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Dear Committee

2018 Franchising inquiry

My credentials

As a transactional lawyer I advised a wide range of franchisors, master franchisees, franchisees (in sectors ranging from petroleum, to fast food, to gyms) and suppliers for 19 years up to 1999 in NZ, Melbourne then Sydney. I worked for the original Office of the Franchise Mediation Adviser. I have been an academic teaching and researching franchise law since 2002. I led a team that created the only MOOC on International Franchise Law. This attracted participants from over 160 countries in 2016.

The research for both my LLM (Melbourne) and PhD (QUT) was in the field of franchise law. I have been a member of the ACCC's Franchising and Small Business Consultative Committee and its predecessor since 2010. Although I worked with Oil Code and the Petroleum Retail suite of legislation when I acted for the petroleum sector my comments will be confined to business format franchising that is regulated under the Franchising Code of Conduct 2014 (the Code).

My research

Much of my research is about franchise law. I use data from Australia when it is available. In my research with Benoliel we research franchisees sourced from government-held, publicly accessible US franchise databases. We used US franchisees as subjects because there is no credible, publicly accessible database of Australian franchisors or franchisees.

In *theoretical research* I have, with Gunasekara, investigated the possible application of administrative law principles to the evaluation of conduct within franchise networks.[1] We observed that a franchise network becomes a private bureaucracy, and that assessing the presence/absence of good faith among the parties would be done more accurately using administrative law than the current blend of statute and common law tests.

[1] J Buchan & G Gunasekara, 'Administrative Law Parallels with Private Law Concepts: Unconscionable Conduct, Good Faith and Fairness in Franchise Relationships' (2015) 36 *Adelaide Law Review* 541 - 575. https://www.adelaide.edu.au/press/journals/law-review/issues/36-2/alr-36-2-ch09-buchan-gunasekara.pdf

My franchise-related *empirical research* is in the areas of:

- dispute resolution,[2]
- due diligence,[3]
- franchisees' optimism bias,[4]
- franchise education,[5]
- franchisor insolvency and its effects on franchisees.[6]
- governance of franchise networks,[7]
- the history and future of franchise regulation in Australia,[8]
- mergers and other competition law issues,[9]
- real and intellectual property,[10]
- stakeholder input into government-initiated franchise inquiries.[11]

I am happy to provide copies of any of these articles to the Committee on request.

Unmet high-level challenges in business format franchising.

Since 1993 the nature of franchising has changed radically with the entry of venture capital as an investor into franchisors https://www.avcal.com.au/documents/item/1428 and the agglomeration of brands into multi-branded public companies. The 'franchisor' is now a lightly-capitalised entity that is nestled among a network of supporting entities (see my comments and links re Aussie Farmers Direct on p 10). Some of these are proprietary companies, some grandfathered Exempt Proprietary Companies,[12] some public companies and some trusts. Some of these entities are based in Australia, others are spread across the globe.

Eminent New Zealand Judge, Sir Edmund Thomas, wrote that 'a law that is out of step with the needs and expectation of the times is not serving the society it is designed to serve. It is failing in its basic function'.[13] It's time we took a reality check on what todays' franchises are like; who the franchisors and franchisees are, how they are structured, how money and thus tacit control flows through the networks, whether franchisees can

[2] Buchan J; Harris JA; Gunasekara G, 2011, 'Franchise mediation: confidentiality or disclosure: a consumer protection conundrum' presented at 25th Annual International Society of Franchising Conference, Boston, 16 - 18 June 2011

3 J Buchan, 'Ex ante information and ex post reality for franchisees - the case of franchisor failure' (2008) *36 Australian Business Law Review*, 407 – 431; J Buchan, L Frazer, S Weaven & B Tran-Nam; A Grace, 'The Adequacy of Pre-purchase Due Diligence in Independent Small Business and Franchising' (2018) 28 *Australian Accounting Review*, 127 – 139; L Frazer, J Buchan, S Weaven, B Tran-Nam & A Grace, 'Pre-Contractual Due Diligence by Franchisees and Independent Small Business Buyers', (2018) 46 *Australian Business Law Review*, (in press).

[4] U Benoliel, J Buchan & T Gutentag, 'Revisiting the Rationality Assumption of Disclosure Laws: An Empirical Analysis' *Hofstra Law Review*, (2017) 46, 469 – 488; U Benoliel & J Buchan, 'Franchisees' Optimism Bias and the Inefficiency of the FTC Franchise Rule' (2015) 13 *DePaul Business & Commercial Law Journal*, 411 – 431.

[5] D Cumberland, J Buchan & B Litalien, 2018, 'Franchise Education in the United States: A Content Analysis of Syllabi from U.S. Business Schools' (presented at 32nd Annual International Society of Franchising Conference, Escuela Politicnica Nacional. Quito, Ecuador, 28 - 30 June 2018).

[6] P J Omar & J Buchan, 'Bucolic Dream or Arboreal Fantasy? The *Willmot* Saga, Insolvency Disclaimers and the Contract/ Property Dichotomy' (2016) 3, *The Conveyancer and Property Lawyer*, 197 – 214; R Nicholls & J Buchan, 'The Law of Unintended Consequences: The Effects of Voiding Ipso Facto Clauses in Business Format Franchise Agreements', (2017) 45(6) *Australian Business Law Review*, 433-447; J Buchan. L Frazer, CZ Qu, &R Nicholls, 'Franchisor Insolvency in Australia: Profiles, Factors, and Impacts' (2015) 22 *Journal of Marketing Channels*, 311 - 332, http://dx.doi.org/10.1080/1046669X.2015.1113487; J Buchan, 'Franchising: A Honey Pot in a Bear Trap' (2013) 34, *Adelaide Law Review*, 283 – 315. http://www.austlii.edu.au/au/journals/AdelLawRw/2013/17.pdf

[7] J Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences*, 2013, Springer, 101 – 109.

