

**Submission – McDonald’s Australia Limited**

**Joint Committee on Corporations and Financial Services**

**Inquiry into Franchising Code of Conduct 2008**

**1. Introduction and Background**

On 25 June 2008, the Joint Committee on Corporations and Financial Services (“Committee”) announced that it had resolved to enquire into the Franchising Code of Conduct.

The Committee are to report by 1 December 2008 on the following Terms of Reference (paraphrased)

- The nature of the franchising industry, including the rights of both franchisors and franchisees.
- Whether an obligation for franchisors, franchisees and prospective franchisees to act in good faith should be explicitly incorporated into the code (having regard to its presence as an element in the Trade Practices Act).
- The interaction between the franchising code and the Trade Practices Act on the issue of unconscionable conduct.
- The operation of the dispute resolution provisions under the code.
- Any other matters

In November 2007 the SA and WA Governments announced separate and different inquiries into franchising. These announcements were somewhat of a surprise as the Federal Government has traditionally overseen the regulation of the sector, and had (with bi-partisan support from the Opposition parties) only recently enacted its legislative response to the Mathews Committee Review of the Franchising Code of Conduct. The amendments to the Code were in fact yet to take effect, when those inquiries were called.

The announcement of this current Inquiry is also somewhat of a surprise and is now the fifth Inquiry, Federal and State, into Franchising within the last dozen years.

According to the Franchise Council of Australia (“the FCA”), the peak industry body for the franchise sector, the motivations for all the inquiries is slightly different. The WA inquiry appeared to have arisen largely as a result of lobbying by interests associated with [redacted] in connection with a dispute he still has with [redacted] brands in relation to the extension of his KFC restaurant franchise agreements. In SA the inquiry appears to have been driven largely by a Labor Party backbencher who had constituents affected by the behaviour of a small franchisor, and has sought by media comments to question franchising more generally. SA was also the State in which the business of the franchisee that unsuccessfully sued [redacted] was located. Recent adverse media publicity surrounding a disaffected [redacted] franchisee and others was also probably a factor in both instances.

The Background Paper to the Inquiry posted on the Committee’s website in relation to this Inquiry makes the remark that “Despite the strengthened regulatory framework, concerns remain that the

problems that led to the establishment of the Code have not been adequately rectified”<sup>1</sup>  
However, it does not identify what those problems specifically are, except to refer to the Mathews Committee and the WA and SA Inquiries already held in 2008.

In broad terms, McDonald's supports the submissions made at those Inquiries by the Franchise Council of Australia (FCA) and the commentary the FCA has recently produced as a response to the findings of those Inquiries<sup>2</sup>.

The question this Inquiry prompts is - Why the need for a further Inquiry? Notwithstanding the comments that there are still problems to solve, the [REDACTED] issue still appears to underpin the rationale for the Inquiry given the second term of reference. In addition, the recent Private Members Bill introduced by Don Randall, MP, points the finger at the rise of conduct by rogue franchisors and a return to the “churning” of franchises that underpinned the original move to regulate the sector.

It is not McDonald's intention in this submission to provide a treatise on the law, nor on detailed amendments to the law or on the relative merits of an argument between two corporations who have had a dispute that they are big enough to sort out for themselves.

McDonald's wishes to make a submission that may be read by the members of the Committee in some comfort, in its entirety, by providing some general observations surrounding the franchising sector generally in Australia and McDonald's key comments regarding the Terms of Reference and other issues raised, generally.

McDonald's also seeks to make a submission at the Public Hearings, as requested.

## **2. General Observations on Franchising**

### **2.1 What actually is Franchising?**

McDonald's is of the view that generally there is confusion about what franchising actually is and how it operates. We consider it important to provide this background for the members of the Committee.

Most importantly, Franchising is usually described as an industry. To provide a perspective on what Franchising is we wish to quote a passage from a letter provided to the FCA by the International Franchise Association (IFA) earlier this year and which was provided to us by our parent company who is a member of the IFA.

