



Yum! Restaurants Australia Pty Limited ABN 16 000 674 993
Kentucky Fried Chicken Pty Limited ABN 79 000 587 780
20 Rodborough Road (Locked Bag 522)
Frenchs Forest NSW 2086 Australia
Tel (612) 9930 3092 Fax (612) 9930 3097

LEGAL DEPARTMENT

Geoff Dawson
Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Dear Member of the Committee,

Re: Inquiry into the operation of the Franchising Code of Conduct.

We are writing in response to your call for submissions to this Inquiry.

We understand that the purpose of the Inquiry is to look at the operation of the Franchising Code of Conduct, in particular:

- Franchisor and Franchisee relationships.
- Good faith being incorporated into the Code.
- Unconscionable conduct.
- Dispute resolution.
- Other related matters.

1. Executive Summary

- Yum! Restaurants Australia Group (YRA) is the reputable franchisor some of the longest running food franchises in Australia, KFC and Pizza Hut.
- The Yum! systems and brands have been established over 50 years of global operations. KFC and Pizza Hut are among the world's longest running and most respected franchise systems, being started in 1952 and 1958 respectively. The first KFC store in Australia was launched in 1968, the first Pizza Hut store in 1970, making them the longest-running food franchises in Australia.
- The franchisor in YRA's system is responsible for managing the system and the brand, and as such generates substantially all of the goodwill and other intangible property rights.
- Franchisees obtain the right for a fixed period to use the brand and system and generate a return on their investment. They retain the physical assets of the business at the conclusion of the agreement, but not the right to use the brand and system.
- YRA has been accused of opportunism by its franchisee [REDACTED], as result of YRA's decision to allow its franchise agreements with [REDACTED] to expire. These allegations are unsupported by the facts. [REDACTED] has had or will have twenty years in which to recoup its investment on each of its KFC stores. It is a large business which understands the contracts it enters into. It is seeking a windfall that it has not contracted for.



- The franchise relationship is regulated by a number of factors, including the contract, so that there is a much more even distribution of power between franchisor or franchisee than is suggested from the agreement alone.
- If further regulation of franchising is deemed necessary, YRA favours regulation that:
 - encourages franchisees to understand the risks and rewards of franchising, prior to entering into agreements;
 - encourages the franchisor-franchisee relationship to be conducted honestly and reasonably;
 - is certain and does not unduly interfere with the right of the parties to achieve the anticipated return they have agreed to.
- Regulation of the end of contract, particularly through mandatory assignment of goodwill or compulsory rights of renewal. will retrospectively re-price contracts. Franchisors such as YRA would respond to this by reviewing the fees that they charge, opening more stores on their own account and diverting investment to less unfavourably regulated jurisdictions.
- Experience in the few jurisdictions that have adopted such regulation, shows that investment has decreased.
- While YRA does not condone franchisors that act opportunistically, the statistics show that such an event is rare, highlighting that opportunism is inconsistent with running a successful franchise system over the course of time.

2. Background

Yum! Restaurants Australia Group (YRA) is the licensee of the trade marks and systems behind KFC and Pizza Hut in Australia. YRA is a group subsidiary of Yum! Brands Inc (Yum!), the world's largest restaurant company.

The Yum! systems and brands have been established over 50 years of global operations. KFC and Pizza Hut are among the world's longest running and most respected franchise systems, being started in 1952 and 1958 respectively. The first KFC store in Australia was launched in 1968, the first Pizza Hut store in 1970, making them the longest-running food franchises in Australia.

There are currently approximately 280 Pizza Hut and 560 KFC restaurants in Australia, making it one of the largest franchise systems in this country. The majority of the restaurants in Australia are operated by franchisees, with YRA owning approximately 20% of the system.

Globally Yum! is responsible for the employment of over 1 million people in 35,000 restaurants in more than 110 countries, and is one of the biggest employers in the world.

In Australia, YRA and its franchisees employ over 30,000 people, making the KFC and Pizza Hut franchise systems substantial creators of jobs and wealth in this country.