[8] M Schaper & J Buchan, 'Franchising in Australia: A History' (2014) 12 *International Journal of Franchising Law*, 3 – 23.

[9] R Nicholls & J Buchan, 'Failing firm, failing franchisor: Local market analysis in Australian merger clearance' (2016) 23(3) *Competition &Consumer Law Journal* 247-265.

[10] J Buchan & CW Butcher, 'Premises occupancy models for franchised retails businesses in Australia: factors for consideration' (2009) 17 *Australian Property Law Journal*, 143 – 177; J Buchan, 'Franchisors' registered trademarks - empirical surprises' (2009) 21(7) *Australian Intellectual Property Law Bulletin*, 154-157.

[11] J Buchan, J Harris, 'Stakeholder input into franchise inquiries: an Australian exploratory study' presented at 24th Annual International Society of Franchising, Sydney, 08 - 09 June 2010.

[12] https://www.legislation.gov.au/Details/F2015L01545/Explanatory%20Statement/Text

13 Thomas, E.W., The Judicial Process: Realism, Pragmatism, Practical Reasoning and Principles (Cambridge Press, 2005), 287.

conduct meaningful pre-contract due diligence, what rights the franchisees have if the franchisor does not deliver on its 'promises', and what rights franchisees have if their franchisor enters administration or is wound up insolvent. Then we need to re-think whether it is reasonable to expect the Code to remain as the only statutory instrument in Australian franchising.

Ideally, we will arrive at law that is less onerous for franchisors but more meaningful for franchisees and their advisers.

Franchisors have no accountability for delivering on their claims. Once a franchisee has signed the franchise agreement and the 7-day cooling off period has passed there is no practical way they can hold their franchisor to account other than through mediation or litigation. This places all the responsibility on the franchisee. There is no requirement that franchisors take account of their franchisees as stakeholders. Franchisors are seldom found to owe fiduciary duties to their franchisees.

This lack of responsibility carries through to when/ if the franchisor trades while insolvent. Although administrators are bound by the Code (as they 'step into the shoes' of the franchisor's directors) they do not pay attention to it and have not demonstrated any willingness to attend mediation with franchisees. Administrators regard franchisees as sources of free labour, and their franchise agreements as assets or liabilities. A key distinction between a relationship categorised as employment or as a franchise is that where the employer is a corporation, the conduct of its directors and officers towards employees is measured against standards in corporations' law. In franchise relationships, this additional layer of governance regulation is absent. Franchising is purely a contract-based relationship. The franchisor drafts the contract and the franchisee decides to accept it or walk away.

The absence of any accountability for governance of the franchise network is a problem that franchisees cannot counter alone. They deserve better. Possible solutions could include:

1. Implement something like Australia's new Banking Executive Accountability Regime (BEAR), making key people in the franchisor (and especially the ultimate entity that owns the franchisor) responsible for taking the franchisees into account in every decision that may affect them. For financial institutions the impact of the new BEAR regime will require them to take customers into account, not simply make all decisions with a view to profit and shareholders. (https://www.aph.gov.au/Parliamentary_Business/Bills_LEGislation/Bills_Search_Results/Result?bId=r6000)
2. Abolish the *Exempt Proprietary Company* (EPC) status under the *Corporations Act*, s 319(4) for any company in any way involved in business format franchising. At least one franchisor that has been under very serious scrutiny by regulators since 2017, enjoys this status.
    - The practical effect of EPC status is that, since 1994 when the EPC category was created, that master licensee for Australia (essentially, the franchisor here) has not been required to file annual returns with ASIC. Thus, franchisees have no chance of objectively verifying any data that is in the franchisor's disclosure material.
3. Amend to the *Corporations Act* to clearly locate franchisees as stakeholders. This would require amendment of Directors Duties, and priorities in insolvency. This becomes critically important if a franchisor becomes insolvent. See more on insolvency below.
4. Create a free, public database of franchise disclosure documents and unit and master franchise agreements (more on this below) controlled by one of the regulators, probably the ACCC. Three US states require franchisors to register their current disclosure document(s) and unit franchise agreement template on a publicly accessible, free, government website.
    - The **Californian** link https://docqnet.dbo.ca.gov/search/ enables you to choose a franchisor and search the Franchise Disclosure Document. The FDD includes copies of documents like the standard franchise agreement for that franchisor. You can find names of all franchisees, some contact details for them. As you see, it is a state government owned and operated website as the specific franchise laws in the US are per state.

- **Minnesota** is quite easy to use, http://mn.gov/commerce/industries/securities/
- To access the **Wisconsin** one from outside the US you must fiddle around with your computer settings to trick it into thinking you are in the US.

5. Give franchisees a statutory right to exit the system by requiring the franchisor to buy their businesses back at a current market value on the occurrence of any 'shock' event. These events might include, for example, the franchisor changing the focus of its efforts and diluting the value (to franchisees) of their businesses through a public listing.
6. The legal and accounting professions need to upskill members to understand franchising from the perspective of both franchisors and franchisees. It would be wise for them to include 'accredited franchise specialist' in their accreditation programs. This would help franchisors and franchisees obtain assistance from advisers who understand the model and can read between the lines in the various agreements.

Current environment

As can be deduced from the **RED Group's organisation chart** (Figure 1), the franchisor's strategic decisions, conduct and ongoing solvency are only some of the factors that could impact on its franchisees. Failed endeavours anywhere in the network could damage/ destroy the franchisees' businesses. Where the franchisor is part of a complex network it might not be the party in ultimate control of the franchise's future.

