September 8, 2008

TO: PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES
RE: INQUIRY INTO FRANCHISE CODE OF CONDUCT

We are writing as a franchisee for [redacted] in Australia. We are unfortunately unable to voice our opinion without threat or intimidation from the master franchisee, [redacted], [redacted] and therefore we request anonymity. We offer our comments and evidence to the inquiry on behalf of the [redacted] franchisees and more importantly, former franchisees who have lost hundreds of thousands of dollars, families, marriages, and homes to this company.

[redacted] is a 60-year-old American company, with over 2,600 stores in the USA and another 2,800 stores outside the USA run by their subsidiary [redacted] ([redacted]). In some markets, stores are franchised to individual owners, in other markets all the stores are owned by the Master Franchisor and run by them.

[redacted]

In Australia there are currently about 80 [redacted] shops. This number has not changed appreciably in ten years of operation. During this time the company has probably sold 50 shops, some locations more than once. The fact that the total number of stores has remained stagnant is a serious warning sign for a potential purchaser. A warning sign that is unavailable to new potential franchisees, as the information is "hidden" from them in loopholes and other trickery.

It should be noted that unfortunately, [redacted] ([redacted]) continues to offer less and less guidance and involvement with [redacted] Australia and their master franchisee, [redacted]. ([redacted]). This is resulting in a steady erosion of longstanding practice by [redacted] as to how franchisees are treated and is already resulting in abuses by [redacted].

INHERENTLY A RELATIONSHIP BETWEEN UNEQUALS

For example, our franchisor who gets the bulk of our products from Canada (paying in US Dollars) has never lowered the pricing to us as the exchange rate went from .55 to .96 over the last few years. Management even RAISED our pricing for no reason, other than to increase their own profit margin! What can franchisees do? Nothing, because of the inherent unequal relationship. We are forced to buy product from one source, and they can

act in a completely non-competitive way for their own self-interest, and franchisees can do nothing. And the ACCC refuses to act to protect us from this kind of blatant profiteering.

Likewise, franchisees who have been swindled with bad locations, a broken business model, higher than estimated costs, or other events out of their control lose their investment, sometimes their house which has been used to secure their investment in the business, and everything else. The committee already has submissions in this regard, as well as statements from the Judge Kirby in the recent case *Master Education Services vs. Ketchell.* Even if they have legitimate and provable grievances against the company, the failed franchisee is now an empty shell while the cashed up franchisor can fight them in the courts easily. This unequal relationship is balanced in the US courts as lawyers routinely take this type of David vs. Goliath case on a "contingency fee" basis. This is even more shocking when you consider that the investment of the franchisees in their businesses far exceeds the investment the franchisor has in their business. Without some method to impose a more-equal playing field, the future of franchising is doomed.

A healthy franchise relationship is always unequal, with the franchisor hopefully having the expertise, experience, and business acumen to share with the franchisee to make the group successful. But the franchise system is seen by the unscrupulous more and more a method to enrich a small few at the pain and penalty of the franchisee. This is especially disconcerting when one realises that the franchisee has the most money invested in the group and the most risk to shoulder (quite often retail leases). That's why more insurance on the motives and capabilities of the franchisor are now proving to be necessary.

WHAT DOES A FRANCHISE SELL?

A good franchisor is selling a proven business model, the expertise to select a successful location, and the guidance and support to operate a successful business. For a potential franchisee, it is vitally important that they be able to evaluate these items prior to purchase.

However our franchisor refuses to stand by the "business model", distorts the "business model" in order to make sales to new franchisees, and then blames the franchisee for running a bad business.

In fact our company has NEVER provided a business model for a potential franchisee to evaluate, or even for current franchisees to benchmark their performance against their fellow franchisees. Other ice cream franchisors provide this information as part of the first contact with a potential franchisee. The company claims they are not allowed to provide any kind of financial projections "due to government regulations", and yet most current franchisees will tell you that they had ballpark figures told to them orally during the sales process. This is usually done by an "agent", not an employee of the company in an attempt to give the franchisor "deniability" about what has been said.

