



Statutory Review of the Australian Government Mandatory Franchising Code

September 2023

Submission on behalf of the Australian Association of Franchisees

Introduction

The Australian Association of Franchisees (AAF) appreciates the opportunity to participate in this critically important code review. AAF is the peak body representing franchisees in Australia. We were formed in 2018 in parallel with the activities of the Parliamentary Joint Committee of Inquiry (PJC) into franchising, which was occurring at the time.

AAF was born out of a recognition by franchisees, that the many problems that were being experienced in franchising, were due to a massive imbalance of power as between franchisors and franchisees. That imbalance of power was, at least in part, due to a very influential franchisor lobby, the FCA, which even claimed to represent franchisees. The FCA was not being counter balanced by any genuine register

and coordinated advocacy on behalf of franchisees.

AAF is strongly supportive of the business and investment model that is franchising. Franchising provides the opportunity for good business ideas to grow rapidly. It provides an opportunity for entrepreneurial Australians to invest their careers and money in, what should be, an arrangement that maximises their prospects of long-term security, success and a level of personal autonomy.

The however is, that franchising in Australia, as it is currently regulated, presents way too many risks for franchisees. Their success and security is left entirely at the whim of their franchisor. History is now very clear. There are many franchisors who abuse the trust placed in them by franchisees. The trail of financial and emotional wreckage is embarrassingly long.

Through this review, the opportunity is in front of us to create a far better and more balanced franchising sector.

AAF's specific responses to the Code Review Terms of Reference are as follows:

Fitness for purpose

In schedule 1 of the current code, the purpose of the code is defined as follows:

The purpose of this code is to regulate the conduct of participants in franchising towards other participants in franchising.

It is hard to imagine a less useful purpose statement. So, the starting point for any discussion on the future regulation of franchising needs to be the question of what the purpose of the regulatory framework should be. The participants are clearly franchisors and franchisees. The purpose of the code needs to be informed by the nature of the relationship between these parties.

In the case of franchisors, when setting out, they have a commercial idea that needs a wide geographic footprint. They lack the resources, both in people and finance, to achieve their growth objective.

For franchisees they are looking for a relatively safe way to invest their time and money in creating an income and a saleable asset while achieving a level of personal autonomy.

The current code caters to the needs of the franchisor. It completely fails any test of safety, security or asset creation for the franchisee.

On this basis, it is fair to say that the current code is not fit for purpose, unless the purpose is to create the opportunity for franchisors to legally exploit franchisees.

This assessment is not just the view of AAF. It was also the conclusion of the very comprehensive Parliamentary Joint Committee of Inquiry into franchising, the report of which, was tabled in Parliament in March 2019. The PJC Inquiry summary conclusion was that *there is a massive and unacceptable imbalance of power as between franchisor and franchisees*.

More recently Mercedes Benz dealers used the general provision of the code relating to unconscionable conduct, to seek damages when MB unilaterally changed their business model, at great cost to their franchisees. The dealers lost the case. In delivering his judgment Justice Beach offered the following:

Given the facts of this case leading to an adverse result for the applicants, it may be that further consideration needs to be given to the terms of the Franchising Code and possible modification. But that is a matter for another day and obviously in another forum.

Clearly Justice Beach was applying the regulation as he saw it, and clearly, he was very troubled by the decision he felt forced to make.

In responding to a complaint from a franchisee, for its part the ACCC stated as follows:

“The good faith provision of the code doesn’t require a party to act in the interests of the other party or prevent a party from acting in their own legitimate commercial interests”. K. Piniuta 4 June 2021.

This form of words, as we understand it is widely repeated in ACCC correspondence to franchisees. It makes clear that franchisors have no duty to apply any balance as to their interests where those interests are in conflict with the interests of franchisees. Franchising, under the current code, is therefore, a licence to exploit.

For all of these reasons, AAF totally rejects any idea that the code is fit for any worthwhile purpose. It doesn’t need modification. The regulatory framework for franchising needs a rethink from first principles. Whether an industry code is an adequate arrangement on its own is a serious question. Legislation, whether an extension of the Corporations Act or standalone, needs to be considered, potentially in tandem with a much-modified code.

In starting the process of rethinking the regulatory framework, a key starting point is the question of what is franchising, again the current code is fatally flawed.

As part of the Compliance Manual published by the franchising regulator, the ACCC, on Page 10, there is a definition of franchising. It reads as follows:

In a general sense a franchise is a business arrangement in which knowledge, expertise and a trademark or trade name are licenced to a franchisee, for an initial fee and under specific conditions.