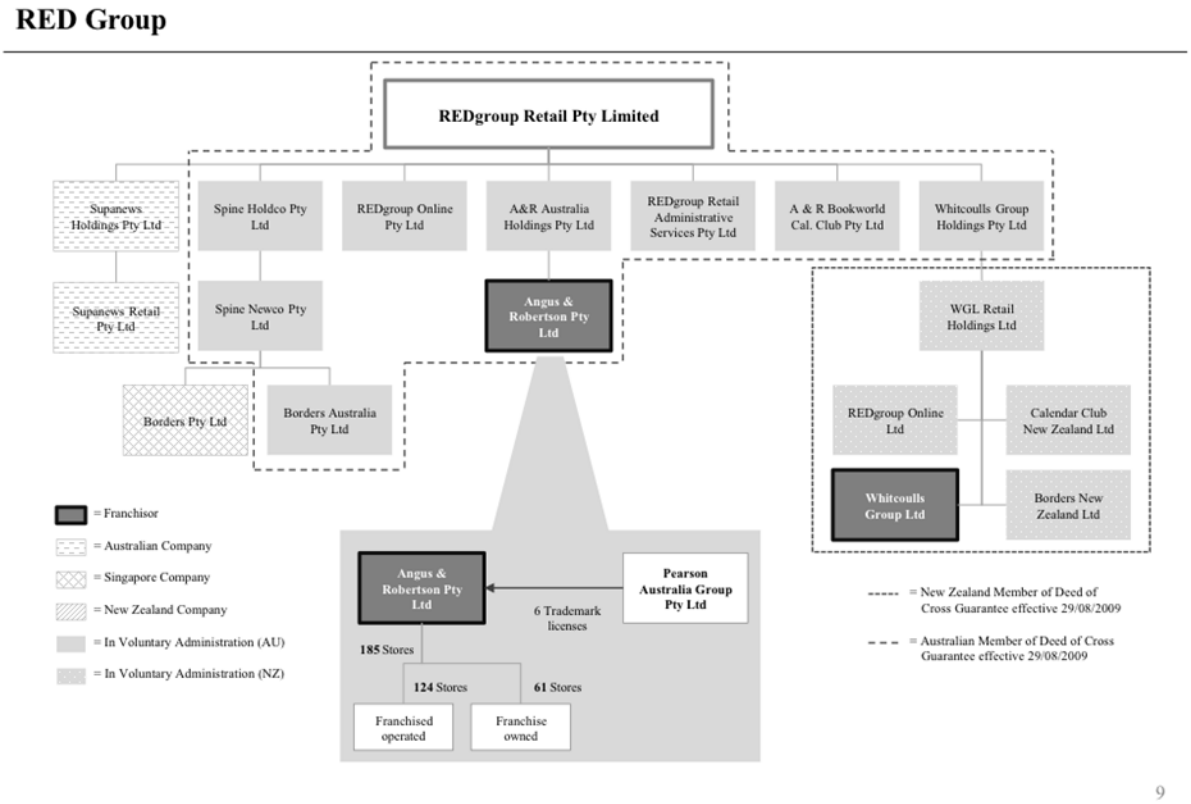

Figure 1: RED Group organisation chart.

The Code provides some protection for both franchisors and franchisees. But, even the duty of good faith is diluted by Clause 6 (6) of the Franchising Code (Code) which provides:

> 1. To avoid doubt, the obligation to act in good faith does not prevent a party to a franchise agreement, or a person who proposes to become such a party, from acting in his, her or its legitimate commercial interests.

Thus, there is no requirement for a franchisor (or franchisee) to consider the **impact of strategic decisions** on its franchisees. Franchisees are expected to trust that the franchisor will act in such a way as to enhance the brand and enable franchisees to prosper. This trust can be misplaced. For example, in 2016, the Sizzler restaurants in Australia were recategorized 'non-core businesses' by parent company Collins Foods to give way to a focus on growing its KFC outlets. Consequently, Sizzler was not allocated any growth capital in 2016 following a $37.5 million write down of the brand.[14] A prospective Sizzler franchisee looking at the Collins Foods website would never be able to figure out this change of priorities. In fact, they would now find that a development in the business model is that by May 2018 'Q: Are Sizzler Franchises available? A: There are no longer franchised Sizzler Restaurants in Australia. All of our restaurants are company owned and managed. Therefore, franchises are not available' (Collins/ Sizzler website).

Collins' website contains the company's 2 Charters, 10 Policies and 1 Workplace Gender Equality report. Despite billing itself as a franchisee (ie: a master franchisee) there is not a single reference to 'franchisee'. Collins has done nothing wrong. This is a direct result of the emphasis in the *Corporations Act* on stakeholders being employees and shareholders, not the parties who today replace these players by providing labour and finance (equity and borrowed), franchisees.

A current franchisee could do nothing about any risky strategic decision taken by their franchisor, even if they became aware of it. They are locked into a long-term franchise agreement, and to consequential leases, supply agreements and other contracts.

(a) The operation and effectiveness of the Franchising Code of Conduct, including the disclosure document and information statement, and the Oil Code of Conduct, in ensuring full disclosure to potential franchisees of all information necessary to make a fully-informed decision when assessing whether to enter a franchise agreement, including information on:

(i) likely financial performance of a franchise and worse-case scenarios

(ii) the contractual rights and obligations of all parties, including termination rights and geographical exclusivity

(iii) the leasing arrangements and any limitations of the franchisee's ability to enforce tenants' rights

(a) Problems with disclosure document under the Franchising Code of Conduct (the Code)

Scope: Full disclosure requires full disclosure of the **entire network** within which the franchisor exists. It is not sufficient to disclose the 'franchisor' entity and 'associates'. Disclosure should be made of the organisation chart – as for REDGroup, with the full legal identity of each of the players. This could enable a diligent and well-funded franchisee to do better due diligence.