“Franchising is not an industry. Instead, it is a business strategy, and it has become an important method of business organization and job growth. Some 100 industries use franchising as a means of efficiently producing and distributing products and services of a uniform quality. Hundreds of thousands of people in the United States have opened their own businesses by buying a franchise.

There are two types of franchises. The first is a ‘product-distribution’ franchise. Product-distribution franchisees simply sell the franchisor's products. In product-distribution franchising, the franchisor licenses its trademark and logo to the franchisee, but typically does not provide the franchisee with a system for running its business. Product-distribution franchising is most often found in the soft-drink distribution, automobile dealership, and gas-station industries. Familiar product-distribution franchises in the United States include Pepsi, Exxon Mobil, and Ford Motor Company.

---

<sup>1</sup> Inquiry into Franchising Code of Conduct Background Notes page 2

<sup>2</sup> Available at the FCA website – [www.franchise.org.au](http://www.franchise.org.au)

Product-distribution franchising represents the largest percentage of total retail sales from franchises, but most franchises are of the second type of franchise, the "business format" franchise. Business-format franchisees not only use a franchisor's products, services, and trademarks, but also the franchisor's complete method for conducting the business itself, such as a marketing plan and operations manuals. McDonalds, 7- Eleven, and Domino's Pizza are business-format franchises.

Business-format franchises rely on an interdependent relationship in which the franchisor licenses to the franchisee the right to use its trademarks, intellectual property, and business and operating plans in exchange for a fee, usually a royalty payment. In return for the royalty payment, franchisees gain the advantage of operating a business with a recognized trademark, as well as an operating plan and the on-going support and training provided by the franchisor. The result is a relationship in which both the franchisor, who is able to develop new units more effectively than through corporate ownership, and the franchisee, who is able to operate an independent business backed by the power of a recognized brand and proven operating system, win. This mutually dependent relationship requires the franchisor and the franchisee to collaborate to achieve mutual success, since neither will be successful without the other.

The key to successful business-format franchising is the protection of the business format itself. The brand and what it represents are the reasons consumers are drawn to franchised businesses. They know that when they shop at or obtain services from a franchise, they are receiving a consistent, high-quality product at a good value. In franchising, consistency and predictability are everything: the consumer knows what he or she is going to get at a franchised hotel or a motel along the highway, or that he or she can count on a particular meal at any restaurant in a chain. This uniformity distinguishes a franchised business from a completely independent business.

IFA conducted opinion research on attitudes toward franchising among American franchisees in May, 2007. The research confirms that franchisees have chosen to invest in franchise businesses because they view it as a superior method of doing business, offering a higher likelihood of success than operating an independent establishment. The survey also shows the high value that franchisees place on such key elements of the franchising as maintaining system standards and adopting a proven brand and business plan. In fact, 85% of the franchisees surveyed had a positive view of franchising as a business method, and 52% indicated that their views were "strongly favourable." More than half of all respondents indicated, on an unaided basis, that franchise systems and franchisor support are the key benefits of the franchise business model. Thus, it is clear that all elements of franchising share the view that the protection of the brand and uniform delivery of a product or service are the foundations of a franchise system, and ultimately relate directly to the success of the franchisee."<sup>3</sup>

Given that Franchising is usually characterised by a Licence given by the Franchisor to the Franchisee, which by its nature is non-exclusive, the question is then raised what is the motivation for a potential Franchisee to enter into a Franchise.

