory disclosure period and often make requests to waive the disclosure period, which the Code does not currently allow. McDonald's likens this situation to a property purchase, with the exception being that purchasers can opt to waive their cooling-off periods. This would not take away from the 7 day cooling-off period that applies after the franchise agreement is signed. As stated above, a step further would be to consider allowing all franchisees (sophisticated and prospective / first-timers) to opt out of the disclosure period.

In the case of prospective rather than existing franchisees, an exemption to the 14 day disclosure period could perhaps be conditional on the prospective franchisee having received legal, business and accounting advice and the exemption/waiver request coming from such adviser. Whilst McDonald's sees some merit in making it mandatory for franchisees to obtain legal, accounting and business advice, there needs to be a weighing up of how these changes to the Code may increase start up and administrative costs and limit the freedom of franchisees to choose how they do business and conduct their affairs. McDonald's holds the same view in relation to calls for compulsory pre-franchise education for franchisees. Such additional costs may deter potential franchisees from buying a franchised business and choosing instead to go into business on their own on a possibly misguided belief that it will be cheaper. As mentioned above, franchising has continued to outperform the general market in tough economic times in Australia. For inexperienced operators who are looking to start their own business, franchising in Australia is a safer bet than 'going it alone', so the obstacles to obtaining a franchise should not get so high as to take away from the benefits in the minds of potential franchisees.

The Code as it stands requires indiscriminate compliance despite the varying levels of franchisor and franchisee sophistication. There is no recognition by the Code of multi-unit franchise operators. The majority of McDonald's system's comprises of multi-restaurant franchisees. Having to treat each franchising transaction the same under the Code, regardless of the status of the franchisee, has caused franchisee frustration and lead to delays in processing transactions. McDonald's is of the view that certain provisions of the Code, and any proposed changes to the Code as a result of this Review, should require compliance only until a certain threshold has been reached. For example, as mentioned above, multi-unit franchisees should be exempt from the 14 day disclosure period, or otherwise be entitled opt-out of these provisions. Other more onerous aspects of the Code and disclosure requirements could perhaps be subject to certain sales thresholds. For example, mandatory advice, obligations of good faith, long form disclosure could be applicable only to franchises that are estimated to turnover less than $1 million per annum.

Disclosure of rebates and financial benefits

McDonald's supports this provision. However, McDonald's opposes any move which would require additional disclosure in this area.

Disclosure of business experience

In a general sense McDonald's supports this provision and has not found compliance with this provision to impose an unreasonable burden. However, as a large organisation with many corporate officers McDonald's believes this provision adds pages to an already lengthy disclosure document for information which is not of much importance to prospective franchisees. The financial reports and business experience of the Franchisor are far more relevant considerations to a prospective franchisee. In the interests of working towards providing more concise disclosure to franchisees, McDonald's recommends eliminating this part of the disclosure material or limiting the provisions to refer to particular positions, like Chief Executive Officer and Chief Financial Officer, or directors only as opposed to all officers as defined in the *Corporations Act*.

Provision of financial reports

McDonald's supports this provision. However, the form of financial reports required under the Code may be confusing to some franchisees. McDonald's is of the view that the increased amount of material required for disclosure should creates an increased obligation on prospective franchisees to properly understand all aspects (particularly financial aspects) of the documents they are receiving and reviewing.

Foreign Franchisors

The 2008 Code amendments removed the exemption of foreign franchisors from providing disclosure material. This obligation on foreign franchisors is particularly onerous in the context of a foreign franchisor granting master franchise rights to only one master franchisee, particularly where that master franchisee is wholly or partly owned by the foreign franchisor. The provisions of section 6B(2) of the Code, which require master franchisees to provide their sub franchisees with copies of their disclosure document together with the disclosure document of their master franchisor, further adds to the volume of disclosure material provided to prospective franchisees and includes a duplication of some documentation / information. The bigger the volume of a disclosure document, the greater risk there is of a prospective franchisee missing key aspects of the material that is most relevant to their decision to enter into a franchise agreement. McDonald's submits that the information disclosed in the foreign franchisor disclosure document, in the context of a single master franchise arrangement, is irrelevant to sub franchisees and has little to no bearing on their decision to enter into a franchise with the master franchisee.