Franchisors should be required to include the full name and legal identity of 'the franchisor' on their websites.

Accountants making submissions to this inquiry will be able to explain how a franchisor can legitimately sign the statement that the franchisor is solvent (**Item 21** of the disclosure) and then become insolvent within weeks.

Timing: The timing of the issue of the disclosure means that a franchisee is psychologically fully committed to become a franchisee of the franchise system they get the disclosure for before getting the disclosure. Any disclosure document is a snapshot of the franchisor's business at the date it is made. It is always going to be of limited value for that reason.

Franchisees do not compare several disclosure documents as they must pay a deposit before being given the document. If the franchise offering does not 'add up', it is extremely difficult for the intending franchisee's advisers to dissuade potential franchisees at this stage. For instance, the experience of Mr Muriniti, a retail pie shop franchisee below is not uncommon:

[14] Jason Gherke, 'Sizzler on Life Support as Stores Shut' (Franchise Advisory Centre newsletter) <http://www.news.com.au/finance/business/retail/sizzler-on-life-support-as-stores-shut/news story/754dfaa661aa32479cbe2396dcd9909c> accessed 26 March 2018.

In *Shakespeares Pie Co v Multipye* [2006] NSWSC 930, Paragraph 36 of judgment reads;

> "Mr Thadani (franchisee of failed pie franchise outlet in Sydney CBD) gave evidence of negotiations conducted by him and Mr Muriniti (franchisee's lawyer), with Mr Gualdi and others, during September 2003. According to his evidence, Mr Gualdi (franchisor) told him **more than once not to listen to Mr Muriniti, because Mr Muriniti was not a franchise lawyer and was causing delay that would only add to the cost of the transaction**. Mr Muriniti told Mr Thadani not to pay any money until satisfactory documentation had been produced. At one stage Mr Thadani handed over a cheque and then, on advice, told Shakespeares not to bank it and that it would be cancelled. Mr Muriniti told his client in late September 2003 that there was something seriously wrong with the deal because the documents did not coherently relate to one another. Amongst the unresolved matters was absence of consent to Multipye's occupation by Westfield, the landlord."

Content: the Mathews Report recommended the disclosure included specific information to a franchisee about what would happen to it if the franchisor became insolvent. The consequences for franchisees can be catastrophic. What could be a better reality check for a prospective franchisee?

This recommendation was loosely adopted by the Federal Government as a request to the ACCC to provide general information about the consequences of franchisor failure. A generic, watered down warning was included in the Disclosure in response.

The Wein Report in 2014 also made recommendations about franchisees' rights in franchisor's insolvency – these, again, were largely ignored.

The franchisee should be given information that is specific to its actual business. The franchisee needs to base its purchasing decision on full and accurate information.

Given the number of franchisor businesses that are now owned by a public company, or a venture capitalist, a watching brief should be kept on the consequences for franchisees of the company restructuring.

Due diligence: Franchisees are told to conduct due diligence. It is expensive, sometimes impossible and not always helpful. Franchisees whose expectations are not met may be blamed by courts and franchisors for failure to conduct adequate **due diligence** prior to purchasing the business. This blame-casting can be disingenuous. Due diligence is expensive and there are some obstacles for franchisees attempting to be thorough.

For example;

Who is the franchisee dealing with? Who/what should due diligence be conducted on? The challenges facing franchisees are thrown into focus by the judgment in *Acer Computer Australia Pty Limited v Carter (No 2)* [2007] FCA 1943 where the court observed;

> The relevant franchisor **would appear to have been** one or other of the companies in the 'Betta Group,' which comprised Betta Stores Limited ACN 009 710 605 ('Betta Stores'), Betta Stores (Southern) Pty Limited ACN 059 881 220 ('BSS'), Betta Stores (Northern) Pty Limited ACN 112 330 944 ('BSN'), A.K. Truscott Investments Pty Limited ACN 007 818 493, Truscott Electronics Pty Limited ACN 007 549 206 ('TE'), Truscott Finance Pty Limited ACN 007 598 389, PGA & Associates Pty Limited ACN 007 755 615 and BSL Finance Pty Limited ACN 058 061 822 ('BSLF').

If the court could not establish the accurate identity of the franchisor, what hope is there for the franchisee to conduct thorough due diligence?

In 2006, 70% of franchisors were proprietary companies, 14% public companies and 10% trusts. (page 34, *Franchising Australia 2006* by Frazer, Weaven and Wright.

- A public company's reports do not contain meaningful information about the franchise division.

- It is impossible to conduct due diligence on a trust.
- If a franchisor/ master franchisee/area developer is an Exempt proprietary Company they do not have to file annual returns with ASIC. Their operations are virtually invisible to prospective franchisees.

The franchisee thus must accept what the franchisor has disclosed, ask more questions and hope the franchisor provides full answers, or walk away.

Intellectual Property

The Code requires disclosure that complies with Clause 8 (see below). The most publicly visible item of intellectual property is the trademarks that identify the brand. Research I conducted in 2009 (see footnote 10 above) revealed that:

- 26% of franchises the franchisor was sole owner of the TMs. For these franchises only the franchisor can reliably grant licences to franchisees to use the brand without fear of losing the right themselves.
- 14% of trade marks (TMs) used by franchisors were not registered.
- 14% it was impossible to determine the legal identity of the franchisor entity because there is no public register of franchisors in Australia and the franchisors websites did not identify the legal entity that acted as 'the franchisor', so no further reliable investigation was possible.
- 16% of the TM owners were foreign companies based variously in the Bahamas, Bermuda, Canada, Cape Province, France, Germany, Hong Kong, Japan, Mauritius, the Netherlands, NZ, Republic of Ireland, UK and USA. Sometimes the motivation is to locate intellectual property in a tax haven, sometimes it is because the franchisor is based overseas.
- 29% of franchisors were one of the joint owners of TMs.
- 25% of franchises the franchisor had no ownership of the TMs.
- 3 of the 337 franchisor I surveyed had provided their TMs as security for loans. Presumably these loans and their terms would be identified in franchisor's disclosure 8.1(f). While providing the TMs as security for loans makes sense commercially it does put the franchisees in an awkward position if the franchisor defaults and the TMs are sold to a third party and the franchisor thus loses the right to grant authorised user rights to franchisees.