We would respectfully submit that the nature of a Franchise, particularly in a business format model, is, in essence, the purchase of a right to an income stream generated by that business model and not an asset capable of appreciation in its own right. A key element that under pins any franchise model is the capacity of a Franchisor to insist on certain standards. Once a franchisee does not feel the need to meet standards the whole franchise system suffers

## 2.2 Sector Statistics

Sector statistics confirm that franchising continues to prosper throughout Australia. Indeed the briefing paper to the WA Inquiry noted the enormous contribution franchising makes to the Australian economy. The most recent sector statistics note turnover at \$195 billion, or 5.2% of

---

<sup>3</sup> Letter from International Franchise Association to Franchise Council of Australia dated 1 February 2008

national revenue, with 1140 franchisors, approximately 61,500 outlets and 671,000 people employed in the sector.<sup>4</sup>

McDonalds believes that the current Federal regulatory framework is working well. The recent Mathews Committee Report on the operation of the Franchising Code of Conduct noted as follows:-

*"Strong support for the Code has been registered throughout the review process. It is widely seen as pivotal to the continued success of the franchising industry".<sup>5</sup>*

McDonalds has been strongly supportive of the current Federal regulatory framework, including the recent reforms, introduced following the Mathews Committee report which will provide additional protection for prospective franchisees. McDonalds believes the current regulatory environment creates a fair balance between the need for effective regulation supported by a strong and well resourced regulator, and the importance of minimising compliance costs for the sector.

McDonalds is concerned to ensure that the franchise sector operates efficiently and fairly, and there is a strong positive perception of franchising in Australia. McDonalds does not believe there are any endemic problems in franchising and that current regulation adequately safeguards against potential abuses.

### **3. Terms of Reference Issues and Issues Generally**

The broad position of McDonalds in relation to the Terms of Reference and other potential issues raised by the Inquiry or by the recent Private Members Bill can be summarised as follows:-

- (1) McDonalds does not believe that current laws disadvantage franchisees. Indeed the laws provide strong protection for franchisees. Australia has the most comprehensive franchise regulatory framework in the world. The cornerstones of that framework can be summarised as follows:-
  - (i) the Franchising Code of Conduct requirement to provide a comprehensive disclosure document prior to a franchisee signing a franchise agreement;
  - (ii) the Code requirement for franchisees to obtain legal, business and accounting advice, or certify they have been told they should do so but have elected not to obtain advice;
  - (iii) various Code requirements governing the operation of marketing funds, prescribing a process for transfer, limiting the grounds for termination and establishing a mediation based dispute resolution process;
  - (iv) the prohibition on misleading or deceptive conduct contained in s52 of the Trade Practices Act, and supplemented by 51A, which ensures that a franchisor must be able to prove it had reasonable grounds for making any representation as to a future event;

---

<sup>4</sup> See the IBISWorld Report: 2008 and Beyond – the Business Climate and the Future For Franchising and Small Business, presented to the FCA National Convention, October 2007.

<sup>5</sup> Foreword by Graeme Mathews, p4, Review of the Disclosure Provisions of the Franchising Code of Conduct.

- (v) the prohibition on unconscionable conduct in s51AC of the TPA; and
  - (vi) a well-resourced regulator – the ACCC – with extensive powers of investigation and prosecution to oversee the industry and act on any complaints.
- (2) A disclosure document prepared in accordance with the comprehensive requirements of the Franchising Code of Conduct provides sufficient information to assist a prospective franchisee to make an informed decision in relation to the franchise. The disclosure process was further strengthened, as you know, by the recent amendments to the Code which took effect on March 1, 2008;
- (3) The current disclosure process seems to be working well:-
- (a) McDonalds is not aware of any endemic problem with information quality in disclosure documentation. The Code is highly prescriptive as to the information required, the format and layout and even the headings to be used, so any deficiencies in information are readily apparent. The provision of inaccurate information would either be a breach of the Code or a breach of the Trade Practices Act. Strong sanctions apply in the event of breach, and the ACCC is a vigilant and effective regulator;
  - (b) The disclosure document is not intended to be the sole or authoritative source of all information. It is a starting point for the franchisee's due diligence.<sup>6</sup>
- (4) Any aggrieved franchisee can, at no cost, seek to have the ACCC investigate any matter where there has been an alleged breach of the Code or the Trade Practices Act. The ACCC is well resourced, is duty bound to investigate all claims where there is a breach of the Code or the TPA, and has a strong track record of taking enforcement action where necessary.<sup>7</sup>
- (5) The parties to a franchise agreement should be left free to negotiate the commercial terms to bind them in their business relationship. It would be totally inappropriate, and distort many existing commercial arrangements, to provide franchisees with specific rights of renewal or other statutory entitlements at the end of a franchise agreement;
- (6) There is no demonstrable need for further disclosure of the respective rights of the parties to a franchise agreement either in relation to renewal or extension of a franchise agreement, or generally. It is now a mandatory requirement that the franchise agreement be provided with the comprehensive disclosure document