McDonald's proposes a change to the Code to partially reinstate the exemption on foreign franchisors from providing disclosure, where that foreign franchisor only has one master franchisee in Australia.

Disclosure of information re directors

McDonald's supports this provision. Further to the discussions above regarding disclosure of business experience, the disclosure of information on directors, accompanied by a summary of the business experience of each director is sufficient disclosure in this area.

Copy of Franchising Code

McDonald's supports this provision with the exception that where section 6B(2) of the Code applies, only one copy of the Code should need to be given.

Extension of term or scope of franchise agreement

McDonald's is generally supportive of this provision. As discussed above in relation to the timing of giving a disclosure document and entry into a franchise agreement, in the case of extension of term or scope, McDonald's holds the view that in these circumstances, existing franchisees (while they should be provided with a current copy of the disclosure document) should have the option to waive the disclosure period.

Need for long-form disclosure

McDonald's agrees that franchisees need to be armed with all information that will

be relevant to their decision on whether to enter into a franchise agreement. McDonald's also agrees that the franchisor is in the best position to give most of that information. However, McDonald's holds a strong desire to reduce the volume of disclosure material to allow the documents to be as meaningful as possible for prospective franchisees and to facilitate an increase in franchisee understanding of all material facts about franchising and the franchisor. The aim of the disclosure requirements under the Code is to arm franchisees with as much information as possible before they enter into a franchise agreement. Disclosure is an important tool assisting franchisee understanding and comprehensive, detailed, *relevant* disclosure reduces the likelihood for disputes down the track. It is for this reason that McDonald's submits the long-form disclosure document should be more closely scrutinised to make sure it provides only that information which would reasonably be regarded as relevant to a franchisees decision whether or not to enter into a franchise agreement.

5. Trade Practices (Industry Codes – Franchising) Amendment Regulation 2010 (no 1)

Franchise Failure

McDonald's is of the view that this mandatory statement is 'passed over' by prospective franchisees as they search for the more important information (like financial reports and payment information). McDonald's proposes the mandatory statement accompany the disclosure document receipt required under section 23 of Annexure 1 of the Code. This would require franchisees to sign the statement as part of their acknowledgement that they have read and had a chance to understand the disclosure materials provided.

Payments to third parties

McDonald's appreciates the rationale behind the inclusion of this provision to disclosure requirements under the Code, even where franchisors operate company-owned outlets. However, all payments to third parties cannot reasonably be estimated by franchisors at the time the agreement is entered into. This amendment added significant volume to disclosure material and compliance costs to franchisors with little reciprocal value.

In circumstances where such payments to third parties are known, it can be difficult to estimate the anticipated cost to a franchisee, particularly where a franchisor operates nationally with a variety of structures with differing costs (e.g the cost of electricity in a shopping centre kiosk versus a full service restaurant). This difficulty leads to franchisors disclosing wide value ranges by default. By virtue of the ambiguity of such wide ranges, the disclosure of such information then provides little value to prospective franchisees who do not know where on a large spectrum, they might sit in relation to a particular franchising proposal. The purpose of the amendment was to arm prospective franchisee with more

information about the costs involved in the business so they can be better prepared if and when they enter into a franchise agreement and start the business. The purpose is not always achieved. Also, while certain items may be "reasonably foreseeable" or "within the knowledge of" a franchisor, they're ultimately greatly dependent on franchisee choice (for example, a franchisor might foresee / know that franchisees will require an accountant to prepare their business accounts but these costs will vary greatly depending on the franchisees own involvement in their book-keeping; and their choice of accountant).

Furthermore, financial items outside the control of the franchisor may increase at a greater rate than the franchisor can anticipate year to year (e.g. electricity). Where large ranges are not used, this could result in disclosure documents inadvertently being inaccurate shortly after their issue (and perhaps even within the 6 month period where franchisees can terminate a franchise agreement for false disclosure). A franchisor could be in breach of the Code despite any intention to mislead or provide false information on the part of the franchisor. This could have wide-reaching implications on franchising and is a further incentive for franchisors to use large value ranges in such disclosure, rendering the information disclosed less meaningful. Accordingly, in our view, this amendment has added volume to the disclosure material without adding significant value thus not achieving the amendment's intention.

