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10 November 2008

Mr Bernie Ripoll MP
Chairman
Joint Parliamentary Committee on Corporations and Financial Services
Parliament House
CANBERRA ACT 2600

Dear Mr Ripoll

SUPPLEMENTARY SUBMISSION

I write to follow up some matters raised with us at the Committee hearing in Sydney, and to respond to some of the evidence subsequently presented to the Committee in writing and at the hearings to date.

It is clear that there is one fundamental issue that goes to the heart of franchising regulation in Australia, which is reflected in the publicity of the company owned by the current Chairman of the FCA addressed to prospective franchisees on the FCA website:

> ***"It is much more than buying a job. It's creating a business empire in carefully thought through and supported stages."***

We see this as the ultimate question of principle for the Committee's Inquiry:

- If franchising is about building businesses, the regulatory environment must provide ***continuity of opportunity*** for franchisees – this involves a presumption of renewal unless good cause exists:
  - This supports all existing franchisees and is not retrospective, because it merely gives effect to and codifies current industry practice.
  - Such a provision is sound economically (see attached report of Professor Stephen Gray), as well as legally and ethically (see eg. Submission 39 by Professor Elizabeth Spencer).
  - It recognises that franchising is unique – it is not like retail leasing, but involves a business created jointly over time in the context of a partnership-type relationship.
- If franchising is about a "renting an opportunity" or "buying a job", the Committee may ***increase precontractual disclosure but do nothing about "end of term" conduct***. This means:
  - Franchisees have no assurance about renewal rights, and must organize their finance to be fully repaid during the contractual term (which has significant cash flow implications);
  - Franchisees must make their investment decisions as if they were a retail tenant – which means running down their investment as the end of term approaches;
  - Franchisors are free to act opportunistically to exploit their economic and contractual powers at the expense of franchisees.

The case for maintaining the status quo has been put by the FCA, including in their Supplementary Submissions. However, their three main arguments against change are all wrong:

- ***Uncertainty*** – the present state of the law in relation to *good faith* is highly uncertain, and the introduction of a well defined obligation as proposed by CFAL in its model provisions[1] would:
  - Remove the uncertainty of the implied contractual duty – which the Matthews Committee recognised, and recommended be addressed by an express obligation in the Code;
  - Spell out the three key requirements of good faith in the Code: acting *honesty*, *reasonably* and *having regard to the interests of the other party to the franchise.*
  - Remove the uncertainty of the role of good faith as a factor to be taken into account in an action for unconscionable conduct under s.51AC of the Trade Practices Act;
- ***Retrospectivity*** – the FCA's analysis of the "*likely economic impacts*" of what they term "*an automatic right to renew a franchise agreement*" is mathematically flawed (as well as incorrectly characterising good cause renewals as being "automatic"):
  - The FCA fails to take into account that over 90% of all franchises are renewed on expiry. In fact their 2008 Franchising Survey puts the renewal rate as high as 98%.
  - Professor Stephen Gray, a Finance Professor at University of Queensland, has examined the effect on franchisors of codifying the existing practice of 90+% franchise renewals and demonstrated that the "*overall economic effect of the proposed terms is small*". (See Report attached, pp. 19-20). It would be even smaller if a 98% renewal rate was used.
  - The argument about retrospectivity is an emotive furphy. ***Codifying existing and long-standing practice will not involve any retrospectivity of relationships.*** It is relationships which count in franchising – not just what the franchisor writes into the contract.
  - CFAL has tendered a legal opinion from Alan Robertson SC to demonstrate that an amendment to the Code to regulate *conduct* not *contracts* is not legally retrospective.[2]
- ***Unintended consequences*** – the FCA has also raised the prospect that any change to the Code would have potential flow on effects for other relationships, such as commercial leasing, IP licensing and outsourcing contracts. This is simply a scare tactic without any foundation:
  - Franchising is a unique business relationship that distinguishes it from every other form of relationship, because of the mutual interdependence of the franchisor and franchisee. The FCA called this relationship "akin to a commercial partnership" in its submissions to the South Australian Inquiry earlier this year.[3]
  - None of the other relationships they refer to have this "partnership" character – where the parties are continuously working together to build a business. Indeed the existence of the Code itself recognises the unique characteristics of the franchising sector.
  - In particular, and contrary to the suggestion on p.4 of the FCA's supplementary submissions, there is not one jot of credible evidence to suggest that franchisors consider themselves to be like landlords – just like PoolWerx, they encourage their franchisees to believe that they are creating a valuable business and not merely renting an opportunity.

[1] CFAL Submissions, submissions no.22, attachment 1.

[2] CFAL Submissions, submissions no. 22, attachment 4. See also Professor Pengilley's evidence about "the squeals that came out about s.52", a provision which also regulated conduct, when it was introduced (Sydney transcript p.63).

[3] FCA Submissions to the SA Inquiry, 21 January 2008, p.23 (Part of submission no. 103)

Rather than respond to the other, emotive arguments in the FCA's submissions, we have great confidence that the Committee will not be distracted from examining the real problems that have been highlighted about the regulation of the franchise sector, in the interests of the 71,000 franchisees in Australia and not merely the 1,000 franchisors (as estimated by the FCA's 2008 Franchising Survey).

To this end, we attach the following documents which we believe will be of assistance:

- Report of Professor Stephen Gray, a Professor of Finance at the University of Queensland. We commissioned this report in light of questions asked of us by Senator Boyce, in particular, about how to value a franchisee's business. It deals with "goodwill" and business valuation issues, and endorses the regulatory changes we have proposed from an economic and finance perspective.
- A summary of the key evidence presented to the Committee on the critical issues of (i) Good Faith and (ii) Good Cause Renewals, both of which refute any suggestion that the current problems in franchising are CFAL-specific.

So far as the submissions by are concerned, CFAL welcomes 's change of position on the fate of expiring restaurants, with its recognition that a franchisee can realize its investment by a sale on a going concern basis, rather than closure. If this had been 's position last year, Rockingham would never have closed. This change of position highlights the need for regularizing "*responsible franchisor behavior*" in the Code (which the FCA has called one of the "twin pillars" of the franchise sector).

CFAL does not wish to debate 's submissions, other than to reject any suggestion we have breached any obligation or that the relationship has disintegrated. As to the suggestion that CFAL had done "nothing" for 4½ years before its Rockingham restaurant expired, had no right to force CFAL to sell its network of 50 restaurants (as had sought to achieve) and the only value put by on those restaurants was a terminating value up to their expiry date. It was in this context that 's previous threat of non-renewal and closure were correctly characterized as "opportunistic" conduct.

We remind the Committee that we have proposed model provisions in our submissions (Attachment 1, sub no.22) to achieve appropriate outcomes in relation to Good Faith and Good Cause Renewals, which we have put forward as both franchisor and franchisee. We would invite the Committee to make specific recommendations for their adoption (following the precedent of the Reid Committee in 1997).

If any further proof were needed about the urgency of addressing ***post-contractual conduct*** in the Code, see the attached article which appeared in *The Wall Street Journal* on 21 October 2008. Given the changing economic conditions, how will our 71,000 franchisees fare if the status quo remains?

The report from this Inquiry will undoubtedly provide the foundation stone for regulation of the Franchise Sector for at least the next decade. Now that the problems with the Code have been clearly defined and effective solutions are in reach, we urge the Committee to make a difference for the benefit of all participants in the sector and make the far-sighted recommendations that can deliver a world-leading franchise sector in Australia and ensure its success for many years to come.

Yours sincerely

Tim Castle

General Manager-Business Development
General Counsel

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FRANCHISING | OCTOBER 21, 2008

Owners Say Franchisers Are Passing on More Costs

By RICHARD GIBSON

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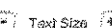

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Some franchisees say they are being forced to pay for a variety of expenses for the first time -- making difficult economic times even tougher.

Associated Press

McDonald's franchisees contend they have to take on some expenses once covered by their franchisers

For instance, operators of McDonald's Corp. restaurants, under pressure from the fast-food giant to install equipment and counter space for an array of new beverages, complain that they have to pay for nearly half the upgrade's architectural and engineering fees -- items the company used to cover. Franchisees put those added fees at several thousand dollars, and some say the entire project has yet to be cost-justified.

McDonald's acknowledges that in the past it has paid for architectural and engineering work done when an individual franchisee made construction improvements to a restaurant. But because the beverage project is systemwide and so substantial, those costs are now part of the expenses that McDonald's will cover at only 40%.

Franchisees of Hollywood Tans LLC, an upscale tanning salon chain, say the company is billing them for maintenance on some equipment they had purchased under warranties that covered servicing charges.

"They're reclassifying what had been normal wear and tear [and] we now have to pick up" the cost on items such as fans and booth door locks, says Jeff Wogan, who operates a salon in Ranson, W.Va., and is a member of the franchisee owners' association. He adds that it can take days for someone to show up to fix items, partly because the company's maintenance crew has been downsized.

A spokeswoman for the Sewell, N.J., tanning chain acknowledges maintenance-staff reductions "to improve the service level and our cost efficiency," but contends that despite the chain's purchase by private investment firm ACI Capital in June 2007, the service-warranty policy hasn't been altered. She says the warranty doesn't cover normal wear and tear.

Soaring fuel prices are pinching UPS Store franchisees. Last month, parent United Parcel Service Inc. changed its policy on refunding shipping costs to customers under its money-back guarantee for packages not delivered on time. Now, UPS won't refund fuel surcharges added to those bills.

For an overnight envelope, those surcharges could easily be several dollars. Franchisees say customers expect to be reimbursed the full amount, and may become upset and take their business elsewhere if they don't get it. As a result, many franchisees are digging into their own pockets to make up the difference.

Confirming the refund reduction, UPS spokeswoman Karen Cole says the shipper's fuel costs are up 61% so far this year. "It's a huge expense," she says, "and we all have to adjust, unfortunately."

Training is another contentious area for some franchised systems. "More franchisers are saying, 'We'll do it, but only for a fee' or 'We're going to drop that activity,' " says Andrew Selden, a franchising attorney at law firm Briggs & Morgan in Minneapolis. "It adds an unexpected cost to the franchisees' business." Franchisees in such situations may not realize services they had assumed were contractually promised really were provided at the franchiser's option, he says.

KFC franchisees contend that company training support has been cut and that they're now being

charged for training manuals, which they say used to be provided at no cost.

A spokeswoman for Yum Brands Inc.'s KFC says the company and third-party vendors provide free and fee-based training to franchisees, which she says is outlined in the firm's franchise disclosure document.

Write to Richard Gibson at dick.gibson@dowjones.com

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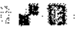
Email Printer Friendly Order Reprints Share: 

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Introduction

1. There does not appear to be any dispute that franchisors can act opportunistically in relation to franchise renewals at the expiry of a franchise agreement. There is also no dispute that franchise regulation does not stop this conduct from occurring, the result of which can be that the franchisee can lose its entire business. To make matters worse, the franchisee's ability to set up a new business is often restricted by contractual restraints of trade.

2. The real dispute in the evidence presented to the Inquiry concerns the regulatory response needed to address opportunistic renewal conduct by franchisors. This in turn raises a fundamental question about the nature of franchising:

    - Does it involve the development of a business – which is based on a continuing relationship between the franchisor and franchisee, with the franchisee being able to realise the value of its investment by selling the business to a third party; or

    - Does it merely involve something with a fixed term like "a contract for service",[1] "renting the business"[2] or "buying a job"[3] which ends at the expiry of the agreement, just like a retail lease.

3. These outcomes lead to completely different regulatory responses:

    - In the case of a continuing relationship, statutory protection against opportunistic renewal conduct is required;

    - In the case of a fixed term opportunity, the correct regulatory response would be to ensure that a franchisee fully understands the limitations of the agreement, and that when it ends the franchisee must plan to walk away with nothing.

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[1] The Cheesecake Shop Pty Ltd, Transcript, 9 October 2008, Sydney, p 20
[2] Frazer, Transcript, 10 October 2008, Brisbane, p 10
[3] de Leeuw, Transcript, 17 October 2008, Canberra, p 53

4. There is no apparent dispute about a number of other key facts, namely:

   (a) Over 90 per cent of franchises are renewed on expiry in Australia, and that this is consistent with US experience;

   (b) In practice most franchises are renewed unless good cause exists for the non-renewal;

   (c) Most franchise agreements are silent as to what will happen when the franchise term expires, although some agreements do include provisions for exit payments and other agreements provide for rolling renewals provided certain criteria are met.

Issues

5. There are five issues raised in the submissions:

(a) What type of opportunistic conduct do franchisors engage in?

(b) What is the nature of the franchise bargain? This includes the following sub-issues:

- What are the interests of the franchisor and franchisee in the business, and how do you value them (the so-called "goodwill" issue");

- How does the franchise business model work from an economic point of view?

- How does franchising differ from retail leasing?

- What is the appropriate role for restraint of trade clauses?

(c) What is the correct regulatory response to deal with franchisor opportunism and renewals?

(d) Should CFAL's model provisions for the Code be adopted?

(e) Is there a problem of retrospectivity?

Issue 1: Types of conduct

Churning

6. The clearest illustration of franchisor opportunism is the practice of churning. This is where a franchisor uses its powers of non renewal or termination in order to acquire the franchisee's business for nothing, or for substantially less than market value.

7. The most extreme form of churning was identified by Professor Lorelle Frazer who offered the narrow definition that churning occurred "when you put a franchisee into a store that you know will fail" in order to keep on obtaining the initial fee.[4] An example of this type of conduct may be provided by the evidence of Deanne de Leeuw, a former franchisee of Bakers Delight, who gave the following evidence to the Inquiry of her experience of being "churned" by Bakers Delight:[5]

> **Ms de Leeuw**—[...]. The main issue—what put us into the financial position we were in and resulted in the final breaches—was that the Shellharbour store was failing and we could not get out of it. We requested to sell it or eventually even to close it, but they would not let us out of the agreement. Rather, they just sat back and basically watched us fall over.
>
> We had to pay the bills that were coming in for the Shellharbour store with the takings from the other two stores. Effectively, the Shellharbour store dragged down the other two. We believe that, if they had acted in good faith, we could have rectified the problem and either closed the store, because it was not working, on-sold it, or something else. Rather, they just sat there and waited for it to fall over so that they could get hold of our other two profitable stores.
>
> **Ms OWENS**—Is there another franchisee in the Shellharbour store?
>
> **Ms de Leeuw**—They closed the Shellharbour store. On two separate occasions after we were out of the system, Bakers Delight representatives said that they knew the store would fail, but they still let us buy it. They still signed a franchise agreement with us.

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[4] Transcript, Brisbane, 10 October 2008, p 12.
[5] Transcript, 17 October 2008, Canberra, p 58

> **CHAIR**—Does Bakers Delight now run the other two stores?
>
> **Ms de Leeuw**—No, they on-sold those stores. That is another part of our argument against the fact that they do not operate in good faith. They manipulated those sales processes basically by offering better deals to the current franchisees.

8. The Franchise Council of Australia (***FCA***) argues that this type of premeditated churning would be caught by the existing law relating to *pre-contractual* representations:[6]

> Churning, or the deliberate sale of non-viable franchises with the objective of the franchisor taking them over and re-selling them, would constitute misleading conduct in breach of s52 of the Trade Practices Act.

9. However, the evidence to the Inquiry suggests that churning involves a much broader definition than that offered by Professor Frazer and the FCA.

10. Rather than being premeditated, the real problem with churning is when a franchisor realises, during the term of the agreement, that there is nothing to stop it from using its renewal and termination powers to obtain a windfall gain at the expense of the franchisee. This type of *post-contractual conduct* is not restrained by any current law or regulation, even though the FCA has argued:[7]

> Collusion and allegations of deliberate 'churning' of franchisees by franchisors are the most heinous of accusations which can be made against franchisors. Such actions are illegal and should be prosecuted.

11. It would be more correct to say that such actions ***should*** be illegal, and that the Code should prescribe standards of conduct which allow franchisees to have a legal remedy to stop churning.

[6] Submission 103, p 7, footnote 3
[7] Submission 103, p 11

12. The problem of franchisor opportunism and churning is not new. It was recognised in the Reid Committee report which led to the introduction of the Code:[8]

> The Committee notes that franchising contracts typically impose very heavy obligations on franchisees while leaving franchisors' duties relatively undefined. But the obligations of the franchisor are vital to the franchising relationship. Such contracts and the franchisees' sunk costs necessarily involve the danger of opportunistic abuse.

13. Clearly the Franchising Code has not fixed the problem. As CFAL has pointed out in its submissions:[9]

> ... reliance on regulation of pre-contractual disclosure as a means of preventing franchise failure, which is the principal regulatory mechanism in the current Code, has also proved ineffective in responding to post-contractual franchisor opportunism. In this respect it is telling that the Matthews Committee, which had limited terms of reference to consider the disclosure obligations in the Code, felt the need to make a recommendation for the introduction of a duty of good faith generally in the Code (i.e. a duty which was not limited to pre-contractual conduct).

14. The South Australian Parliament's Economic and Finance Committee noted that during the course of its inquiry it was presented with numerous allegations regarding 'churning'.[10]

15. Earlier this year, the Chairman of the ACCC acknowledged on a radio programme that churning existed in the sector, contradicting earlier denials about churning from a former head of the FCA. Mr Samuels went on to illustrate the lack of remedies available at present to deal with the problem: [11]

> So if you are asking me can we guarantee there'll be no more churning, no we can't.

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[8] Standing Committee on Industry, Science and Resources, *"Finding a Balance: Towards Fair Trading in Australia"*, p 91, paragraph 3.24
[9] Submission 22, p 40, paragraph 16
[10] Submission 37, recommendation 7.1.17
[11] Radio 2UE Franchising Forum, 9 February 2008.

16. CFAL gave the following evidence about its experience with [redacted] in relation to the Rockingham KFC store:[12]

> With our restaurant at Rockingham the franchisor wanted to get the farm back, too. It wanted to get back a restaurant that we built. It wanted us to transfer the staff. It wanted simply to walk in and take that back over without making any allowance for what we had done, and that was contrary to what we understood to be the rules of the game. By that I mean accepted industry practice.

17. The MTAQ cites the following example in support of its position:[13]

> A big oil fuel company owned a service station site on the Gold Coast which was leased to a franchisee. Competing big oil outlets were nearby. The franchisee built up the business through upgrades, competitive prices, good service, pleasant outlook, food and other items. It became popular. Customers queued for service. The franchisee was advised that the big oil company would not renew the franchise arrangement but would operate it. There was no recognition of goodwill which includes taking the business from marginal to highly profitable with high customer satisfaction.

Franchisor Opportunism Generally

18. Churning is simply one example that neatly illustrates the regulatory void in relation to renewals and franchisor opportunism. Professor Spencer describes the renewal problem more generally as follows:[14]

> Nonrenewal, also called passive termination, involves a franchisor's failure to renew at the end of the term. It is a significant example of the way in which the power and information advantage enjoyed by franchisors can create unanticipated hardship for franchisees. ...
>
> A franchisee enters the contract believing that the contract will be renewed; it is estimated that 90% of franchises are renewed in Australia. Occasionally, however, a franchisee's reasonable expectation of renewal is not met; the resulting loss for a franchisee in this position can include remaining lease obligations, fitout and refurbishment costs, costs to train staff and the loss of goodwill. Currently a

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[12] Transcript, 9 October 2008, Sydney, pp 24 - 25
[13] Submission 36, para 4.1.8, footnote 1
[14] Submission 39, pp 29 - 30

> franchisee has no recourse in such a situation, because on expiry of the contract a franchisee has no enforceable right.
>
> [A] franchisor should not be permitted to walk away with everything a franchisee contributes over the course of the franchise relationship. Since most franchises are renewed, those franchisors that fail to renew are actually free-riding on the reputation of others. Such free-riding creates market inefficiency, and appropriate methods to correct it should be considered by legislators.

19. There were a number of examples provided in the submissions to the Inquiry about a range of opportunistic conduct engaged in by franchisors.

20. FAA provides an example of a chain of 25 franchisees who fought their multinational franchisor over clauses in their offers of renewal.[15] Their business and legal advisers told them that the clauses did not comply with the Code. Only two franchisees had the finances to exit the franchise. The others were subjected to conduct by the franchisor, including refusal to mediate and withholding of funds and bookings, before agreeing to the demands of the franchisor. The legal advice they were provided was that s 51AC of the *Trade Practices Act* was too uncertain to bring an action.

21. Mr Gardini has given evidence to the Inquiry that the lack of a good faith obligation has been felt significantly in the motor vehicle retail industry, and that there has been many occasions where franchisor's conduct has fallen short of the statutory standard of unconscionable conduct, as advised by senior counsel. His evidence was that there were numerous instances in the motor vehicle industry of motor vehicle dealers, who nominally only had a short agreement of one to three years, but who have nevertheless been in arrangements with motor vehicle distributors for periods of 20 to 30 years. As he identified, it is the franchisee's risk of losing their investment through non-renewal that makes them economically captive or vulnerable to exploitation by the franchisor:[16]

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[15] Submission 51, p 22

[16] Transcript, Sydney, 9 October 2008, p 3

> In the last few years a number of longstanding dealerships have been terminated where there has been no default by the dealer. This continues to happen as distributors with considerably more bargaining power than dealers include termination-at-will provisions in dealer agreements. A number of dealers enter into such agreements optimistically believing that an implied term of good faith will govern the dealership agreement and that termination will not be affected for unjust reasons. **However, even the more experienced dealers who have significant investments in their dealerships are often left with little choice but to accept such oppressive clauses given the investment they have already made in their dealerships.** The dealer then loses their ability to establish a distributor's unconscionable conduct because the dealer has freely entered into a binding contract and the option to terminate at will is within the contractual rights of the agreement. [Emphasis added]

22. Mr Gardini gave the following evidence of the type of conduct that was occurring in the motor trades specifically in response to a question from the Inquiry Chair:[17]

> **CHAIR**—In your area of expertise with dealers in motor trades, are the majority of disputes around the period of termination, or end of contract, or are there other disputes that arise? I want to get an idea of the level of disputation and what those causes are.
>
> **Mr Gardini**—The main area is termination and, principally, at will. The second area relates to non-renewal of agreements. Originally, as I indicated, a number of the agreements were evergreen, which provided that they had no end-of-term date. Some distributors are using the fact that agreements now have moved to fixed terms, but those terms actually do not reflect the balance between risk and return of the amount of investment made in dealerships. You can appreciate that, having invested something like $10 million to $15 million in a dealership, being offered a three to five year agreement is inadequate in terms of the opportunity to obtain a return on investment. If distributors do not want to be at risk of termination of a dealer agreement or threat of litigation, another mechanism being employed is not to renew a franchise agreement. A notice of non-renewal would be given towards the end of the term. In fact, in the last week I have had two matters where two dealers have received such notices. The notices are being sent to their accountants, not even to them at their business address. One dealer has been in business for something like

[17] Transcript, Sydney, 9 October 2008, p 5

> 33 years with that particular distributor. That distributor does not know why its dealership is not being renewed.