---

<sup>6</sup> The Code expressly notes in clause 6A the purpose of the disclosure document, being to give to a prospective franchisee "information from the franchisor to help the franchisee make a reasonably informed decision about the franchise". On the front page of every disclosure document as a mandatory requirement is a detailed statement advising that the disclosure document contains "some of the information you need in order to make an informed decision", and telling prospective franchisees "take your time, read all documents carefully, talk to other franchisees and assess your own financial resources and capabilities to deal with requirements of the franchised business". Franchisees are also advised to "make your own enquiries... get independent legal, accounting and business advice... prepare a business plan and projections for profit and cash flow ... and consider educational courses, particularly if you have not operated a business before." (Underlining added to demonstrate key points.)

<sup>7</sup> See for example ACCC v Simply No-Knead (Franchising) Pty Ltd; re Cheap as Chips Pty Ltd; ACCC v Kwik Fix International Pty Ltd, re Suffolke Park Pty Ltd and ACCC v Arnolds Ribs & Pizza Australia Pty Ltd.

and in the form it is intended to be executed. Disclosure is supported by a process that ensure franchisees have ample time to make a considered decision and are strongly encouraged to obtain legal and business advice;

- (7) 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. The current legal position is clear, supported by High Court of Australia legal precedent and well understood by market participants. Further, it is consistent with principles applying to commercial leases and other non-franchise business relationships. The inclusion of a legislative right to goodwill under a franchise agreement would lead parties to avoid franchising, which would be damaging to franchisors, franchisees and the Australian economy. It would, by definition, increase the barriers to entry by raising the initial price that was charged for entry into a franchisor/franchisee relationship. The nature of goodwill, in itself, assumes a notional increase in the value of an operation over time. Query who is to bear the burden in the event a franchisee decreases the value of the operation over time;
- (8) It would be totally inappropriate to require the parties to a franchise agreement to negotiate franchise agreements "in good faith". There are already substantial protections for franchisees entering into franchise agreements, including the Franchising Code of Conduct and s52 of the Trade Practices Act. There is also an existing implied duty of good faith and fair dealing implied into a franchise agreement in the context of the ongoing relationship.<sup>8</sup> The insertion of a good faith obligation in relation to franchise negotiations, or in relation to renewing an agreement after expiration, particularly in the hands of the franchisee alone, would create massive legal uncertainty, destroy the standards required for a business format franchise and interfere with many existing commercial arrangements not the least being any property leases that underpin the operation;
- (9) The prohibitions on unconscionable conduct contained in the Trade Practices Act and the State Fair Trading legislation operate effectively in the context of the franchise relationship, and the ACCC has been active in enforcement. There are several precedents for the application of the unconscionable conduct provisions in a franchise context.<sup>9</sup> The arrangements work less effectively in the context of commercial leasing, but this is as a result of other factors more related to abuse of market power by landlords;
- (10) The Code requirements and the Trade Practices Act prohibitions on misleading or deceptive conduct provide a comprehensive regulatory umbrella for the sector. There is already an implied duty of good faith and fair dealing implied into every franchise agreement. The purpose of State Fair Trading legislation in the business context is to essentially mirror the Federal Trade Practices Act and provide coverage to those few limited areas not covered by the jurisdiction of the TPA under the Corporations power of the Constitution
- (11) The level of disputation in Australian franchising is statistically very low. It also compares very favourably with the levels of disputation in other jurisdictions including the USA. The mediation based dispute resolution procedure set out in

---

<sup>8</sup> See *Far Horizons Pty Ltd v McDonald's Australia Ltd*, where Byrne J noted "there is to be implied in a franchise agreement a term of good faith and fair dealing which obliges each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and not capriciously or for some extraneous purpose. Such a term is a legal incident of such a contract."