Franchisees should be expected to undertake their own due diligence in relation to owning a business, including analysing all the potential costs of running a business, outside those costs controlled or payable to the franchisor. Buying a business involves a certain level of entrepreneurial risk and a personal assessment that franchisees must accept and understand before entering into a franchise agreement. The more regulated that franchising becomes, the less perceived risk there is for a franchisee. This may create dangers in franchisees feeling relieved from needing to themselves assess the usual risks that come with running a business.

McDonald's suggests that if this requirement is to be maintained further clarity should be provided around what payments require disclosure – specifically what is the meaning of: "within the knowledge or control of the franchisor or is reasonably foreseeable by the franchisor". A franchisor should not be liable where any costs are incorrect, (or shortly after commencement of the franchise agreement are rendered incorrect) provided the franchisor's estimate was, at first instance, reasonably based and not misleading.

Significant capital expenditure

McDonald's supports this provision with some qualifications. First, McDonald's believes the use of the word "unforseen" as it stands in the Code is superfluous and creates confusion. Franchisors necessarily cannot disclose "unforseen" capital expenditure. While acknowledging the use of the term means that the cost

is 'unforseen' to the franchisee, this is also incorrect as most franchise agreements have broad ranging provisions allowing franchisors to request or mandate significant capital expenditure. McDonald's agrees that information on significant capital expenditure should be provided in the disclosure material. However, this could more simply be added to section 16 of a disclosure document, which requires franchisors to point out those clauses of a franchise agreement that contain certain important obligations.

Unilateral variation

Most franchise agreements include provisions that expressly include system materials (policies, procedures, manuals etc) as incorporating part of the 'franchise agreement'. Such policies, procedures and manuals do not contain core contractual provisions and are subject to regular change as the franchised business innovates and develops day to day. Further clarification is required to this amendment so that only unilateral changes in relation to the substantive franchise agreement need disclosure. Changes to subsidiary documents, like an operations manual, should not require disclosure under this section.

Arrangements to apply at the end of the franchise agreement

McDonald's strongly opposes any amendment to the Code that would, directly or indirectly, give franchisees automatic rights of renewal on expiry of the franchise agreement or any change that requires franchisors to pay compensation to franchisees on expiry. These issues are discussed in detail below.

Good Faith

McDonald's rejects the addition of a defined concept of good faith into the Code. McDonald's believes common law concepts of good faith have always applied to franchise relationships in the circumstances recognised under the general law and where there was any doubt, the 2010 amendment to the Code clarified the question.

The issue of good faith is discussed in further detail below.

Behaviour in Dispute Resolution

McDonald's supports this provision but believes a clear penalty regime should apply to franchisees and franchisors in the event of breach. In McDonald's experiences; a franchisor is more likely to be subject to poor behaviour by a franchisee than the reverse. During disputes, a franchisor is conscious that during the process, the whole franchise system is "watching" – the same disincentive does not necessarily exist for disgruntled franchisees and this can create an environment where the franchisee feels less constrained in their behaviour

Of course, franchisors may also behave badly in disputes so a dual-penalty regime is appropriate. Although the type and quantum of any penalties imposed may be different, changes to the Code seem to have been informed by the misguided belief that all franchisees are small "mum& dad" businesses. Many McDonald's and other systems' franchisees are businesses of significant size.

Clause 29(8) of the Code, on its own, does not go far enough to deter parties from frustrating the dispute resolution process. While McDonald's believes it is important that any party not be deterred from engaging in the dispute resolution process (given the many benefits of the process) franchisees may hold disproportionate power in their ability to cause great reputational damage to the brand and affect other franchisees, as well as the franchisor. A tougher and clearer penalty system under the Code or increased powers to the ACCC would be helpful in further smoothing out the dispute resolution process.

Not just in relation to disputes, but in a general sense, McDonald's supports the introduction of civil penalties for breaches of the Code. Such penalties should apply only to serious or wilful breaches of the Code and they should apply equally to franchisors and franchisees.