I have today become aware, anecdotally, of a franchisor that uses its trade marks pursuant a licence agreement. The agreement can be terminated by either party (owner or franchisor/licensee) on short notice. This was, apparently, not disclosed to franchisees. Franchisors need to be aware of their obligations under the Code.

Real property rights/ leases

See my article J Buchan & CW Butcher, 'Premises occupancy models for franchised retails businesses in Australia: factors for consideration' (2009) 17 *Australian Property Law Journal*, 143 – 177.

(iv) the expected running costs, including cost of goods required to be purchased through prescribed suppliers.

(b) the effectiveness of dispute resolution under the Franchising Code of Conduct.

Justice obtained through the courts can be ferociously expensive, well beyond the means – financial, emotional and time – of an average franchisee.

The current mediation system works, essentially, well. However, no information is available on the public record about the frequency or subject matter of mediations in franchise systems, or the refusal of franchisors to mediate. Some transparency would enhance the value of mediation. 'The absence of meaningful data about mediations that have occurred within a franchise system fails to satisfy a broader consumer protection agenda. This absence of data exacerbates the information asymmetry facing prospective franchisees. It diminishes the ability of advisers to advise, and policy makers to make appropriate policy, or to test the effectiveness of existing policy'.[15]

[15] Buchan J; Harris JA; Gunasekara G, 2011, 'Franchise mediation: confidentiality or disclosure: a consumer protection conundrum' presented at 25th Annual International Society of Franchising Conference, Boston, 16 - 18 June 2011

(c) the impact of the Australian consumer law unfair contract provisions on new, renewed and terminated franchise agreements entered into since 12 November 2016, including whether changes to standard franchise agreements have resulted.

Currently, in legal terms, franchisees are investors who sign a standard form contract with the franchisor, thereby committing themselves to initial and ongoing payments to their franchisor for a term that ranges from one year to infinite years. In this contract they agree to let the franchisor call the shots, which the franchisee will obey. If the franchisor turns out not to know what they are doing the franchisee can try to sell its business, tough it out until the franchise term expires, or attempt to mediate to achieve a decent outcome. If the contract contains unfair contract terms the franchisee can litigate under the 'unfair contract terms' provisions of the Australian Consumer Law if it fits within the criteria.

> 2. The unfair contract terms regime of the Australian Consumer Law (Competition and Consumer Act 2010 (Cth) sch 2 sections 23 - 28) apply to contracts entered into … by small businesses who employ less than 20 people and the value of the contract is $300,000 in a single year, or $1million if the contract runs for longer. The regime means that a court can declare that a term of a standard form contract is void if it considers the term is "unfair".[16]

To continue with the Sizzlers example, Sizzlers is a large restaurant, likely to employ 20 or more staff; the cost of a Sizzlers is also likely to exceed the dollar threshold. This can be deduced from the size of the outlets which franchisees would have been responsible for building, and staffing.[17]

I suggest that the unfair contract terms provisions should apply to all franchise agreements, irrespective of size of the investment or number of employees.

(d) whether the provisions of other mandatory industry codes of conduct, such as the Oil Code, contain advantages or disadvantages relevant to franchising relationships in comparison with terms of the Franchising Code of Conduct.

No comment

(e) the adequacy and operation of termination provisions in the Franchising Code of Conduct.

Termination is addressed in franchise agreements and in the Code (clauses 26-29)

Clause 26: I also suggest the franchisor should be able to 'cool off' during this period as they may have realised the franchisee would be unsuitable and it would be better to pay money back and free both parties from the prospect of years of hell than force them to continue.

Clause 27 – 29: There are numerous examples since 1998 of franchisors becoming insolvent, being deregistered, abandoning the franchise, being convicted of offences that are not minor, and operating fraudulently. Franchisees need to be given the same rights to terminate their agreement, with compensation if appropriate, if their franchisor gets into any of these situations.

See my comments on Termination and Insolvency below.

(f) the imposition of restraints of trade on former franchisees following the termination of a franchise agreement.

There should be no restraints on a former franchisee. If they are no longer entitled to be a franchisee because, for example, the term has ended, they should not be prevented from earning a living doing what they have become good at during the term of the franchise.

[16] https://www.lawhandbook.sa.gov.au/ch10s03s06.php

[17] http://www.news.com.au/finance/business/other-industries/sizzler-closing-more-restaurants-but-why-have-we-fallen-out-of-love-with-it/news-story/a46911a39e8d55ba3665052850293bed

(g) the enforcement of breaches of the Franchising Code of Conduct … and other applicable laws, such as the *Competition and Consumer Act 2010*, and franchisors.

See below.

(h) any related matter.