<sup>9</sup> See for example *ACCC v Simply No-Knead (Franchising) Pty Ltd*; *re Cheap as Chips Pty Ltd*; *ACCC v Kwik Fix International Pty Ltd*, *re Suffolke Park Pty Ltd* and *ACCC v Arnolds Ribs & Pizza Australia Pty Ltd*.

the Code has been extremely successful, with the Office of Mediation Adviser reporting that over 80% of disputes it sees are successfully resolved via the mediation process. The cost of mediation is minimal, and far less than even the simplest court or tribunal procedure. The ACCC has been an active and efficient regulator. Any aggrieved franchisee can, at no cost, seek to have the ACCC investigate any matter where there has been an alleged breach of the Code or the Trade Practices Act. The ACCC is well resourced, is duty bound to investigate all claims where there is a breach of the Code or the TPA, and has a strong track record of taking enforcement action where necessary;

- (12) McDonalds believes the current regulatory environment creates a fair balance between the need for effective regulation supported by a strong and well resourced regulator, and the importance of minimising compliance costs for the sector. McDonalds does not believe there are any endemic problems in franchising and that current regulation adequately safeguards against potential abuses. McDonalds supports ongoing review of the regulatory regime at a Federal level, but does not consider any regulatory change is necessary at present. The Australian regulatory environment is already more prescriptive and comprehensive than most regimes overseas. Interestingly the UK, Singapore, Hong Kong and New Zealand – countries that are probably the closest to Australia in terms of legislative framework – in fact have no specific franchise legislation at all.
- (13) It is inappropriate to seek to somehow enshrine “good practice” into legislation, as that is not the role of legislation. Legislation should establish mandatory standards, not attempt to codify “good practice”. The Franchise Council of Australia endeavours, through its Member Standards and through educational and other initiatives, to provide guidance on best practice. However this is always done as guidance, not regulation. In franchising “good practice” is driven by the mutuality of interest of franchisor and franchisee. So, for example, many franchise systems have internal dispute resolution mechanisms that come into play well before mediation. In the context of the franchise term, it is not uncommon for franchisors to allow a franchisee to continue to enter into a new franchise agreement after the expiry of the original term of a franchise. However this is driven by mutuality of commercial interest, as otherwise the franchisor has to find and train a new franchisee or operate the business itself, which many franchisors prefer not to do. However it would be totally inappropriate to legislate any of these common practices as a mandatory requirement.
- (14) In the event that there has been a return of ‘rogue franchisors’ as speculated by the Private Members Bill, then McDonald’s view is that they have no place in business and it is important they are identified before they have wrought havoc on any unsuspecting potential franchisee. The notion of amending the Franchising Code of Conduct is, with respect, only shutting the gate after the horse has bolted. The legacy is that every franchisor that acts honourably in developing a system that provides a return for all the participants then bears the increased transaction costs which in turn may well be borne by franchisees and ultimately, the consumer. It is much more preferable that the unconscionable conduct provisions of the Trade Practices Act must be applied in this situation to Franchisors.

#### **4. Summary**

In the circumstances, as outlined above, McDonalds sees no compelling reason to augment the existing Franchising Code of Conduct, particularly given the Government's view on lessening rather than increasing regulation.

In the event that there are Franchisors who are not meeting expectations then the current sanctions should be applied. It is the reason they exist in the Trade Practices Act.

McDonalds cannot support reform that fundamentally changes the characterisation of what Franchising actually is, be it by way of shift of ownership of process or re-allocation of value added to a system.