Chapter 5

Issues arising during franchise agreements

Challenges to the working relationship

5.1 Many franchise agreements result in successful and profitable ongoing business relationships between franchisee and franchisor, with both parties benefiting substantially from the arrangement.

5.2 However, there is an inherent potential for tension during the relationship. While an individual franchisee's priority is the profitability of their unit franchise or franchises, the franchisor's aim is to grow and protect the overall network of franchises in order to maximise returns. Although most of the time both parties are likely to be working towards complementary goals, there will be occasions when what is best for the network as a whole, from a franchisor's perspective, is potentially detrimental to the business of an individual franchisee.

5.3 In particular, difficulties may arise when franchisees feel that operations or expectations during the life of the franchise agreement are contrary to what was disclosed to them before the agreement was signed and that these changes put them at a material disadvantage.

5.4 A range of issues raised with the committee about the realities of being in a franchise agreement are discussed in more detail below.

Unilateral variation of franchise agreements

5.5 The committee received submissions expressing concern that the Franchising Code of Conduct (the Code) does not prohibit unilateral variation of contracts. As explained by the Motor Trades Association of Australia (MTAA):

> The purpose of disclosure is to provide franchisees with sufficient information to decide whether or not to enter into the business agreement proposed by the franchisor. It is on the basis of that disclosure that the potential franchisee assesses the financial rewards and risks associated with the business. The ability of the franchisor to subsequently vary the terms of the agreement in a unilateral manner may, therefore, result in a circumstance whereby the revised terms of the agreement are materially different to those contained in the original agreements. In such circumstances, it is possible that the franchisee may not have entered into the agreement had the revised terms been included in the original agreement.[1]

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1 MTAA, *Submission 90*, p. 16

5.6 Acknowledging that there may at times be sound commercial reasons for requiring changes to business practice and franchise operations, the MTAA suggested the following:

> While MTAA acknowledges that franchisors may need to amend certain elements of the agreement in response to marketing and trading conditions, the Association is firmly of the view that such changes should only be made after the franchisor has consulted with its franchisees and they have consented to the proposed changes. This approach, in MTAA's view, is necessary to ensure that franchisors do not materially alter the terms of the franchise agreement in a manner that may have a significant detrimental impact on the viability of a franchisee's business. It also ensures that the nature of the business arrangements do not vary materially from that disclosed by the franchisor in its disclosure document (upon which the franchisee made its decision to invest in the business).[2]

5.7 Other submitters emphasised that the power to vary contract terms lies almost exclusively with the franchisor and that, relative to the franchisee, the franchisor has a limited range of contractual obligations—many of which are to be carried out at the franchisor's discretion.[3]

Compliance with the operations manual

5.8 The committee heard similar concerns relating to the widespread practice of including a clause in franchise agreements stipulating that a franchisee will comply with an operations manual supplied by the franchisor, the contents of which are subject to change at any time.

5.9 From a franchisee's perspective, this can have the effect of changing the conditions that were in place at the time the franchise agreement was signed:

> There can be no better example of systemic problems in franchising if …
> (b) There exist Service or Operational Manuals which have the effect of materially altering the costs of compliance to the advantage of the franchisor but the disadvantage of the franchisee.[4]

5.10 Some submitters indicated that such variations should be prevented:

> The Franchising Code should prohibit the unilateral variation of Franchise Agreements and variations effected by changes to Operations Manuals…
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> … A change to that manual, say in relation to the shopfit requirements can be in effect a major change to the franchise agreement and a major cost. Any directive that incurs costs changes the financial basis of the decision to enter that franchise and can have significant consequences. This would be

2 MTAA, *Submission 90*, p. 16

3 For example, see Dr Elizabeth Spencer, *Submission 39*, p. 42

4 Franchisees Association of Australia, *Submission 51*, p. 21

> avoided if unilateral contract variation was outlawed including variation to an operations manual which incurs franchisee costs.[5]

5.11 However, others submitted that the ability to make unilateral variations or change the operations manual is essential to ensuring that business practices and expectations evolve to fit a changing market. The Federal Chamber of Automotive Industries (FCAI) explained:

> As a relational contract, it is clear that various commercial elements of a franchise agreement will need to be modified from time to time in order to reflect the dynamic nature of a franchise business system. The concept of "unilateral variation" could be capable of extending to changes in programs, strategies, presentation, policies, models and brands and other elements essential to the efficient operation of a franchise system. Modifications of this kind are a necessary part of the business relationship between the franchisor and the franchisee.[6]

5.12 The FCAI also submitted that there are sufficient remedies in the *Trade Practices Act 1974* (TPA) to cover situations where a unilateral change introduced by a franchisor is seriously detrimental to a franchisee.[7]