Insolvency

Franchise agreements always contain provisions that allow a franchisor to terminate a franchise agreement if the franchisee. A long list of ways a franchisee can default on its obligations under the franchise agreement is included in the agreement. Failure to make good a default enables a franchisor to terminate a franchise agreement. The list of potential franchisee defaults will include, the occurrence of:

'an Insolvency Event occurs in respect of the Franchisee or any of the Guarantors'

***'Insolvency Event** in respect of the Franchisee or a Guarantor means the happening of any of the following:*

(a) an order is made, or the Franchisee or a Guarantor passes a resolution, for its winding up;
(b) an application is made to a court for an order for its winding up;
(c) an administrator is appointed;
(d) (i) a resolution is made to appoint a controller or analogous person to the Franchisee or Guarantor or any of its or his property;
(ii) an application is made to a court for an order to appoint a controller, provisional liquidator, trustee for creditors in bankruptcy or analogous person to the Franchisee or Guarantor or any of its or his property;
(iii) an appointment of the kind referred to in paragraphs d(i) or (ii) is made (whether or not following a resolution or application);
(e) a person holding security takes possession of any of the Franchisee's or a Guarantor's property;
(f) the Franchisee or a Guarantor is taken under s459F(1) of the Corporations Act (Cth) 2001 to have failed to comply with a statutory demand;
(g) the Franchisee or a Guarantor suspends payment of its debts; and
(i) ceases, or threatens to cease, to carry on all or a material part of its business;
(ii) states that it is unable to pay its debts or is or becomes otherwise insolvent;
(iii) is taken by applicable law to be, or if a court would be entitled or required to presume that the Franchisee or a Guarantor is, unable to pay its debts or is otherwise insolvent;
(h) the process of any court or Authority is invoked against the Franchisee or a Guarantor or any of its or his property to enforce any judgment or order for the payment of money or the recovery of any property;
(i) the Franchisee or a Guarantor dies, ceases to be of full legal capacity or otherwise becomes incapable of managing his own affairs for any reason;
(j) the Franchisee or a Guarantor takes any step that could result in it becoming an insolvent under administration (as defined by the Corporations Act (Cth) 2001);
(k) the Franchisee or a Guarantor takes any step towards entering into a compromise or arrangement with, or an assignment for the benefit of, any of its members or creditors; or
(l) any event analogous to those described in paragraphs (a) to (k) above.'[18]

This, combined with the current Clause 29 (b) of the Code (below) has several consequences.

'Code: Clause 29 Termination—special circumstances

(1) Despite clauses 27 and 28 (ie notice and remedy opportunity), a franchisor may terminate a franchise agreement without complying with either clause if the agreement gives the franchisor the right to terminate the agreement should the franchisee:
(b) become bankrupt, insolvent under administration or an externally-administered body corporate'

Franchisee rights are open to serious compromise by any "special circumstances breach" by a franchisor. Some reciprocity on termination matters should be extended under the Code to franchisees. Franchisors are not all model corporate citizens!

The Committee should note that 'Federal Treasury has released draft regulations and a draft declaration for public consultation. The regulations and declaration support the stay on enforcement of ipso facto clauses

[18] Wording from typical franchise agreement in mature system.

against relevant entities. Ipso facto clauses allow parties to enforce a right, and terminate or amend a contract, when their contractual counterparties have entered into formal insolvency, regardless of the counterparties continued performance of their obligations under the contract.

The exposure draft of the Corporations Amendment (Stay on Enforcing Certain Rights) Regulations 2018 and the Corporations (Stay on Enforcing Certain Rights) Declaration 2018 support the reforms in the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017 (the Act) which received Royal Assent on 18 September 2017.

The draft regulations and declaration recognise that in some circumstances it is necessary or desirable for ipso facto clauses to continue to operate, for example, where there is an established market mechanism already in place or where it would be a commercial nonsense for an ipso facto clause to be stayed. As a result the draft regulations and declaration include certain exemptions to the ipso facto stay.

The public's views are sought on the regulations and declaration. Submissions are due by 11 May 2018. See Treasury's website. See also Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer's media release.'

This new regulation will be directly relevant to franchising. Any changes should be reflected in the Code and drawn to the attention of franchisors and franchisees.

Consequences of franchisee's agreement being terminated because of an insolvency event

- The franchisor can take back a territory and re-sell it without paying any compensation to the franchisee – thus making a windfall gain for itself and depriving franchisee's creditors of the opportunity to sell the franchise.
- The unexpired portion of the licence agreement is not refunded to the franchisee as it has been absorbed into the franchisors consolidated revenue. The franchise fee of, say, $50,000 for a 5 year licence, should be earned progressively by the franchisor. Even if paid fully at the start it is arguable that the franchisor has not earned each increment of $10,000 per year until the franchise has a profitable business each of the 5 years of its term. I believe the franchisor should be required to hold much of the franchise fee in trust, in a separate account, only being able to draw down on it each anniversary of the franchisee's term. That would help the franchisor stay focussed on the franchisees. It would also leave money paid for future services quarantined in case the franchisor became insolvent.
- There is no reciprocal right for a franchisee to terminate a franchise agreement if any Insolvency Event occurs.
- The franchisee remains bound to all other contractual obligations that it entered on becoming a franchisee. These include finance agreements, leases of premises/ vehicles, and others. Without an income the franchisee quickly defaults on its obligations under these agreements. All agreements that a franchisee has to enter on becoming a franchisee should be able to be terminated at the franchisee's instigation if the franchisor becomes insolvent.

The one-sided nature of the right in Clause 29(1)(b) of the Code is naive. The implication is that franchisors don't fail. Franchisors regularly enter administration, are often (like Aussie Famers Direct, and Kleenmaid before them) hopelessly burdened by debt at that point and, having entered administration, are rarely 'saved'. Eg: Aussie Farmers Direct (AFD) failed this year. Administrator, 'Mr Shephard said there was little cash in the company and most of the debt was held by entities associated with local and overseas investors.' See ABC News. It is also reported of AFD that:

> 'The company behind the brand, Stay in Bed Milk & Bread is reported to owe $86.7 million to creditors, including $384,000 to its 100 franchisees, and just over $3 million to farmers who supplied the company with fresh produce. Assets including the database of nearly 100,000 customers are expected to yield only around $3.4 million, leaving virtually nothing for distribution to unsecured creditors such as franchisees'.