In this definition, franchising is a simple licencing arrangement.

This ACCC definition, is a summation of a somewhat wordier definition in the code itself. The definition in the code is not so much a definition as a description, and it is incredibly naïve. This is at the core of the fundamental problems that are being felt very widely across the franchising sector. These problems are very much in the present, but have occurred continuously since the sector started to emerge in the 1970s.

So, if the definition in the code is the problem, then why? The answer is that it is nothing like a full definition. A proper definition would lead to a different view of the regulatory requirements for the sector. A proper definition of franchising would include other elements of the relationship and might read as follows:

A franchise is a business arrangement in which knowledge, expertise and a trademark or trade name have been developed, to at least pilot stage, and are owned by a party known as the franchisor. The intellectual property involved requires the proposed business to have a wide geographic footprint and a commitment of considerable fixed and or working capital to reach its potential. The franchisees in the relationship first and foremost provide this investment. They pay a fee to use the brand as well as paying for the infrastructure and working capital. Franchisees also take responsibility for any lease liability and become the core of the operational management structure. As the relationship becomes operational, franchisees will frequently also pay for the I.T. system through a levy, and the marketing and development of the brand through compulsory contribution to a cooperative fund.

The essence of this definition is that franchisees are stakeholders in an enterprise. Franchisors contribute the initial intellectual property and the franchisees provide the investment to fund the enterprise and give value to the initial I.P. The implication of this thinking is that, in reality, franchising is a mechanism to raise the necessary funds to turn an idea into a commercial success. It has other benefits for both parties but the funding of an underdeveloped business idea is at its core.

The logical extension of this, and the obvious reality, is that franchise businesses are co-venture investment schemes with two equally important partners. Franchising regulation needs therefore, to be about creating a fair balance of rights and responsibilities between two parties who have a massive vested interest in all of the key decisions that are made, while ever the particular franchise continues to exist.

A Code of Conduct which aims to regulate the behaviour of independent businesses, a licensor and a licensee, that is characterized by an imbalance of power is the wrong solution, because it is trying to solve the wrong problem.

ACCC role

As stated above, franchising is a co-venture business and investment model.

At a conceptual level, the ACCC is not an appropriate organisation to have responsibility for franchising. The ACCC is designed to implement laws relating to competition and the rights of consumers. It is not designed to protect investors, or balance the rights, responsibilities and obligations of parties to a shared venture.

At a practical level, the ACCC is not resourced to enforce the very questionable and limited obligations franchisors do have under the code. The percentage of prosecutions to complaints makes this position clear. In the rare event that a franchisee makes a successful complaint, the best end result is a fine. There is no provision for the awarding of compensation. It is a lot of physical and emotional effort for little prospect of a worthwhile outcome for the complainant

The emphasis in the future needs to lie in the prevention of conflict. This can be achieved through the creation of much clearer obligations on the part of franchise enterprise governance structures. Franchise governance structures must include substantive franchisee nominated representation. The responsibilities of franchise governance structures need to mirror the obligations of Company Directors under the Corporations Act.

Additionally, consideration must be given to the position and rights of franchisees in the event of franchisor insolvency.

ASBFEO role

ASBFEO is a user friendly and supportive organisation. The concern is not about ASBFEO, it is about the dispute resolution protocols under the Code. Specifically, the right of franchisors to play the game, but not genuinely address issues. AAF wants to see a different power structure that reduces conflict to a minimum, however to the extent that conflicts will still

arise, there needs to be a stepped process culminating in compulsory arbitration. The availability of a compulsory arbitration step would greatly encourage recalcitrant franchisors to engage more constructively at mediation or conciliation.

The creation of a compulsory arbitration step has been considered and shelved in the past. That is because of limits to the Commonwealth's powers in this area. This obstacle can be overcome. AAF believes franchisors should be licenced. A compulsory condition for franchisors to obtain a licence, should be their agreement to participate in compulsory arbitration if required.

The next issues around conflict resolution are then about cost and time.

The objectives of an effective conflict resolution system need to include compulsory engagement, affordability, timeliness, and third-party determination, where needed.

AAF believes this issue is interconnected with the broader questions of franchising sector oversight, including the licencing of franchisors, and the operation of the disclosure register.

At around ten percent of GDP, Franchising has grown to be a major component of the Australian economy. It is three times the scale of farm gate agriculture, for example. Franchising must now be treated as a serious part of the Australian economy, and also recognised as a major investment model, giving rise to a compelling need to protect the interests of the franchisee investors.