23. The LAAV provides details of the recent experience of its members during the reissue of franchise agreements as a result of the Victorian Government's decision to split lottery licences in Victoria.[18] During this reissue, the franchisor offered, on a "take it or leave it" basis, agreements with terms of six months to four years, while at the same time requiring franchisees to revise their shop fitouts – at costs of up to $30,000. This meant that the franchisees were left with additional costs, with no automatic right of renewal at the end of the franchise. The LAAV advocates the imposition of a duty of good faith as an antidote to this type of conduct by franchisors.

24. Another example of the economic captive problem was provided by CFAL in relation to an earlier episode with KFC, where the franchisor used the threat of non-renewal to force CFAL to divest its interest in Dominos – not because of any issues about the conduct of CFAL's KFC business, but because Dominos competed with KFC's sister business, Pizza Hut. As CFAL's submissions explained:

> 24. The background to this issue was the fact that CFAL had acquired an interest in Dominos, as it had in Hungry Jack's, at a time when KFC's then current franchise agreements permitted multi-brand franchising (provided CFAL did not hold an interest in a competitive cooked chicken brand). When KFC subsequently changed its franchise agreements to exclude an interest in any other fast food brand, it allowed CFAL to maintain its interest in Hungry Jack's but not Domino's. CFAL understood that this was due to the fact that KFC's parent company also owned the Pizza Hut brand, which was a direct competitor to Domino's and Pizza Hut was losing market share at the time to Domino's.
>
> 25. But for KFC's threat to not renew these 12 restaurants, CFAL would have had no reason to divest its interest in Domino's at the direction of KFC, and should have been entitled to keep its interest in Domino's just as it kept its interest in Hungry Jack's. However, the true position is that KFC/Tricon was not engaging in any "hard bargaining" but was engaging in a naked

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[18] Submission 45, p 2, section 2

exercise of power for a completely unrelated purpose by threatening not to renew the 12 franchise agreements.

26. Thus, not only did CFAL experience a direct application of franchisor opportunism, but it is noteworthy that this example of franchisor opportunism would be hidden in the statistics that indicate over 90% of franchises are renewed on expiry. Thus, it might be inferred that the 90% headline statistic actually masks the extent to which opportunistic conduct occurs in one form or another in relation to franchise renewals.

27. In the absence of any regulation in the Franchising Code, there is nothing to prevent a franchisor doing to any other franchisee precisely what [redacted] and KFC did to CFAL. That is, to use the threat of non-renewal to extract benefits from the franchisee that were not part of the original contract and did not form part of the basis on which the parties entered into their franchising relationship.

25. In dealing with the Rockingham closure, [redacted] confirmed in its submissions that it has no issue at an operational level with CFAL and it has *"admiration for those members of [CFAL] working in KFC stores"*.[19] It submitted that the reason it was terminating CFAL as the franchisee in Western Australia was because it alleged it had breached an obligation not to compete with [redacted] by having an interest in Dominos Pizza.[20] This allegation is denied by CFAL, arising as it did out of [redacted]'s prior opportunistic conduct, and has never been the subject of any termination or breach action by [redacted] However, [redacted]s ultimate position was that it could do what it wished because the contract was clear, as the following exchange demonstrates:[21]

> **CHAIR**—Some people might argue—I am not saying I would—that if you were to say that in the end there was no black-and-white breach of any law, you just did not like it, that that poses a conundrum for you and for me. The conundrum for you is that if you just did not like it and you decided to act in a harsh manner in relation to what you just did not like but there was no breach that could be used in reverse for a franchisee using that very same principle in response. That is what I am trying to establish. Trust has broken down because basically they breached an agreement. If

[19] Transcript, 17 October 2008, Canberra, p 75
[20] Transcript, 17 October 2008, Canberra, p 74
[21] Transcript, 17 October 2008, Canberra, p 77

> the agreement they breached is because they allowed a family member to own a competing business, I wonder how far the law stretches in your view in terms of family member ownership. Whether there is trust in place or not is irrelevant, because that is legal and proper. We are not questioning the validity or credibility of trust. If people make arrangements, where is there a breach? I am just trying to establish the pattern, because it is relevant to all franchise systems in that if you breach a contact there are some serious consequences.
>
> **Mr Bryden**—That proposition is fine and if this had ever been a matter about simply what the law is and the what the contract is, we would not be entering into a inquiry about what our modus is after terminating. **The point is that the contract is absolutely clear.** Not only that, we provided four and a half years of notice that it would end. **If it is just a matter of strict reliance on contract, then our motivations, intentions, whether it is lack of trust or anything else, are absolutely irrelevant**. [emphasis added]

26. This evidence misses an important point. The potential for dispute arises where the contract does not reflect the reality of the relationship, particularly at the time of expiry of the franchise agreement. This was explained in the following passages in CFAL's submissions at the hearing in Sydney:[22]

> **CHAIR**—I would like to focus on a key point. The issue of goodwill only becomes a matter of dispute, as it were, when there is a failure to renew or there is a termination. The goodwill is the end problem and not the original problem. The original problem is the non-renewal.
>
> **Mr Castle**—That is correct. You do not get into that problem if you keep the streams clear where franchisors stay franchisors and franchisees get renewal and continuity. It is when franchisors want to cross over and get back the farm that the problems arise.
>
> **CHAIR**—The problem originates out of the issue of non-renewal?
>
> **Mr Castle**—Yes.

And:[23]

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[22] Transcript, 9.10.08, Sydney, p.34.
[23] Transcript, 9.10.08, Sydney, p.30

> The argument we would make is that the franchisor set up the system and decided it was going to build the market with itself as a franchisor using other people's money, and then it is really bound by that. If it wants to change that relationship and wants to, in effect, take the business off the franchisee, why should it not pay the fair value for that business like anybody else in the market? Why should it influence the franchisee's rights simply because it has got economic power at the end of the franchise agreement, or contractual power because it has got whatever provisions are in its contract that give it a superior position to the franchisee?

27. The problem arises because the contracts are typically silent on the ownership of the value in the business, as opposed to the ownership of goodwill in the trade marks and intellectual property:[24]

> **CHAIR**—Are those contracts silent on goodwill?
>
> **Mr Castle**—The only thing that they talk about with goodwill is that the franchisor keeps the goodwill in the brand, the systems and the IP.
>
> **CHAIR**—Which then becomes the dispute.
>
> **Mr Castle**—That becomes a given, because if you have a brand name then of course you keep the goodwill in the brand name. That is very different from goodwill in the business.

28. There is a reason for this silence, which becomes highly relevant in relation to the issue of retrospectivity (considered below). Franchisors and franchisees contract on the basis of ordinary industry practice that franchises are overwhelmingly renewed on expiry, thus allowing franchisees to have continuity of their businesses and to sell as and when they choose. Given that franchisors write the "take it or leave it" contracts, they have no reason to depart from this understanding (at the time of contracting), because they want to encourage their franchisees to believe that they will be building up a valuable business asset. It is only later when "rogue franchisors" recognise their contractual and economic strength that they choose to exploit this silence at the expense of the franchisee, by acting opportunistically.

[24] Transcript, 9.10.08, Sydney, p.33

Issue 2: The franchise bargain

What are the interests of the franchisor and the franchisee?

29. The fundamental feature of franchises is that they are businesses created jointly by the franchisor and the franchisee. The franchisor contributes a system for the business. In return for that, the franchisor receives a fixed percentage royalty based on gross revenue. The franchisee earns a profit from the business after paying all the overheads (including franchise royalties and other payments to the franchisor) as well as other business costs.

30. The reason that franchising has been such an attractive business model is that it creates rewards for both parties. This idea is encapsulated in the promotional material for PoolWerx, a franchisor run by the current Chairman of the FCA, Mr John O'Brien, which appears on the FCA's website:[25]

> It is much more than buying a job. It's creating a business empire in carefully thought through and supported stages.

31. This sentiment was echoed by the evidence from Mr Cowin, one of Australia's first franchisees who gave evidence about his experience in the Australian industry over a period of 40 years:[26]

> **CHAIR**—Can you outline the key issue in determining the difference between someone just buying a job and somebody buying a franchise and then operating that franchise? Can you tell us why this is a special relationship? Mr Castle has talked about the investment of capital, time and effort. This can be compared with the view that you are buying a job for a period of time and then you walk away.
>
> **Mr Cowin**—Forty years ago, when I was 26 years of age, and had to cross that Rubicon of getting into business myself I had a job and I got 30 people to lend me some money so that I could move to Australia from Canada to establish a business. The primary reason for that was to try to develop a business that would have some net worth or value. That is why you do it. You live on a minimal salary that is required to keep the business alive, and every dollar you make or every dollar that you can borrow from the bank to expand and develop that business goes back into

[25] http://www.franchisebusiness.com.au/Franchise/PoolWerx-Corporation-Pty
[26] Transcript, Sydney, 9 October 2008, pp 28 - 29

> the business. The whole reason you do that is because you are trying to create an asset, trying to build the business, and the cash flow would evolve from that.
>
> Franchising has been a wonderful industry. It has been a terrific thing for making businesses competitive. As to an individual getting into business for himself, as I did with a single store, if that opportunity did not eventuate then I would not have been able to create the business that we have. In the process of developing the business the whole reason for doing it is to create an asset. If the perception becomes that this is a job and that it does expire at the end of 20 years and the franchisor can take it back without any just cause or any reason, that would be a significant body blow to this industry.

32. The difficult issue of determining exactly who owned (or should own) what was addressed by the Committee in its questions to the CFAL witnesses:[27]

> **[Mr Castle]** [The Rockingham business] was turning over, prior to it shutting, $3 million per year. It was obviously a business in an operating sense that was worth a lot of money. If you have a business turning over $3 million a year, someone is going to pay you money for it. That is your goodwill. But the goodwill because of franchising is almost like a jointly held goodwill. It is a goodwill because the franchisor has provided the systems, recipes, trademarks and advertising, but it is also your goodwill because you have put in the time and effort, you built the store, you hired the staff, you organised the supply chain, your people manage the store and you look after your people well so that you have good motivated employees. It is a jointly owned goodwill, but it is a goodwill that the franchisor can destroy at the stroke of a pen, and that is the real issue. The franchisor has the power to destroy the franchisee's interest in that joint goodwill. That is the abuse of power, particularly where there are unwritten laws or unwritten expectations—and industry practice with figures as high as 97 per cent—that franchises are renewed.

and:[28]

> **Senator BOYCE**—Should they pay fair market value or should there be a special deal for franchisors?
>
> **CHAIR**—Given that the franchisor is in a special or unique position.
>
> **Senator ARBIB**—You did say earlier that goodwill was jointly held.

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[27] Transcript, 9 October 2008, Sydney, p 29

[28] Transcript, 9 October 2008, Sydney, p 31. See also the continuation of this evidence on pp.32, 37.

> **Mr Castle**—That is right. It is jointly held. It is a bit like a marriage in a sense where you jointly own all the assets and then you come to a difficult split. How much is one partner's assets and how much is the other partner's assets? It may be that the sum total of the broken down assets is worth less than if everything is going forward. I am sympathetic to the view that there should be some sort of recognition of the franchisor's contribution. I think it is very difficult to quantify that.
>
> **Mr Parker**—The model is that the goodwill [in] the brand is owned by the franchisor. The franchisee has goodwill because they have a business in the business that sells the brand. They are separate. They have different valuation multiples and different methodologies with which to value them. Under the current law there is an opportunity for a franchisor to sell his brand on an agreement to somebody knowing that over time he can take back that whole network. If a franchisor were to offer his business for sale, under the current law he could also offer all of his franchisees for sale at the same time and enhance the value that he gets for his business.
>
> **Mr Cowin**—I do not know the answer to the question. However, we have not had to deal with it because we have not been in the business of buying and selling, and trying to distribute who gets what share of it. What we are dealing with is a renewal basis which says that, if you play by the rules, do all the things that the contract says and if you are a good citizen, the contract is renewed. The issue on the table here is the split that we are debating is zero if the franchisor does not wish to renew it. That, to me, is the inequity. However, whatever the split is, in our particular case we have not dealt with that because, as I said, there is a commercial market out there; people buy and sell the stores. The franchisor does not get paid a portion of the sale. If I am selling you one of our businesses, he does not get a cut of that.

33. One of the problems illustrated by the preceding debate is that the use of the term "goodwill" is confusing, and leads to false analogies with retail leases. A franchised business is not like a shop in a shopping centre, where the question involves a decision whether the customer is attracted by the shop, the shopping centre, or some extraneous factor.

34. Subsequent to that discussion, CFAL sought an opinion from Professor Stephen Gray to clarify the economic analysis applicable to the valuation of the business. Professor Gray is Professor of Finance at the University of Queensland Business School.

35. In summary CFAL submits that the use of the term "goodwill" is apt to create confusion, when talking the value that has been ***jointly created*** by the franchisor and franchisee. It is important to understand the terms of the bargain between the parties to understand who owns what:

- The franchisor's part of the bargain is the ability to earn revenue from exploiting the increased value of the trademarks and the system (e.g. By creating new franchises), as well as to earn royalties from the operation of the individual franchised businesses;

- The franchisee's part of the bargain is to earn the net profits of the franchised business after paying royalties to the franchisor – and this value can be capitalised through a sale of the business, which is usually done at an industry standard multiple.

36. The problem illustrated by the Rockingham case study is that the franchisee's ability to continue to earn the net profits (or to be paid out the capitalised value of those net profits) is dependent upon a decision by the franchisor to renew the agreement on expiry. That is, the franchisor has the power to create an "all or nothing" situation for the franchisee in relation to its business investment.

37. Professor Gray's report provides evidence about aspects of franchising and a framework for analysing the relevant policy consideration when a franchisor chooses not to renew a franchise agreement at the end of its term. This report was commissioned by CFAL in response to the questions raised at the Sydney hearing, in particular by Senator Boyce as set out above.[29]

38. Underlying Professor Gray's analysis are two fundamental assumptions typically made by economists: first, that people will act rationally in their own best interests and, second, that people respond to incentives. Based on these assumptions, Professor Gray explains the success of franchising in

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[29] Transcript, 9 October 2008, Sydney, p 32

terms of a robust economic model where there is a complete alignment of the incentives and interests of franchisors and franchisees.

39. He describes the alignment of the incentives of franchisees and franchisors as follows:[30]

> While the franchisee continues to operate the business, both the franchisor and franchisee benefit from the business being built up to deliver higher earnings. The franchisor benefits as it typically receives a fixed percentage of gross earnings. The franchisee benefits as it keeps the profits of the business, after payment of the franchise royalty and other business costs. Consequently, the incentives of the franchisor and franchisee are generally aligned – both benefit from growing the business to increase earnings.

40. Professor Gray's evidence is discussed in detail in the next section below.

41. There have been differing views presented to the Inquiry as to whether franchisees create anything of any value while they operate the franchises. In general terms, the franchisors have favoured the position that the franchisees do not create anything of value, whether called goodwill or something else, during the course of the franchise term. The FCA argues that franchisees create nothing of significance during the period of the franchise and has put its position as follows:[31]

> It would be totally inappropriate, and distort many existing commercial relationships, to legislate in relation to the rights of the parties to goodwill at the end of a franchise agreement.

42. However, other franchisors do recognise the value of what franchisees bring to the bargain. For example, Australia Post confirmed that its franchisees create significant value in their businesses during the term of the franchise and this value can be recouped by the franchisee when they exit the franchise:[32]

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[30] Gray Report, paragraph 25
[31] Submission 103, p 92
[32] Transcript, 17 October 2008, Canberra, p 96

> **CHAIR**—How important is the concept of your system of franchising and licensing in perpetuity to the success of the overall model?
>
> **Mr Ramm**—Listening to today, I think it probably assists. There is always equity in the business for the licensee. Our licence does not actually recognise, and we do not recognise, value, but we know the underlying businesses sell and they sell quite well. I think that means that the licensees always know that they have value in the business and at the end of the term they will always get that value.

43. Australia Post's views on the value created by franchisees is not limited to those of its franchisees who hold perpetual licences. Australia Post gave evidence that it has introduced recently a new model for its franchising operations under which franchisees are offered fixed 10 year terms. Importantly, the franchisees are paid an exit payment when they leave to recognise the mutual dependency and building up of the business and the investment of time, capital and effort by the franchisee.[33] The Inquiry received the following evidence from the Australia Post witnesses:[34]

> **CHAIR**—So the expectation is that if for whatever reason at the end of the 10 years the two parties part ways there is a stipulated formula that recognises the value in the business. You could call that goodwill; you could call it whatever you like. But it is the market value.
>
> **Mr Ramm**—We call it an exit payment.
>
> **Senator BOYCE**—On purpose.
>
> **Mr Ramm**—Yes.
>
> **CHAIR**—Of course, that is why you would call it an exit payment!
>
> **Mr Staunton**—It goes a little further than that because that is not the process that applies only at the end of 10 years. It applies at any time during the term should there be an end to the arrangement for any reason.
>
> **CHAIR**—In effect, you recognise that mutual dependency and building up of the business. It is not just about the brand, in the end you still need people who are prepared to invest their time, capital and effort?

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[33] Transcript, 17 October 2008, Canberra, p 101
[34] Transcript, 17 October 2008, Canberra, pp 100 – 101

Mr Ramm—Yes.

CHAIR—You actually just write it down as a formula. Does the formula work?

Mr Ramm—We believe it will.

CHAIR—You expect the formula would work if you ever needed to use it.

Mr Ramm—Yes.

Senator BOYCE—As you know, some of the issues are around if goodwill was paid at the end then there would be far higher licence fees at the beginning and the like. Could you talk about some of the principles underlying how you got to the formula that you use for your entry and exit fees? [...]

Mr Ramm—The model has been built on a specific return to the franchisee. The franchisee will pay an amount that we will calculate based on the volumes at that particular site.

Senator BOYCE—Are these new sites?

Mr Ramm—They can be. Typically they are conversions. New sites are obviously more difficult because we have no history. That amount is paid. There is a cash flow for the franchisee throughout the 10 years, which is also calculated based on a particular return. The exit payment is also calculated so that the franchisee will get an appropriate amount on their up-front investment plus their investment through the term of the 10 years. It is a reasonably conservative one because we say it is a less risky business. But it is exposed and explained and people understand it when they come in. I cannot tell you what the formula is; it is convoluted.

44. Additionally, the position of the FCA and others to the effect that that franchisees do not create anything of value during the life of the franchise has been challenged by a number of parties giving evidence to the Inquiry. For instance, Indcorp gave evidence refuting the suggestion that franchisees in effect added no significant goodwill and were essentially renting a revenue stream from the franchisor:[35]

[35] Transcript, 10 October 2008, Brisbane, pp 86 - 87

CHAIR—Typically, what is the risk investment component of the franchisor who has the brand compared to the franchisee who is buying into the system? What is the risk investment component?

Mr Fisher—If we go through it, I guess the franchisor would attract an initial franchise fee. The franchisee would pay for the building of the store, the staffing of the store, the fit-out of the store, the compliance with all the manuals and training of the store, the equipment within the store, and obviously the foodstuffs and the stock within the store. To that point in time, really there has been no franchisor input other than affording the franchisee the use of the logo or the brand.

CHAIR—There is no capital risk—zero.

Mr Fisher—None at all.

CHAIR—All the financial risk and economic risk is being taken by the franchisee. Is this the most common circumstance?

Mr Fisher—To the point now where in the current operations manual, the franchisor has made the franchisee insure for royalty and advertising if the store burns down during the period when the store is burnt down. If the store burns down and it takes six months for the store to be rebuilt, the franchisee's personal insurance has to cover ongoing payment of royalties and advertising for that period to the franchisor, so they lose nothing. While the franchisee would lose income stream, potentially good will from being closed for six months, the franchisor loses nothing.

CHAIR—The agreement is much more than a passive investment purchase of an income stream where you basically make an investment, sit at home and watch the income come in.

Mr Fisher—Yes.

CHAIR—This is a very much involved, proactive, capital investment risk.

Mr Fisher—Day in, day out, every night, every weekend. You are in it. Your family is in it. It would be playing it down just to say you are just leasing an income. There is a lot more goes into it than that with every franchising model.

How does the franchise model work from an economic point of view?

45. Professor Gray's analysis provides valuable assistance in providing a economic model in which to understand and analyse the nature of the

relationship between franchisees and franchisors, and where the opportunities for opportunistic conduct exist in that relationship. The model also provides a framework in which to value the contribution to the franchise made by franchisees during the life of the relationship.

46. It has already been noted that Professor Gray's report supports an analysis of the franchisee and franchisor bargain that depends on incentives and mutual dependency. Professor Gray explains in his report that the observed high rate of renewals of franchise agreements is explained by the fact that the interests of the franchisees and franchisors are aligned in a way that generally favours renewal.[36]

47. Professor Gray surmises that a franchisee will usually seek to renew the agreement because it has already borne a substantial amount of fixed costs. These costs can be amortised over a longer period if renewed, whereas restraint of trade clauses usually prevent the franchisee from operating a similar business (which would provide an alternative use for the assets to which the costs relate) for a certain period.[37] A franchisor will usually seek to renew the agreement because franchisees that reach the end of the term will usually be successful (or they would have gone out of business or been terminated before that time) and renewing a successful franchisee avoids the biggest risk a franchisor faces: selecting a franchisee that will not perform.[38]

48. Professor Gray states that a renewal rate of over 90 per cent is:[39]

> ... precisely what would be expected in an economic framework in which both parties act rationally

49. Professor Gray's conclusion on this point is:[40]

> In summary, there are a number of economic forces that will tend to result in the franchise agreement being renewed when there is a well-performing franchisee

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[36] Gray Report, paragraph 17
[37] Gray Report, paragraph 17(a)
[38] Gray Report, paragraph 17(b)
[39] Gray Report, paragraph 17
[40] Gray Report, paragraph 52

> seeking renewal. The franchisee has an incentive to continue the relationship as this is the only way to unlock the economic rents (future profit stream) tied up in their business. The franchisor has an incentive to continue the relationship with a well-performing franchisee as an "unreasonable" failure to renew may have reputational effects. This conceptual analysis is consistent with the empirical data documenting that more than 90% of franchise arrangements are renewed.

50. Professor Gray's analysis confirms that the franchise model is a strong one because the incentives are aligned by franchisees and franchisors in a way that ordinarily leads to renewal.

51. In order for the model to be fully effective it needs to take account of the possibility of both franchisee and franchisor opportunism. Franchisee opportunism takes the form of "shirking" on the terms of the franchise arrangement. Franchisor opportunism takes the form of early termination or non-renewal to obtain additional benefits for the franchisor.