Essentially, unscrupulous franchisors are selling a product without any warranty to the purchaser. What other business can be so callous to its customers? I am aware of new franchisees being provided with a list of business expenses where every item was, in my view, deliberately grossly underestimated. One example is electricity. Our business consumes lots of electricity as would be obvious. The company routinely quotes monthly electricity at $700 – the average store would use almost double this amount. Since the company has selected and installed the equipment and fitout, they could clearly estimate this item to a very fine degree. They choose not to, to give the franchisee purchaser a view of larger but fanciful profit.

The franchisee disclosure documents currently being given out by our company and many other companies are a combination of legal mumbo-jumbo, obfuscations, and in the view of some plain untruths. And much important information is completely missing.

For example, there are a number of failed franchisees who have negotiated "settlement agreements" with the company in order to get out of their failed franchise. Sometimes it involves a lease agreement on the site the company holds. Sometimes it involves finance partially provided by the franchisor. And sometimes it is a "release of liability" so that the company is not sued or prosecuted by the failed franchisee. These "settlement agreements" often contain "keep quiet" provisions that prohibit the failed franchisee from discussing the terms of the settlement. This has the affect of "gagging" the failed franchisee from sharing his experience with a new potential franchisee.

The company has a horrendous track record at selecting new sites. For franchisors, the bulk of their income comes not from servicing the existing franchisees, but by selling new franchises. Of the top 20 performing [redacted] franchises in Australia, franchisees and not the company have selected the locations, and negotiate and hold the leases. A couple examples include:

• Bondi Beach: existing franchisees rejected the proposed location because it was too far away from "the action". The company sold the shop to a Canadian couple who failed in about a year losing tens of thousands of dollars in the process. The company closed the shop for a period, and then reopened it under company management, attempting to market it again for sale. The company then closed the store.

• Gold Coast Oasis: one of the oldest successful franchisees in Australia, the company refused to renew his franchise against his will. The company then sold the site to another new franchisee, where the franchisee has failed and given the store back to the company

• Sydney/Brisbane : The franchisor has recently begun selling franchises to South Korean migrants to Australia in conjunction with providing them 457 migration visas. [redacted] is a very successful brand in South Korea, with over 600 stores in that market. There are reports that the locations provided to the Koreans (Henry Dean Plaza in Sydney, Strathpine and New Farm in Brisbane) are "duds" and that because the Koreans are more

interested in the migration then the store operation, they are unlikely to complain. And disclosures were provided to them in English, hardly appropriate for Korean-only speakers.

Our company in large degree is selling franchisees its skill at selecting profitable sites. The companies who do this, claiming a site is "A" grade (what the hell does this mean, anyway?) should be required to sign the lease guarantee on behalf of the new franchisee. THE COMPANY should assume this risk. THIS WOULD BE A MUCH FAIRER APPROACH. If the franchisee fails do to bad business practices, the franchisor can easily take the site back to resell. If the franchisor has failed in his duty of care to select an appropriate site, THEY should be made to pay the consequences.

Another key fact that should scare the daylights out of potential purchasers: To my knowledge, there has been no resale of any of our franchises in Australia for a price equal to, or greater than the purchase price. Despite their assertions in their sales literature, that has been NO capital appreciation for any franchisee.

Disclosure documents should be forced to show resales, time held by the owner, and profit or loss on the resale. And "non-disclosure" clauses forced on failed franchisees by the company when closing a store should be not be allowed.

And all disclosure information should be freely from the company's website on the internet. Previous submissions in past years have seen franchisors resist access to disclosure documents based on their production cost. The internet has no such associated cost, and if solicitations for new franchisees are being done on the internet, these documents must also be available to potential purchasers there before the company "sales goons" can begin to put the pressure on a potential customer.