As an important sector, franchising also needs to be positively regarded by financial institutions. With the number and scale of catastrophes that are impacting the credibility of franchising, financial institutions have reacted by applying a greater risk premium to franchising. They are now also examining franchise agreements. None of this is positive for the growth and contribution of the sector.

Franchising needs a regulator of its own. Such an overseeing organisation would have responsibility for the operation of franchising law. It would administer a licencing regime, set and enforce disclosure standards, and manage the dispute resolution system. Given the \$180 billion revenue of the sector, such a body could be easily afforded, with a levy placed on each licenced franchise system, according to scale. Under such a regime dispute resolution could be made timely and affordable for franchisees.

Automotive Sector Amendments

AAF is somewhat bemused by the recent code amendments, primarily relating to asset amortisation, but solely for the automotive participants in the franchising sector. The unanswered question is why, when this baby step of reform was introduced, it did not apply to all franchising enterprises? Nearly all franchisees make capital investments, the same rules need to apply universally across the sector.

We are well aware that the AADA, fought hard for this reform and does place considerable value on it, however AAF is strongly of the view that there should be no right for franchisors

to place arbitrary time limits on franchise agreements. We address the question of tenure and investment below.

Disclosure register

There is clearly a place for transparency in franchising. However, our feedback is that the current approach is counter-productive. The failure of the register is primarily that potential franchisees interpret the information on it, as having been vetted and endorsed by government. There is also a key failing in that the most important document, the standard form agreement is not included. Finally, as there is no licencing regime, participation is effectively, optional. Even where franchisors submit information, required documents are missing. There appear to be no arrangements for enforcing disclosure compliance

AAF supports a disclosure regime, but only as part of a comprehensive overhaul of the regulatory framework for the sector

AAF Reform priorities

At present, the code provides virtually no workable rights or protections for franchisees. They are totally open to exploitation. In combination with a mandatory code which creates rights and obligations for both parties that are balanced and enforceable. The franchising sector also needs legislation which ensures there is an enforceable duty of care to both franchisors and franchisees built into the governance structures of franchise enterprises. The Corporations Act provides many clues as to how such legislation could operate.

While there many issues to be resolved in franchising, the commentary below highlights four issue areas and potential solutions which, if constructively addressed, would make a massive difference to the stability and reliability of franchising in Australia

Problem one

The PJC Inquiry in 2018 neatly summarized the problem with franchising in Australia with the single phrase “There is a massive and unacceptable imbalance of power in the franchisor-franchisee relationship”.

This imbalance of power is not fixed by better preparation and due diligence, which has been the major emphasis of recent code changes, because the power imbalance normally manifests itself when the relationship is already established. Nor can it be remediated by better dispute resolution mechanisms because the obligations of franchisors as defined in franchise agreements are almost non-existent.

If a franchisee takes issue with the behaviour of a franchisor, the good faith obligation is the lowest bar that can be established. The other obligations on franchisors under the code, that is, misleading and deceptive conduct and/or unconscionable conduct have an even higher requirement for proof. Proof, which in the end, must be established in civil court by the franchisee. The onus is on the franchisee to take action which is normally beyond their means and always unacceptably slow. Lawyers looking at such cases are quoting \$1 million

as a minimum realistic cost if the franchisee wins. They are also quoting two years as a minimum time to get into court.

The official recognition of the rights of franchisees to seek multi-party mediation through the dispute resolution mechanisms of the code is a positive step, but there has been no acknowledgment of the role of relevant franchisee associations in initiating and managing such disputes on behalf of member franchisees. This is making the job of franchisees initiating such actions considerably more difficult.

The underlying problem is that franchisors are free to act in their own interests and those interests are often diametrically opposed to the interests of their franchisees. The code simply enables exploitation. Not all franchisors take advantage of this opportunity but many do.

Solution one

The first imperative lies in the recognition of the role of franchisees in funding and staffing the franchise enterprise. AAF estimates that 90% of all investment in franchising comes from franchisees.

Such recognition then leads to the acceptance of the obvious, that franchising is an investment model and that the franchisee investors are critically important. It follows that their needs to be a Board responsible to both stakeholders of the franchise enterprise, with a duty equally to both, as would be the case if franchisees were investing as conventional shareholders.

The franchise board would be required to include franchisees in consideration of such matters as corporate and competitive strategy, marketing, management structural change, senior management appointments and change of franchisor ownership.

Problem two

The next key issue is tenure. Franchises are routinely advertised as enabling franchisees to be their own boss and to own and run their own businesses with the support and guidance of the brand owner. The word partnership is often used. In reality all that the franchisee is getting for their investment, with any certainty, is the licence to a brand name for a limited period.