52. Franchisors create incentives to stop franchisee opportunism through contractual mechanisms. That is, franchise agreements have built into them performance benchmarks against which the franchisee can be assessed, with contractual rights to allow the franchisor to terminate underperforming franchisees. As Professor Gray puts it:[41]

> A key element of the franchise model is that there must be a strong incentive for the franchisee to optimise the performance of their business. This comes in the form of a threat of termination for breach or non-renewal – a going concern business can be sold at a price reflecting the expected future profits, whereas a terminated (or non-renewed) franchise is worthless.

53. These contractual mechanisms provide an incentive for a franchisee to perform its end of the bargain, and allow a franchisor to prevent a franchisee from engaging in opportunistic conduct.

54. However, franchisor opportunism in relation to termination and renewal is entirely self-regulated, because franchisees do not have the bargaining power

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[41] Gray Report, paragraph 36

to include terms in the franchise agreement to prevent it taking place. There are two incentives on a franchisor not to engage in opportunistic conduct:

(a) the reputational risk of treating franchisees badly, which will make it harder to attract new franchisees to the system;

(b) the financial risk that any substitute franchisee will not perform as well as the franchisee it replaces and not deliver the stream of income that the franchisor needs and expects.

55. Professor Gray concludes that these incentives are not always sufficient to stop franchisor opportunism. Accordingly, the position of strength that a franchisor has as against a franchisee means that inequitable and unfair results can occur. This raises whether a policy response is necessary to address this inequity. It is submitted that, when the incentives and interests of franchisors and franchisees are not properly aligned, it is the role of policy to seek to realign them so as to ensure that the franchise model continues as a successful and robust business model.

56. Accordingly, it is relevant to assess the strength of the incentives on a franchisor not to act opportunistically.

57. The incentive provided by reputational risk is not a particularly strong one. The Inquiry has heard evidence of the actions of some franchisors in preventing new franchisees contacting previous franchisees.[42] Also, franchisors can explain away one-off acts of franchisor opportunism as peculiar to the relationship with that particular franchisee, and argue that that

[42] The South Australian Parliament's Economic and Finance Committee noted that a practice whereby franchisees insert confidentiality clauses in franchise contracts to prevent franchisees informing prospective franchisees of their experiences with that franchisor was "not uncommon": Submission 37, recommendation 7.2.5. Accordingly, it recommended that the Code be amended to prohibit any conduct that has the effect of preventing or obstructing communication between prospective and existing franchisees. This would occur through an expansion of clause 15 of the Code. Similarly, the ACCC recommends that this Committee consider whether the Code should be amended to expressly prohibit franchisors from limiting the disclosure of relevant information to prospective franchisees through confidentiality clauses: Submission 60, pp 26-27. It submits that such clauses can circumvent the purpose of the Code's prohibition against a franchisor inducing franchisees and prospective franchisees not to associate.

conduct is not representative of their general approach to the franchise relationship.

58. Reputation is also not a constraining factor in circumstances where a franchisor is acting opportunistically to bring a particular franchise in-house and operate that business itself. Once it decides to operate and control a particular territory itself, it does not matter that the franchisor's reputation amongst prospective franchisees is tarnished, as it will no longer be seeking franchisees in that territory.

59. Similarly, the incentive provided by financial risk is not a particularly strong one when a franchisor has other reasons to recoup its losses. This occurs when the franchisor brings the business in-house or when it appropriates the value of the business by "churning" the franchisee (i.e. buying the business cheaply and selling it for full value).

60. In fact, in an unregulated environment, the incentives here are the opposite of what they should be. The better performing franchisees are more attractive targets for opportunistic conduct of this type because there is a greater margin to be made on successfully "churning" their businesses.

61. In this context, Professor Gray's most striking conclusion is that, if a franchisor brings an outlet in-house at the end of the franchise term without any payment to the outgoing franchisee, this represents **a significant wealth transfer** from the franchisee to the franchisor.[43] He notes that this occurs because the franchisee receives nothing, and the franchisor will continue to receive a fixed percentage of gross revenues for as long as the franchise continues to operate, as well as a the benefit of the net profit stream that the franchisee had previously received.[44] If the franchise is renewed, then the status quo will continue: the franchisor continues to receive royalties and the franchisee receives any net profit.

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[43] Gray Report, paragraph 43
[44] Gray Report, paragraph 42

62. This conclusion refutes [redacted]'s submission that a franchisee gets a "windfall" if the franchise is renewed.[45] It also refutes the submission of the FCA set out above that requiring franchisors to account in some way to franchisees whose business they acquire or shut down would be *"totally inappropriate, and distort many existing commercial relationships"*. To the contrary, such an adjustment recognises the underlying commercial relationship and is equitable in that it requires a franchisor to account for the benefit they receive or willingly forgo when they acquire or shut down a franchise site.

63. But how should a franchisor account to a franchisee on non-renewal, and in what amount?

64. One possibility was identified in the evidence of Australia Post referred to above; namely, the use of a predetermined formula which is written into the contract.

65. However, Professor Gray points out that the usual way for a franchisee to exit is to sell the business to a "replacement" franchisee.[46] For the purpose of valuation , it does not matter whether the "replacement" franchisee is a true third party, or whether it is the franchisor itself.

66. Having taken these matters into account, his ultimate conclusion is that a system in which the franchisor renews the agreement with the franchisee unless good cause can be established, **but** has the option of paying the fair market value of the business to buy out the franchisee at the end of the contract term has a number of attractive features. [47]

67. Professor Gray notes that these attractive features of this system are that:

    (a) it **preserves the key economic incentives** – this is because the franchisee has a clear incentive:

[45] Submission 118, p 1
[46] Gray Report, paragraph 32(a)
[47] Gray Report, paragraph 6

- to maximise the value of the business (because this maximises the chances of renewal and the value of the payout if no renewal is allowed);
- to follow all contractual terms and operations manual, so as to complete the contractual period as a well-performing franchisee so as to maximise the chances of renewal;

and the franchisor has a clear incentive to renew the franchisee in order to avoid the reputational effects that would arise from terminating a franchisee without good cause;

(b) it is **consistent with equity considerations** – the franchisee receives a payout for the value of business that they have built up and the franchisor receives ongoing royalties. Without a payout, the franchisee is not properly rewarded and a wealth transfer away from it occurs;

(c) it **maintains flexibility for the franchisor** – the franchisor is free to bring the outlet in-house at the end of the contract period or replace the incumbent franchisee with a new one, provided the franchisor accounts to the outgoing franchisee for the value of what it has contributed to the increased value of the business.

68. Professor Gray recognises that this requirement imposes additional administrative costs because it requires a franchisor to document good cause and to establish fair value.[48] Any decision as to whether to impose a statutory test for renewal must take account of this cost. However, as Professor Gray demonstrates, this cost is relatively low. As he points out:

> An important consideration in relation to these costs is that there is high probability that, for a particular outlet, those costs will be zero. The great majority of franchise contracts are renewed, and for these contracts there is simply no need to determine whether good cause exists or to quantify fair value.

[48] Gray Report, paragraph 64

69. In terms of measuring fair value, because both the renewal rate observed, and the renewal rate predicted by economics, is high, Professor Gray favours a multiples valuation method to value franchises.[49] This method applies a multiple to the present (or forecast) earnings of a business.[50] It is used where the business is expected to generate cash flows indefinitely.[51] The multiple is determined by examining the multiples that comparable firms have sold for.[52]

70. Importantly, the model that Professor Gray recommends largely corresponds with established market practice. As the following examples demonstrate, some of the most established and reputable franchisors already have in place strong systems to protect the value of the franchisee's investment in the business.

71. Professor Gray's analysis also provides significant insights on the question of valuation. It follows from his analysis that, even if franchises are not always renewed, then the appropriate method of valuation will always be a multiples one, as a recognition of the valuable business that the franchisee has built up as its share of the franchise bargain.

Automatic renewal is not the answer

72. The appropriate response to franchisor opportunism is **not** automatic renewal for franchisees, and such a right is not what CFAL advocates. As Professor Gray has notes, an automatic right of renewal would cause a misalignment of the interests and incentives of franchisors and franchisees because it would allow franchisees to act opportunistically without a franchisor being capable of deploying termination as means of preventing such conduct. Such a result would not be to the long-term benefit of the franchise model.

73. The FCA has sought to malign submissions to the Inquiry that advocate a policy response to the issue of franchisor opportunism at the end of the franchise agreement by characterising these submissions as seeking

[49] Gray Report, paragraph 21
[50] Gray Report, paragraph 82
[51] Gray Report, paragraph 86
[52] Gray Report, paragraph 85

"[h]owever cloaked ... to provide franchisees with either an automatic right of renewal at the end of the term of their franchise or a right to receive a payout from the franchisor".[53] But this is not what is advocated at all. All that is sought is some protection from the ability of a franchisor to appropriate the value that a franchisee has created in the business based on existing market practice. The FCA itself recognises that this value is created. In commenting on data gather in the 2006 Franchising Australia Survey, the FCA states that this date suggests that *"many franchisees succeed in gaining an extension of their agreements, and then sell part of the way during the second term when the business value is probably at its optimum".*[54] Implicit in this submission is the recognition of the value created by franchisees in their business, which has a value to potential purchasers.

74. Similarly, the McDonald's representatives who gave evidence to the Inquiry made it clear that they were opposed to an automatic right of renewal for franchisees. However, they gave significant details of the system that McDonald's used when its franchisees were coming to the end of the 20-year franchise term which shows how McDonald's approaches franchisee renewal. That process of considering renewal of the franchise starts in year 17. Importantly, the McDonald's representatives were not aware of any franchisees being terminated.[55] They gave the following evidence about how McDonald's approaches the issue of renewal:[56]

> **CHAIR**—You do not specifically expect after 20 years—even though that seems to me to be a longish period for an agreement—that just because it is over that is the end of the relationship and everyone walks away. There is no specific reason why you would not renew someone for a further 20 years, given that the relationship is fine.
>
> **Mr Maloney**—Subject to their not meeting criteria.
>
> **CHAIR**—Sure, absolutely. That was not a trick question.

[53] FCA Supplementary Submission, 30 October 2008, p 2
[54] FCA Supplementary Submission, 30 October 2008, p 8
[55] Transcript, 17 October 2008, Canberra, p 41
[56] Transcript, 17 October 2008, Canberra, p 39

Mr Maloney—That is understood. The issue and the correlation to that to me, is that, in instituting some form of compulsory right of renewal in favour of a franchisee, if that is what it is, we run a risk that their capacity to maintain the required standard may be diminished somewhat because they feel that they already have another term in the bag, so to speak.

CHAIR—But, clearly from your perspective, you are saying that nothing specifically prohibits you or there is no particular reason—other than, say, a dispute or a good cause—from renewing the contract for another 20 years after the contract has ended?

Mr Maloney—I think it is fair to say that in any board review we undertake with licensees, which takes place in about year 17, **we would be going there with an open mind to look at reentering another relationship with them.**

CHAIR—Sure. Given that you do that at the 17-year mark, why do you leave three years open?

Mr Maloney—In case there are some issues that we need to resolve.

CHAIR—So that would give you some options, but **it would also give your franchisees the option to divest themselves of the business?**

Mr Maloney—Absolutely.

CHAIR—To move on or sell to someone else?

Mr Maloney—Yes. [emphasis added]

75. The evidence given by Eagle Boys Dial-A-Pizza was to similar effect:[57]

Mr ROBERT—When the first five years are up, how does Eagle Boys generally deal with the option to extend? I am just trying to get a bit of a feel for how franchisors deal with options and then at the end of a term.

Mr Stewart—We look at whether the franchisee has been a complying franchisee in terms of doing the right thing, submission of required information and also doing the right thing by the overall system and the brand. In my cases our franchisees comply to that level. **If that is the case, then we just automatically offer them renewal.** We do not even make it their obligation. The agreement says they have to

[57] Transcript, 10 October 2008, Brisbane, pp 67- 68

come to us, but we actually write to them and tell them. At the end of the 10 years, more often than not franchisees renew. In three years, there are no franchisees who have not wanted to renew at the end of their term. We offer them a further five-year period.

Mr ROBERT—Have you had any who want to go over the 15 years?

Mr Stewart—Yes. We have had franchisees over 15 years. The system has been going for over 20 years, so we have some very long-serving franchisees.

Mr ROBERT—Am I correct in saying that there are some franchisees who hit the 10 years and you have extended by five years, and they have hit the 15 and you have extended again?

Mr Stewart—Yes.

CHAIR—At least within your organisation—I will not ask you to comment on others—and within your own system, your expectation and perhaps those of your franchisees is that you do have a long-term relationship that really does go beyond, 'Look, I know we are signing for five years.' That is the initial period, and everyone may want to pull out at some point, but if things are going well and they are making money and you are making money, the expectation is, for want of a better reason, you just continue.

Mr Stewart—Yes, that is exactly right. At the end of the day we are building a business in partnership with our franchisees, so over many years we want that business to continue to grow. We are only going to grow it by retaining our existing franchisees. [emphasis added]

76. Eagle Boys Dial-A-Pizza also recognised the valuable goodwill that their franchisees built up themselves in their own businesses during the life of the franchise, as the following evidence demonstrates:[58]

Mr Stewart— [...] I listened to a conversation when we talked about good will earlier. We have many franchisees that sell their business after a number of years for well in excess of what they paid to get into it because they built up what the previous speaker spoke about as the personal good will component. Obviously we are retaining the good will component associated with the brand and what they have

[58] Transcript, 10 October 2008, Brisbane, p 69

> helped us build. What they have built their business into over that period of time helps us as well, so there is shared good will there.
>
> **CHAIR**—There is no situation, at least within your franchise system, whereby at the end of a contract, there is zero value in that franchisee business because the contract has expired and there is nothing to sell. You do not have that situation in your system where the value diminishes over time, the closer it gets to expiry date, because if it is not renewed, it has no value because there is no business.
>
> **Mr Stewart**—No.

77. The evidence provided by Eagle Boys Dial-A-Pizza supports a view that a requirement of renewal unless good cause would be consistent with its practice and cause no change to its current methods of operating:[59]

> **Mr Stewart**—Under a normal renewal, more often than not or in virtually every case, we are going to renew because, when you think about it from a business value point of view, business value is a multiple of profits. The revenue from your store network gives you the profits that build your business value. If you let your revenues go away, your business value is going to fall. It does not make logical sense for franchisors to want to let franchisees go away, if they operate under the type of system that we operate whereby we are purely a franchise model.
>
> **CHAIR**—Unless there is a good cause—
>
> **Mr Stewart**—Yes, unless there is a good cause—
>
> **CHAIR**—There is no reason to go down that path.
>
> **Mr Stewart**—And there could be significant dispute. That may happen from time to time and you do not renew. We have had situations in the past where we have had significant disputes with franchisees and put them on notice that we are not going to renew prior to renewal. That is the exception rather than the norm.

78. The Cheesecake Shop in its oral evidence stated that, wherever possible, it is desirous of having relationships with its franchisees for a long as possible, and that the store lease terms are the major constraint:[60]

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[59] Transcript, 10 October 2008, Brisbane, p 69
[60] Transcript, 9 October 2008, Sydney, p 14

> **CHAIR**—Is it then your expectation and a clear understanding of either your master franchisee or franchisee that it is a five- or 10-year agreement and at the end of that agreement everyone will walk away? Is that the expectation?
>
> **Mr Konopacki**—Not necessarily. **In fact, as the franchisor we are interested in developing a network of single unit franchisees in perpetuity if at all possible.** The fact is that in developing those units we are restricted by the term of leases that we can organise for the franchisees and in many cases we will not be able to extend a lease term beyond the initial agreement. Where we can—and we are active in doing this—we extend a lease arrangement under which a franchisee can in fact extend their licence agreement with us. [emphasis added]

79. This specific evidence is supported by the general evidence provided by Mr Conaghan, an experienced franchising lawyer from DLA Phillips Fox, was that in most cases there is automatic right of renewal and a requirement that a proposed sale by a franchisee can only be opposed by a franchisor with a reasonable basis:[61]

> **Mr ROBERT**—Whether it is five or 10 it is largely irrelevant for the example. At the end of the five-year or 10-year period, if there is no option to extend, the franchisor could simply exercise his contractual obligations and say, 'Thanks very much. The time is up. I know you built a cracker of a business, or we have together, but we are taking it over with no recompense to you', which would be allowable if indeed the contract allowed it and both parties entered into it with absolute knowledge that that would happen. There is no argument about that. The question is: Is it right? Is it reasonable under the pub test? Does the average bloke sit in the pub and say, 'That is a fair thing?
>
> **Mr Conaghan**—In my experience the vast majority of the franchise agreements provide a term. That term used to be 10 by 10. In many franchises it has come down either to five by five or five by five plus five. When we say that it is a term, it is an initial term with an option for renewal. In the vast majority of systems that option for renewal is at the election of the franchisee, provided that he is not in breach.
>
> **Mr ROBERT**—I fully accept that.
>
> **Mr Conaghan**—So our terms are either 10-year, 15-year or 20-year terms. We talked previously about the model of a franchise. It is very clear that you are buying

[61] Transcript, 10 October 2008, Brisbane, pp 55 - 56

an income stream. Good advisers will make it clear to someone considering this type of business acquisition or environment that he is buying an income stream. It is very clear what happens at the end. Having said that, the vast majority of circumstances reveal that if it is working well there is automatic renewal beyond that term. Let us take the example of, say, a 10 by 10 term. Somewhere into that second term, and relatively fairly easily, either the franchisor or the franchisee will be raising the issue about what happens at the end.

In most circumstances, if it is working well, some renegotiation occurs and there is an extension or, alternatively, a franchisee will move to sell the business to take out the capital benefit in an existing business when someone is buying cash flow business. A franchisor, in considering usual provisions about identifying a suitable franchisee coming in, will then enter into a new agreement for a new term—10 by 10 or whatever—with the new franchisee. There are those provisions. It also goes back to the fact that when you enter into that type of transaction you are acquiring an income stream.

Mr ROBERT—The other option is that franchisors would simply say, 'No you cannot sell it', and, 'No we are not allowing you after the end of the term. We will just take it over.'

Mr Conaghan—In most franchise agreements there has to be a reasonable basis for a franchisor to refuse a sale in the franchise agreement.

80. These practical illustrations demonstrate that the regulatory model recommended by Professor Gray is consistent with industry best practice.

81. Indeed, there is evidence in both Australia and the US that some franchisors have adopted rolling 10 year rights of renewal, provided that good cause requirements are met. In Australia this includes the second largest franchisor (in terms of the number of franchisees), the Jim's Group:[62]

Senator BOYCE—You mentioned in your submission the idea of rolling renewal rights. Could you talk about how that works?

Mr Castle—Yes. In the US KFC contracts and in some of the Jim's Group contracts—Jim's Group being one of the biggest franchisors—there is a term which says that every 10 years is a renewal occasion. For example, in KFC US contracts

[62] Transcript, 9.10.08, Sydney, p.35.

> they have to upgrade the stores to the then current standards. You have to make a capital contribution commitment, not be in breach, and enter into the then current form of the franchise agreement. You have to pay fees as set by relatively clear standards. Every 10 years you get an opportunity to update the relationship. On the franchisee's side, the franchisee has to commit to upgrading the restaurant. That is a very important thing in the restaurant industry, because it is well accepted that well presented restaurants attract more customers, so you have to make sure that franchisees are committed to doing this.

82. CFAL contends that these contractual provisions simply give effect to existing industry practice. However the benefit of having them clarified expressly, either in the contract or in the Code, is to ensure that all parties can plan their futures with a degree of predictability that is not available at present.

<u>Franchises are not retail leases</u>

83. A number of submissions to the Inquiry have characterised franchises as being like retail lease. For example, the Australian Retailers Association (***ARA***) states in its submission:[63]

> [Franchisees] are after all renting the franchise system, **and like any other lease** that has no security at the end of the term, franchisees must understand their need to return their investment within the available period of the franchise agreements. [emphasis added]

84. In fact, franchises are nothing like retail leases (or IP licences or outsourced contracts) for reasons that include the following:

    (a) Franchise agreements are relational contracts, in which franchisors and franchisees work together to maximise the return in the business. Franchisees are answerable to the franchisor for the conduct of the business. Retail leases (or IP licences or outsourced contracts) do not have this aspect of interdependence and landlords do not dictate how the tenants are to operate their business (other than high-level matters such as store opening times).

[63] Submission 135, p 12

(b) The obligations on a franchisee under a franchise agreements can change during the life of the franchise. Franchisors can impose additional obligations on franchisees through operational directions, and these can require significant ongoing investment by franchisees. Retail leases do not have this changing character and the obligations of a tenant are clearly defined in detail at the outset by the lease. Also, the investment made by tenants under a retail lease are generally upfront, such as store fit-out costs, which will be amortised over the life of the lease. There is no ongoing requirement to continually invest in the business in a manner comparable to that in a franchise arrangement.

(c) Franchise agreements commonly include a restraint of trade clause which prevents a franchisee from engaging in a similar business for a particular period after the conclusion of the franchise.[64] Retail leases do not contain these restraints, and it is usually open to a tenant to move their business to other premises at the conclusion of the lease if a further lease is not agreed upon.

85. The difference between retail leases and franchises was demonstrated by the evidence of Indcorp. Indcorp provided evidence of the experience of its members, KFC franchisees, being required to undertake ongoing investment in their franchises over the life of the franchise by the franchisor. It submitted that it was not valid to analyse the position of a franchisee as making an initial investment at the beginning of the franchise which it then recouped over the life of the franchise. The reality for Indcorp's members was that they were required to engage in ongoing and significant investment by the changes to the Operations Manual promulgated by [redacted] This raised

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[64] See, for example, LIV letter to The Hon Chris Bowen MP, 24 October 2008, p 3, which states: *"Due to the unique nature of franchising, unlike retail leasing for example, the franchisee cannot take its business elsewhere once the franchise agreement expires. Restraints of trade upon the franchisee also place limits on the franchisee's future business option."*

serious issues where [redacted] decided not to renew a franchise, and instead take over that store itself, as the following evidence of Indcorp reveals:[65]

> **CHAIR**—Can I take you down a slightly different path. I am interested in the principle or the view that the corporation—for example, Yum—decides that it wants to now go down a new path. It decides that over a period of time it wants to no longer have franchisees but wants to corporately own all the stores as company stores. Does it in principle have a right to do that in any circumstances? If it does, what sort of process should that take? What sort of process should that look like?
>
> **Ms Steggall**—In principle, it does have the right to do that, but you have to look maybe at the five years or the 10 years leading into such a policy change. You cannot have a right to take over all the stores and have the company all owned, but the year before, without a franchisee being aware that they are about to lose their store in a year's time, require them to do the major refurbishment and refit, put the capital investment into it, and then take over the store. At this point, there is nothing stopping a franchisor, or Yum, at 19 years, from requiring a major refurbishment while a franchisee, believing they will get a renewal, undertakes that capital investment and at the 20 years experiences termination of the agreement, with the franchisor taking over that store and receiving the benefit of the capital investment, the refurbishment and the upgrade. There are no provisions for that franchisee to be compensated for the investment.
>
> **CHAIR**—Not compensated in any way at all? So it is the drop dead clause, as I think you referred to it, that at the expiry of the contract.
>
> **Ms Steggall**—That's it!