The consequences of the franchisor terminating the franchisee's business on insolvency but the franchisee having no reciprocal rights are unfair from the perspective of the franchisee, and its creditors. The Wein Review rightly concluded that the franchisor's right to terminate for franchisee insolvency only arose if there was a contractual right included in the franchise agreement. The franchisor drafts the agreement. There ALWAYS is! It is standard form contract and terms relating to Termination of the franchise agreement by the franchisor are not negotiable.

The Wein Review recommended. R6 below. It is a good starting point and although it was not adopted in 2014, I suggest it be adopted now. I have ruled through the proposed right to secure an extension of time by application to the Court as this already exists in the *Corporations Act*, s 439A(6).

Recommendation (#6)

1. The Code be amended to:
    a. Provide franchisees and franchisors with a right to terminate the franchise agreement in the event that any administrator of the other party does not turn the business around, or a new buyer is not found for the franchise system, within a reasonable time (for example 60 days) after the appointment of an administrator. ~~It should be made possible for the courts to make an order extending this timeframe in appropriate cases.~~ It should also be clear that the parties can negotiate a right to terminate at an earlier stage.
    b. Ensure the franchisees can be made unsecured creditors of the franchisor by notionally apportioning the franchise fee across the term of the franchise agreement, so that any amount referrable to the unexpired portion of the franchise agreement would become a debt in the event the franchise agreement ended due to the franchisor's failure.

Start time

In Australia, 42 % of brands began franchising immediately, or within the first year of operation.[19] It is misleading for the Franchise Council of Australia (FCA), which funded survey that provided data for *Franchising Australia* 2016, to make any of the claims that I have **highlighted in bold** as impliedly applying to all franchise brands:

> 3. The franchisee benefits from operating under the name and reputation (brand image) of the franchisor, which is **already well established** in the mind and eye of the public.
>
> 10. The franchisee taps into the bulk purchasing power and negotiating capacity made available by the franchisor by reason of the **size of the franchised network**.
>
> 11. The franchisee can call on the **specialised and highly-skilled knowledge and experience of the franchisor's head office organisation**, while remaining self-employed in their business.
>
> 16. The franchisor provides a knowledge base **developed from their own experience, as well as that of all the franchisees in the system,** which would otherwise be impossible for a non-franchised business to access.[20]

It would be a good idea for the FCA to be more careful about the accuracy of the material on their website.

A franchisor that has been operating for less than a year cannot substantiate any of the above claims. There is a requirement in China that franchisors must have operated the franchise prototype for 2 years before offering

[19] Lorelle Frazer, Scott Weaven, Anthony Grace, & Selva Selvanathan, 'Franchising Australia 2016' (Griffith University 2016) 20.
[20] https://www.franchise.org.au/process/knowledgebase/knowledgeBaseAnswers.html?categoryId=293&answerId=1037

franchises for sale. This bears investigation. If a decision is taken to impose a minimum operation time on a franchisor before it offers franchises for sale, Item 21.1(a)(ii) of the disclosure document will need to be amended.

Housekeeping matters re the Code

The following are some shortcomings of the Code that merit attention under this review.

1. Neither the 14-day pre-execution waiting period, nor the 7-day post execution cooling off period, specify whether the days are **calendar** or **business** days. They are probably calendar days[21] but given the naivety of some prospective franchisees, and the lack of experience of some franchisors, this should be clarified. Ideally, franchisees need longer than 14 days to conduct due diligence and *both parties* should be given the right to cool off. A franchisor might realise a franchisee is unsuited to the business, just as a franchisee might realise this.
2. Some US state franchise laws contain exemptions for **sophisticated franchisee investors**. A future review may be warranted on the desirability of a "sophisticated investor" exemption. If this were to be introduced it would benefit from some research. For example, a sophisticated investor should not include someone who owns 2 outlets and agrees to take on a third that the franchisor knows is under performing.
3. The main body of the Code says nothing about the contractual terms for franchisee renewal to be included in a franchise agreement. It does require some disclosure of amended terms in the circumstances of a transfer under **Item 19** of **Annexure 1**.
4. The concept of **material change** in Clause 4 of the Code is not defined. It leaves an assessment of its impact open to the circumstances applying, and a court's assessment of them as guided by existing case law. The Explanatory Statement provides limited guidance. The examples of material change should be extended to include 'the franchisor sells the franchise network'. This is a time of great uncertainty for franchisees and is a decision into which franchisees have no input into.
5. It is expected that nearly all changes to an operations manual will be operational and, if applicable to the terms of the franchise agreement, will be "variations of a minor nature". If they are not, then apart from the application of **Item 17** to any future disclosure documents, thought will have to be given as to whether those changes fall within the terms of **clause 9** of the Code concerning extensions of the term or scope of a franchise agreement and, if so, what the consequences are of non-compliance.
6. The recognition of practical impediments and later rectification of financial disclosure provisions under **clause 17(1**) applies only to "prospective franchisees.
7. The term "prospective franchisees" is defined in **clause 4** to mean *"… a person who deals with a franchisor for the right to be granted a franchise."* The definition does not assist existing franchisees who are renewing or being offered an extension of scope. Circumstances for renewal and extension of scope must from time to time arise in the context of the practical difficulties that **clause 17(1**) addresses. Why then does the clause limit itself to prospective franchisees?
8. No provision is made for action or relief in favour of the franchisee if any later disclosure of material facts under **Clause 17(2)** and **17(3)** is of consequence to the conduct of the franchisee's business. For example,
   - what if a conditional sale contract between a franchisor and a buyer of the system is already in place at the time a prospective franchisee is considering commitment though certain matters to make the contract for sale binding have not been concluded? or
   - what if confidentiality agreements relevant to either scenario are in place?