As with all businesses, ours is cyclical, enjoying periods of prosperity and challenge. However, over the course of the systems' operation in Australia, the businesses have generated substantial wealth and employment, not just for YRA and its employees but for its franchisees and suppliers. This is a testament to our business model's fundamental effectiveness.

3. The Nature of Franchising

We understand that the Committee is interested in the nature of the franchising industry and the rights of franchisors and franchisees.

At the outset it is important to note that franchising is probably better understood as a business concept, rather than an industry. The business concept operates across many different types of industry and takes multiple forms.

This needs to be taken into account when assessing the information provided to the Committee. It will often be the case that the problems and solutions that appear appropriate to one type of arrangement will be inappropriate to another.

Successful franchise systems strike a balance between rewarding the efforts of the franchisor and those of the franchisee. In essence the respective roles are:

- **The Franchisor creates and manages the brand and the system, to ensure consistency of product and/or service.**
- **The Franchisee pays fees and royalties to acquire a licence to use the system and the brands for a fixed period of time.**

The arrangements between franchisor and franchisee provide both parties with a basis upon which, if the business succeeds, a strong return may be generated over a fixed period.

One of the hallmarks of a great franchise system is that there is a close, productive relationship between franchisor and franchisee, each party playing an important role for mutual benefit.

YRA has a reputation as a quality franchisor, built up over many years of operation in Australia. YRA hopes that, in explaining how it operates, it will help the Committee as it forms a view on the roles of franchisors and franchisees.

3.1 Our Role as Franchisor of KFC and Pizza Hut

As franchisor of the KFC and Pizza Hut systems, YRA invests considerable capital, time and human resources into developing its brands and franchise systems in Australia.

YRA currently employs over 200 people in its Australian Restaurant Support Centre (RSC). The RSC is a hub of innovation, best-practice, market insights and knowledge sharing for both systems. These activities are a fundamental pillar of the successful operation of the business.

YRA supports franchisees to achieve success through the following activities:

- Human Resources:
 - Providing comprehensive, best-in-class training.
 - Maintaining a Registered Training Organisation.
 - Providing effective OHS systems.
 - Developing world-leading talent management and development programs.
- Research and Development:
 - New product development.
 - Devising nutritional improvements and better-for-you products.
 - Process and technical design and improvements.

- Marketing:
 - Consumer insights.
 - Brand strategy.
 - Brand positioning.
 - Marketing.
 - Promotional campaigns.
 - Pricing.
- Property Development:
 - Defining and sharing insights into positioning and appearance of stores.
 - Identifying potential store sites.
- Supply chain:
 - Ensuring adequacy of supply.
 - Negotiating favourable pricing.
 - Supply forecasting.
 - Warehousing and logistics.
- Operations:
 - Providing in-field business support and coaching to franchisees.
 - Creating best practice operating protocols.
 - Administering world-class Recognition and Reward schemes.
- Finance and Administration:
 - Financial analysis and reporting.
 - Reviewing IT solutions.
 - Managing system compliance and risk.
 - Monitoring and responding to regulatory and issues.

As a result of its performance, YRA has become an exporter of product innovation, knowledge, talent and systems. Its former senior executives fill key positions in Yum!'s global business.

Franchise systems are only as strong as their brand. Yum! invests heavily in its trade marks, systems and image. YRA actively takes steps to preserve and enhance the brand. This can include taking steps to prevent non-compliant franchisees from damaging the brand to the detriment of the franchise system as a whole.

Through our actions, YRA creates enormous value, including substantially all of the intangible property- intellectual property rights, reputation, know-how and goodwill- in the system.

3.2 The Role of our Franchisees

YRA would like to take this opportunity to recognise the contribution of our franchisees to our systems. Their energy, industry and willingness to invest in their businesses are critical to the ongoing success of the systems.

In essence, our franchisees act as independent operators of our systems. When they enter into a franchise agreement with YRA, our franchisees pay for the licence to use, for a fixed period in an assigned location, our system and intangible property.