86. The differences between retail leases and franchises mean that different analytical models and policy responses are appropriate with respect to each. The fact that franchises are separately regulated by the Code is a strong indication of the need to treat them separately. Because retail leases do not impose ongoing investment obligations during the life of the lease and because the landlord does not have a significant say in how the tenant's business is operated, the relationship between landlord and tenant can be appropriately managed by requiring full disclosure before the lease is entered. However, because franchises have an ongoing, relational nature, the

[65] Transcript, 10 October 2008, Brisbane, p 81

relationship between franchisor and franchisee can only be partially addressed through up-front disclosure.

87. The expiry of franchise agreements provided the most significant point of difference between the two models. This is for the simple reason that on non-renewal a retail tenant at least has some options for relocation of its business, whereas the franchisee has no option but to close the business (if it will not yield to the franchisor's demands) and will even be prevented by restraint of trade clauses from starting again.

Role of restraint of trade clauses

88. Restraint of trade clauses are one of the contractual mechanisms imposed by franchisors which have the effect of preventing franchisee opportunism. A franchisee will not act opportunistically because this will risk termination and the restraint will prevent the franchisee from running a similar business.

89. Accordingly, restraint of trade clauses in franchise agreements make sense and are justifiable in preventing franchisees from voluntarily leaving the relationship, i.e. because franchise agreements are understood as relational contracts in which the franchisor and franchisee are jointly building a business.

90. There can be no justification for a franchisor to enforce restraints of trade where the relationship is terminated by the franchisor – either by termination for breach or due to non-renewal. In this case, the "incentive" / justification for the restraint (i.e. to ensure the franchisee remains committed to the relationship) is no longer required.

91. Alternatively, if the Inquiry were to accept the submissions that franchising is nothing more than "renting an opportunity" or "buying a job", there can be no justification for restraint of trade clauses in this model. If this view of franchising were accepted, then an appropriate policy response would be to limit the ability of franchisors to impose restraint of trade clauses on franchisees. It should be emphasised that this model of franchising is not the

one favoured by CFAL. However, if the contribution that a franchisee makes to a franchise relationship in building up a business is not protected, allowing restraint of trade clauses to be imposed operates as an additional penalty on franchisees. Not only can a franchisee have its business taken in-house by a franchisor without compensation at the end of the term, but the franchisee can be prevented from building a similar business for a period by the restraint of trade clause. This is an inequitable result.

92. CFAL gave the following evidence to the Inquiry about this issue from its perspective in relation to non-compete clauses affecting its KFC franchise in WA:[66]

> In our case it is a 12-month non-compete provision but, as Mr Gardini said, when you have multiple contracts or multiple sites with the franchisor, as we do with our KFC business, the non-compete provisions last; whenever you have one remaining store you are subject to non-complete. Our non-compete in relation to the KFC business is that we are not allowed to engage in any fast food activity, anywhere in Australia, other than Hungry Jack's, which was a specific exception—even if we have one KFC restaurant. That is obviously the most powerful non-compete you can have. In other words, as some bloggers suggested on a blog site, we could not just rebrand this restaurant as some other chicken brand. We could not do that in 12 months. We could not do that while ever we have a KFC restaurant.

93. Similar evidence was given by Mr Beddall for the FAA:[67]

> I can give you instances of large multinational franchises that have unilateral power. People invest not hundreds of thousands of dollars but tens of millions of dollars in their franchises. Once you are in there is not much that you can do. The lawyers always tell them never to sign the renewals or the contracts, but when you have $25 million exposed and there is a no compete clause in the original agreement, there is not much you can do except sign. That is what happens.

94. This experience of non-compete provisions is contrary to the position put by the SCAA that franchisees do not need any recognition for goodwill because anything they have they can take with them to a new business – *"you can*

[66] Transcript, 9 October 2008, Sydney, p 34.
[67] Transcript, 10 October 2008, Brisbane, p 31.

certainly open up another restaurant selling hamburgers if it is a hamburger business that you are in".[68] That is, the SCAA's submission does not recognise the legal constraints on franchisees leaving a franchise. Although it does not support an obligation to renew unless there is good cause, the SCAA recognised in its evidence to the Inquiry that there is an expectation on the part of franchisees that there will be negotiations at the end of their franchise term for a further period:[69]

> CHAIR—What you are telling me is that the expectation is that you sign up for five years and then everyone walks away?
>
> Mr Speed—No. The expectation is that you then have to renegotiate and enter into a new arrangement if you wish to continue with that arrangement.
>
> CHAIR—So there is an expectation, though, that there will be renewal?
>
> Mr Speed—No, there will be new negotiations if you do wish to renew.

95. Professor Gray points out the economic inefficiencies caused by restraint of trade clauses. These make the outgoing franchisees' fixed assets (such as equipment particular to the franchise) valueless, and require the incoming franchisee, or the franchisor taking over the franchise, to replicate those assets.[70] This analysis raises squarely whether the Code needs to be modified to restrict the ability of franchisors to prevent franchisees who they fail to renew from engaging in similar businesses for any period after the end of the franchise.

96. Professor Gray recognises franchisors must have the ability to terminate poor performing franchisees and that the threat of termination for breach or non-renewal provides a strong and important incentive for the franchisee to optimise the performance of the business.[71] This incentive prevents

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[68] Transcript, 9 October 2008, Sydney, p 44 - 45
[69] Transcript, 9 October 2008, Sydney, p 43
[70] Gray Report, paragraphs 44 – 46
[71] Gray Report, paragraphs 34 - 36

"franchisee opportunism". Professor Gray summarises the position as follows:[72]

> Regulation that prevented (or made it more difficult) for a franchisor to protect against this via the insertion of performance standards into the contractual relationship would fail tests of equity and economic efficiency. It would fail the test of equity to the extent that the performance is under the control of the franchisee (noting, of course, that the standard by which performance is judged is under the control of the franchisor). It would fail the economic efficiency test to the extent that a (likely) better performing franchisee is available. For both of these reasons, franchisors should not be made hostage to under-performing franchisees.

97. However, importantly, he notes that even where a franchisee is poorly performing and is in breach of the franchise agreement, it does not follow that the franchisee's business is worthless and that the franchisor should be allowed to acquire the business at zero cost. If that were the case, then there is a risk of franchisor opportunism, and for that reason Professor Gray recommends that franchisee performance be tested against objective, transparent and measurable benchmarks.[73]

[72] Gray Report, paragraph 34
[73] Gray Report, paragraphs 37 - 39

Issue 3: Statutory response

98. How best to implement a statutory requirement that addresses the issues with renewal discussed above?

99. A general statutory duty of good faith, and certainly an implied common law duty of good faith, would not stop opportunistic renewal conduct of the type described above. This was amply illustrated by the following submission from the SCCA:[74]

> Where you have a fixed term franchise agreement which expires on a certain date without a franchisee option you have no gap to fill and therefore no common purpose in respect of which "good faith" may operate.

100. That is, an obligation to act in good faith alone is not sufficient protection for franchisees. Franchisors will rely on the position that they have no obligations after the end of the agreed franchise term – *"once a franchise term ends, it ends"*.[75] More specific provisions in the Code dealing with renewal of franchise agreements are necessary in order to recognise the contribution of franchisees. As the South Australian Parliament's Economic and Finance Committee put it:[76]

> While an individual franchise may not succeed without the brand power and resources provided by the overarching system, the efforts of the franchisee operating that outlet at that location need to be acknowledged when the relationship reaches a crucial point such as renewal or expiration.

101. Professor Gray's analysis provides a powerful theoretical underpinning for a regulatory response, because it is a response which preserves the franchise bargain while allowing the franchisor flexibility. As stated above, the response he favours is that the franchisor renews the agreement with the franchisee unless good cause can be established, but has

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[74] Submission 115, p 29
[75] FCA, Submission 103, pp 46
[76] Submission 37, recommendations 7.2.15 and 7.2.16

the option of paying the fair market value of the business to buy out the franchisee at the end of the contract term:[77]

> This does not imply that *every* franchise agreement that should (from an economic efficiency standpoint) be renewed will in fact be renewed. There may be cases in which a well-performing franchisee who seeks a renewal is not granted one, although the economic analysis above (and the empirical data) suggests that such incidents are likely to be rare.
>
> However, the consequences of non-renewal for a franchisee are substantial. The financial impact of non-renewal is that the value of the franchisee's business is effectively reduced from the present value of the expected future cash flow stream to zero. That is, even though the incidence of such non-renewal is low on average, the consequences for a particular franchisee are substantial. This has led to various calls for regulation and other practical remedies.

102. CFAL's experience with the closure of its Rockingham store provides the classic example justifying such a statutory response. Neither party wanted the store closed; yet [redacted] did not have any provision in its agreement that would allow it to keep the store open by acquiring it from CFAL, and CFAL had no entitlement to a renewal, or even to contest the decision made by the franchisor not to renew the restaurant.[78] A stalemate therefore eventuated in which all parties lost – employees lost their jobs, CFAL lost its investment in the business, and Yum lost its royalties from having the store operating.

103. There is substantial support for law reform in this area.

104. The RTAWA argues that CFAL's experience with [redacted] Restaurants in WA demonstrates that there is *"a serious 'loop-hole'"* in the Code.[79] The RTAWA has described this as an example of 'franchisor opportunism' as follows:[80]

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[77] Gray Report, paragraphs 53 and 54
[78] Submission 22, Part I.
[79] Submission 14, p 1
[80] Submission 14, p 1

> ... the franchisor by not renewing the franchise agreement, forces the franchisee out of business, purely and simply to set up its own business at the same location and thus profit exclusively from the goodwill built up by the former franchisee without having to pay anything for it. Even with this threat in hand, the franchisor can exploit the franchisee in the acquisition of the franchisee's business or assets at significantly below market value.

105. The RTAWA submits that the current law does not adequately address this type of conduct. It argues that the solution is:[81]

> ... to incorporate a 'good faith' obligation to the renewal of franchise agreements, which would create a 'level playing field' for all participants. Our understanding of the franchise industry suggests that this would cause minimum disruption to existing practice within the industry, whilst protecting franchisees from unscrupulous conduct by franchisors who attempt to take advantage of the current regulatory void to benefit themselves at the expense of franchisees.

106. The MTAQ supports reform for the manner in which franchisees exit the franchise arrangement. It points out that the Code is prescriptive of entry requirements, but deficient on the basis of termination when the term of the franchise expires.[82] It argues that exit arrangements must be the focus for regulatory reform as there are many instances of unfairness in goodwill.[83] It comments as follows:[84]

> The problem manifests when the other party terminates before or after the agreement. The franchisor secures the goodwill leaving the franchisee with the risk and disposal of stock, pumps, computers, etc.
>
> The lack of recognition of goodwill seriously disadvantages the small franchisee in the instance of a large suppler. The franchisee exits with little reward for efficient business operation; his skill set in achieving high benchmarks is of negligible value when the arrangement is terminated. The stance of the franchisor (large supplier) is that the goodwill derives from the branding of the product and not by the franchisee's promotions, reputation and service etc.

[81] Submission 14, p 2
[82] Submission 36, para 4.1.2
[83] Submission 36, para 4.1.2
[84] Submission 36, paras 4.1.3 and 4.1.4

107. The MTAQ also supports reform of the rights of franchisee on renewal, and makes the following comments in its submission:[85]

> It would be highly desirable that the Code require an enunciation of the basis for renewal of the franchise. It should be defined in the initial agreement so that both parties are aware of renewal arrangements. For example, what are the conditions on which the franchise business will be renewed? Will the franchisor have to pay for goodwill as an entry fee for the next period or not?
>
> Renewal is a vexed issue and one that worries many franchisees. Some hold the opinion they have the right to a renewal although it is not included in the agreement. It is obvious if the agreement/document is silent on the right to renewal then it should be clear that renewal will have to be earned by performance. If it is a conditional right of renewal, the conditions to satisfy the right for renewal should be stipulated in clear terms and agreed between the parties.

108. The MTANSW made the following submissions which illustrate the importance of introducing a statutory protection for renewal:[86]

> **Senator BOYCE**—I can understand why you might stay in there trying to desperately protect your history, but I do not understand why anyone would come into this industry now.
>
> **Mr Robinson**—Not to belittle the issue that I know has been ventilated during the course of today, but there is an expectation that, notwithstanding termination and effluxion of time provisions, unless you have done something wrong your agreement will be renewed.
>
> **CHAIR**—Where does that expectation come from?
>
> **Mr Robinson**—Purely from course of conduct that it has happened. As previous witnesses have said—
>
> **Senator BOYCE**—It has generally happened.
>
> **Mr Robinson**—Yes, it has generally happened. The problem that we have at the moment is that when a factory—to use an inelegant word—might turn feral in terms of a particular thing it wants to do it feels it is able to shed the concept of what is usual practice and then go back to the literal terms of the contract and say for

[85] Submission 36, para 4.3.1 and 4.3.2

[86] Transcript, 9 October 2008, Sydney, p 94

> instance, 'This agreement after its initial term has a nine month termination provision.' They can then go back and use that notwithstanding the general practice.

109. The MTANSW supported this submission by providing the following example in the context of the motor trades industry:[87]

> But the problem with motor vehicle dealerships is you can have a minimum term of one year, five years, 10 years or 20 years but what, for example, would be the equitable principles if seven years into a 10-year dealership the factory said to the dealer, 'You must spend $6 million renewing your premises', effectively to clean it up ready for the factory to take it over in 18 months. How could you say that the pure expiry of the agreement by effluxion of time could be in any way a fair or conscionable result out of that exercise?
>
> If you look at what the Texas Automobile Board is authorised to do, it says that before a factory can terminate or not renew an agreement there must be good cause shown. And if there is a disagreement it goes to the board. Then the board is given a list of things it looks at, one of which is whether the agreement has expired. To the MTA that is the kind of environment that would result in a fairer system and fairer controls relating to questions of termination or nonrenewal.

110. Professor Frazer, who has conducted a great deal of research into franchising in Australia, was supportive of a protection of franchisees' rights on renewal:[88]

> **Mr ROBERT**—Let us take the pub test of the average Australian again. If an agreement came to an end, at a pub test level, is it reasonable to assume that a franchisor would negotiate in good faith to allow a continuation?
>
> **Prof. Frazer**—Do you want my personal opinion on that?
>
> **Mr ROBERT**—Absolutely.
>
> **Prof. Frazer**—Personally, because I know a little bit about franchising, I would say that is reasonable, because you entered a five-year agreement or whatever it is.

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[87] Transcript, 9 October 2008, Sydney, p 90

[88] Transcript, 10 October 2008, Brisbane, p 12

111. Mr Beddall for the FAA supported the position that franchisors taking over the business of their franchisees at the end of the term, rather than renewing the franchise, was not best practice:[89]

> **Mr ROBERT**—How do you think industry should deal with renewals? If there are five-year or 10-year contracts, or an option for five-year contracts, do you believe it is fair at the end for a company to take over a successful business and that is it?
>
> **Mr Beddall**—No, I do not at all. That is not international best practice. One particular franchise rang an American counterpart because he had a five-year term and he was told that the United States would not sign anything. That same franchise, which sold a five-year term here, had an open-ended term with the United States franchisees. I think five years is crazy, not for a lawn mowing franchise or whatever, but for anything with a large capital injection where you will add value to the franchisor because you would be selling their product and, if you do it well, you will sell more. We have made some suggestions but my view is that it should not be renewed in the breach rather than a drop-dead date.
>
> I know a bit about the economic market, but if you ask franchisees whether they have amortised the cost of the franchise over the five years they will inevitably tell you that they have not. With a $250,000 franchise you have to make $50,000 after tax just to get back your capital. Most franchisees have never done that. That is where you can have some input with an education program. In many instances you can talk to franchisees—and no doubt you will—and you will find that they are told with a nudge and a wink, not in the document, 'Of course we will renew', and people believe it. In most instances a lot of franchisors renew, but some do not.

112. Dr Spencer argues in her submission that a duty of good faith is needed in the context of renewal of franchises:[90]

> Nonrenewal is an issue that raises the possibility of the option of a statutory requirement of good faith. A statutory requirement of good faith for termination and nonrenewal has been enacted in approximately half of the US states that have relationship laws for the franchise sector.

and:[91]

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[89] Transcript, 10 October 2008, Brisbane, p 31 – 32
[90] Submission 39, p 30
[91] Submission 39, p 32

> A statutory duty of good faith may be appropriate for broader application in franchise regulation, for example in some of the other instances where franchisor opportunism is an issue. Non-renewal is different from all other situations in which franchisor opportunism may arise, because there is no contractual or regulatory protection available to franchisees facing nonrenewal. Nor can good faith be implied after the term of the contract has expired. It is therefore the primary example of a situation where franchisor opportunism requires in the form of a statutory duty of good faith.

113. Those who oppose law reform in this area do not advance any cogent reasons why it should not occur. The comments of the FCA have been set out in paragraph 39 above. The National Retail Association (the ***NRA***) similarly opposes any change to the law to protect the "goodwill" created by the franchisee during the life of the franchise.[92]

114. The only rational explanation to support the NRA's analysis would be that franchisors actually expect to make opportunistic profits at renewal time and factor these profits into their calculations in advance. The problem with this explanation is that it is inconsistent with market practice and the high renewal rates experienced in Australia. It would also be distinctly unethical in the case where a franchisor is relying on a franchisee to spend its own money building a business for the benefit of the franchisor.

115. The Cheesecake Shop gave the following evidence that unfairness would be avoided in relation to renewals if the Code contained a term that franchisors should act in good faith:[93]

> **Senator ARBIB**—You have made a very solid case in terms of your own corporation but, obviously outside your corporation, there are numerous cases where franchisees have found themselves in an unfair bargaining position and had their contract terminated for unfair reasons. I am just wondering how you see this being remedied outside your corporation. Do you have any views as to how things can be improved so that franchisees are not in this unfair position or, I should say, where there are unethical practices going on by the franchisors?

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[92] Submission 109, p 5

[93] Transcript, 9 October 2008, Sydney, p 22

> **Mr Meagher**—If it is unethical then, if there is a term added to the code about having to act in good faith, I think that may well solve the problem. Franchisors do not like being involved in litigation. They do not like having to disclose the fact that they have terminated stores or they are in dispute with franchisees because now there is the requirement for franchisors to disclose the contact details of franchisees that are former franchisees. They will be contacted. It is not in their interests to have disputes. It is really distracting. Having to act in good faith would go a long way, I think, to solving any unethical practices. It would make it against the law and give a remedy to franchisees for that breach without being too prescriptive in terms of behaviour that would adversely affect different industries.

116. However, this answer was contradicted by their earlier evidence about their own approach to dealing with their "master franchisees":

> CHAIR—I am clear that they do not go on forever. I do not think the expectation from anybody is that they go on forever and it is perhaps an automatic right. We are talking about slightly different things. I am asking you is do you believe there ought to be a good cause? If you have a successful franchise unit or a successful master franchisee, should there not be a good cause to terminate at the end of that contract and not renew or should it just be for no good cause?
>
> Mr Meagher—It should be for no good cause because of the economics of it. Just applying it to our master franchisee, if I can, we entered into a commercial arrangement which said, 'It ends. ***We get the farm back*** but in the meantime if you do this work you get this reward.' That was the risk allocation. If that goes on forever, we have an inefficient system. [Emphasis added][94]

117. There is no relevant distinction to be drawn between franchisees and master franchisees – in each case the business exists as a result of the contributions of two parties. The problems inherent in the analysis of the Cheesecake Shop were pointed out in CFAL's submissions which followed immediately afterwards:

> **Mr Castle**—We have put in a detailed submission so what we would like to do upfront is cover five key points that we feel may be of assistance and that will obviously lead into questions. The first point to make is that franchising is actually about using other people's money. Franchisors use other people's money, time and

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[94] Transcript, 9 October 2008, Sydney, p.21.

effort to build up the businesses. One of the previous witnesses, Mr Meagher, used the expression in terminating or in not renewing master franchisees, 'We want to get the farm back', but ***the farm only exists because of the money, time and effort put in by the franchisees in building up that business***. To say we want to get something back which did not exist before the franchisees came into the system is a bit of a false analogy. This goes to the very heart of one of the key points we make about renewals. The farm exists, like our restaurant existed, because we took the time, the effort, put in the money and took the risk and yet in his view of the world it would seem to be the franchisor, whether it is a master franchisee or some other sort of franchisee, does not have to make any recognition for what the franchisee has done in building up the farm.

In practice what has happened in this sector is that renewal of franchise agreements has meant that people recoup their investment over time by being able to sell their business. The point was made in answer to Senator Arbib's question apropos goodwill by Mr Meagher that there is a market for these things, so it is the market where the franchisee recoups effectively their goodwill or effectively gives them the opportunity to get some benefit from what they have put in and built up. I do not know the facts and I am only speculating, but the master franchisees presumably have a point of view about what they did to build up this great business that the franchisor now wants to get back. The franchisor says, 'You have come to the end of your contract. You knew what you were getting in for. We want to corporatise it and bring it in-house.' They said the different industries and different franchise systems have different rules, but quite frankly that is not correct. It is the principle which is the same throughout.

With our restaurant at Rockingham the franchisor wanted to get the farm back, too. It wanted to get back a restaurant that we built. It wanted us to transfer the staff. It wanted simply to walk in and take that back over without making any allowance for what we had done, and that was contrary to what we understood to be the rules of the game. By that I mean accepted industry practice. [Emphasis added][95]

[95] Transcript, 9 October 2008, Sydney, p 24.

Issue 4: CFAL's model provisions

118. CFAL has put forward model provisions for inclusion in the Code to address the issue of good cause renewals.[96] It has argued that franchising:[97]

> ... is about using other people's money and if you take other people's money where you have elements of trust, relationship and corporate marriage, you have to honour that by duties like duties of good faith, and having a default situation where renewal is the norm unless there is good cause.

119. In its model provisions, CFAL has sought to balance the interests of franchisors and franchisees on renewal and create a more level playing field:[98]

> ... one of the circumstances we think should be taken into account is what the respective financial and non-financial contributions were. In other words, if somebody has invested a huge amount of money to build up a motor dealership that is obviously going to weigh in the franchisee's favour. If you have a real estate franchisee that has been paid money to join the franchise system, that is going to weigh in the franchisor's favour. In other words, what we feel would be appropriate in section 23A is to set up some objective principles that people can look at and apply them to the disputes in question. We cannot detail down to a fine degree what should happen in every dispute in every franchise system, but if we set the right principles and framework then we will be able to cover the problems.