An additional issue in the Code as it stands is the procedure franchisors must undertake for franchisee breaches of a franchise agreement under clause 21. The amount of time typically allowed to remedy breaches means franchisors are often faced having to wait out unacceptably lengthy or repeated periods of franchisee noncompliance, which is damaging to the entire system.[iii] In a consumer retail environment (particularly food) even a 24 hour cure period can be too long. Once a breach has been notified and remedied, there is little deterrent to the franchisee not to breach the franchise agreement again, even in the exact same manner as previous breaches. As long as a breach is remedied, under the Code, the franchisor cannot terminate the franchise agreement or use the possibility of termination to find a *long term* cure for the relevant behaviour. This gives the franchisor no relief from a franchisee that continuously breaches their franchise agreement and operates outside the parameters of the system. This unfairly limits the capacity for a franchisor to seek a proper resolution for persistent breaches that are cured within the required timeframe and potentially replace the noncompliant franchisee with a compliant operator. The Code should include a facility to aggregate breaches over a certain period, that when taken together show persistent and continuing breaches by a franchisee and can lead to more serious consequences (like termination, or non-renewal). Franchisee's who continue to breach their obligations under a franchise agreement, regardless of whether they breaches are continuously cured, demonstrate a consistent incapacity to meet the minimum standards of the franchising system.

As mentioned above McDonald's has strong views on the following topics:

6. Good Faith in franchising

Status quo is adequate and appropriate

McDonald's believes the current position in relation to good faith as outlined in Clause 23A of the Code should be maintained and strongly opposes the introduction of a newly defined express obligation of good faith. McDonald's does not believe there is any evidence to suggest that the current formulation inserted by the 2010 amendments has deprived franchisees of relief in appropriate circumstances. Additionally introducing a major change only 3 years after clause 23A was introduced in the absence of any clear evidence to suggest there is a need for review is only prone to lead to greater uncertainty and would constitute a retrospective change in the law that could create inequalities within the sector and also amongst participants in the franchise industry and unregulated competing businesses.

As outlined above, mandatory codes (and extensions in their scope) are directed to addressing identifiable needs arising from industry or sector market failure or clear gaps in available generic laws. These circumstances are not evident with the franchise sector, franchisees are not failing at statistically abnormal rates, in fact, Griffith University's Franchising Australia 2012 study reports that 90% of Australian franchisees are operating profitably. Since the introduction of the ACCC's audit powers, "only 3 per cent of franchisors reported that they had been subject to a formal audit by the Australian Competition and Consumer Commission to ensure compliance with the Franchising Code of Conduct"[iv] indicating that most franchisors have not engaged in activities that have been subject to enough complaints to attract the scrutiny of regulators and trigger the ACCC's use of its discretionary audit powers. Of those Franchisors audited, a presentation by the ACCC at the Franchise Council of Australia's 2012 National Franchise Conference noted that no significant Code breaches were discovered during these audits and on the whole, Franchisors seemed to be compliant with their obligations under the Code. There is also no evidence to suggest that franchisee/franchisor disputation rates are high or increasing. In fact the general statistics suggest otherwise.

The ACCC statistical reports on franchising and small business complaints show a significantly higher amount of small business complaints compared to franchising complaints. Further, the ACCC data shows that franchising complaint levels have remained generally static since the ACCC began reporting these statistics in July 2010. The number of franchising enquiries (not classified as complaints) has also dropped significantly from 224 enquiries for the second half of 2010 and 76 for the first half of 2012 to 47 for the second half of 2012. In the last 3 financial years, McDonald's has not been involved in any litigation in relation to breaches of a franchise agreement or contravention of trade practices law. Any consideration to amending the Code flies in the face of the lack of evidence of franchisee / franchisor disputation.

The general law position has already been augmented significantly by the unconscionable conduct and misleading and deceptive conduct provisions contained in the Australia Consumer Law ('**ACL**') together with the implied duty of good faith as it is understood and applied at common law. These laws and remedies provide adequate protections for franchisees and a significant history of case law has shown that these remedies are routinely utilised by franchisees in litigation and in negotiating and resolving disputes. The protections garnered by these laws are further enhanced by the extensive investigative and enforcement powers given to the ACCC.

There is no available evidence that the absence of an express obligation of good faith in the Code has disadvantaged franchisees in pursuing claims for relief in court proceedings or in their day to day dealings with franchisors. Franchisees can and do bring actions against franchisors, the ACCC can and does bring actions against franchisors, an overlay of good faith into the Code together with the CCA is unwarranted.