Over a period of up to 20 years, they have the ability to generate a reasonable, and we hope, exceptional, return on their investment.

The main role of the franchisee is not to systematically improve the entire system, protect the brand and create intellectual and other proprietary information. It is to execute at a local level,

in accordance with the broader system standards created and managed by YRA and its global parent.

3.3 The Franchising Agreement

The relationship between YRA and our franchisees is formally underpinned by a written contract. This contract frames the parties' rights and duties. The essence of this contract is as follows:

- A fixed license for the franchisee to use YRA's brands and systems.
- A minimum term of 10 years.
- A right of renewal for a further 10 years, subject to certain minimum conditions being met.
- A maximum contract length of 20 years.
- Payment of a fixed fee on entry into an agreement and another, smaller fee, on renewal at 10 years.
- Payment of an ongoing royalty based on a percentage of gross turnover.
- Payment of an amount based on a percentage of gross turnover into an advertising co-operative, jointly managed by YRA and the franchisees.
- An obligation to periodically upgrade stores.
- Compliance with minimum standards of product and service, which are set out in our Operations Manuals.

The terms of this arrangement are clear to both parties. YRA's disclosure document, which complies with the Federal Franchising Code of Conduct (the Code), sets out the relevant points. In compliance with the Code, franchisees are encouraged to seek independent legal and commercial advice.

YRA consciously strives to ensure that its contracts are consistent among franchisees. This reduces administrative complexity and manages risk, while providing a level playing field among all of our franchise partners.

The agreements have been shown to be capable of providing both parties with a satisfactory return on investment, allowing our franchisees to recoup their investment in the physical assets and people, and allowing YRA to grow, manage and protect its brand and system.

3.4 Beyond the Franchising Contract: Self-Regulatory Factors

The franchise agreement forms a backstop for the rights of the parties. In practice, it is rarely resorted to. This is largely because of the powerful self-regulating factors that operate.

While it is true that our franchise agreements place significant rights in the hands of YRA, franchisees also have power. This goes beyond their rights under contract and results from:

- holding an agreement that entitles them to operate the franchise for up to twenty years;
- controlling the stores and physical assets- the store location, equipment, lease etc;
- controlling the employees who run the store, through whom new initiatives will be implemented;
- participating in forums and having voting rights on the allocation of marketing funds and other matters; and
- having access to capital.

It would be rare for YRA to make unilateral changes to its policies and procedures. It goes through a process of education, persuasion, discussion and negotiation with its franchisees. It is with their agreement that we implement major initiatives and grow the systems.

The relationship between franchisor and franchisee is intended to continue for many years. It relies on co-operation, trust, and mutual respect. While it is inevitable that the parties will have their differences during the course of a long term agreement, it is vital to the ongoing success of the system that the parties are able to work through these issues and maintain an effective working relationship.

3.5 The Identity of Franchisors and Franchisees

The standard view of franchising appears to be that franchisors are large business, run by commercially sophisticated corporations and franchisees are small businesses, run by commercially naive individuals. While YRA is part of a very large global organisation, our franchisees are by no means all "small businesses".

The KFC and Pizza Hut systems encompass a range of different franchisees. At one end of the spectrum, there are "corporate franchisees" owning 40 plus stores. These businesses are large by Australian standards, with annual turnovers in excess of AUD\$100 million. They are run by experienced, competent executives and have access to quality external advisors.

At the other end of the spectrum is the one- and two- store franchisee. These franchisees have varied backgrounds, but are assessed for their business acumen. If anything, the benefits of YRA's expertise, insights and know-how are more valuable in the hands of franchisees of fewer stores than the larger businesses described above.

3.6 YRAs Attitude to Regulation

YRA is supportive of sensible regulation of franchising. YRA supports regulation that:

- is certain;
- prevents clearly abhorrent or unethical behaviour;
- ensures both parties have a clear view of the risks and rewards of the agreement prior to entering into it; and
- obligates the parties to act honestly and reasonably in their dealings with one another.