These disclosures should also include, under the penalty of perjury, basic sales, expense, and profit disclosures by the company.

RENEWALS

For most food-based franchises, the issue of renewal at the end of the term is a critical item. The cost of food shop fitouts (including the equipment) is usually much higher than other types of businesses. This requires a much longer period for amortization of the investment in this equipment and fitout. Our US parent company traditionally recognized this in most of its markets around the world, and provided leases with an "automatic" right by the franchisee to renew at the end of the contracted period (generally five years, but in many cases ten years). Our Australian master franchisor however has begun stripping this clause from new leases, and in fact now existing franchisees can be "pushed out" of their stores at the end of the franchise agreement with impunity.

Why would they do such a thing, surely a working franchise paying royalties, and buying captive products is important? NOT AS IMPORTANT AS SELLING NEW STORES. In

fact many franchises around the world are often used by unscrupulous operators to generate income by "churning" the stores instead of being proud and happy that stores are being profitably and competently run.

Additionally, our company has also inserted "renewal fees" into their franchise agreements, exceeding $15,000! This is designed only to strip income from renewing franchisees for no apparent service or need other than GREED.

This type of activity is widespread and has affected many "mom and pop" franchisees for years with impunity. A successful franchised location existed at the Oasis Centre on the Gold Coast, Queensland. The franchisee had been the longest tenure franchisee with the company, and he was a successful and competent operator with a high-volume location. The company arbitrarily refused to renew his franchise, and reopened the store as a company-owned location for several months before selling to a new franchisee.

This franchisee has subsequently failed, and the company has again taken the store apparently to resell to some other poor suckers.

• Automatic right of renewal without onerous renewal fees for successful franchisees must be implemented to prevent this franchisor abuse.

STORE CHURNING

Our company has in the past few years engaged in what to many looks to be "store churning". One egregious example:

Two years ago, the company opened a location on the beachfront at Bondi Beach, Sydney. The store was a "dual brand" with the second brand being another company franchise called [redacted] Until that point, [redacted], in over five years of attempted operation, had NEVER had a profitable location either alone or with a [redacted] This Bondi Beach location suffered from three other serious problems.

- Two blocks too far from the main action area
- Shop much too big
- Rent much too high

The first purchasers for this shop were told all kinds of fanciful stories about how they should expect to have the #1 volume location in Australia, etc, etc. The purchasers of this franchise operated for about 1 ½ years, losing in excess of $350,000.00, and were basically unable to even take a mediation action against the company. The company took all the equipment back (which was apparently resold for a new franchisee elsewhere).

Just recently the company has REOPENED this same dud location, this time with a bakery-type franchise co-located (the company last year bought the stagnant bakery

company from the founder). This location has been offered for sale again, but contains all the same flaws. Some sucker will buy it and lose another couple hundred thousand dollars.

There is no method available in the current regulations to enable a new prospective franchisee to see the number of stores that have been opened and closed and the time franchisees have been with the company at a given location. New potential franchisees are suckers ripe for picking by unscrupulous franchisors, due to the lack of information being provided by franchisors. And because of "non-disclosure" agreements forced on failed franchisees, they are never able to be contacted by a potential purchaser to enquire about their opinion of the company. Essentially, all the negative comments have been stifled by "non-disclosure" agreements, as well as intent of recent changes to the Code!

- Franchisors must be required to produce a list of franchisees, current and former, for a five year period
- Franchisors must notice in bold print franchisees taking over failed locations
- Franchisors must provide accurate "range of income and expenses" from existing store.
- Franchisors must provide a "business plan" and projected Profit & Loss analysis for new locations, in good faith

AD FUND MISUSE

Our franchisor has allowed some franchisees to 'opt out' of paying their marketing fund levy, in order to keep these obviously dud locations from going under. The company has refused to "make up" these contributions, leaving our ad fund short of vital revenues. *They have recently reported that over 30% of our franchisees are delinquent in ad fund and/or royalty payments.* The company cannot be allowed to deplete the ad fund with these "allowances", which are clearly designed only for the company to prevent the embarrassment of further store failures.