Introducing a Code-specific definition of 'good faith' would therefore only create uncertainty in franchising and add unnecessary complexity and cost to the resolution of franchising disputes without addressing any obvious or demonstrated need.

In any case, the codification of a good faith obligation into the franchise relationship would not be meaningful unless content was given to that obligation through detailed definitional provisions but any attempt to define good faith for the purpose of the Code separately to that recognised under the general law is inherently fraught with great difficulty. Even when applied at common law it is said with great circularity "it is easier to spot bad faith than it is to define good faith, so good faith is the absence of bad faith."[iv] The conclusion in the franchising context being that the absence of unconscionable conduct and misleading and deceptive conduct by a party to a franchise agreement, would suggest the parties have been acting in good faith. An examination of franchising case law would suggest judicial decisions have aligned with this position (e.g. in the cases of Allphones, Seal-A-Fridge and Billy Baxters: these franchisors were either found to have been acting unconscionably or to have engaged in misleading and deceptive conduct, in McDonald's view, the outcomes of those cases would not have changed if instead the courts had implied a duty of good faith).

There is already an array of matters governed by the Code that are capable of giving rise to claims concerning a lack of good faith. These are specifically regulated with precise obligations identified and include: disclosure; remedies of franchisors in the case of franchisee breach; timeframes for the giving of notices; mandated procedures in relation to resolving disputes and other aspects. These provisions go well beyond general concepts of good faith. Adding a general catch all good faith requirement would add nothing to these specific obligations and if left

at large to operate generally in all franchise agreements would only create the confusion referred to above.

The Federal Parliament has previously considered and rejected the need to introduce legislation incorporating good faith obligations for these and other reasons and the occasion presented by this Review should be used to confirm the status quo.

Changes would create uncertainty and inequalities and stifle the industry

The franchise relationship and the link between franchisee success and franchisor success are well understood. Each party is heavily dependent on the other to succeed. While most commercial contracts are entered into for mutual benefit, this is most clearly evident in the franchising context and the industry fundamentally relies on this concept. Overlaying a good faith obligation into this relationship will create confusion and other distortions. This is because the concept of good faith at general law, let alone in any proposed codified form is not well understood, whereas:

- the express contractual obligations of the parties;
- the current specific requirements of the Code;
- the law relating to unconscionability and misleading and deceptive conduct; and
- the fundamental nature of the franchise relationship;

are all very clear.

The tension between these well understood and workable concepts and a new uncertain good faith obligation will inevitably cause uncertainty and confusion. To take this risk in the absence of any demonstrable need for change is not sound policy and would place franchising at a competitive disadvantage to businesses that are not classified as franchises but compete in the same industries as franchisors and franchisees.

At its core, a franchise agreement is not dissimilar to many contractual arrangements like leases, distribution agreements etc. Once there is a binding contract in place, a franchise agreement should not be treated any differently to other commercial contracts.

The introduction of an express good faith requirement into franchise agreements would also stifle investment by franchisors in the market and may cause franchisor's to reconsider their business model. The negative effects of such a change to franchising regulation without sufficient cause have been demonstrated in the state of Iowa in the United States of America. In 1995 Iowa introduced a "general requirement of the law that franchisors act in 'good faith' in the performance and enforcement of the franchise contract."[vi] The detrimental effects of the law were felt almost immediately after introduction of the law, studies

compared franchising activity the pre-1995 changes against the post-1995 changes and found a significant decrease in the amount of new franchises being granted, and several companies halting expansion plans for Iowa or opting for a company-owned expansion model.[vii] It was claimed that the losses were "not limited to the jobs and revenues that were expected to have been generated by franchise units. They... extended to include franchisee suppliers, real estate companies who... lost opportunities to sell property to franchisees, construction companies, and business developers. Furthermore, many companies... restricted themselves to opening company owned stores, which may not provide the same benefits to the local economy that a franchised unit would since profits from company owned stores are returned to corporate headquarters, which are usually located outside of Iowa."[viii]

As noted above, Policy Guidelines published by Treasury state that industry codes are "co-regulatory measures, designed to achieve minimum standards of conduct in an industry where there is an identifiable problem to address."[ix] The guidelines continue by stating "prescribed codes must address specific problems and [be] drafted in clear and unambiguous terms that set out requirements and obligations rather than aims and ideals."[x] Good faith, generally expressed, is an "aim and ideal". Its introduction into the Code review has been made despite there being little evidence to suggest there is "an identifiable problem to address" or that there is "compelling evidence to indicate that the problems experienced are so significant"[xi] as to require regulation as stated in the Guidelines.