YRA would not support regulation that:

- creates unnecessary administrative costs;
- unduly interferes with the rights of the parties to enter into and rely upon commercial contracts;
- compels the parties to remain in business with one another should they not wish to do so at the conclusion of the agreement;
- makes franchising commercially disadvantageous relative to other forms of comparable business arrangements; and
- makes Australia a less attractive investment option by fundamentally changing the balance of return in our franchising arrangements.

Given that franchising is such a success story in Australia, outpacing the growth of other forms of business arrangements, YRA believes that regulation should be cautious and steer well clear of imposing fundamental alterations to the basic rights of the parties.

The thrust of regulatory intervention to date has been prior to the agreement. This remains the most equitable approach for both parties.

YRA has no desire to gloss over the risks of franchising. We seek commercially aware, committed franchisees, who understand both the risks and rewards of the arrangements they enter into.

We address some specific regulatory options that the Committee may choose to consider below.

a) The Obligation to Act in Good Faith

As a long-standing, reputable franchise operator we wish to distance ourselves from any businesses which act in bad faith, or unconscionably.

The failure of a franchise is tragic in any circumstances, but where it is not the consequence of ordinary commercial risks but rather unethical commercial practices we have no hesitation in condemning it.

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.

The principal criteria YRA would place upon a legislative concept of good faith is that it must be sufficiently certain and it must not unduly interfere with the contractual rights of the parties. These are not inconsiderable hurdles to overcome.

Broadly speaking, YRA believes good faith means acting honestly and reasonably during the course of the relationship. YRA would expect nothing less of its employees and officers. Beyond this, it is not an easy concept to define without risky imposition upon the ordinary operation of business in a market-based economy.

We see two legislative alternatives:

- **A general statutory duty to act in good faith:** This would confirm that good faith is imported into franchise arrangements, but would not otherwise remove uncertainty as to its meaning. However, it would allow the concept to develop organically and incrementally, based on actual, rather than hypothetical scenarios.
- **An express and enumerated set of factors that would indicate what is (and isn't) a lack of good faith.** This would potentially provide more certainty, though much would depend on the factors ultimately chosen and whether they were proscriptive factors, or whether they provided a framework for discretionary decision-making.

YRA is happy to be an active participant in the development of policy in this area and feels it has much to offer as an experienced and reputable franchisor.

(b) Good faith and "franchisor churning"

A lot of attention has been given to the potential for franchisors to engage in the practice of "churning".

Churning as we understand it occurs where a franchisor terminates a franchise agreement before there is adequate time to recoup the franchisee's initial investment and despite meeting acceptable performance standards.

This would occur as a consequence of either a termination on non-material grounds or the contractual term being too short (this latter seeming to us to be a matter for pre-contractual disclosure and education).

The presumed benefit for the franchisor is that either it obtains the capital investment of the franchisee at reduced or no cost, and/or that it obtains new fees from the incoming franchisee.

In YRA's system, churning is completely against our interest.

Firstly, YRA's contracts are for an initial term of 10 years, with a right of renewal for a further 10 years. This is an exceptionally long arrangement in comparison to other forms of licence arrangement, such as leasing, and it provides ample time to recoup any capital investment and costs.

YRA also puts an enormous amount of time, cost and energy into sourcing potential franchisees. Franchisees are required to meet a number of criteria including business acumen, system knowledge, operational capability and financial capability.

YRA does this because the costs to it associated with an unsuccessful franchise operation, including loss of royalties, costs of sourcing a new franchisee and the diminishment of the system arising from a bad franchise, far outweigh any fees that might be generated.

It is just not in YRA's interests to remove a successful franchisee or install commercially naïve franchisees with little prospect of success. We believe that any franchisor with a track record of success would agree.

(c) Good Faith and End of Term Arrangements

A high profile issue in franchising, and a proximate cause of much of the recent legislative interest in the area, has been the so-called 'dispute' between YRA and one of its franchisees, [REDACTED].

YRA has been the subject of various accusations by [REDACTED] regarding its conduct in this matter, including that it has bullied, churned and acted opportunistically¹. These claims are completely unsupported by the facts.