Franchisees believe they are buying a business for the long term. They leave their jobs redirect their careers mortgage their houses based on this belief. Their risk is enormous.

AAF has had the opportunity to review many franchise agreements. With very rare exception they are for a limited period, somewhere between one and ten years and normally five. We have not seen one that guarantees long term rights. Many are structured to enable the franchisor to repossess the franchisee's business without cause or justification and without compensation for the loss of the goodwill associated with the site or the loss of the franchisee's job. Some agreements specifically state that no matter how much risk the franchisee took, or how much of a business they built, they have no entitlement for compensation in relation to goodwill. Many franchise agreements enable the franchisor to

repossess the franchisees business before the initial term is even up, once again without the need for substantive justification.

The understanding outlined above was strongly reinforced in the recent decision in the Mercedes Benz case. That decision may be correct in law, but it was also an astonishing demolition of the previous custom and practice. Mercedes Benz dealerships have historically changed hands as going concerns, with the presumption by the parties, including Mercedes Benz, that they would be owned by the buyer indefinitely.

The decision in this case confirms what is the standard misrepresentation in franchisor marketing and that is that you are *buying a business and will profit from its growth and asset value increase*. The implications of this decision are not yet fully understood, but they are horrendous.

At the very least the MB decision legitimises the phenomenon known as burning and churning, where the franchisor deliberately repossesses a franchisee's business usually at the end of the first term and then resells it to gain the benefit of all the going in fees and charges.

For most franchisees this uncertainty and dependency creates massive fear of the franchisor, and great uncertainty as to their future, even though they are funding the business.

Solution two

Franchisees believe they are buying and dedicating themselves to a long-term opportunity. Continuity of tenure should be the default position. Any decision by the franchisor to terminate a franchisee's agreement should be based on fair and objective criteria. These criteria should form part of the contract and be the only basis on which a franchisee can be terminated. Breach notifications giving grounds for termination should be of such a standard as to pass a test of reasonableness. The franchisee is at risk of losing their massive investment, often their home and, nearly always, their career.

Problem three

Franchisors generate revenue through royalties, fees for services provided, commissions and rebates from suppliers. All of these income streams create the potential for *perverse incentive* problems.

In most royalty-based systems, franchisors toll the gross revenue/sales of the franchisees' business. This form of revenue stream does not require that the sales on which they are based, generate a positive return for franchisees. If sales are not what the franchisor wants, he can force discounting which drive sales higher and increases his income, but at the same time reduces the margin for franchisees, often to the point of loss making. This was the central issue in the Pizza Hut case. It was also a major factor in the Laser Clinics dispute. It is very common when markets become more mature and there is no profitable innovation.

Fee for service often applies to services such as I.T. and marketing. The Franchisor enjoys a monopoly over the service pricing mix. Marketing funds in particular are one of the most frequent topics for complaint. Franchisors regularly use such cooperative funds to pay for

activities that are not directly related to promoting the franchisees' business. Also, franchisees object to their funds being used for marketing that relates only to brand equity. They do not have any equity in the brand, and see this as a cost that should be borne by the franchisor. Franchisees are also concerned by the value for money equation associated with franchisor provided IT services.

Finally, rebates and commissions, as with the other issues of commercial terms, fairly administered these charges are acceptable. However, price gouging is commonplace and not precluded by the code. In one recent case, a piece of mission critical capital equipment which cost the franchisor \$100k was offered to franchisees for more than \$170k. At no point did the franchisor pay for, store, or take any commercial risk on the transaction, nor did they even negotiate exclusivity. This scenario is also played in the supply of consumables, where franchisors take advantage of their monopoly supplier position to take manifestly excessive commissions and rebates. The franchisee refrain "I could buy it cheaper at Woolworths" sums up the reality.

Taken together all of these discretions available to franchisors can easily make the difference between a good business for franchisees and a financial disaster.

Solution three

With respect to royalties, there should not be the opportunity to levy royalties on unprofitable sales. The objectives of the stakeholders will be far more closely aligned if royalties are levied at the nett margin line on the franchisee's P & L. By dint of this simple change franchisors would have an immediate incentive to maximize franchisee profitability. Discounting initiatives that go beyond promotional requirements would no longer be attractive to franchisors.

Importantly, in collecting royalties from revenue, franchisors are placing themselves as creditors above the ATO, employees, suppliers and landlords. It is surprising that this arrangement has been accepted by government.