When the Ad Fund was managed by our US franchisor, we were provided annual audits showing how funds were spent with some specificity. Since the local company began management of the fund, the "audit", a requirement of the current Franchise Law, has shown all the expenses lumped together – in essentially a big "miscellaneous" category. This is NOT transparent and NOT in keeping with the spirit of the Franchise Act.

- Ad funds must be independently managed, and expenditures approved by a committee of franchisees along with the franchisor
- Franchisees must be given an equal footing with the franchisors, who routinely threaten to withhold product as "punishment" for franchisees. A process allowing franchisees to withhold royalty payments, either individually or as a group, while grievances are being addressed must be part of any tribunal grievance process.
- A public record of all disputes filed in the mediation process (including the Victorian mediation system) should be required to be made public on the company website

NEW EMERGING DIFFICULTIES

One of the "safety valves" in the system has traditionally been the commercial banks. Our bank, [redacted] loaned us a large percentage of the purchase price for our franchise. To do that, they required a business analysis from us including business plan and other documentation. They also made inquiries with the franchisor to ensure the loan was a sound business decision.

Many franchisors have begun touting "relationships" with banks that are designed to secure funds to purchase the franchise. However in many cases the banks and their "franchise relationship" department care little about the use of the money – they are just throwing the money at the franchisee using their homes as collateral – not the franchise! When the franchise fails, the banks just grab up the home if they can't get paid out. This kind of lending short-circuits the usual fiduciary responsibility a bank should have.

Our franchisor, and many others, now aware that the commercial banks are wary about the high failure rate, are starting their own "franchise finance" subsidiaries. This is an extremely dangerous practice and this should be prohibited on an emergency basis until a proper set of regulations can be promulgated to ensure that this does not perpetuate the sale of unviable franchises.

There are many other reforms that can, and should be undertaken to make the franchise business system more fair for the franchisee. The system as it stands is one-sided and unfair to most franchisees. Ruthless franchisors are stripping hard-working people of their investments and livelihood with no recourse due to these unfair, one-sided laws. American franchise regulations offer much more protection to the franchisee, who can always been assumed to be the party with the least negotiating power in this unbalanced relationship.

The company has at least seven ex-franchisees that I am aware of that easily would have had a lawsuit if this had occurred in the United States. However after losing tens or hundreds of thousands of dollars as a result of the actions of the franchisor, they have no financial resources with which to draw on to fight their grievance against the company.

Access to the legal system must be more balanced between the parties, and reforms should be undertaken to do this. The ACCC routinely takes no action on cases filed with them by franchisees, and instead pushes them into a one-sided and unfair "mediation" system. If the government is not going to have an aggressive system of enforcement against franchisor abuses, lawyers must be given greater powers to go after these companies by encouraging contingent fee agreement representation, and restricting award of legal fees for franchisors to only when a franchisee lawsuit is obviously frivolous. Also, the award of "treble damages" as is done by other countries is another method for "balancing the scales" of inequality between franchisee and franchisor. Additionally, the ability to sue off-shore parent companies for their breaches should be enshrined into the Code.

Current laws are clearly inadequate to protect the consumer from predatory franchisors. I have read the submission sent to you by Scott Cooper, and support fully his analysis of the current legal and enforcement regime we currently operate with.

Clearly potential franchisees have responsibilities and must accept certain levels of risk when investing in a franchise. However we don't deserve to be scammed by unscrupulous operators; we deserve to have a level playing field. The current system of both disclosure and especially enforcement does not offer this. The need for a vibrant and effective franchise business market is vital to a modern economy, as is the need to protect from predatory companies. The current system has been successful for those on both sides that have good intentions and play by the rules. The system has however been exploited and manipulated by a growing minority with only their own agendas and profits at heart.

Thank you to the committee for reading this submission. I can be reached for questions thru the committee management.