YRA has not chosen to air its grievances in public, preferring to work constructively toward negotiating the transfer of [REDACTED] remaining franchises. This should not be misinterpreted as meaning that YRA has acted in a manner that is in any way inappropriate.

¹Mike Preston, Smart Company, 29 April 2008 who quotes a [REDACTED] spokesperson, [REDACTED] "the bullying tactics of a multinational taking over an Australian business without any reference to the value of goodwill established over 30 years of operation". Le Mesurier. Sydney Morning Herald. "Franchisees Call for Code Change" February 5 2008

The situation is absolutely regrettable, but it is and always has been a commercial issue caused by YRA's determination not to enter into further long term relationships with [REDACTED], and [REDACTED] desire to achieve a higher price than that initially offered by YRA for its businesses.

YRA believes that the facts speak for themselves:

- **[REDACTED] is a large business, with access to the best advisors.** [REDACTED] is the franchisee of over 40 stores in the KFC system in Western Australia. It has multiple business interests, including being the franchisor of Hungry Jacks in Australia. Its reported turnover in 2006 was around \$700 million, making it one of Australia's larger privately held businesses. [REDACTED] has access to quality legal advice and can be assumed to have a full understanding of the contractual arrangements that it enters into. [REDACTED] knew when it entered into its KFC franchise agreements that they were fixed term contracts, which assigned whatever incidental goodwill [REDACTED] generated during the term to YRA.
- **[REDACTED] has achieved an exceptional return on investment over a long period of operation of its KFC franchises.** The extraordinary wealth accumulated by [REDACTED] and its principal from its KFC businesses speaks volumes for the capacity of the system to generate exceptional returns for its investors. [REDACTED] has had 20 years in which to recoup its investment from its last franchise agreement for Rockingham. This can be assumed to have more than covered its input costs, in terms of people and assets. [REDACTED] plea for regulatory intervention if successful would compensate it for something that it did not bargain for, and was not priced into the agreement.
- **The relationship between [REDACTED] and YRA has completely disintegrated, due to a lack of trust.** There are a number of issues which have, over the course of the past decade, led to this outcome. YRA has chosen not to respond to the baseless and harmful accusations regarding its conduct because it sees no reason to. It has compelling, clear and cogent reasons for wanting to move on and [REDACTED] is aware of these reasons.
- **The expiry of the stores was certain, orderly, and predictable.** There can be no suggestion that [REDACTED] was not aware that its agreement would expire at the conclusion of the term. It was notified in 2003 (the first agreement in Rockingham expired at the end of 2007) by YRA that it would be not be offered new agreements.
- **Despite ample opportunity, [REDACTED] has not sold its stores to a suitable franchisee or YRA:** YRA notified [REDACTED] that it should negotiate the transfer of its WA KFC businesses to a suitable third party, prior to [REDACTED] requesting that YRA make an offer for those businesses. To our knowledge, apart from publicly rejecting YRA's offer, [REDACTED] has not counter-offered or solicited alternative offers, despite the four years notice it has had.
- **[REDACTED] has not demonstrated that YRA's initial offer was under market value.** YRA made a very substantial offer for [REDACTED]s businesses, which it believes was within the range of other offers made in franchisee-to-franchisee transactions. It is not rare that a buyer of a business (or any other asset) believes it is worth less than the seller. It has not had a counter-offer from [REDACTED]. Instead [REDACTED] has publicly speculated that YRA's offer has not compensated it for goodwill, which it was not entitled to in the first place.