As a final comment on this issue and a lead into the discussion below, McDonald's also feels the need to point out that the call for good faith to be introduced to the Code seems to have stemmed from the lobbying of one well-resourced franchisee whose main concern was the claimed actions of their franchisor at the end of the franchise term in not granting a renewal of their franchise agreement. As concepts of good faith under the general law typically relate to the performance and exercise of contractual rights during the term of a contract, incorporating a good faith obligation in the Code would not necessarily address the concerns relating to renewal and other rights on termination. Further, there is a general presumption that good faith obligations are needed to protect franchisees from franchisors, and not vice-versa, and this is not always the case.

McDonald's address the issue of end of term rights below and believe this topic should be considered separately to good faith obligations.

7. The rights of franchisees at the end of the term of their franchise agreements, including recognition for any contribution they have made to the building of the franchise

The discussion paper highlights the principal issues regarding end of term

arrangements as having historically been:

- franchisors terminating or refusing to renew franchise agreements when they do not have 'good cause' for doing so; and
- lack of clarity and/or fairness regarding the benefits the franchisee is entitled to when they leave the franchise, in recognition of their contribution to the 'goodwill' of the franchise system as a whole.

Specific changes to the Code in relation to the above concerns would be legislating to the exception not the rule. Again, end of term disputation or 'churning" is not at the level it might be perceived to be. Griffith University's study Franchising Australia 2012 states that the percentage of franchises that changed ownership in the 2010-2011 financial year represented 9% of total franchise operations. Out of that small number, only 3% of ownership changes arose from termination, non-renewal or buy back by the franchisor.[xii] Approximately 50% of the franchisees who left their franchise business during this period did so at their election for personal reasons.[xiii] Data regarding non-renewal of a franchise agreement on expiry is required to be disclosed under section 6.4 of the long form disclosure. In the McDonald's system, in the last 3 financial years (ending December 2012), there have been no instances of a franchise agreement not being renewed on expiry. McDonald's is of the view these statistics would not be dissimilar across other franchise systems, indicating there is no great need for a change to the Code to address what is essentially, a non-issue.

Where a franchisee has an express option to renew in their franchise agreement the current laws would prevent a franchisor from terminating such a franchise agreement or refusing to renew a franchise agreement improperly or for no good cause.

In relation to the second principal issue McDonald's holds the view that the changes to the Code after the 2010 review have sufficiently provided franchisees with clarity and fairness regarding what will happen at the end of their franchise term.

There would be serious unintended consequences should franchisees gain automatic or unilaterally exercisable rights of renewal (or perceive they gain such rights due to the operation of a new good faith obligation or specific end of term provisions in the Code).

For example, Code prescribed end of term obligations which require "good cause" for non-renewal of a franchise agreement (even where that agreement contained no option to renew) or payment of an "exit fee" may result in Franchisors taking a much stricter interpretation of each and every performance obligation of franchisees contained in their franchise agreements. The result being that franchisors may readily seek to terminate franchise agreements during the term of the agreement for non-compliance than risk having the agreement face automatic renewal or rights to exit payments. The day to day running of a franchisee's

business may be interrupted by increased supervision on franchisee operations by franchisors. Further, a de facto right of renewal would stifle franchisee motivation to perform at a high level in order to "earn" a renewal. This may have negative impacts for consumers, franchisors and franchisees. A franchisee that is happy with their level of income and performs to the bare minimum standard of the system would have no incentive to maintain or improve performance in order to ensure their renewal. A franchisor should not be constrained from removing a franchisee from the system through non-renewal of the franchise agreement. A broad safety net in the form of an automatic right of renewal or some form of "exit payment" would not drive franchisee performance at the end of their franchise terms and would negatively impact the franchise system and the economy.