120. The model provisions recommended by CFAL match up with the recommendations of Professor Gray set out above.

121. The effect of the provisions is to make renewal the default, which accords with industry practice. The evidence of the FCA was that 98 per cent of franchises are renewed.[99] Instances where a good cause would exist not to renew would include:

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[96] Submission 22, Attachment 1
[97] Transcript, 9 October 2008, Sydney, p 25
[98] Transcript, 9 October 2008, Sydney, p 27
[99] FCA, Transcript, 5 November 2008, Melbourne, pp 36, 40

(a) the franchisor has offered a new franchise agreement in good faith which the franchisee has rejected (i.e. not proposed for the purpose of being rejected by the franchisee);

(b) the franchisee is liable to be terminated for breach of the existing franchise agreement – i.e. because it has failed to meet the performance benchmarks necessary to make the franchise viable;

(c) the site which the franchisee has operated from is no longer available and an alternative site is not practicable;

(d) the franchisor has offered to buy out the franchise at fair market value on a going concern basis; and

(e) some other reason reached in good faith by the franchisor.

122. The FAA agrees that there should be a new standard in the Code along the lines of that proposed by CFAL. However, the FAA points out that a franchisor providing 90 days' notice of its intention may not be sufficient for some types of franchises.[100] It provides as an example that truck rental franchises require vehicle leases of up to eight years. As most franchise agreements have a 'non compete' clause on the termination of the franchise for whatever reason, the FAA points out that the franchisee may be left with vehicles it is unable to use, but otherwise be bound by their equipment lease, exiting early from which may be financially ruinous.

123. In its submission, the RTAWA has proposed similar amendments to the Code to:[101]

(a) oblige a franchisor to renew a franchise agreement (or provide compensation in lieu) unless that franchisor has a good faith reason to justify non-renewal;

[100] Submission 51, p 22
[101] Submission 14, p 2

(b) set appropriate time limits for notification of the franchisor's decision about renewal / non-renewal before expiry, together with the provision of reasons; and

(c) provide an ability for the franchisee to enforce its right of renewal (or compensation in lieu) with the onus placed on the franchisor to justify its good faith reason for deciding not to renew the agreement.

124. The RTAWA notes that the issue of "franchisor opportunism" was recognised as an issue in relation to petrol station franchises in the 1960s and 1970s and that the *Petroleum Retail Franchise Marketing Act 1980* (Cth), now encapsulated in the *Oil Code Regulations 2006* (Cth), sought to address the renewal of franchise agreements.[102] It also notes that this type of regulation is commonplace in the US.[103]

125. There is therefore a powerful precedent for the type of model provisions advocated by CFAL.

126. Dr Spencer also points out that an obligation of good faith on renewal is an appropriate regulatory response because it reflects the relational nature of the contract:[104]

> One advantage of good faith is that it is a principles-based rather than a rules-based regulatory strategy. It has therefore an aspirational quality that rules cannot offer, and is potentially more conducive to relationships of trust rather than suspicion. Also, principles rather than rules allow regulation to respond effectively to evolving conditions without the need for frequent amendment to rules, amendment that can undermine the effectiveness of such rules.

127. Mr Beddall for the FAA provided the following views on the appropriate approach to renewal:[105]

> **Mr ROBERT**—You have no ability to roll something over. You are approaching the end of an agreement. You went into the contract in good faith. A contract is a

[102] Submission 14, p 2 and Appendix 1
[103] Submission 14, p 2 and Appendix 2
[104] Submission 39, p 30
[105] Transcript, 10 October 2008, Brisbane, p 33

contract. At the end of 10 years or five years the contract states you have no rights. You signed it and you need to take responsibility for it. But the question is: Is that right?

Mr Beddall—I have a view that unless you breach you should virtually have a perpetual franchise. That is not necessarily the view of my association; that is my personal view. If together you have built a successful brand you have to take into account the fact that you can have two separate stores from the same franchise and they trade very differently. Much of it is to do with the hard work and effort of one person building the goodwill of that business. Does that goodwill belong to the franchisee or to the franchisor? I think it is a joint thing. How you determine that is a Solomon solution, but there has to be some requirement.

We think there should be a formula in the code based on the amount of capital invested at the start to ensure that you return that capital over a period and there is such an opportunity. However, it is difficult to put that into the code. If I am a franchisor and I say, 'The chairman is not the right person'—he may be the perfect person—'but I have someone else to whom I want to sell that franchise', currently there is nothing that I can do.

Mr ROBERT—There seems to be something inherently unreasonable about putting a five year, 10-year, or a longer period in place to jointly build a business and, at the end of that period, one party has all the rights and the other has none when it has been a joint exercise the whole time.

Mr Beddall—I could not agree more. I think good franchisors recognise that. You will see it often when they are allowed to sell. They will bring a potential buyer to the franchisor. The franchisor must have the right to vet those people to make sure that they are appropriate. If they are and they are knocked back I think that has to be a breach of the good faith provisions of the code.

128. Hank Spier, a former CEO of the ACCC, submits a formula for compensation of goodwill in the event a franchise is not renewed should be included in franchise agreements.[106]

[106] Submission 151, p 3

Alternative regulatory reform

129. Those submissions which argue for the "retail leasing" model put forward an alternative model of regulation based on more disclosure and education, which implicitly accepts that franchising is not about a continuing relationship. For example, the ACCC has recommended that the Committee consider whether to require franchisors to explicitly advise prospective franchisees about their rights to renew or extend their franchise agreement and about whether goodwill may accrue to the franchisee upon exiting the system.[107]

130. Not surprisingly, this is also the view of the FCA. The FCA in its submission to the South Australian and Western Australian inquiries, which is an appendix to its submission to this Inquiry, states that it opposes any changes to the Code to address this issue. It makes the following submission:[108]

> The FCA rejects the recommendation that the Code be amended to include a provision mandating that franchise agreements must include the basis on which termination payments or goodwill or other such exit payments will be paid at the end of the agreement. This is unnecessary interference with the freedom of the parties to contract.

131. However, other than the submission that *"once a franchise term ends, it ends"*,[109] no submissions are made in support of this submission by the FCA, other than to argue that this amendment is only being advocated to the Inquiry to advance the interests of CFAL in its dispute with Yum!.

132. The Australian Retailers Association (***ARA***) also makes a recommendation that the Code be amended to require this type of disclosure in order to allow franchisees to understand fully what will happen at the end

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[107] Submission 60, p 28
[108] Appendix 2 to Submission 103, p 31
[109] Appendix 2 to Submission 103, p 31

of the franchise term. The ARA makes the following submission in support:[110]

> This may reinforce to the franchisee what their rights and what they are entitled to at the end of the term. They are after all renting the franchise system, and like any other lease that has no security at the end of the term, franchisees must understand their need to return their investment within the available period of the franchise agreements.

133. Put another way, if all franchisees are doing is “buying a job”, franchisors should be required to disclose that in their material, and remove any suggestion that the franchisee is creating their own business through the franchise arrangement from their sales pitches to potential franchisees.

[110] Submission 135, p 12

Issue 5: "Retrospectivity"

134. It has been suggested that amending the Code to include duties of good faith and fair dealing, as well as specific provisions imposing a duty to negotiate in good faith in relation to contract renewals, would involve an element of retrospectivity, and impose a significant cost on the franchising industry.

135. In actuality, these amendments will not involve retrospective action. The new duties will only affect future **conduct**, and will not change the terms of contracts entered into in the past. This is the point made in the opinion provided by leading constitutional and administrative lawyer, Alan Robertson SC.[111] The amendments suggested would make explicit the current market practice, which is that franchise agreements are renewed by franchisors unless there is good cause not to do so. Logically, there can be no significant effect when the amendments are merely formalising industry norms of conduct.

136. Professor Gray has also addressed the issue of retrospectivity in his report. His conclusion is that amending the Code to require the franchisor renews the agreement with the franchisee unless good cause can be established, but with the option of paying the fair market value of the business to buy out the franchisee at the end of the contract term, would impose no significant cost because the number of instances where the Code would need to be invoked would be relatively small. His views on this matter are as follows:[112]

> That is, to the extent that the "retrospective" terms apply only to cases of franchisor opportunism, and to the extent that this occurs only rarely, the overall economic effect of the proposed terms is small. For an individual franchise agreement, there is a low probability of franchisor opportunism requiring the application of these terms at the end of the contract period. This can be established by empirical evidence on the frequency with which franchise agreements are renewed at the end of the

[111] Attachment 4 to CFAL Submission, Submission 22
[112] Gray Report, paragraphs 71 and 72

> contract period. More comprehensive empirical analysis along these lines might be useful in quantifying the historical and perceived probabilities of renewal.
>
> In summary, the key policy consideration on this point is the trade-off between economic efficiency and equity considerations on the one hand, and the effects of "retrospectivity" in terms of applying new terms to existing contracts, on the other. Retrospectivity may have symbolic or reputation effects for a policy-maker, but for the reasons explained above, **the overall economic impact of the application of these terms is likely to be relatively small**. This is because the terms in questions are effectively irrelevant to the great majority of cases in which an expiring franchise agreement is renewed. [emphasis added]

137. Professor Gray demonstrated how small this effect would be by reference to an assumption that 90 per cent of franchises were renewed. If the figure is in fact 98 per cent (as per the FCA's 2008 survey) the impact would be even smaller, if non-existent.

138. To the extent there is any effect, it is significantly outweighed by considerations of equity in preventing a wealth transfer from the franchisee to the franchisor in instances of franchisor opportunism.

139. The FCA in its supplementary submission have sought to suggest that changing the law to allow a franchisee an automatic right of renewal or the right to receive a payout from the franchisor could cost the industry between $387 million and $967 million. For the following reasons, this suggestion is a complete furphy and amounts to nothing more than an attempt to obscure the debate by plucking some very large numbers from the air.

140. First, it is based on the mistaken premise that CFAL is proposing an automatic right of renewal or an automatic payout. As has been discussed above, this is not what is proposed at all.

141. Second, the cost is assessed by adjusting the franchise start up fee for the increased term. The start up fee is to represent the costs incurred by a franchisor in bringing a new franchisee on board, and include legal, administrative and training costs. In its analysis, the FCA simply adjusts the

start up fee upwards in proportion to the extended length of the franchise. The FCA offers no explanation as to why these costs would be any greater if a franchisor was required to renew a franchise unless it had good cause for not doing so. There is no logical reason why start up costs would be greater if this was a requirement.

142. Third, the FCA's own evidence is that 98 per cent of franchises are renewed. [113] Accordingly, the cost to the industry, even on the FCA's analysis, could only be 2 per cent of the numbers it postulates, as Professor Gray points out in the extract from his report set out above.

143. Fourth, it makes no allowance for the fact that a proportion of the 2 per cent of franchise agreements which are not renewed will have been not renewed for good cause.

144. In fact, the inclusion in the Code of duties of good faith and fair dealing, including in relation to renewals, is likely to have a significant net public benefit. This is because protecting franchisees from opportunistic conduct by franchisors on renewal will increase the security of tenure of franchisees and therefore make them more attractive businesses generally and, in particular, for financial institutions to lend to. This will have the benefit of reducing costs for existing franchisees and allowing more people to obtain the finance necessary to become franchisees and start their own franchise businesses. This is a potential benefit recognised by Professor Gray.[114] McDonald's also confirmed that it was *"definitely"* the long-tem nature of their franchise contracts which allowed franchisees to obtain finance for their businesses based on the inherent value of the business, rather than some other security (like the family home).[115]

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[113] FCA, Transcript, 5 November 2008, Melbourne, pp 36, 40
[114] Gray Report, paragraphs 73 and 74
[115] Transcript, 17 October 2008, Canberra, p 44

CFAL SUMMARY OF KEY EVIDENCE IN RELATION TO GOOD FAITH

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Introduction

1. The majority of the submissions to the Committee recognise the importance of a requirement that franchisors and franchisees act towards each other in good faith.

Issues

2. There are four issues raised in the submissions:

   (a) Is the existing implied duty to act in good faith sufficient protection?

   (b) Is a statutory response needed to make explicit the duty?

   (c) Would a statutory response create undue uncertainty?

   (d) Should CFAL's model provisions for the Code be adopted?

Issue 1: Existing implied duty

3. There are differing views as to whether there is an existing implied duty of good faith and fair dealing on franchisors and franchisees.

4. The Franchise Council of Australia (the ***FCA***) argues that *"there is already a duty of good faith and fair dealing that a court is able to imply into every franchise agreement"* and cites cases where a duty of good faith and fair dealing has been implied.[1] For example, the FCA points to the decision of Dodds-Streeton J in *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* [2006] VSC 223 (21 June 2006) in which her Honour noted that the implication of an obligation of good faith *may* be particularly appropriate in the context of a franchise relationship because it frequently embodies a significant disparity of bargaining power.

5. The Motor Trades Association of Australia (***MTAA***) refers to recent court decisions which have recognised an implied duty of good faith.[2] The MTAA makes the following submission about this implied duty in the context of franchising:

> While there is judicial support for a term of good faith and fair dealing to be implied into a franchise agreement, it can be negated by an express term of a contract to the contrary. In this context, the lack of bargaining power of an individual franchisee often results in a franchise agreement being entered into in a standard form, and on a 'take it, or leave it' basis.

6. DLA Phillips Fox submit that Australian courts *"by and large"* have ruled in favour of an implied good faith obligation, although implicit in this submission is that there is no general obligation.[3]

7. The Law Society of Western Australia has a similar view. It states in relation to whether a statutory obligation should be incorporated into the Code:[4]

> It should not be necessary to legislate for this. Good faith is ***generally*** implied in contract law and since a franchise agreement contains an implied duty of cooperation, each party will normally be expected to act in good faith towards the other. [emphasis added]

[1] Submission 103, p 17
[2] Submission 90, p 5
[3] Submission 81, p 2, paragraph 2.5
[4] Submission 58, p 2

8. Similarly, the Law Council of Australia also argues that Australian courts have recognised that a franchise agreement includes an implied term requiring the parties to act in good faith.[5]

9. The Shopping Centre Council of Australia (the ***SCCA***) is of the opposite view, and does not consider an implied duty of good faith exists. It says:[6]

> As the law currently stands, there is no general contractual term, implied in law, requiring parties to act in good faith when negotiating a contract or in its performance.

10. The fact that there is such a range of views between the "experts" in this area means that franchisors and franchisees are left totally unclear about whether they are bound by a duty of good faith or not. This difference of opinion provides powerful evidence as to why an express duty of good faith is needed in franchising.

11. This was also the view of the Matthews Committee in 2006, which conducted a detailed review of the law in relation to good faith both in Australia and overseas. That Committee stated in support of its recommendation for the adoption of an express duty of good faith in the Code (recommendation 25):

> In Australia, some courts have accepted to some degree, the implication of obligations of good faith in contractual dealings, for instance it has been suggested that good faith embraces three notions: an obligation on the parties to cooperate in achieving their contractual objects, compliance with honest standards of conduct and compliance with standards of conduct which are reasonable having regard to the interests of the parties. However, uniform acceptance and understanding of concepts, content and implications of good faith obligations has not emerged in the Australian jurisdictions.

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[5] Submission 141, p 2

[6] Submission 115, p 2

Issue 2: Statutory response

12. As noted above, the Matthews Committee recommended that: "*a statement obligating franchisors, franchisees and prospective franchisees to act towards each other fairly and in good faith*" be included in the Code. The present Government also announced prior to the election that it believed "*the Franchise Code should contain good faith obligations as long as the scope of this obligation is well defined*".[7]

13. The real issue is how the statutory response should be framed and implemented; rather than whether there should be a statutory response (see Issue 1 above).

14. The Matthews Committee recommendation and the Government's policy position is supported by many of the submissions provided to the Committee. For example:

    (a) The South Australian Parliament's Economic and Finance Committee recommended in its recent report that the Code be amended by inserting a provision imposing a duty to act in accordance with good faith and fair dealing by each party to the franchise relationship.[8] The Committee stated that it had received substantial evidence suggesting that the introduction of a statutory duty of good faith would be one way to make explicit the underlying ethical standards expected of the whole industry. It noted that the concept of good faith is not new and can be argued, perhaps, to underpin most business activity.

    (b) Yum! Restaurants states in its submission:[9]

    > YRA is not, in principle, against a statutory concept of good faith. Having followed developments in the common law, it seems established that this is imported into franchising agreements. An appropriate statutory concept may even be desirable to clarify this issue.

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[7] Dr Craig Emerson, 24 October 2007. www.franchiseadvice.com.au/content/view/78/1/
[8] Submission 37, recommendation 7.1.13
[9] Submission 118, p 7

(c) Professor Warren Pengilley states in his submission:[10]

> There are good grounds for inserting in the Franchising Code an obligation for parties to act in good faith. This obligation should be imposed on both parties and not on one party only.

He also states that he recommended in 1981 to the Minister for Business and Consumer Affairs that an obligation to act in good faith could be enacted, and that his belief has strengthened since then because:[11]

> ... a franchise (properly defined) is an ongoing relationship involving the trust of one party in dealings with another.

He gave evidence to similar effect:[12]

> I have no objections at all to an obligation to act in good faith. I know lawyers say that the cases differ, the law is developing and so on. It almost seems to me to be a case for saying, 'Let's put it in so that we know clearly where we are.' It is not true that the concepts are unknown. There are obligations in insurance law and partnership law, for example, to act in good faith, and no doubt there are many more.

(d) The Law Institute of Victoria (***LIV***),[13] representing 15000 legal professionals in Victoria recognised the need for franchisors to have "certain scope to their allowable discretionary powers when dealing with franchisees" but concluded:

> The LIV recognizes the uniqueness of franchising in commercial relationships. They are based on a high degree of trust and universally accepted notions of goodwill. Therefore, it is important to balance this against the arguments not to regulate, which by their nature present an unworkable economic model which assumes all franchise relationships have equal power balance and remedies to resolve disputes cost effectively. This is simply not the reality in our emerging commercial markets.
>
> The addition of a statutory obligation on franchisors to act in "good faith" is not out of step with the approach by some courts. For example, the court implied a term of "good faith" in *Burger King Corporation v Hungry Jack's Pty Ltd* [2001] NSWCA 187. Although there is currently some uncertainty about the exact extent of the content of an obligation of "good faith", the insertion of a statutory obligation will allow the courts to flexibly apply the concept to individual factual circumstances.

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[10] Submission 27, p (v)
[11] Submission 27, p 21
[12] Transcript, 9 October 2008, Sydney, p 63
[13] LIV letter to The Hon Chris Bowen MP, 24 October 2008, p 3

(e) The Lottery Agents Association of Victoria (the ***LAAV***), which represents 720 lottery franchisees in Victoria, advocates the introduction of a requirement on franchisors to act in good faith.[14]

(f) The MTAA, as noted above, refers to the issue of franchisees being required to contract out of an implied duty of good faith. It makes the following submission:[15]

> MTAA submits that due to the bargaining power imbalance, the franchisee, as the more vulnerable party to the agreement, will continue to voluntarily enter into agreements despite the existence of unfavourable terms and clauses. For this reason, legislation should intervene to set the minimum standard of conduct to protect the parties to the franchise agreement. If the concept of good faith was expressly included in the Code, it would prevent franchisors from removing the term and attempting to avoid, by contractual arrangement, such a significant common law protection.

(g) The Cheesecake Shop said the insertion of a good faith obligation for negotiation and mediation would not make any difference because there is likely an implied term to act in good faith, and it would be a good outcome because it would clarify whether or not that is the law and it would not be a problem for it.[16]

(h) IndCorp Franchisees Association of Australasia (***IndCorp***), which represents franchisees of KFC, supported the inclusion of a good faith obligation because, as the law stands, any dispute raised by a franchisee about the directions given by the franchisor, [redacted] through changes to the Operations Manual cannot be meaningfully resolved because the franchisee has no enforceable rights:[17]

> The problem is a minimum requirement of good faith on behalf of the franchisors. IndCorp, as the association for both the corporate and the independents, is obviously frequently in negotiations with the franchisor, Yum, over all the changes that occur, the future of the brand and where it is heading. But its problem is it has nowhere to go in the discussion; there is no negotiation process. Even though it represents such a

[14] Submission 45, p 2, section 2
[15] Submission 90, p 6
[16] Transcript, 9 October 2008, Sydney, p 20
[17] Transcript, 10 October 2008, Brisbane, p 79

> significant number, it cannot prevent Yum from ultimately requiring the changes, or you are in default of the operations manual and thus your franchise agreement. Mediation or dispute resolution, while an attractive form and theoretically is a good situation where you can bargain and negotiate, unless it is legally enforceable it cannot really resolve the situation.

(i) Australia Post said that it would not have an objection to a good faith obligation if it were something as simple as *"the parties shall act in good faith towards each other"*.[18]

(j) Professor Zumbo argues that enacting a statutory duty of good faith offers considerable potential as a mechanism for promoting ethical business conduct and submits that such a statutory duty of good faith should operate generally within the franchising relationship, including requiring parties to resolve disputes in good faith.[19]

(k) Hank Spier, a former CEO of the ACCC, submits that parties to a franchise arrangement should have a statutory obligation to act in good faith.[20]

15. The FCA argues that the imposition of a statutory good faith obligation would be inappropriate without explicit definition and that there is no authoritative High Court decision on the matter.[21] Both arguments go to how the obligation should be defined; they do not go to whether the obligation should be included in the Code. In any event, in another part of its submission, the FCA submits that there *"is already an implied duty of good faith and fair dealing that is well understood by the courts"*.[22] It also submits that:[23]

> The implication of an obligation of good faith may be appropriate in the context of a franchise relationship where there is a significant disparity of bargaining power or a franchisee is vulnerable or disadvantaged,

[18] Transcript, 17 October 2008, Canberra, p 99
[19] Submission 140, p 38
[20] Submission 151, p 2
[21] Submission 103, p 18
[22] Submission 103, p 4
[23] Submission 103, p 6

16. Essentially, the FCA's position appears to be that a duty of good faith exists, provided the franchisee is willing to go to court to argue about its precise scope, and that it should be left to the courts to delineate it on an *ad hoc* basis.

17. While the Law Society of Western Australia does not think it necessary to incorporate an express obligation because of its views as to the implied duty, it does recognise the power imbalance between franchisees and franchisors:[24]

> It is the Society's view that the main problem has always been the nature of many franchise agreements. In many franchise agreements there is an inherent imbalance of power in favour of the franchisor giving rise to unconscionability.