- [REDACTED] has retained the physical assets at its Rockingham stores, and will do so over other stores should they expire: While [REDACTED] is not licensed to run a KFC at this store, it retains the leasehold and the tangible assets in the store.
- YRA has purchased land with a view to investing in its own store in Rockingham. YRA has, at significant cost, sourced an alternative site in Rockingham. We bear the same costs as a franchisee in starting up this store. We have done so because we share the local community's desire to have a KFC store in Rockingham. It is not possible to see how this takes advantage of [REDACTED].
- [REDACTED]'s situation is unique: This is the first instance in which YRA has been unable to deal with the expiry of a contract either by offering a new contract, acquiring the store or facilitating a transfer to a third party. This says much about the special circumstances of this situation.
- The relational nature of franchising supports the importance of the relationship. The point has often been made that franchise relationships are unique given their interdependent and relational nature. This only emphasises the importance of a good relationship, based on trust and mutual co-operation. The relationship between [REDACTED] and its principal and YRA bears none of these hallmarks. It would be commercially folly to continue the relationship on this basis, and bad policy to compel the parties to do so.

Collectively these facts demonstrate that YRA has not acted opportunistically, unethically or unfairly, let alone unlawfully. We quote an exchange from the recent South Australian Franchising Inquiry (the SA Inquiry) between Mr Bignell MP and Professor Andrew Terry, Head of Business Law and Taxation at the University of NSW, which is on point:

“Mr Bignell:

From what we could see they [YRA] were obviously doing the wrong thing by the franchisor [sic], but that appeared to be some churning or other reason to get these people out and get fresh people in a few hundred yards up the road

Professor Terry:

“I do not think “churning” is the right word. If people have had a 20-year term, that is certainly not a case of churning..... In a 20 year agreement, the franchisee whether big or small has had a very big opportunity to capitalize on investment”²

[REDACTED] has argued that a statutory concept of good faith should preclude expiry of a franchise agreement without 'good cause'. This is not an issue of good faith at all. Any contract can be terminated for good cause, namely breach of contract. This argument should be exposed for what it is- an argument that franchise agreements should be perpetual.

If good faith took on the meaning suggested, it would create considerable uncertainty, make franchising unattractive relative to other business models and would provide franchisees with a windfall that is not priced into their agreement.

YRA would need to consider a range of responses to this including:

² Sixty Fifth Report of the Economic and Finance Committee, Tabled 6 May 2008. (the SA Inquiry) p68.

- Increasing the continuing or initial fees charged, to offset the lost return as a result of the statutory right.
- Creating a much more proscriptive and inflexible contract and manage performance against it tightly, as termination would be the only available remedy for removing poor to average franchisees.
- Operating our own stores, rather than offer opportunities to franchisees, meaning wealth was less broadly shared and there was less capital available for innovation and training.
- Yum! globally would invest funds in jurisdictions where it was not subject to an unfavourable regulatory regime, leading to a decline in wealth and employment generated by the system in this country.

Based on our research of foreign jurisdictions, it has been demonstrated that there are negative economic consequences of overly restrictive regulation in this area of franchising. Past studies indicate that laws that restrict a franchisor's right to terminate or decision not to grant a new franchise agreement increase risks and costs to a franchisor, which must be factored into its pricing.³ In Iowa, one of the few jurisdictions in the world to adopt a mandatory right of renewal at expiry of franchise agreements, the Iowa Coalition for Responsible Franchising noted⁴ that two years after Iowa had passed its restrictive laws governing franchise relationships:

- 133 franchisors had reduced or halted their expansion in Iowa or had stated that they would not franchise in Iowa until the law was repealed or reformed;
- plans for at least 430 store locations in Iowa were cancelled as a result;
- this would have resulted in over 7,000 jobs not being created in Iowa without considering the impact on local suppliers, property developers and construction companies;
- since 97% of franchisees regularly renew their franchise agreements, the non-renewal law was promoting lawsuits, rather than good business practice; and
- 27 US States had subsequently rejected franchise relationship legislation.

The right of the parties to allow franchise agreements to expire on their plain terms and conditions is absolutely vital to the ongoing success of the system. Expiry of the agreement is an important security against the progressive diminishment of our brand and system.

(d) Good Faith vs Good Cause

It has been argued that the ability to terminate an agreement for breach should be sufficient to protect against non-performance.

This argument has a number of shortcomings, namely:

- Relying only upon breach would promote a relationship that focused on compliance and minimum standards, rather than best practice, innovation and growth.