5.13 IndCorp Franchisees' Association of Australasia put the issue in the following terms:

> IndCorp accepts and recognises the importance of a strong brand and the need for the franchisor to have the power to establish the strong guidelines and the criteria by which prospective and existing franchisees can operate a store. Where the issues arise for IndCorp's members are, to use a slight sporting pun, when the goalposts keep shifting. An operations manual sets out the standard by which franchisees must operate the franchises. Compliance with the operations manual is a mandatory term of the franchise agreement. There is a level of acceptance and knowledge and acknowledgement that the operations manual is an intrinsic part of a franchise agreement and the way franchises work. The issue is when a franchisor reserves the right to change it at any time and with very little negotiation or communication with the franchises.[8]

5.14 Rather than preventing franchisors from using a mutable operations manual, IndCorp suggested that one way to balance the interests of franchisees and franchisors in this matter would be to insert into the Code an obligation on all parties to the agreement to act in good faith:

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5 Lottery Agents Association of Victoria, *Submission 45*, p. 3

6 FCAI, *Submission 155*, p. 23

7 FCAI, *Submission 155*, p. 23

8 Ms Zali Steggall, on behalf of IndCorp Franchisees' Association of Australasia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 74

> Our submission is the good faith requirements would be needed to stop a franchisor from being able to completely alter the very nature of the initial agreement into which a franchisee has entered.[9]

5.15 It is IndCorp's submission that an 'underpinning legal right' to good faith will assist in mediating disputes arising out of changes to the operations manual which are, in a franchisee's opinion, unreasonable.[10]

5.16 The pros, cons and implications of including an explicit obligation in the Code for franchisors, franchisees and prospective franchisees to act in good faith are discussed in detail in Chapter 8.

Opportunism

5.17 The committee received submissions from franchisors indicating that, in some cases of opportunistic behaviour by franchisees, the balance of power in a franchising relationship actually lies with the franchisee. For instance, Fibrecare Australia submitted that:

> Much will be written and said about the "poor" franchisee and the "all powerful" franchisor…nothing could be further from the truth. Most franchisors are like me – small businesses, often family businesses, trying to compete in the marketplace.

They contended that:

> There are laws to protect franchisees from every conceivable wrong. The balance is firmly in the favour of franchisees. Indeed I believe the current system encourages franchisees to pursue spurious claims because it is so easy to make broad allegations that sound credible but don't stand up to scrutiny.[11]

5.18 However, the committee also received many submissions from current and former franchisees outlining situations in which franchisor opportunism had allegedly disadvantaged them and their business. In particular, submitters discussed churning—a practice in which a franchisor sells and re-sells a unit franchise, making a profit each time the business changes hands regardless of the profitability of the unit franchise.[12]

5.19 Since 1 March 2008, franchisors have been required to disclose more information about past franchisees (except where franchisees have requested in

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9 Ms Zali Steggall, on behalf of IndCorp Franchisees Association of Australasia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 80

10 Ms Zali Steggall, on behalf of IndCorp Franchisees Association of Australasia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 80

11 Mr Geoffrey Cope, Fibrecare Group, *Submission 144*, pp 1-2

12 See for example Mr Ray Borradale, *Submission 16*, p. 8

writing that their details not be passed on). The intent of this provision, in part, is to assist franchisees in discerning whether churning may have been taking place:

> …the level of movement in and out of the franchise system and the reason for that movement is also likely to be relevant to a prospective franchisee.[13]

5.20 It is too soon for the committee to judge the efficacy of this change to the Code in reducing churning. The potential to address opportunism in franchising more broadly by introducing a good faith obligation into the Code is examined in Chapter 8.

Restraint of trade clauses

5.21 Franchise agreements commonly include restraint of trade, or non-compete, clauses that oblige franchisees not to engage in business beyond the franchise agreement that operates in direct competition with the franchisor. As Yum! Restaurants Australia explained to the committee:

> In common with all industries, we have restraints of trade in our contracts that prevent our business partners from competing directly against us.
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> …
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> It is common. As you would be aware, restraints are common across all types of arrangements, and franchising is no different. So, employment contracts would contain an element of prohibition against competition as well. I think that is recognised. They are so prevalent because it is recognised as justified as a legitimate business interest…Bearing in mind that the law on restraint of trade is quite clear—that is, it is enforceable only to the extent that it is reasonable…[14]

5.22 For a franchisee, one practical consequence of such a restraint of trade clause is that, if it extends beyond the life of the franchise agreement, it may limit their ability to directly transfer the industry-specific skills, knowledge and assets they have developed through operating a franchise unit into an independent business of their own.