18. Eagle Boys Dial-A-Pizza submits that no change is required to the Code, and there is no need to explicitly incorporate the good faith provisions into the Code.[25] Eagle Boys Dial-A-Pizza does recognise the importance of good faith in franchise relationships and states that successful franchise systems are built by *"acting in good faith over a long period of time"*.[26] When the representatives of Eagle Boys Dial-A-Pizza appeared before the Inquiry, their position was that good faith should be a voluntary rather than a compulsory obligation:[27]

> **Mr ROBERT**—If parliament was to amend the code of conduct to say that you are to negotiate in good faith, especially with respect to renewals and breaches and so on, what difference would it make to how you operate, cognisant that the law already implies it?
>
> **Mr Stewart**—I suppose what needs to be clear is that good faith is not just a franchisor obligation.
>
> **Mr ROBERT**—Correct. That would be in there and across all parties.
>
> **Mr Stewart**—From our point of view, we already have good faith in our franchise agreement. We have franchisees who allow their agreements to expire and just do not renew them and do not talk to us about them, so there is an element of a lack of good faith on the part of the franchisee as well.
>
> **Mr ROBERT**—Unquestionably, but if you already had good faith built into your agreements, why does your submission say that you do not support getting good faith from the code of conduct?

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[24] Submission 58, p 1
[25] Submission 102, p 1
[26] Submission 102, p 1
[27] Transcript, 10 October 2008, Brisbane, p 67

> **Mr Stewart**—I see additional requirements in the code such as that as additional regulation and additional paperwork for a franchisor, and that is why I do not support it.

19. It is not clear on Mr Stewart's evidence what, if any, additional paperwork would be required by an obligation that parties to a franchise agreement act in good faith – particularly for Eagle Boys given their contract.

20. 7-Eleven Stores argues that there is no need for a duty of good faith to be introduced into the Code because current remedies under contract law and the *Trade Practices Act* are sufficient.[28] It submits that including an obligation to act in good faith in the Code will not assist franchisees or franchisors because there is no concluded definition in the *Trade Practices Act* or at general law as to its meaning. Accordingly, it submits that if an obligation is introduced it must be defined in some way, and it provides a definition adopted by Sir Anthony Mason as a possible example.[29] This definition is as follows:

> Good faith means the franchisee and franchisor cooperate to achieve the objects of the franchise agreement honestly and in compliance with reasonable standards of conduct.[30]

21. The LIV have taken a similar approach to describing the content of the duty of good faith, as follows:[31]

> ...this limited obligation to act in "good faith" should be extended to the exercise of all powers and rights arising under a franchise agreement. It is important that any regulated conduct regarding the issue of "good faith" dealing be defined in terms of honesty, reasonableness, and behavior which goes to better the interests of the franchise business.

22. The SCCA opposes a statutory definition of good faith. It also points to the absence of High Court authority.[32] It concludes as follows:[33]

> A review of the key authorities therefore reveals that there is no overriding duty of good faith in equity or common law but rather "good faith", "reasonableness" etc are concepts which are as a matter of construction or by construction used to fill the gaps of contractual provisions

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[28] Submission 105, para 15
[29] Submission 105, para 18.
[30] A.F. Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing', (2000) 116 *Law Quarterly Review* 66.
[31] LIV letter to The Hon Chris Bowen MP, 24 October 2008, p 2
[32] Submission 115, p 25
[33] Submission 115, p 29

> but only where there it is not inconsistent with the express provision to do so – ensuring the sanctity of contract.

23. The ability of franchisors to exclude the implied duty of good faith by making such a duty inconsistent with the terms of the franchise agreement demonstrates why a statutory duty of good faith is needed in the Code. This is a point made by the MTAA:[34]

> In the absence of statutory clarity regarding the duty of good faith, franchisors are able to argue that express powers such as notice period clauses or the aforementioned 'entire agreement' clauses, cannot be subject to an implied term or duty.

24. The ACCC has a similar position to the SCCA. It states that it has concerns about the practical implications of the inclusion of a good faith obligation in the Code and argues that:[35]

> This may introduce ambiguity and confusion about the rights and responsibilities of franchisors and franchisees, and potentially increase disputes and conflict among franchising participants.

25. The point about ambiguity would be resolved by the regulation including at least some objective criteria to be taken into account by the parties and a court – such as the point made by the LIV that:[36]

> ... the respective financial and non financial contributions made by each party to the franchise relationship must be weighted accordingly, and measured against a loss and benefit equation defined through the evolution of the franchise.

26. The ACCC interestingly does not refer to or discuss the recommendations of the Matthews Committee, or the detailed discussion on this issue by the South Australian Inquiry which found: [37]

> While an abstract formulation of a generalised concept of good faith may be indistinct, the courts have demonstrated that they are able to know it when they see it, or more properly, they know a breach of it when they see it.

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[34] Submission 90, p 6
[35] Submission 60, p 19, paragraphs 6.2 and 6.3
[36] LIV letter to The Hon Chris Bowen MP, 24 October 2008, p 2
[37] Final Report, South Australian Economic and Finance Committee, *Franchises*, p.55 http://www.parliament.sa.gov.au/NR/rdonlyres/674BEA3D-98D1-47B4-BEF4-C26BBF208ADD/10962/FinalReportFranchises1.pdf

27. Further, the ACCC does not explain why an obligation to act in good faith would increase disputes, or why an increase in disputes would be a negative outcome. The prospect of litigation is likely to increase self-regulatory behaviour by good franchisors, and see bad franchisors driven from the sector (also a good outcome).

28. The ACCC also argues that the parties to a franchise agreement have the power to negotiate an obligation to act in good faith in their agreement,[38] although it does explain how a franchisee that, for example, is presented with a "take it or leave it" franchise agreement has such a power. This submission is contrary to all accepted understanding of the franchise relationship, and contrary to the express findings on this issue by the Reid Committee in 1997.[39]

29. The MTAA has a different view to the ACCC and considers the existing case law does provide sufficient guidance:[40]

> As the concept of good faith has been judicially considered on several occasions, the large body of case law provides examples of conduct and behaviour that assist in specifically defining the term, and the actions that will be seen to breach it. MTAA submits that the express inclusion of the concept of good faith into the Code would be advantageous to both franchisees and franchisors in that a clear benchmark of acceptable conduct would be defined.

30. As to the scope of a duty of good faith, Dr Spencer notes that a statutory response is needed because the courts have not clearly delineated the scope of such a duty and a legislative response is necessary in order to do so:[41]

> As long as courts are unwilling to imply or construe a duty of good faith, it is up to legislators to provide for it, to fill the gap and to supply some certainty. Without statutory guidance, the courts may be ill-equipped to develop the appropriate duty of good faith that can respond to the challenges identified in this paper posed by both the relational and standard form nature of franchising contracts. There are numerous precedents for imposing or recognising obligations of good faith in statutory contexts in Australia – these include the Oil Code Regulations of 2006 (Clause 32(6) – (9)), the unconscionability provisions of the Trade Practices Act (eg s.51AC), the Victorian Fair Trading Act (s.32W) and Native Title legislation. A statutory duty of good faith also reflects a trend towards increased reliance on good faith in other countries.

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[38] Submission 60, p 19, paragraph 6.4

[39] House of Representatives Standing Committee on Industry, Science and Technology (Reid Committee), *Finding a Balance: Towards Fair Trading In Australia*, May 1997, paras 6.29-6.32

[40] Submission 90, p 7

[41] Submission 39, pp 34 - 35

Issue 3: Effect of good faith requirement

31. Dr Spencer argues that a good faith obligation is:[42]

> ... a tool that provides a low-intervention, principles-based constraint to franchisor opportunism, one that is perfectly calibrated to the relational nature of the contract.

32. The practical utility of such a tool is demonstrated by the example contract presented to the Inquiry by the Motor Traders Association of New South Wales (***MTANSW***).[43] That contract was a standard form contract issued by a factory for a low volume, specialist industrial motor vehicle. As the MTANSW pointed out in its oral submissions, the contract gives the factory the ability to vary the territory allocated to the franchisee, vary the products the franchisee can sell and requires compliance with all of the factory's policies from time to time. The MTANSW argued that it is difficult under existing law for a franchisee who signs such an agreement to have any recourse if the factory starts exercising its powers unfavourably to the franchisee, because such conduct is permitted by the terms of the contract. As the MTANSW submitted:[44]

> In effect, by signing this document you are handing to the factory the ability to single-handedly change the agreement at its discretion without your consent and without recourse.

33. The MTAA made a similar submission:[45]

> **CHAIR**—Would you say that there is a high degree of expectation that what is sold to them is an ongoing relationship?
>
> **Mr Delaney**—Absolutely.
>
> **CHAIR**—Not something that will end in six months.
>
> **Mr Delaney**—Absolutely.
>
> **Mr Gardini**—It is indeed. And, as Mr Delaney said, it is industry practice that although the agreements were of relatively short duration, they will be renewed. Industry practice over 20, 30 or 40 years has been that. You have entered into an agreement that is renewed throughout those 20, 30 or 40 years at three or five year intervals, whatever the interval is. What has

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[42] Submission 39, p 29; see also Transcript, 10 October 2008, Brisbane, pp 37 - 38
[43] Transcript, 9 October 2008, Sydney, pp 88 – 89
[44] Transcript, 9 October 2008, Sydney, p 89
[45] Transcript, 17 October 2008, Canberra, p 25

> happened in the last couple of years is that the agreements, when they come up for renewal, are being changed to fixed term agreements. Essentially that is saying that, despite the industry practice that has continued, these agreements now will be for a fixed period. The best agreements you now get in the motor vehicle dealer agreements is a five-year term with a right, in meeting certain criteria and performance, of having a further five-year term, usually though on the condition that it will be a different agreement.
>
> When you make the original investment, that is really when you have the ability to do the due diligence and make a free choice. Once you have invested capital into that business over 20 or 30 years, the agreements get changed, but your ability to negotiate the change, either on an individual basis or through the dealer counsel's negotiating with the distributors, is just a total power imbalance. It is not freedom of contract. It does not reflect contractual negotiations that exist more generally in commerce because of the relationship that exists. It is a very different situation.

34. The MTANSW and MTAA submissions provide a clear insight into the more general problem that arises because franchisors have strong powers and broad discretions that, properly used, enable them to operate their systems effectively but which powers and discretions also have the capacity to be misused. The FAA give examples of other types of contractual obligations which give rise to contention:[46]

    (a) the manner in which advertising and marketing funds are operated, spent and audited;

    (b) the controls placed on franchisees' maximum prices, which may impose margins which are too low for the franchisee to sustain their business;

    (c) third line forcing conduct;

    (d) non-compete clauses.

35. Similarly, there was evidence from IndCorp about how the franchisor of its members, [redacted], had used its discretionary powers to greatly increase the obligations upon franchisees through its operations manual, which had grown in size substantially over the years.[47]

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[46] Submission 51, pp 17 – 18,paragraphs 12.1 – 12.6

[47] IndCorp, Transcript, 10 October 2008, Brisbane, p.81.

36. The franchisees in each of these examples would have benefited from an overarching statutory duty of good faith and fair dealing. This duty would have ensured that the powers given to franchisors under franchise contracts were not being misused. This outcome, as was pointed out by CFAL, is fundamental:[48]

> There is a lot of rhetoric about freedom of contract, promotion of free enterprise and so on. We accept all of that in franchising and generally about those principles and the importance of those principles in our community, but an even more fundamental principle is the principle that people who have power do not abuse that power. I could quote from a speech that Chief Justice Jim Spigelman of New South Wales gave in March 2003 in which he said:
>
> > A core characteristic of the rule of law is that the law must operate to constrain the arbitrary exercise of power, both private power and public power.

37. There were many other examples in the submissions of the use by franchisors of the powerful contractual rights they possess which an obligation of good faith would, in part, have ensured were exercised in a fair and balanced manner. These include:

    (a) The LAAV provides evidence of what occurred during the reissue of franchise agreements for lottery franchisees occasioned by the decision of the Victorian Government to split the lottery licences in Victoria.[49] The new franchise agreements provided by the franchisor were more prescriptive and demanding that the agreements they replaced and were presented on a "take it or leave it" basis. The new agreements contained heavy penalties, such as termination for minor breaches, and terms as short as six months and, at best, four years. The LAAV submits that the franchisees were in no position to reject the agreement because of the capital they had invested. Once the agreements were in effect the franchisor was heavy handed in preventing franchisees from selling its products in the area of their store where its rival's products were sold. The LAAV submits that the end result was higher costs and lower sales for franchisees. The LAAV argues that these actions would not have been possible or would have been moderated if there had been an obligation on the franchisor to act in good faith towards franchisees, particularly in circumstances where the reissue of the franchise agreements came about

[48] T. Castle, Competitive Foods, Transcript, 9 October 2008, Sydney, p.25.
[49] Submission 45, p 2, section 2

through a change in government policy and not through the franchisees' own actions.

The LAAV also notes that the new agreements provided by the franchisor can be amended without the agreement of the franchisee, and the agreement requires compliance with a substantial operational procedures manual through which costly changes to the franchisees' business, such as revised shop fit-outs, can be imposed.[50]

(b) Ms de Leeuw has made extensive submissions about her and her husband's experiences as franchisees of Bakers Delight.[51] She gave evidence to the Inquiry that she had been served with breach notices by Bakers Delight, which she alleges were fabricated:[52]

> **Ms de Leeuw**—They were financial breaches. The first round of breaches we received was fabricated: based on a non-payment of royalty. It was based around a repayment plan that we had in place with Bakers Delight. We had not missed the payment but they used that to breach us.
>
> **Ms OWENS**—Was that circumstance cleared up on the first breach?
>
> **Ms de Leeuw**—Yes, we paid the breaches. As part of those breaches we had to pay money that we did not believe we owed them, and about which we were in dispute. We had to pay the money to avoid being terminated and losing our substantial investment.
>
> **Ms OWENS**—Up until that point was it just you and Bakers Delight, or did you have lawyers, accountants, or any of your own support?
>
> **Ms de Leeuw**—When we were breached we went and sought legal advice. Once we had rectified the breaches I believed that our relationship should continue as normal because we had rectified the breaches. We wanted to move on. The main issue—what put us into the financial position we were in and resulted in the final breaches—was that the Shellharbour store was failing and we could not get out of it. We requested to sell it or eventually even to close it, but they would not let us out of the agreement. Rather, they just sat back and basically watched us fall over.

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[50] Submission 45, p 3, section 4
[51] Transcript, 17 October 2008, Canberra, pp 53 – 70
[52] Transcript, 17 October 2008, Canberra, pp 58 – 59

> We had to pay the bills that were coming in for the Shellharbour store with the takings from the other two stores. Effectively, the Shellharbour store dragged down the other two. We believe that, if they had acted in good faith, we could have rectified the problem and either closed the store, because it was not working, on-sold it, or something else. Rather, they just sat there and waited for it to fall over so that they could get hold of our other two profitable stores.
>
> **Ms OWENS**—Is there another franchisee in the Shellharbour store?
>
> **Ms de Leeuw**—They closed the Shellharbour store. On two separate occasions after we were out of the system, Bakers Delight representatives said that they knew the store would fail, but they still let us buy it. They still signed a franchise agreement with us.
>
> **CHAIR**—Does Bakers Delight now run the other two stores?
>
> **Ms de Leeuw**—No, they on-sold those stores. That is another part of our argument against the fact that they do not operate in good faith. They manipulated those sales processes basically by offering better deals to the current franchisees. One of them, Debbie Wilson, was my manager in the Kiama store. Both of the women who ended up buying my stores were negotiating with me to purchase the stores, but Bakers Delight went in behind my back and offered them a lease-to buy deal. They could lease it for four months, pay nothing and they then signed an agreement and bought it for a much reduced price, which prevented us from getting a fair price on our two stores.

(c) Ray Borradale, a franchising researcher who provides consultancy services to National Franchisee Advisory Services, sets out in his submission the example of franchisees complaining to the ACCC about the use of threats and intimidation to seek to remove complaints.[53]

(d) The MTAQ argues that consideration should occur of expunging clauses that allow a franchisor or franchisee to unilaterally renegotiate the franchise fees or benefits of an agreement.[54] It cites an example of a highly profitable service station that had its franchise fees changed by the franchisor unilaterally midway through the agreement to gouge on these profits.[55]

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[53] Submission 16, p 13

[54] Submission 36, para 4.2.1 and 4.2.2

[55] Submission 35, paragraphs 4.2.1, footnote 2

(e) Professor Spencer sets out in Appendix A of her submission excerpts from Australian franchise contracts which provide for the franchisor to have wide-ranging discretion to control how the franchisee operates the franchise.[56] She provide examples of a contract which allows the franchisor *"sole control and discretion"* over the franchise system and the products and service offered, and *"absolute discretion"* to amend from time to time the standard terms and conditions pertaining to the grant of the franchise.

38. Professor Spencer also identified the types of problems that can arise, in her evidence about the difference between "franchisor opportunism" and "franchisee opportunism". In essence franchisors can control the conduct of franchisees through the *mechanism of the contract*; but franchisees need the protection of *regulation through the Code*:

> **CHAIR**—Thank you very much, Dr Spencer. We thank you also for your submission. I lead off by asking you to give us a bit more information on your view about that relationship between franchisee opportunism—basically riding on the back of a brand and coasting, and franchisor opportunism may be abusing the power of relationship. How does that work in practice? From your research what do you understand that to be?
>
> **Dr Spencer**—I think you have said it well. You asked whether there were opportunities for franchisees free riding on the brand, on the work of others. Franchisees can appropriate the intellectual property of franchisors. Franchisees may not accurately report income figures, so there are definitely ways. Franchisees may under-perform. There are lots of ways that franchisees can fail to perform and can act opportunistically. They can leave the system and set up their own business and not continue to pay royalties.
>
> These mechanisms generally are protected against in the contract that, as I have mentioned in my submission, is a standard form contract that is drafted by the franchisor, the franchisor's attorneys, and is presented to franchisees generally on the basis of, 'This is not negotiable.'
>
> There are good reasons for that. Franchisors have a legitimate reason to want to control the situation or the relationship. It is their responsibility to protect the brand. We have great franchisors that behave beautifully and that never behave opportunistically, but there is an opportunity for franchisors to behave opportunistically.
>
> We see many examples of this—I am sure you have in your submissions—in the areas of encroachment, in the areas of supply, kickbacks, advertising, churning, non-renewal, transfer,

[56] Submission 39, p 42

> termination, and unilateral amendments. Those are the areas where franchisors can behave opportunistically. Sometimes it seems that there may be a need to constrain that behaviour. [57]

39. In a frank acknowledgment of what constitutes good franchising practice, McDonalds said that it was not opposed to the introduction of a statutory obligation of good faith provided it reflects the common law position, and such an obligation appears to be in accordance with its present method of operating:[58]

> **Ms OWENS**—If, during that 20 years, there is a perceived need to adjust the business model, as you have recently with your coffee and all the rest of it ... Or if there were a sudden potential downturn in the economy or whatever, is there a negotiation process in that at all? How does that happen?
>
> **Mr Maloney**—It would be fair to say that there is a negotiation process. Again, it is a question of looking at what is mutually beneficial for our licensees. It is not a question of going back to the licence agreement, for example, and finding a clause that states, 'This can be done and that cannot be done'; it is a question of saying, 'Okay, we think there's an opportunity here. We think this is the scope of the opportunity. We think we can do this within this amount of time. This is what it will cost,' and we consult.
>
> **CHAIR**—Would you say that in all your dealings the principle with which you approach all this is one of acting in good faith, without leading you too much where I am going?
>
> **Mr Maloney**—We were in a court case a long time ago that talked about good faith. In any negotiation, I would have thought that that should be the underpinning requirement.
>
> **CHAIR**—Do you include good faith in your contracts?
>
> **Mr Maloney**—We do not, no.
>
> **CHAIR**—Are you aware that other systems do?
>
> **Mr Maloney**—I am hearing that that is what happens, yes.
>
> **CHAIR**—Would you have any objection to including good faith—just, 'The parties will act in good faith towards each other' in your own contracts?
>
> **Mr Maloney**—If it is the way that Mr Justice Byrne spelled it out in the Far Horizons case to which we were a party, I do not think I would have a problem. It is a question of whether it is more than that. That is the issue.

[57] Transcript, 10 October 2008, Brisbane, p.39.
[58] Transcript, 17 October 2008, Canberra, p 42

Issue 4: CFAL's model provisions

40. CFAL has put forward model provisions for inclusion in the Code to address this issue.[59] There is a clear precedent in the Reid Committee report for the present Committee to recommend the introduction of specific provisions to remedy a problem which the Committee indentifies.

41. The origin of the six objective criteria stated in CFAL's model provisions for the application of a duty of good faith are explained in an accompanying Explanatory Note. In summary, these model provisions:

    (a) Incorporate key features of the existing precedents under the 1993 Voluntary Franchising Code of Conduct (cl.12.2);

    (b) Draw upon commentaries collected by a leading academic in this area, Dr Elisabeth Peden, which include Sir Anthony Mason's definition of good faith, referred to by 7-Eleven;

    (c) Draw upon concepts from some of the existing case law, as indicated by the LIV.

42. Ms Buchan was supportive of the provisions proposed by CFAL and gave the following example of where such provisions could assist franchisees:[60]

> To return to good faith, Competitive Foods have drafted a provision as to what good faith could be. There was a case in Victoria, which I am sure you have had drawn to your attention. It is one of the unsuccessful 51AC cases that the ACCC did not run. It is Meridian Retail. It is about a franchise network that was established so that franchisees could be in shopping centres and they could be selling a range of insurance products to customers. They were based in shopping centres. The franchisor received advice from a management consultant; they reworked their business model, basically, and the reworked business model identified that they should not have franchisees anymore. Then they decided, 'Well, how are we going to get rid of these franchisees that we have already got?' They decided that they would remove the most lucrative insurance products from the suite of products that they were entitled to sell. So, it would be like removing the Big Mac from McDonalds and saying to the Maccas people, 'Go forth without Big Mac. We'll sell Big Mac ourselves.' Anyway, that was determined not to be unconscionable conduct, but I think it would probably have been caught if there were an

[59] Submission 22, Attachment 1

[60] Transcript, 9 October 2008, Sydney, pp 83 - 84

> obligation of good faith along the model that Competitive Foods have proposed in their submission to the committee.

43. The MTAA also made submissions which support the CFAL model provisions. It submitted that there was not great mystery as to what good faith means; it just means acting honestly and taking into account the interests of the other party.[61] It argued that the problem was not definition, but that the unconscionability provisions of the *Trade Practices Act* provide insufficient protection because they set too high a test.[62] It submitted that the issue was ability of franchisors to contract out of implied good faith obligations:[63]

> It can be excluded though, and having regard to how agreements are negotiated, often in a one-sided manner, there is often an inability of franchisees to prevent a franchisor from excluding that implied term of good faith. If the parliament were to make regulations under the act to amend the franchising to include a provision of good faith, that would substantially enhance standards of behaviour during the course of a franchise agreement.

44. No submissions have been forward by any party in opposition to the model provisions advanced by CFAL, other than the general objections noted earlier to having a statutory duty of good faith in the first place.

