

Chapter 2

The franchise model

The franchise business model

2.1 Franchising is an ongoing relationship between two separate commercial parties, a franchisor and a franchisee. The franchising relationship is based on a prescribed business model offered by the franchisor and carried out under their guidance and oversight by franchise owners (franchisees). The Franchising Code of Conduct (the Code) stipulates that, under a franchise agreement, franchisees are granted the right to trade under the franchisor's brand and use their system or marketing plan. This occurs on the basis of certain conditions, which include:

- the franchisor retains control over the franchise system, including the use of the franchise brand, marketing and advertising, product/service quality and inputs;
- the franchisee's business is associated with the franchisor's trademark, advertising or commercial symbol;
- the franchisee pays a fee in exchange for the use of the franchisor's brand and systems. This can include initial one-off or continuing fees for either or all of the following: starting capital investment, payments for goods and services, royalties on profits and training.¹

2.2 There has been some debate about the breadth of the definition of a franchise during the inquiry. This relates to the prospect of unintended regulatory encroachment—or, in some cases, potential lack of appropriate regulatory coverage—and is discussed further in Chapter 4, starting at paragraph 4.1.

Franchising appeal

2.3 For franchisees, the appeal of a franchise is the potential benefits of being able to conduct a business under an established brand name using tested operational systems. In turn, franchisors are able to grow their business by allowing others to use the model they have developed, within an agreement that allows them to retain substantial control over its use but without the financial risks of significant capital expenditure.

2.4 Franchising has proved a very popular business model in Australia. According to a Griffith University survey of franchising in Australia in 2008, there are now approximately 1100 business format franchisors in Australia, compared with 960 in

1 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, pp. 9-10

2006 and 850 in 2004.² There were an estimated 71,400 franchised units in 2008 turning over \$61 billion (in 2007) and employing over 400,000 people.³ Businesses that have adopted the franchising model range widely in type; examples include bakeries, mechanical services, travel agents, weight loss programs, fast food outlets, gardening services, coffee shops and dog washing services.⁴ They vary in size from multinational franchise systems with thousands of franchisees, such as McDonald's, to emerging operations with just one or a handful of units operating under the franchise system. Further statistical information on franchising in Australia is contained in Chapter 3 starting at paragraph 3.5.

2.5 Despite the popularity of franchising in Australia, variable contracts underpinning the franchising relationship can impair the viability and success of individual franchise agreements for the following reasons:

- differing expectations about the obligations of each party to the agreement; and
- an asymmetric power dynamic within franchise agreements, with potential to lead to abuse of power.

Franchise contracts

2.6 As with other contractual relationships, franchise agreements may take the form of a written, oral and/or implied agreement.⁵ The main difference from most other commercial relationships is that the nature of franchising dictates that each party's contractual obligations are ongoing and variable—forming a contract that is fundamentally based on an ongoing relationship. These are not discrete, one-off exchanges between parties on clearly defined terms that characterise ordinary contractual agreements.

2.7 The variable nature of the franchise agreement reflects the reality that successfully managing a franchising relationship over time requires flexibility of terms to adapt to constantly changing business conditions. Contracts between franchisees and franchisors therefore need continuing cooperation and agreement

2 Frazer, L et al. *Franchising Australia 2008 Survey*, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 2. Business format franchises are the most common form of franchise in Australia, describing franchises operating at retail level under a common trademark and prescribed operating systems. See Franchise Council of Australia, 'What is franchising?', *FCA website*, accessed on 6 November 2008 at <http://www.franchise.org.au/content/?id=183>

3 Frazer, L et al. *Franchising Australia 2008 Survey*, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 10. When car dealerships and franchised fuel outlets are included, turnover increases to \$130 billion.

4 Frazer, L et al. *Franchising Australia 2008 Survey*, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 19. The survey was sponsored by the Franchise Council of Australia.

5 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 9

between the parties to ensure the arrangement provides benefit to them both. Dr Elizabeth Spencer described the arrangement aptly:

Relational contracts are defined by features of incompleteness and longevity. Relational contracts must be flexible, sometimes to the point of being vague. There is often a high level of discretion accorded to the parties, and such contracts therefore rely heavily on reciprocity and on trust that develops over time between the contracting parties.⁶

2.8 The real test of a franchise agreement comes after the contract has been signed and the working relationship between franchisee and franchisor begins. Although education, advice, disclosure and due diligence generate important information about the potential for success, the true nature of franchising cannot be appreciated until the relationship is under way.