5.23 While franchisees arguably have the opportunity to negotiate with regard to the inclusion of such clauses before signing an initial contract or a renewal agreement, in practice the disparity in bargaining power between the parties makes this

13 *Review of the Disclosure Provisions of the Franchising Code of Conduct* (Matthews Review), Report to the Hon Fran Bailey MP, Minister for Small Business and Tourism, October 2006, p. 36

14 Mr Nick Bryden, Yum! Restaurants Australia, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 75

difficult. This may lead franchisees into signing 'take it or leave it' contracts that contain provisions they consider to be unfair.[15]

Committee view

5.24 While the committee recognises the commercial arguments underlying the application of restraint of trade clauses during the time in which a franchisee and franchisor have a working relationship, it is the view of the committee that it may not be appropriate in all circumstances for such restraints to apply once the franchise agreement has ended. The committee notes the severe restrictions that such restraints might impose on the ability of former franchisees to generate income as independent businesspeople.

Confidentiality clauses

5.25 Franchisors have a genuine need to maintain confidentiality around certain commercial information, in order to protect and advance the interests of the franchise as a whole. However, the committee heard that some franchise agreements contain confidentiality clauses preventing franchisees from discussing pertinent details of business arrangements or of mediation outcomes with their fellow franchisees.[16] The ACCC suggested that some such clauses do not serve a legitimate commercial purpose:

> To be quite frank, we have seen confidentiality clauses that do not seem to have any real commercial purpose…other than preventing franchisees from being able to discuss some fairly important details of their franchise arrangement with other franchisees.[17]

5.26 Again, while franchisees have a theoretical ability to negotiate with regard to such clauses if they consider them unfair, in practice franchisees are most likely to enter into standard form, 'take it or leave it' contracts as provided to them by the franchisor.

Advertising funds

5.27 The committee received submissions from franchisees and former franchisees expressing dissatisfaction with the management of advertising funds. In some cases, franchisees can see no apparent marketing in their area. For example:

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15 The committee also heard of franchisees feeling compelled to sign detrimental contracts at renewal, because their substantial sunk costs meant that walking away from the business was not a realistic option. For example, see evidence from Mr Robert Gardini, on behalf of the MTAA, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 25

16 For example, see Mr Scott Cooper, *Submission 15*, p.12 and Mr Ray Borradale, *Submission 16*, p. 29

17 Mr Brian Cassidy, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 92

> Only when we were part of the Franchise Group we were … made aware of the many problems within the group. There were many disgruntled franchisees because they felt there was no support given to the group in general. They believed they paid excessively high royalty and marketing fees with little support and minimal to nil national marketing to show for it. Sales had been in decline since mid 2005…It was apparent that no business plan existed, marketing plan or anything…that would improve the brand and bring clients through the door. Many…had asked for Audited marketing and Sales reports over the years but no one in the franchise community has ever received a copy…[18]

5.28 The committee notes that, depending on their background and experience in business, franchisors are not necessarily well equipped to conduct efficient or effective marketing campaigns. What franchisees perceive to be a lack of returns on their contributions to advertising funds may be a result of poorly conducted marketing, rather than a simple failure to advertise at all.

5.29 Another submission described a situation in which some franchisees were allowed to opt out of paying the advertising levy, presumably because their stores were underperforming. This had a detrimental effect on other franchisees in the system who continued to pay their advertising fees but did not receive adequate advertising outcomes in return.[19]

5.30 Following changes to the Code which took effect on 1 March 2008, franchisors are now required to provide relevant audited financial statements within four months of the end of the financial year to franchisees who make payments into marketing or other cooperative funds.[20] It is too soon for the committee to judge the efficacy of these amendments.

Committee view

5.31 When negotiated and resolved in a reasonable and timely matter, disagreements between franchisor and franchisee need not interfere with the long-term success of a business relationship. However, the issues raised in this chapter are clear examples of the sources of tension that may lead a franchisee and franchisor into dispute (discussed further in Chapter 7), termination or non-renewal (discussed in Chapter 6) or, in worst-case scenarios, litigation (discussed in Chapter 9).

5.32 The committee recognises that there are enormous practical difficulties with trying to regulate specific elements of conduct by parties to a franchise agreement, particularly the various manifestations of opportunistic conduct that franchising arrangements can foster. This is why the inclusion of an overarching standard of

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18 Kerrie Davies, *Submission 64*, p. 1

19 Name withheld, *Submission 63*, p. 6

20 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 18

conduct in the Code may be useful. This matter is discussed in the context of good faith in Chapter 8.