[61] Transcript, 17 October 2008, Canberra, pp 20 - 21
[62] Transcript, 17 October 2008, Canberra, p 21
[63] Transcript, 17 October 2008, Canberra, p 21

Economic Issues in Franchise Agreements

Report Prepared for Competitive Foods Pty Ltd

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Executive Summary

1. This report examines a number of financial and economic issues in relation to franchising. For the great majority of franchise contracts, the incentives of the franchisor and franchisee are aligned, the parties perform their designated roles, and they agree to continue the relationship at the end of the contract period.

2. In a relatively small number of cases, the incentives of the parties diverge, the relationship between the parties fractures and the contract between them comes to an end. One of the key reasons for the success of the franchise model is its ability to keep the incentives of the parties closely aligned so that both benefit from the relationship and will seek to continue it. For example:

   a. It is common for a franchise agreement to allow the franchisor to terminate the agreement with an underperforming franchisee who has breached clauses in the contract that require certain operational standards to be met. This termination usually involves no payment to the franchisee, who loses any "going concern" value in their business. This provides a powerful incentive for the franchisee to meet those operational standards and to perform well. Moreover, the fact that the franchisee keeps the net profit (after paying a royalty and other scheduled payments to the franchisor) also provides an incentive for the franchisee to perform well and maximise the value of their business. The franchise model requires such strong incentives for the franchisee to perform well. This is because poor performance would not only impact the franchisee, but also the value of the franchisor's brand and consequently the value of the businesses operated by other franchisees.

   b. The franchise model also requires strong incentives for the franchisor to perform fairly in relation to the franchisee. Standard franchise contracts tend not to have terms in this regard.[1] Rather, reliance is placed on reputational effects – if a franchisor were seen to act opportunistically in relation to the franchisee (which might be permitted under the contract) their reputation, and consequently the value of their brand and their ability to attract new franchisees, would be damaged.

3. On some occasions, however, these incentive mechanisms are not sufficient and the relationship between the parties breaks down. This may be due to franchisee opportunism (where a franchisee has breached a term of the contract or operating manual). This case can be dealt with under the contract, and economic efficiency and equity considerations would offer little in support of the franchisee.

4. This leaves the case where a franchisee has not breached any provision but the franchisor refuses to renew the contract. The franchisor may do this for one of three reasons:

   a. The franchisor is exiting the line of business (which should always be open to the operator of a business);

   b. The franchisor seeks to replace the incumbent franchisee with a new one; or

   c. The franchisor seeks to bring the particular franchise outlet in-house.

[1] This might be a reflection of the relative bargaining power of the parties.

5. In relation to the latter two cases, the key question is whether the franchisor should have to establish "good cause" for non-renewal of a contract (assuming no breach by the franchisee) or have the option of buying out the value of the franchisee's business at fair value.

6. I conclude that a system in which the franchisor renews the agreement with the franchisee unless good cause can be established, but has the option of paying the fair market value of the business to buy out the franchisee at the end of the contract term has a number of attractive features:[2]

   a. It preserves the key economic incentives – the franchisee has a clear incentive to maximise the value of the business (this being the optimal strategy for them regardless of whether the franchisor selects the renew or payout options at the end of the contract period); the franchisee also has a clear incentive to diligently follow all contractual terms and operations manuals, so as to complete the contract period as a well-performing franchisee; and the franchisor does not bear the reputational effects that might flow from simply failing to renew.

   b. It is consistent with equity considerations – the franchisee receives a payout for the value of the business that they have contributed to building up. The franchisor also receives a benefit in the form of higher royalty payments. If the franchise agreement is simply not renewed, the franchisee would receive no share of the extent to which the value of the business increased during their tenure.

   c. It preserves a high degree of flexibility for the franchisor – the franchisor is free to bring the outlet in-house at the end of the contract period or to replace the incumbent franchisee (who has performed well in the sense that there have been no breaches) with a new franchisee that is expected to be even better.

7. Such a system would result in additional administrative costs such as documenting good cause and establishing fair value. A policy-maker would need to weigh up the economic benefits of such a system against these potential costs. An important consideration in this regard is that there is high probability that, for a particular outlet, these costs will be zero as the great majority of franchise contracts are renewed.

8. An additional question is whether "good cause" and "fair value" provisions should be applied to franchise agreements that are already on foot. The key policy consideration on this point is the trade-off between economic efficiency and equity considerations on the one hand, and the effects of "retrospectivity" in terms of applying new terms to existing contracts, on the other. Retrospectivity may have symbolic or reputation effects for a policy-maker, but I conclude that the overall economic impact of the application of these terms is likely to be relatively small. This is because the terms in questions are effectively irrelevant to the great majority of cases in which an expiring franchise agreement is renewed.

9. It is also possible that "good cause" and "fair value" provisions might increase the flexibility of financing options that are available to franchisees. Without such provisions it is highly unlikely that a lender would structure a loan beyond the contract period. To the extent that franchisees are able to obtain more flexible finance, both franchisees and franchisors benefit.

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[2] Of course, these considerations are only relevant in the small number of cases of non-renewal. Where the franchisor and franchisee have established a good working relationship such that the franchise agreement is renewed as a matter of course, there is no need to even turn to these considerations.

1. Author

10. This note has been prepared by Professor Stephen Gray, Professor of Finance at the University of Queensland Business School and Managing Director of Strategic Finance Group (SFG Consulting), a corporate finance consultancy specialising in valuation, regulatory and litigation support advice.

11. My qualifications and experience are outlined in my curriculum vitae attached to this note.

2. Terms of reference

12. I have been engaged by Competitive Foods Pty Ltd to provide a short report that develops an economic framework for consideration of various issues related to franchising. Specifically, I have been asked to look at the situation where the franchisor elects to not renew the franchise agreement at the end of a contractual term. I examine this from a financial and economic perspective and provide some possible policy implications.

3. Relevant Aspects of Franchising

13. Franchising is a model in which one party (the franchisor) develops a system which it makes available to another party to use (the franchisee) for the purpose of building a business and making money. A key feature of franchising is an on-going relationship between the franchisor and franchisee in relation to the marketing and delivery of the product. This relationship is defined by a franchising contract and regulated by the Franchising Code which is a mandatory industry code under s.51AE of the Trade Practices Act. The Franchising Code is prescribed by the Trade Practices (Industry Code – Franchising) Regulation 1998.

14. To provide the appropriate context for this note, I set out below a number of key features of franchise agreements.[3] Each franchisor will have its own standard-form contract that they enter into with each franchisee. There is some customisation with each contract, but most will share the following common features:

    a. The franchisor retains control of the brand and the goodwill in the brand, intellectual property, and system manuals;

    b. The franchisor has strong powers to control their systems and the conduct of franchisees, usually through operations manuals which the franchisee is bound to follow and which the franchisor can alter at its discretion;

    c. The agreements are usually for a fixed term, or a fixed term with an option to renew. However industry practice is that over 90% of all franchises are renewed on expiry of the final term or option period, and non-renewals typically only occur when there is a breach of contract or some other good cause for terminating the franchisee;

    d. Where real property is involved, there are a range of models to deal with that property. In some systems the franchisee is responsible for finding and owning the site; in some cases the franchisor owns the site; in some cases the franchisor takes a head lease and sub-leases to the franchisee; and

[3] Much of the material in this context section has been provided to me by Competitive Foods Pty Ltd.

e. At the end of the agreement (whether due to termination or expiry) the franchisee is subject to restraints of trade which prevent franchisees from setting up their own competitive business to that of their franchisor.

15. The financial features of a franchise agreement typically involve the following:

a. Franchisors charge a fixed percentage royalty based on gross revenue;

b. Franchisees have to pay other charges to the franchisor – these include contributions to a marketing fund and fees for other specific services, and are usually related to revenues;

c. In some systems, franchisees have to pay for certain business inputs from suppliers nominated by the franchisor, and these suppliers can be related to the franchisor (often with the franchisor receiving a rebate on franchisee purchases);

d. Franchisees are responsible for purchasing their own equipment and, depending on the business model, for capital costs of building and fitout;

e. Franchisees earn a profit from the conduct of their businesses, after paying for the overheads (including franchise royalties and other payments to the franchisor) as well as other business costs such as wages, supplies and inputs; and

f. Franchisees can sell their businesses to third parties, and make a capital profit, subject to the franchisor's consent, which cannot be unreasonably withheld. In practice this is how franchisees typically exit their businesses.

4. Valuation framework for franchise businesses

16. The attached Appendix sets out the general principles of the main approaches to business valuation – the discounted cash flow (DCF) technique and the multiples approach. The remainder of this section considers the application of these approaches to the franchise sector.

17. I understand that a standard franchise agreement between a franchisor and a franchisee runs for a fixed period, possibly with an option to renew. I also understand that over 90% of the franchise agreements in Australia are renewed at the end of the agreement.[4] This is precisely what would be expected in an economic framework in which both parties act rationally. In particular:

   a. The franchisee will usually seek to renew the agreement as:

      i. it has already borne a substantial amount of fixed costs (e.g., real property, fitout costs, acquisition and training of staff);

      ii. these costs will be lost if the agreement comes to an end as a restraint of trade clause will likely have the effect of preventing the franchisee from operating a similar business from the same premises other than under an extension of the agreement with the original franchisor;

      iii. an extension of the agreement enables the franchisee to amortise the sunk set-up costs over a longer period, to generate the required return on those sunk costs, and to maximise the efficiency with which the business is run (via learning and experience); and

      iv. even if the franchisee was seeking to exit the business, it could usually do better by selling the business as a going concern to a "replacement" franchisee rather than by failing to renew the franchise agreement with the franchisor.

   b. The franchisor will usually seek to renew the agreement as:

      i. one of the key areas of risk for the franchisor is in the selection of the franchisee, so it is in the interest of the franchisor to renew the agreement with a well-performing franchisee; and

      ii. the franchisor could potentially terminate the agreement with a poorly-performing franchisor on the basis of breach of the agreement, meaning that agreements that reach the end of their term are more likely to involve well-performing franchisees.

18. When considering a franchise opportunity, a potential franchisee will weigh up the up-front costs (real estate, fitout costs, acquisition and training of staff) against the potential net cash flows (profits net of royalty payments and marketing fund contributions) once the business is operating. This would be done in present value terms, along the lines of the valuation framework set out above. That is the present value of the expected profits would have to exceed the present value of the up-front costs to attract the potential franchisee to the opportunity.[5] In this regard I note that the franchisee may also make further capital investments in the business during the term of the franchise agreement. For example, the outlet may be modified or refurbished to meet market demands. To the extent that this is driven by the franchisor, the franchisee would

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[4] Competitive Foods Pty Ltd submission to Bothams Inquiry, Paragraph 44.

[5] In general the "value proposition" for a potential franchisee is that they are investing in and building up a business, the value of which can be realised by the franchisee at some point in the future.

(in theory) have to incorporate these costs in their decision about whether to initially enter the franchise agreement. In practice, the timing and scale of future refurbishment, remodelling or other required capital outlays will not be known until the agreement is already on foot and well into its term. Capital investment during the contract period may also be driven by the franchisee. This decision would be made within the same framework set out above – the franchisee would only invest this additional capital if the present value of the additional cash flows it is expected to generate exceeded the capital cost.

19. This requires a framework for determining the present value of expected profits. A key issue here is that the original franchise agreement may be for a total of 10 years, but it is the dominant industry practice that agreements are renewed when they expire. If there is some probability of the agreement not being renewed, this would have to be taken into account when setting out the expected cash flows. Specifically, if the probability of the agreement being renewed was p (e.g., more than 90% if there is a high chance of renewal) the present value of expected profits would need to reflect the fact that profits from a second "term" would occur only with probability p. Moreover, profits from a third term would also occur only with some probability and so on. This can be expressed as follows:[6]

$$\begin{array}{c}\text{Present Value of}\\ \text{Expected Profits}\end{array} = PV[\text{Profits Years } 1-10] + p \times PV[\text{Profits Years } 11-20] + \ldots$$

20. There are several implications of this. To the extent that the probability of renewal is considered to be low:

   a. Other things equal, a franchise business nearing the end of a contractual period would have a lower value than one at the beginning of a contractual period. This is because the near-term cash flows of the latter business are more certain than those of the former.

   b. A multiples valuation approach in which the same (or very similar) multiples were applied to all businesses of the same type of franchise would be inappropriate as they would have different values depending on the remaining term of the agreement and this is not taken into account by a multiples valuation.

21. Conversely, if the probability of renewal was considered to be close to 100%, the franchise business could be effectively valued as a perpetual business as outlined above and the multiples valuation approach would be appropriate.

22. When entering a franchise agreement, the franchisee cannot precisely estimate the probability of that agreement being renewed. To the extent that the likelihood of renewal is *uncertain*, the franchise would have a lower value, other things equal.

[6] Blair and Lafontaine (2004) present an expanded discussion of this concept at their p. 266.

5. Industry practice for sale of franchise businesses

Market Practice

23. I understand that the dominant market practice is for franchise businesses that change hands during the period of a franchise agreement, to do so based on a multiples valuation. That is, the incumbent franchisee sells the franchise business to the incoming franchisee at a price based on a multiple of present (and possibly forecast) earnings.

24. This enables the incumbent franchisee to capture the increase in the value of the business that they have built up during their time as the franchise operator. That is, the value of the business will have increased to the extent that its earnings have grown over time. Both the franchisee and the franchisor will contribute to this increase in earnings. The franchisor has contributed via marketing, brand management, and optimising the franchise system. The franchisee has contributed via efficient management of the particular franchise outlet (having well-trained and reliable and efficient staff, efficient execution of the franchise system, and otherwise developing the goodwill of the business).

Alignment of Incentives

25. While the franchisee continues to operate the business, both the franchisor and franchisee benefit from the business being built up to deliver higher earnings. The franchisor benefits as it typically receives a fixed percentage of gross earnings. The franchisee benefits as it keeps the profits of the business, after payment of the franchise royalty and other business costs. Consequently, the incentives of the franchisor and franchisee are generally aligned – both benefit from growing the business to increase earnings.

26. Under the dominant market practice, the sale of the business during the franchise agreement results in the franchisor and franchisee sharing the benefits in approximately the same way as would have occurred if the incumbent franchisee had continued to operate the business:

    a. The franchisor was receiving a fixed percentage of gross revenues from the incumbent franchisee and will continue to receive the same percentage of gross revenues from the incoming franchisee. The franchisor may also receive some sort of up-front franchise fee from the incoming franchisee, but this is usually offset by the cost to the franchisor of selecting an appropriate franchisee and establishing them in the business, and by the risk that comes with the appointment of a new franchisee.

    b. The franchisee was entitled to receive a stream of net profits over time. By selling at a multiple of earnings, the franchisee receives the discounted or present value of that expected earnings stream.

27. Note that the incoming franchisee must also be happy with this arrangement (otherwise the transfer of the franchise business would not occur). The incoming franchisee makes a payment to effectively buy the expected future net profit stream from the incumbent operator. These future profits have been discounted (in the manner set out above) to account for the time value of money and risk. This is done by determining an appropriate required return. The expected future net profit stream will then provide that required return on the (present value) sale price of the business. In the example above, the incoming franchisee would pay $1,667 for the business,

knowing that the future expected profit stream would provide the required return of 10% p.a. on this up-front capital investment.[7]

28. Consequently, the incentives of all of the parties are broadly aligned under the dominant market practice governing the sale of the business during the period of a franchise agreement.

Implications

29. I also understand that it is common for franchise businesses to trade at reasonably standard multiples of earnings. For example, fast food franchises may tend to trade at multiples different from those of bakery and mowing franchises. As I have explained above, this reflects differences in risk and growth prospects. This in turn depends upon the power (and uniqueness) of the brand, and on competition.

30. The fact that a particular kind of business tends to trade at around the same multiple suggests that there is little relationship between the period remaining in the present franchise agreement and the price at which the business sells.[8] This is also consistent with a general expectation that, but for a breach on the part of the franchisee, there is a high probability that the franchise agreement will be renewed when it expires.

[7] Blair and Lafontaine (2004) present an expanded discussion of this concept at their p. 265. The incoming franchisee, paying the present value of the expected future earnings will receive a normal return on their up-front capital investment.

[8] I understand that an exception to this is where the franchise business is tied to a retail lease that may or may not be renewed by the third-party landlord. In these cases, the incoming franchisee will generally buy out the only the balance of the contract. It would be more appropriate in these circumstances to use a discounted cash flow valuation approach than to apply a multiple to earnings.

6. Non-renewal of franchise agreement at end of contract period

Context and framework

Reasons for non-renewal

31. In a small number of cases, the franchisor will elect not to renew the franchise agreement when it expires. There are a number of possible reasons why the franchisor would take this course of action:

    a. The franchisor is exiting the business entirely;

    b. The franchisee has performed poorly and the franchisor believes that a different franchisee could generate higher revenues; and

    c. The franchisor proposes to take over the operation of the business themselves.

Franchisor exit

32. I understand that the first two cases occur rarely.[9] Consider first the case where the franchisor decides to exit the industry:

    a. If the franchisor does decide to exit the industry, they would typically do so by selling their business to a new franchisor. If the franchisee is performing well, it would be rational for the new franchisor to renew the agreement with the franchisee. This is because a key risk for the franchisor is the selection of appropriate franchisees – an established franchisee with a good track record takes away this risk.

    b. The alternative is that the franchisor does not sell their business, but simply closes it down. This would only rationally occur if the franchisor's business had little value, in which case the franchisee's business is also likely to have little value. But even if the franchisor did decide to simply close their business and a particular franchisee had developed a profitable operation, that franchisee may be able to continue to operate from the same premises in the same line of business, free from any restraint of trade terms. Of course the fundamentals of the business would have to change somewhat – as a now independent operator, the former franchisee would need to manage their own marketing and any other functions formerly provided by the franchisor. The risk of this occurring, although unlikely, is something that the franchisee must consider when deciding whether to initially enter the business.

Poor-performing franchisees

33. The second case occurs when the franchisee is performing poorly. The following discussion is based on the case where this can be determined objectively and transparently with regard to various performance metrics. Indeed many of these metrics may be incorporated into the franchise agreement (or detailed operations manuals) and may allow early termination of the agreement if breached.

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[9] Brickley, Dark and Weisback (1991) note that the vast majority of US franchise agreements are renewed. See also Footnote 2.

34. It may be simpler and cheaper for the franchisor to simply not renew the agreement, rather than to seek an early termination due to breach. The level of performance (relative to objective benchmarks that might be set out in the franchise agreement) is something that is largely under the control of the franchisee. If it can be objectively demonstrated that the franchisor is performing poorly relative to these benchmarks, the efficient and appropriate outcome is for the agreement to not be renewed. Regulation that prevented (or made it more difficult) for a franchisor to protect against this via the insertion of performance standards into the contractual relationship would fail tests of equity and economic efficiency. It would fail the test of equity to the extent that the performance is under the control of the franchisee (noting, of course, that the standard by which performance is judged is under the control of the franchisor). It would fail the economic efficiency test to the extent that a (likely) better performing franchisee is available. For both of these reasons, franchisors should not be made hostage to under-performing franchisees.

35. Another economic consideration in this case is that of *externalities.* The actions of an under-performing franchisee have a direct impact on the franchisor in that gross revenues, and consequently the franchisor's royalty stream, will be lower than they would otherwise be. There are also indirect effects, or externalities, for the franchisor and other franchisees. To the extent that a poor-performing franchisee provides a bad experience to customers, the value of the brand to the franchisor is reduced and sales to other franchise outlets may be reduced (as customers refuse to return to *any* outlet in the chain and the reputation of the entire brand is tarnished).

36. A key element of the franchise model is that there must be a strong incentive for the franchisee to optimise the performance of their business. This comes in the form of a threat of termination for breach or non-renewal – a going concern business can be sold at a price reflecting the expected future profits, whereas a terminated (or non-renewed) franchise is worthless.

37. If a stand-alone business is operated poorly, the owner will simply receive a lower price (reflecting the lower profits) when selling. Under the franchise model, a poorly-operated business becomes worthless to the franchisee due to termination for breach or non-renewal for poor performance. This, in part, reflects the fact that the poor operation of a stand-alone business impacts only the owner – generating lower profits (and business value) for themselves. In the franchise model, the poor operation of one outlet also has a negative impact on the franchisor and other franchisees. It is for this reason that the franchise model applies higher stakes to the poor operation of an outlet to increase the incentive of the franchisee to perform well.

38. Of course a balance must be struck between providing a powerful incentive to the franchisee and what is known as "franchisor opportunism." That is, the foregoing arguments apply only to poorly performing franchisees – those who the economics literature in this area refers to as "shirking" or "cheating" or "franchisee opportunism."[10] These arguments do not suggest that a franchisor should be able to terminate or fail to renew a well-performing franchisee at zero cost. It should be clear that these arguments apply only to shirking or cheating franchisees. Well-performing franchisees are dealt with below.

39. The discussion of poor-performing franchisees, set out above, has implicitly assumed that all relevant parties can observe and measure the performance of the franchisee. In practice, this requires franchisee performance to be tested against objective, transparent and measurable benchmarks. For example, it is common for franchise agreements to contain a number of

[10] Franchisee opportunism is usually the subject of several contractual terms that specify required levels of performance and compliance. Franchisor opportunism is not the subject of contractual terms, reflecting the relative bargaining power of the parties.

performance metrics and for this to be set out in some detail in the franchise operations manuals. Breaches of these conditions could be objectively determined.[11]

Franchisor opportunism

40. The final reason for the non-renewal of a franchise agreement is the most interesting. In this case the franchisee is operating the business efficiently and is willing to renew the agreement for another term but the franchisor refuses to renew. This might occur because the franchisor seeks to take over the operation of the business themselves – to bring that business "in house." To put some structure on this case, consider the following example. A franchisor and franchisee enter into a 10-year franchise contract. The franchisee invests up-front capital in respect of real estate and fitout costs. Over the contract period, the profits of the business steadily increase and are $500,000 in the last year of the contract. Also suppose that a standard multiple for this industry is 4 times earnings. In this case, the business is valued at around $2 million. This represents the present value of the future earnings stream that the business is expected to generate in the future. It also represents the price that the franchisee could obtain if it sold the business to another franchisee who then entered an agreement with the franchisor and continued to operate the business as a franchise.

41. If the franchise agreement is renewed, the franchisor will continue to receive their fixed percentage of gross revenues, and the franchisee will continue to receive the net profit after payment of this franchise royalty and other business costs.

42. If, however, the franchise agreement is not renewed:

    a. the franchisee receives nothing – no future stream of profits and no lump sum payout that equates to the present value of those future revenues; but

    b. the franchisor will continue to receive the fixed percentage of gross revenues so long as a franchise business continues to operate (whether operated by a new franchisee or by the franchisor itself) *and* the franchisor will also receive the benefit of the net profit stream if the franchisor does decide to bring that outlet in-house to be operated by the franchisor.