³ Brickley, Misra and Lawrence Van Horn, at p.12

⁴ Iowa Franchise Report 1995, The Iowa Coalition for Responsible Franchising (January 1995)

- It is rarely commercially in the interests of the franchisor to terminate for breach. The costs of getting a new franchisee in place are enormous and substantially outweigh any perceived benefits that would be gained from terminating unless there is a serious default.
- There are enormous risks for the franchisor associated with wrongfully terminating a long term contract.

(e) Good Faith vs Good Will

Under YRA's system, goodwill in the business is assigned to YRA clearly and unambiguously under our franchise agreement. This is appropriate to our system as YRA's activities generate the majority of the intangible rights in the system. In her submissions to the SA Inquiry, Buchan⁵ made a distinction between three types of goodwill:

- Brand;
- Site; and
- Personal.

In our system, brand goodwill represents all of the significant goodwill in the business. The overwhelming majority of consumers choose to eat KFC or Pizza Hut because of the brand. They are largely unaware of the identity of the Franchisee. They do not distinguish between sites to any appreciable degree.

We understand that past Inquiries have looked at and dispensed with the notion of mandatory goodwill. The 1986 Review noted the difficulties with this, concluding that:

"it is not desirable (even if possible) to make provision by legislation for an apportionment of goodwill on termination of a franchise agreement and the Franchisee should be cognizant from entering an agreement of the possibility/likelihood that they will not be compensated upon termination for goodwill built up by them".⁶

It is not possible to measure the respective contributions of a franchisee and a franchisor in any single context, let alone across different contexts and industries.⁷

In the case of [REDACTED], it has argued that YRA ought to recognise "franchisee goodwill" in its Western Australian stores⁸. It would be completely uncommercial and inappropriate for YRA to do so.

Its contracts do not entitle it to any goodwill, it has not paid for any goodwill, and it has enjoyed the benefit of using YRA's system and brands to generate extraordinary wealth for twenty years without complaint about this aspect of the contract. It is far too late for [REDACTED] to complain about this element of the agreement now.

(f) Should there be a Right of Renewal?

⁵ SA Inquiry p 71

⁶ *Attorney-General's Franchising Review Consultative Paper, at paragraph 29*

⁷ Pengilly, W, "Franchising: the present law and the likely impact of Franchising Legislation" (1983) 11 ALR 327 at p.35

⁸ Michael Pelty "Burger King Pushes for Franchisee Claus" *The Australian*, May 13 2008; Committee Hansard 5 March 2008, p 86.

One proposal for overcoming the inherent uncertainty of valuing goodwill is to provide the franchisee with an automatic "right of renewal" at the end of the term⁹. At the outset, we would point out that a right of renewal is an option for further term, which is granted expressly in the franchise agreement. The request for a "right of renewal" is really a request for a mandatory new contract upon expiry of the term of the first agreement, regardless of the original intent of the parties.

The proponents of the "right of renewal" support it on the basis that it creates the incentive for the parties to negotiate the sale of the business¹⁰.

The right of renewal argument suffers from a number of problems. First, it addresses an essentially non-existent problem. The current situation is that the parties already negotiate in advance of the expiry of the Agreement the disposal of the franchisee's assets, and usually do so successfully.

A right of renewal does nothing to remove uncertainty. At best, it creates another, worse type of uncertainty- that of an indefinite agreement.

It is not clear why this right would be selected in preference to any of a number of other potential rights and remedies.

To the extent there is any inequity or unfairness, which for reasons outlined above we deny exists, a right of renewal is an absolutely disproportionate means to redress it. It is outweighed by the unfairness that will follow from the legislative denial of the franchisor's basic right to fix a maximum contractual term.

(g) Commercial and best practice at end of agreements

The reality is that there are powerful commercial factors that drive franchisors to provide clarity around end of term arrangements.

Franchisees need to know well in advance what the intentions of the franchisor are, and what conditions will be attached to any new contract. Without this they cannot be expected to invest in their businesses.