   On the present drafting of **clause 17** these circumstances are not caught by the material circumstances disclosure requirement as the relevant wording envisages transaction finality. In the case of ownership there is a need for "a change" to have occurred. This does not mean that disclosure is irrelevant to the franchisor where the prospective franchisee has made it clear that the interest it has in joining the system is significantly driven by the continuing involvement of the system owner or that of the major shareholder. In that case some form of appropriate disclosure would be appropriate lest the later conclusion of events give rise to allegations of misrepresentation or deceptive and misleading conduct.
9. Compare the wording of **Item 4(1)** of **Annexure 1** with the wording of **clause 17(3)** of the Code.

[21] Acts Interpretation Act 1901(Commonwealth).

- In **Item 4.1 (a**) the reference is to required disclosure of "current proceedings" by a public agency, court action or arbitration.
- The terminology of **clause 17(3) (b),** on the same subject matter, is to "proceedings by a public agency" only, with the other matters associated with courts and arbitration requiring judgement before further disclosure. One can certainly understand that the currency of any such actions are a matter of interest to franchisees at the time of pre-contract disclosure as is the matter of disclosure of convictions or judgements as required by **Item 4.2 of Annexure 1**.
- Why in **clause 17(3) (b)** is the word "current" deleted in the context of public agencies actions?

10. A further observation is the partial overlap concerning the entering of judgements, convictions and arbitral awards between **clause 17(3) (b**) and notification of the same subject matter in **clause 17(3) (f).** Is the point of difference that whereas the former is applicable to directors of the franchisor and an associate, the latter makes no reference to such directors whereas **Item 4(1) of Annexure 1** specifically includes them in pre-contractual disclosure?
11. **Sub-paragraph 17 (3) (h)** requires disclosure of issues associated with **intellectual property** including a change in intellectual property that is material to the system. Intellectual property is not defined in **clause 4** of the Code. It is however explained, as to its constituent elements, in **Item 8 of Annexure 1** to include;

3. "… any trade mark used to identify, and for any patent, design or copyright that is material to the franchise system".

- The obligation to disclose under **clause 17(3)(h)** can be troubling in practice when applied to **copyright**. Here the applicable intellectual property is usually described broadly using descriptions in **Annexure 1** such as manuals, processes, menus, guides, marketing documents and the like. These compilations are the physical representations of that copyright.
- Copyright in these compilations and across a broad range of its manifestations, can change on a regular basis, so does this create a need to disclose such changes as a "material" matter?

12. A matter of interpretation that may need clarification is the meaning of "partner of the franchisor" being one of the identified classes of persons who may be an associate under **sub part (a) (iii)** of the definition in **clause 4**. There is no definition of partner in the Code and **clause 4(2),** which adopts certain meanings given by the **Corporations Act 2001,** does not refer to the phrase. See sub-chapter 5.8.2.
13. Does the obligation imposed by **clause 6** on the parties to act in good faith towards each other apply to associates?
14. If a franchisee seeks an amendment to a proposed franchise agreement by request and triggers the application of **clause 9(3) (a)** what is the position if the franchisor agrees to it, but with modifications?
    - Does a request to modify a time period from say 14 days to 28 days with a compromise reached at 21 days still have the benefit of **clause 9(3)(a**) or need the franchise agreement be re-served and the 14-day consideration period restart? Will the franchisor be open to criticism from the regulator or a court if it does not re-serve because it merely reached a compromise position? Some clarification is required.
15. What is a financial year? The definition under the Code is not consistent with that found in the Corporations Act, 2001. This provides ambiguity in compliance with times frames for audits, annual disclosure and other matters. What is the position of the Code to entities that have existed for part only of a financial year?
16. **Item 3,** on the matter of business experience, requires disclosure of "officers" as referred to in **Item 2.8.**
17. **Item 4** does not repeat the term "officers' and refers only to directors and associates in the context of individuals. Disclosure under this item pertains to important events of which the franchisee should be aware such as convictions, insolvency and others. This disjunction is interesting given the broader meaning of "officers" under **Section 9** of the **Corporations Act, 2001.**
18. **Item 19** requires a statement from the franchisor on its future intentions to change the terms of a franchise agreement. Franchisors often answer "No". Is it possible, in a later update of **Annexure 1**, for the franchisor to express a contrary view which changes the original disclosure under **Item 19**? Will that only apply to subsequent franchisees with the original representation remaining in place? Some clarity is desirable absent a judicial determination.

Conclusion

Both the 1993 Franchising Code of Practice and the current Code were designed to regulate a very simple business model: a franchisor and its contract-based relationship with its franchisees. This is not the model of business format franchises today.

The **public trust** in franchisors is waning. To restore it franchisors and their sector organisation (the Franchise Council of Australia) need to display a high level of integrity. Several unmet challenges need to be acknowledged and addressed.

The Competition and Consumer Act and the ACCC cannot do all the heavy lifting in business format franchising any longer. The Corporations law needs to adapt to the presence of franchisees within a corporation's structure, in the same way as the financial sector is being forced to accommodate the legitimate rights of customers through BEAR.

To continue to regulate the franchisor's relationship with its franchisees without acknowledging the legal complexity of the modern franchise network, means we will be hearing calls for yet another franchise inquiry soon. We can only hope this inquiry will address the franchise model fully, in the spirit of 'root and branch.

Yours faithfully

Jenny Buchan