43. That is, if the franchisor brings the outlet in-house rather than renewing the agreement, the economic effect would be a wealth transfer of $2 million (the present value of the future profit stream) from the franchisee to the franchisor. The key questions are whether this situation is consistent with the principles of economic efficiency and equity.

Economic efficiency

44. Consider the example set out above where the franchisor does not renew the agreement, but rather decides to bring the particular franchise business in-house. Also suppose that this franchise business involves a fixed shop-front that is fitted out for the particular purpose and that the franchisee paid for this when setting up the business at the beginning of the franchise agreement that has just expired.

[11] It is also common for franchise agreements to allow the franchisor to update the operations manuals from time to time as required. A change to the manuals that made it impossible for a particular franchisee to meet a particular benchmark would not be a reasonable basis for classifying the franchisee as a poor-performer. This reasonableness of this type of variation would have to be assessed on a case-by-case basis. One important consideration would be the extent to which the changed condition also applied to other franchisees and the extent to which they were able to meet it.

45. The non-renewal of the franchise agreement is likely to cause a decrease in the capital value of those fixed assets. This is because the fitout and possibly also the building have been designed for a specific purpose – the operation of the franchise business. I understand that it is likely that a restraint clause will prevent the franchisee from using the same premises to operate the same kind of business for a period after expiry of the franchise contract term. Consequently, the former franchisee would be faced with either refurbishing the premises or selling the premises. To the extent that the premises and fitout had been customised for the operation of the particular franchise business, any buyer of these premises would need to perform their own refurbishment and this would be reflected in the sale price. In summary, there exists a capital asset fit for, and engaged in, a particular purpose and it can no longer be used for that specific purpose.

46. Moreover, whether the franchisor seeks to bring the business in house or to appoint a replacement franchisee, new premises will have to be developed and fitted out. To the extent that the new premises are effectively a replica of the existing premises, this will result in no additional revenues or profits from the franchise business – the same product will be sold to the same customers at the same price. But there is the substantial additional cost of setting up new premises. That is, the same revenue stream is generated at a higher cost and this fails the test of economic efficiency.

Equity Considerations

47. There are also considerations of equity to be taken into account. In the example set out above, the earnings of the business were built up over the 10-year franchise contract period and the going-concern value of the business (net of the franchise royalty) was $2 million at the end of the contract period. It is likely that both the franchisor and franchisee contributed to the increase in earnings and consequently the value of the business. The franchisor has contributed via marketing, brand management, and optimising the franchise system. The franchisee has contributed via efficient management of the particular franchise outlet (having well-trained and reliable and efficient staff, efficient execution of the franchise system, and otherwise developing the goodwill of the business).

48. If the franchise agreement is not renewed, the franchisee receives no share of the increase in the value of the business that has been created over the contract period. If the franchisor brings this outlet in-house, they obtain all of the increase in the value of the business.

Rational economic reactions

49. The next step in an economic analysis is to consider how economic forces might impact on the behaviours of franchisees and franchisors.

50. The economic forces acting on the franchisor are as follows:

    a. There is no apparent economic incentive for the franchisor to refuse to renew the agreement with a well-performing franchisee only to execute a new agreement with a new franchisee. This is because there is risk in the appointment of a new franchisee and there may be an initial period of lower revenues while the new franchisee "settles in" to the operation of the business.

    b. There is an economic incentive for the franchisor to fail to renew in favour of bringing the operation in-house if the costs of doing this are more than outweighed by the benefits.

The benefits are the capture of the stream of future profits. The costs include set-up costs to transition the business in-house and importantly may also include reputational effects. If a franchisor obtains a reputation for acting opportunistically at the end of the contract period, this could result in potential franchisees being unwilling to participate in franchise arrangements with them. Alternatively, potential franchisees may require terms that are more favourable to the franchisee. In either case there is a cost to the franchisor. If this cost is sufficiently large, it will constrain the franchisor from acting opportunistically at the end of the contract period. The cost of this reputational effect will be specific to the particular case. For example, if the franchisor had decided not to renew any of its franchise agreements and take all of the businesses in-house, the reputational effect would be very small. Finally, note that this reputational mechanism does not apply only to the franchisor bringing the outlet in-house. It would also apply to cases where well-performing franchisees did not have their contracts renewed for any other reason. That is, the disciplining effects of reputation effects apply generally to the non-renewal of agreements with well-performing franchisees.[12]

51. The economic forces acting on the franchisee are as follows:

    a. In determining whether to participate in a franchise agreement, and under what terms, potential franchisees will consider the probability of non-renewal. Higher perceived probabilities of non-renewal will result in fewer franchise agreements, other things equal.

    b. A franchisee will generally seek to renew at the end of the contract period. This is because the franchisee is likely to have substantial economic "rents" tied up in the business. Renewal will result in the franchisee receiving the stream of future profits, but non-renewal will not.

    c. Having entered a franchise agreement, if the franchisee perceives a high chance of non-renewal the incentive is to reduce investment in the business. The franchisor can exert some influence on this behaviour via quality control terms in the franchise agreement, but this is not a perfect remedy and investment will inevitably be lower than it would otherwise have been. If the intention of the franchisor *is* to renew, the under-investment problem can be eliminated by immediately entering a new (e.g., 10-year) franchise agreement with the same franchisee. That is, it is always open to the parties to re-set the contract clock to lengthen the franchisee's time horizon.

52. In summary, there are a number of economic forces that will tend to result in the franchise agreement being renewed when there is a well-performing franchisee seeking renewal. The franchisee has an incentive to continue the relationship as this is the only way to unlock the economic rents (future profit stream) tied up in their business. The franchisor has an incentive to continue the relationship with a well-performing franchisee as an "unreasonable" failure to renew may have reputational effects. This conceptual analysis is consistent with the empirical data documenting that more than 90% of franchise arrangements are renewed.

53. This does not imply that *every* franchise agreement that should (from an economic efficiency standpoint) be renewed will in fact be renewed. There may be cases in which a well-performing franchisee who seeks a renewal is not granted one, although the economic analysis above (and the empirical data) suggests that such incidents are likely to be rare.

54. However, the consequences of non-renewal for a franchisee are substantial. The financial impact of non-renewal is that the value of the franchisee's business is effectively reduced from the

[12] Blair and Lafontaine (2004) present a discussion of these reputation effects at their pp. 269-270.

present value of the expected future cash flow stream to zero. That is, even though the incidence of such non-renewal is low on average, the consequences for a particular franchisee are substantial. This has led to various calls for regulation and other practical remedies.

Practical initiatives

55. Two examples of responses to the issue of non-renewal and franchisor opportunism are:

    a. A number of US states have passed so-called "good cause" provisions.[13] These provisions effectively require a franchisor to renew the agreement unless good cause can be shown. Good cause can include poor performance (shirking) on the part of the franchisee. In theory then, a franchisee can invest in and manage their outlet knowing that the contract will be renewed unless the franchisor can establish good cause. If renewal is refused without good cause, and the franchisee can establish this, the remedy will be damages based on the present value of lost profits to the franchisee.

    b. Some franchise agreements now include embedded options.[14] In some cases the franchisee has the option to sell (or "put" the business back to the franchisor on some terms that are specified up-front in the franchise agreement. In other cases, the franchisor has an option to buy (or "call") the business from the franchisee – again under some pre-specified terms. The sale (or "exercise") price of these transactions may be set as a multiple of some measure of earnings, for example. This can provide a degree of certainty to a franchisee about the terms under which the franchisor can acquire the business and preserves the incentive of the franchisee to maximise the cash flow stream and consequently the value of the business. However, it does not necessarily prevent the franchisor from not renewing the agreement at the end of the contract period.

56. A common feature of both of these responses is the franchisor paying the franchisee a sum of money to acquire their business at the end of the contract period. Under the US legislative remedy the damages award is based on the present value of the future income stream, and this is also the case for the embedded call option.

57. A system in which the franchisor renews the agreement with the franchisee unless good cause can be established, but has the option of paying the fair market value of the business to buy out the franchisee at the end of the contract term has a number of attractive features:[15]

    a. It preserves the key economic incentives – the franchisee has a clear incentive to maximise the value of the business (this being the optimal strategy for them regardless of whether the franchisor selects the renew or payout options at the end of the contract period); the franchisee also has a clear incentive to diligently follow all contractual terms and operations manuals, so as to complete the contract period as a well-performing franchisee; and the franchisor does not bear the reputational effects that might flow from simply failing to renew.

    b. It is consistent with equity considerations – the franchisee receives a payout for the value of the business that they have contributed to building up. The franchisor also receives a benefit in the form of higher royalty payments. If the franchise agreement is simply not

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[13] Brickley, Dark and Weisback (1991) deal with this subject at some length.

[14] Blair and Lafontaine (2004) present a discussion of these embedded options at their p. 272.

[15] Of course, these considerations are only relevant in the small number of cases of non-renewal. Where the franchisor and franchisee have established a good working relationship such that the franchise agreement is renewed as a matter of course, there is no need to even turn to these considerations.

renewed, the franchisee would receive no share of the extent to which the value of the business increased during their tenure.

c. It preserves a high degree of flexibility for the franchisor – the franchisor is free to bring the outlet in-house at the end of the contract period or to replace the incumbent franchisee (who has performed well in the sense that there have been no breaches) with a new franchisee that is expected to be even better.

7. Implementation and retrospectivity

58. The foregoing analysis develops an economic framework for considering a number of issues relating to franchising. It ends with the consideration of a system in which the franchisor renews the agreement with the franchisee unless good cause can be established, but has the option of paying the fair market value of the business to buy out the franchisee at the end of the contract term. The economic benefits of such a framework would need to be considered in light of several implementation issues that are addressed in this section.

Complexity and litigation

59. Under present standard franchise arrangements in Australia, at the end of a contract period the franchisee has no rights to renewal or to receive any payout from the franchisor in the event that the contract is not renewed. The franchisor is free to simply allow the contract, and the relationship between the parties, to come to an end. This is administratively simple for a franchisor who wants to terminate the relationship, for whatever reason.

60. The requirement for a franchisor to show good cause before terminating the relationship would be an additional administrative cost. This cost could be minimised by careful and clear drafting of the definition of "good cause" so that whether or not the franchisor did have good cause was as objective and transparent as possible. Nevertheless, this will amount to an additional cost to the franchisor.

61. The requirement for a franchisor to pay fair value to a franchisee when not renewing (and there is no good cause) is also an additional cost to the franchisor. There are a number of issues in relation to this:

    a. In some cases, the franchisor could pass this cost on to the incoming franchisee. The incoming franchisee would ordinarily make this sort of payment to the incumbent franchisee when purchasing the business *during* a contract term. The fair value payment would simply extend this also to the case where the sale occurred at the *end* of a contract period.

    b. If the franchisor were seeking to bring the particular outlet in house, the requirement to pay fair value to the franchisee would be a cost to the franchisor that does not presently exist.

    c. The determination of "fair value" would be an additional administrative expense. Careful thought would have to be given to clear drafting of the definition of "fair value" so that was as objective and transparent as possible.

62. In addition to the administrative expense, the franchisor would also need to consider possible legal expenses in cases where there was a dispute about whether good cause had been established or whether a fair value had been paid.

63. Consequently, a policy-maker would need to weigh up:

    a. the economic benefits of a system in which the franchisor renews the agreement with the franchisee unless good cause can be established, but has the option of paying the fair market value of the business to buy out the franchisee at the end of the contract term; against

b. the additional administrative and legal costs that might result.

64. An important consideration in relation to these costs is that there is high probability that, for a particular outlet, those costs will be zero. The great majority of franchise contracts are renewed, and for these contracts there is simply no need to determine whether good cause exists or to quantify fair value.

65. To illustrate the quantum of these costs, consider the following example. A franchisor and franchisee enter a 10-year franchise contract. The franchisee invests capital and labour and develops a business that earns revenues of $100 per year and profits of $20 per year for each of the 10 years (to keep the example simple). Also suppose that the franchise royalty rate is 6% of revenues and that this type of business usually sells for four times earnings. Finally, suppose that the franchisor has many such contracts and would fail to renew 10% of them at the end of the contract term.

66. In this case, the franchisor's revenue stream is $6 per year. At the end of the contract period, the fair value of the outlet (as a going concern) is 4 × 20 = $80. This would represent a new cost to the franchisor if it sought to terminate the relationship at the end of the 10-year period and if it could not pass this cost on to the incoming franchisee. That is, this cost would only be borne by the franchisor who sought to bring the outlet in house at the end of the 10-year period. But if 90% of agreements are renewed, there is only a 10% chance that this payment would have to be made by the franchisor. Consequently, the *expected* payment is 0.10 × 80 = $8. If the franchise royalty were 80 cents per year higher, the additional royalty fees would be sufficient to offset this cost. That is, an increase in the royalty rate from 6% to 6.8% would offset this cost. Of course the required increase would be lower than this to the extent that:

   a. No allowance has been made for the time value of money – the cost will be borne in Year 10, but the additional revenues will be received earlier. If the required return is 25% p.a. (consistent with the business selling at four times earnings) the required royalty rate would be only 6.2%;

   b. This example has applied a 10% chance of the contract not being renewed. To the extent that the average non-renewal rate was lower than this, the required increase in the royalty rate would also be lower. For example, if the non-renewal probability were only 5%, and the time value of money were taken into account as above, the required royalty would be only 6.1%; and

   c. The franchisor could likely recover this cost from the incoming franchisee (unless the franchisor was bringing the outlet in house) in which case the royalty rate would not need to increase at all.

Retrospectivity

67. All of the foregoing analysis is (implicitly) in terms of new franchise agreements that might be entered into in the future. It may also be possible to apply the same types of provisions to existing franchise agreements. One argument against this is that it would involve an element of retrospectivity – a change to legislation (the Code) would have the effect of altering the terms of a contract that has been made between the parties and which is already on foot.

68. One key consideration in this regard is the extent to which application of these provisions would have a substantial economic impact on franchise contracts that are already on foot. Here the argument is that two parties have agreed on terms and put a contract in place. If some of the

terms of that bargain are effectively changed exogenously, the economic position of each of the parties is also changed. In particular, franchisors might make the argument that they would have applied a higher royalty rate (or changed some other terms in the contract) if they had known that good cause and/or fair value terms were to be imposed on the bargain. Indeed, it is quite feasible that some terms in the franchise contract would change, depending on whether or not the contract operated under good cause and fair value terms. The key policy consideration is which terms are likely to change and by how much they might change.

69. The example in Paragraph 66 shows that the changes to royalty rates that are required to offset the expected costs associated with non-renewal are likely to be relatively small. Of course this is a simple stylized example, and a more comprehensive empirical and survey analysis would assist in more precisely quantifying this effect.

70. The break-even royalty rate would be much higher in the case where the probability of non-renewal was much higher than is assumed in the example above. In the case where the franchisor does not intend to renew, even at the time of entering the contract, there is a 100% probability of having to pay the fair value amount (unless good cause can be established) and the breakeven royalty rate will be higher. Presumably this would signal the franchisor's intention to the franchisee and the initial bargain would never be struck.

71. That is, to the extent that the "retrospective" terms apply only to cases of franchisor opportunism, and to the extent that this occurs only rarely, the overall economic effect of the proposed terms is small. For an individual franchise agreement, there is a low probability of franchisor opportunism requiring the application of these terms at the end of the contract period. This can be established by empirical evidence on the frequency with which franchise agreements are renewed at the end of the contract period. More comprehensive empirical analysis along these lines might be useful in quantifying the historical and perceived probabilities of renewal.

72. In summary, the key policy consideration on this point is the trade-off between economic efficiency and equity considerations on the one hand, and the effects of "retrospectivity" in terms of applying new terms to existing contracts, on the other. Retrospectivity may have symbolic or reputation effects for a policy-maker, but for the reasons explained above, the overall economic impact of the application of these terms is likely to be relatively small. This is because the terms in questions are effectively irrelevant to the great majority of cases in which an expiring franchise agreement is renewed.

8. Financing implications

73. Another aspect of franchising that may be affected by good cause and fair value provisions is the form of finance available to franchisees. The present situation is that the standard franchise contract and the relevant legislation contain no provision about the renewal of the agreement (e.g., a good cause provision) or about the terms under which the franchisor can elect to end the relationship with the franchisee (e.g., a fair value provision). In this case, lenders will be highly unlikely to consider a loan that continues past the end of the contract. In these circumstances it is highly likely that the lender would require that the principal of the loan and interest be repaid in full by the end of the contract term.

74. Under good cause and fair value provisions, there is a reduced likelihood of the franchisee's income stream being eliminated at the end of the franchise period. Other things equal, this would reduce the risk to a lender. It is possible that some lenders may extend the term of financing for franchisees operating under these provisions. (The extent to which more flexible financing arrangements might be forthcoming may be the subject of further investigation.) More flexible financing arrangements would be of benefit to franchisees and also to franchisors – as it would assist in widening the pool of potential franchisees.

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Appendix: Business Valuation Framework

Discounted Cash Flow Valuation

75. It is common to value going concern businesses using the *discounted cash flow* technique. This involves forecasting the expected future net cash flows of the business and discounting them back to their equivalent present value, which is known as the *net present value*. The idea is that an investor would then be indifferent between receiving that cash flow stream over time or receiving the net present value as a single immediate payment.

76. The rate at which these cash flows are discounted to a present value is known as the *discount rate* or *required return*. This reflects the time value of money and any premium that investors would require to compensate them for bearing the risk of the particular business.

77. Consider, for example, a business that is expected to generate a net cash flow of $100 per year for the next three years, and then cease to operate. If investors required a 10% p.a. return from this business, the net present value of the business would be computed as:

$$\begin{aligned} Value &= \frac{100}{(1.1)^1} + \frac{100}{(1.1)^2} + \frac{100}{(1.1)^3} \\ &= 249 \end{aligned}$$

78. This implies that investors would be indifferent between owning the business and receiving an expected cash flow of $100 per year for three years or receiving an immediate lump sum payment of $249. Alternatively, the expected cash flows of $100 per year are sufficient to provide an expected return of 10% p.a. on an investment of $249.

79. This same valuation framework can be applied to a business that is expected to continue to operate into the indefinite future. In this case, rather than individually add the present values of a very long series of expected future cash flows, it is standard practice to make some simplifying assumptions so that the present value of the infinite series can be computed via a simple mathematical formula.

80. It is most common to assume that the future cash flows will grow at a constant rate in perpetuity. In this case, the present value of the infinite series of expected future cash flows is given as:

$$Value = \frac{CF_1}{r-g}$$

where CF_1 is the first cash flow in the series, r is the return required by investors, and g is the rate at which the cash flows are expected to grow in the future.

81. By way of example, if a business is expected to generate a net cash flow of $100 next year, cash flows are expected to grow at 4% p.a. indefinitely, and investors require a return of 10 % p.a., the value of the business could be computed as:

$$Value = \frac{100}{0.10-0.04} = 1{,}667.$$

Multiples Valuation

82. The *multiples valuation* approach is related to the discounted cash flow approach that is outlined above. Practitioners will often value a business by applying a multiple to the present (or forecast) earnings of a business. For example, a particular type of business may be said to *trade at 10 times earnings*. A simple way of valuing that type of business is to multiply the earnings of that business by 10.

83. Different types of businesses will trade at different multiples and the multiple applied to a particular business will tend to vary over time. This is because the multiple reflects investors' views about the required return and the growth prospects of the firm. To see this, note that we can express the "infinite growth" valuation formula above as:

$$Value = 100 \times \frac{1}{0.10 - 0.04} = 100 \times 16.67 = 1{,}667.$$

84. That is, the multiple in this case is 16.67, which is clearly a function of the required return and the expected growth prospects of the firm. Since different firms will have different risks (and consequently different required returns) and different growth prospects, they will trade at different multiples of earnings. Those firms with less risk and higher growth prospects tend to trade at higher multiples.

85. The multiples valuation technique is usually applied by examining comparable firms that are listed on the stock exchange – because there are continuous prices available for these firms. The approach is to select a set of comparables and to examine their earnings multiples (current price divided by earnings).

86. It is important to note in the present context that the multiples valuation approach really only applies when the firm is expected to generate cash flows indefinitely. If, for example, a firm was expected to generate cash flows for the next three years and then cease to exist, the multiples valuation framework would not apply. To use the multiples approach would require the analyst to identify a reasonable set of comparable listed firms that also intended to operate only for three years and then cease trading. It is highly unlikely that one could find any comparable firms that are listed and which intend to cease trading after exactly three years.

87. For this reason, businesses with relatively short finite lives would not be valued using a multiples approach, but rather would be valued using a discounted cash flow approach.

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- **Capital management and optimal capital structure**
  - ⇒ **State-owned electricity generator:** Built detailed financial model to analyze effects of increased leverage on cost of capital, entity value, credit rating, and stability of dividends. Debt of $500 million issued.

- **Cost of capital**
  - ⇒ **Cost of Capital in the Public Sector:** Provided advice to a government enterprise on how to estimate an appropriate cost of capital and benchmark return for Government-owned enterprises. Appearance as **expert witness** in legal proceedings that followed a regulatory determination.
  - ⇒ **Expert Witness:** Produced a written report and provided court testimony on issues relating to the cost of capital of a cable TV business.
  - ⇒ **Regulatory Cost of Capital:** Extensive work for regulators and regulated entities on all matters relating to estimation of weighted-average cost of capital.

- **Valuation**
  - ⇒ **Expert Witness:** Produced a written report and provided court testimony. The issue was whether, during a takeover offer, the shares of the bidding firm were affected by a liquidity premium due to its incorporation in the major stock market index.
  - ⇒ **Expert Witness:** Produced a written report and provided court testimony in relation to valuation issues involving an integrated mine and refinery.

- **Capital Raising**

⇒ Produced comprehensive valuation models in the context of capital raisings for a range of businesses in a range of industries including manufacturing, film production, and biotechnology.

- **Asset pricing and empirical finance**
  - ⇒ **Expert Witness:** Produced a written report on whether the client's arbitrage-driven trading strategy caused undue movements in the prices of certain shares.

- **Application of econometric techniques to applied problems in finance**
  - ⇒ **Debt Structure Review:** Provided advice to a large City Council on restructuring their debt portfolio. The issues involved optimisation of a range of performance measures for each business unit in the Council while simultaneously minimizing the volatility of the Council's equity in each business unit.
  - ⇒ **Superannuation Fund Performance Benchmarking:** Conducted an analysis of the techniques used by a large superannuation fund to benchmark its performance against competing funds.

- **Valuation of derivative securities**
  - ⇒ **Stochastic Volatility Models in Interest Rate Futures Markets:** Estimated and implemented a number of models designed to predict volatility in interest rate futures markets.

- **Application of option-pricing techniques to real project evaluation**
  - ⇒ **Real Option Valuation:** Developed a framework for valuing an option on a large office building. Acted as arbitrator between the various parties involved and reached a consensus valuation.
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