In the absence of this, franchisees will, presumably, depreciate their physical assets for the remainder of the contractual period. This in turn has a negative impact on the system and franchisor's income stream.

On expiry, the franchisee holds onto the physical assets. If the store is not in operation, the franchisor gets no income from the use of the system. It is difficult to see how this is in the interests of the franchisor.

YRA informs franchisees of its intentions regarding the relationship well in advance of expiry. In ██████████' case this was 4 years prior to the expiry of its first agreement.

⁹Castle TD, Steggall Z, Terry A, ██████████ - Submission to the Productivity Commission Inquiry Into the Market for Retail Tenancy Leases in Australia" (██████████ Submission) at p24

¹⁰██████████ at p20

If we do not intend to continue the relationship, this gives the franchisee the opportunity to sell their business to YRA or another party. In accordance with the Code, YRA would not unreasonably withhold its consent to the transfer for its own benefit.

This approach provides certainty for both parties, and the opportunity for our franchisees to either continue in the business or dispose of their assets in an orderly manner. It is a practice which has evolved for sensible commercial reasons, not regulatory intervention.

(g) An Appropriate Regulatory Response

It is technically possible for franchisors to allow agreements to expire, and not provide further agreements. Statistically, it rarely happens. It is even less likely that it will be in the interests of a franchisor to act opportunistically, churning through franchisees to obtain some short term benefit. In the long term, these businesses would have no ability to attract good franchisees.

YRA has offered its experiences as a demonstration of why it believes statistically this is not a large issue, namely powerful self-regulatory forces flowing from the financial and commercial factors at play.

Any regulation which had the effect of reapportioning the investment, or interfering with the basic right of the parties to enter into a fixed term contract would be disproportionate to the possible issues. It would also result in a number of detrimental economic effects, which we've outlined above.

YRA believes that the fairest and most equitable solution is to ensure that franchisees are fully aware of the risks of entering into franchise agreements. This would take the form of:

- Education and notification of potential franchisees regarding the risks of franchising, including that it is fixed term license to use a system.
- Education and notification of potential franchisees that they need to plan to obtain a return on investment over the stated life of the contract, not beyond it.

YRA is also of the view that franchisors and franchisees ought to provide reasonable notice to each other if they do not intend to enter into new agreements on expiry. Given that the length of franchise agreements varies, it is unlikely that a minimum notice period could be crafted, but, to ensure there is certainty, a period of notice (ie 12 months) which is deemed reasonable, might be considered.

(h) Should the unconscionable conduct provisions be extended to merely "unfair" conduct?

As noted above, YRA believes it is not the role of the legislation to mandate good or best business practice. Business is a tough environment. All parties to business need to make decisions which may be to the detriment of one party but not the other. In a franchising context, franchisors make decisions not just in their own interest but in the interest of their system as a whole. Often they will need to make decisions to the benefit of other franchisees which may be to the detriment of one. In a business setting, things can and do happen which may seem "unfair" from one person's perspective but which clearly are not fraudulent, abhorrent or beyond all good conscience. Any attempt to prevent businesses from exercising their business

judgment within these bounds would be inappropriate and could seriously impact the development of the industry in question.

Section 51AC was included in the *Trade Practices Act* in 1988 to assist small businesses in their business dealings with larger businesses, such as is the case with franchising. Sub-section 51AC is routinely used by the ACCC in legal proceedings, including against franchisors.¹¹ Case law is growing and evolving its meaning. Unconscionable conduct was designed to cover seriously inappropriate conduct, not something which is merely unfair. In our view, that is the appropriate role of such legislation.

(f) Dispute Resolution

YRA has no objection to the principle of an effective, low cost means of resolving disputes.

We would be pleased to answer any questions the Committee may have regarding our submission and to comment on any regulatory proposals.

Yours faithfully,



Nicholas Bryden
Chief Legal Officer
Yum! Restaurants Australia Group

¹¹ *Auto Masters Australia v Bruness Pty Ltd* [2002] WASC 286, *ACCC v Simply No-Knead (Franchising) Pty Ltd* [1999] FCA 1842