In drafting standard form franchise agreements, Franchisors rarely, if ever, stipulate what the franchisee will receive by way of support in return for the royalties they will pay. The use of a brand name in most instances is nothing like sufficient to justify the scale of royalties extracted. All franchise agreements should be required to contain a summary of franchisor deliverables beyond the brand name. These items should not be part of separate and specific levies.

As to fees and charges for services such as marketing and I.T. these should be subject to clear service-level agreements and clear budgets agreed with franchisees. All service arrangements should be priced on a third-party competitive basis. The service regime should be fully transparent and subject to independent audit as to the commerciality of each service offering.

With respect to the monopoly position franchisors enjoy, price gouging is a major source of financial stress and failure of franchisees. The regulatory regime must insist that supply chain arrangements managed by franchisors must not include mark ups, commissions or

rebates that are not competitive with third party alternatives. If franchisees are not getting value from their franchisor supply chain, they should be able to utilize better options.

Exemptions from third line forcing provisions, currently available under the competitions code, need to be reviewed in light of the recent history of price gouging.

Problem four

Franchisors are currently free to make changes to their business model or ownership without consideration for the impact on the franchisees whose historic investments have funded the business.

There are many examples of issues arising from this unconstrained right. AAF is currently dealing with a system wide problem where a seafood restaurant chain has been purchased by vegetarians.

The problem is that the new owners are seeking to introduce a major vegetarian initiative. This creates enormous costs in infrastructure because there are vegetarians who are subject to major allergic reactions when their food is contaminated with seafood. So, additional kitchen equipment is required including cooking and washing up. This leads on to a bigger kitchen space requirement. This is also an increase in working capital requirement for ingredients which have a short shelf life. This initiative is not working. Unsurprisingly, people go to seafood restaurants for seafood.

This is one of many examples of franchisors changing course, without the approval of their franchisees.

Another major change is change of ownership. This is an especially difficult problem where the new owner has short term imperatives to extract the maximum short-term profit. Private Equity owners who want to buy and sell within a short time frame are a particular problem in this regard. IPO initiatives can have similar problems. The incoming CEO is under pressure to meet revenue growth targets, so appoints new franchisees overlapping and undermining existing territories.

This issue is enormous and overlaps into the catastrophic implications for franchisees if their franchisor becomes insolvent.

Solution four

In the current regime, there are no provisions for franchisees to be able to protect their interests. There needs to be serious consideration within the regulatory regime as to the point at which the franchise agreement can be severed by the franchisee where the business model or strategy is plainly inimical to their interests. The basis on which this can be done is a massive issue. Franchisees are regularly caught up with fatally flawed strategic decisions, or owners who are incompetent or whose objectives require them to throw their franchisees under the bus.

Process Issues

The final point in the terms of reference for this review, talks about the outputs from this review needing to be assessed against the criteria for a post implementation review as set out in the Australian government's Guide to Policy Impact Analysis.

In the period following the PJC report in 2019, A taskforce of bureaucrats was formed to conduct a process described in broadly similar words. That process was used to completely undermine the central conclusions of the PJC Inquiry. The reasons for the failure of that taskforce have never been explained, but it was very convenient for the franchisor lobby.

It is fair to say any worthwhile reforms may well be opposed by the franchisor lobby. They have shown in the past that they are wedded to their freedom to exploit, and their total lack of genuine accountability.

AAF believes the only way positive reform can be achieved is by pressure from government, transparency of debate and active involvement and negotiation between the franchising parties. It will not be achieved through closed bureaucratic processes.

Summary

Franchising is experiencing a protracted but silent crisis. All franchisees are subject to contractual obligations under headings of confidentiality, non-disclosure and non-disparagement. Such clauses extend for years beyond their time as franchisees. They often lose everything and say nothing due to the very real fear of litigation.

The four key issue areas discussed above, are elements of a system that is dysfunctional and is creating a disproportionate number of catastrophes. The franchising sector is almost entirely funded by the life savings and borrowings of ordinary Australians with initiative. It is clear from experience and the outcomes of the 2019 PJC Inquiry report that the time has come for a legislative approach to the sector.

The franchising code has outlived its usefulness. Franchising in Australia is now big business, and it is being exploited by foreign multi-national corporations, private equity opportunists, and listed companies. We understand and accept that reform is a big task and will take time. The sector does not need more regulation, but it does need a different regulatory mindset placing more responsibility on franchisors raising enormous amounts of money from franchisee investors.

As an Association representing franchisees, we believe the ideas outlined above are constructive and useful. We are more than willing to play a positive and constructive role in the process going forward.

On behalf of AAF.

Vincent Caruso

Chairman

Mike Sullivan

CEO