McDonald's is against the introduction of a requirement for franchisees to be paid an "exit fee" or be "compensated" for any significant capital expenditure undertaken during the term. First, the legal concept of "compensation" invokes notions of wrongdoing and the 'righting of a wrong' in which one person has suffered loss – that is not the case on the expiry of a franchise agreement, the agreement is merely coming to an end in accordance with the agreed terms of the commercial contract. To again use the analogy of a lease, a lessee is not "compensated" or otherwise paid to exit a premises at the end of their lease, there is no substantive difference in the franchising space and in contrast, a lessee is routinely required to 'make good' the leased premises at its costs to the satisfaction of the landlord. Accordingly, Franchisors should be able to choose whether, and if so, how, they pay exit fees to franchisees. Once the term expires, the benefit each party derives from the contracts should naturally end with no further obligations (other than terms which expressly survive, such as confidentiality) left to fulfil.

During the term of a franchise agreement, the Franchisee receives the benefit of the operating profit of the business In addition, franchisees are typically allowed to transfer or sell their interest in the franchise during their term (with franchisor consent) in order to realise any earlier capital gains.

Introducing express concepts of "franchisee goodwill" would fundamentally change the commercial and economic underpinnings of the industry and in McDonald's opinion, would reduce expansion and investment in the industry. Franchise agreements would need to be re-priced and the fee structures and revenue sharing arrangements would need to be substantially revisited. This could not be done retrospectively in any fair manner. It would be impossible to determine how much goodwill can be attributed to the franchisee's efforts (if any) compared to the goodwill generated by the franchisor and the general brand and promotional efforts. People enter into franchise agreements in order to "fast-track" the potential gains to be had from associating themselves with the goodwill of a franchisor's trademarks and systems which are often global in scope and are underpinned by many decades of trading history and brand and product development.

Franchisors own the relevant intellectual property and brand recognition / reputation and this cannot be owned or assigned by the franchisee, only licensed or used during the term pursuant to the terms of the franchise agreement. Control of the system by the franchisor is a primary reason people invest in franchised businesses. Accordingly, fundamental decisions like who should be granted franchise agreements (or not granted franchise agreements) is a an essential right that should not be abrogated or subjected to ambiguous conditions or fetters in the Code referring to "good cause", automatic renewal rights or exit fees. Franchisors who act unconscionably in relation to an expiry or early exit / termination are subject to the current provisions of the Code and the CCA and the general law prohibitions on such behaviour.

In most cases, the assets used in the business by the franchisee will be unique or at least still useful to the franchise system. Those franchisees who are exiting the system have the ability to sell those assets either back to the franchisor or to another franchisee and thus realise a return on those assets. The collection of the operating profits over the term of the franchise agreement and the ability of the franchisee to sell its business assets at the end of the term are fair and reasonable in the circumstances on a franchisee expiry / exit.

McDonalds' considers the principal issues raised in the discussion paper to be issues of clarity and fairness in managing the expectations of franchisees. The prior changes to the Code requiring further disclosure of the end of term obligations and position remain an adequate means for managing these issues.

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[i] PriceWaterhouseCoopers, 'Franchising holding strong in tough times' [2012], p.4

[ii] Policy Guidelines on Prescribing Industry Codes under Part IVB of the Competition and Consumer Act 2010 May 2011

[iii] Angela Hurst, 'The Impact of the Iowa Franchise Law on Restaurant Franchisor Engagement' [1997].

[iv] Frazer, Weaven and Bodey, Griffith University, *Franchising Australia 2012*

[v] E Allan Farnsworth, 'Ten Questions About Good Faith and Fair Dealing in the United States Contract Law' [2002] AMPLA Yearbook 1, 5. As quoted in William M Dixon "An Examination of the Common Law Obligation of Good Faith in the Performance and Enforcement of Commercial Contracts in Australia' [2005], Queensland University of Technology, p45.

[vi] Angela Hurst, 'The Impact of the Iowa Franchise Law on Restaurant Franchisor Engagement' [1997].

[vii] Hurst.

[viii] Hurst.

[ix] Australia Government – The Treasury, 'Policy Guidelines on Prescribing Industry Codes under part IVB of the Competition and Consumer Act 2010' [2011].

[x] Policy Guidelines on Prescribing Industry Codes under part IVB of the Competition and Consumer Act 2010

[xi] Policy Guidelines on Prescribing Industry Codes under part IVB of the Competition and Consumer Act 2010

[xii] Frazer, Weaven and Bodey.

[xiii] Frazer, Weaven and Bodey.