Differing expectations

2.9 Franchise contracts establish a broad, loosely defined set of obligations for both parties. Franchisors are expected to offer an appropriate level of support, guidance and advice to franchisees on using their business model; maintain support through advertising and marketing; provide inputs and equipment of an agreed standard; and update the model when business conditions demand it. In return, franchisees are expected to pay agreed fees and royalties and execute the business model as prescribed by the franchisor, to a standard that maintains the reputation of the franchise network as a whole. The success of a franchise model depends on the provision of a consistent, quality product or service to consumers, who generally view the brand as a homogenous entity and exercise their spending preferences accordingly.

2.10 While contractual flexibility is necessary in the franchising context, an absence of clear and unambiguous responsibilities over the longer term provides a potential source of dispute or tension between franchisors and franchisees. Although the initial contract remains static, the terms of the contract are such that, in practice, changes in fees, conditions and business systems can be imposed on the franchisee by the franchisor through changes in the operations manual. Where expectations about performance and/or conduct do not match that of the other party, disagreements about how the franchise agreement is to be carried out can occur and the relationship can break down.

2.11 For instance, a franchisee might be disgruntled with the franchisor's prescribed model for offering a core product, based on direct customer feedback. The franchisee may be dissatisfied with a perceived lack of responsiveness to evolving consumer preferences and make minor changes independently to maximise store sales. In such a case, the franchisee expects the franchisor to update the business model to meet changing business conditions and may consider that these expectations have not been met. Conversely, the franchisor expects that the franchisee will strictly adhere to

6 Dr Elizabeth Spencer, *Submission 39*, p. 7

the model in order to maintain brand integrity. In the hypothetical scenario presented above, their expectations have also not been met—which precipitates a dispute between the parties over who should be doing what and how. This example portrays a very basic version of the genesis of disputes that occur in practice, but demonstrates the potential for unmet expectations and consequential disputes within franchise agreements.

Power imbalance

2.12 Compounding the 'expectation gap' problem for franchisees is the asymmetrical distribution of power within the franchise agreement. The franchising model is necessarily predicated on strict franchisor control over the use of their brand, allowing them to impose strict terms and conditions on the way franchisees operate their franchise business. Because the franchisor's model needs to be implemented uniformly across the franchise network, franchise agreements are typically underpinned by standard form contracts drafted by the franchisor. These are presented to franchisees on a 'take it or leave it' basis: the franchisee can either agree to establish a franchising relationship on the franchisor's terms or not proceed at all.

2.13 In practice, franchisors are able to dictate business operations and procedures to franchisees, and are able to change these at will. Standard form contracts specify the beginning of a franchising relationship, but—as allowed for in the contracts—the operations manual and other communications or directions from the franchisor form the basis of daily operations. Franchisors can impose rigorous obligations on the way the franchisee operates, which are subject to change at the discretion of the franchisor. These obligations may be strictly enforced: failure by the franchisee to meet their obligations, as interpreted by the franchisor, can trigger termination of the contract.⁷ This control allows franchisors to prevent franchisees from exploiting their intellectual property to the detriment of the overall franchise network but can also lead to the potential for abuse of power.

2.14 On the other hand, standard form contracts provide little or no scope for franchisees to impose stringent obligations on franchisors or apply their own discretion to open-ended terms of the agreement.⁸ Despite their investment in the business and their dependence on the use of the franchise model to derive returns from this investment, franchisees can exert little or no leverage when seeking to impose their interpretation of the franchisor's obligations on the agreement.

2.15 Franchisors are therefore in a position to exercise far greater power than franchisees when enforcing the terms of open-ended, variable agreements. From the franchisee's position of relative weakness, they must hope that the franchisor will not exercise their discretion opportunistically. In good franchising relationships the

7 Termination provisions in the event of franchisee breach are set out in Part 3 of the Code; see *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 22

8 See for example Dr Elizabeth Spencer, *Submission 39*, pp. 4-13

franchisor nurtures and assists franchisees to maximise profit royalties and achieve growth of their brand. Such is the cooperative and interdependent way the majority of franchising relationships are conducted. However, the imbalance of power within the relationship means that scope exists for rogue franchisors to use their control opportunistically for financial gain at the expense of franchisees.

2.16 Franchising regulations need to operate in a way that seeks to prevent these instances from occurring. This is the focus of the committee's inquiry.