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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Franchising Code of Conduct

THURSDAY, 9 OCTOBER 2008

SYDNEY

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JOINT STATUTORY COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

Thursday, 9 October 2008

Members: Mr Ripoll *(Chair)*, Senator Coonan *(Deputy Chair)*, Senators Arbib, Boyce and Marshall and Ms Grierson, Mr Keenan, Ms Owens and Mr Robert

Members in attendance: Senators Boyce and Arbib and Mr Ripoll

Terms of reference for the inquiry:

To inquire into and report on the operation of the Franchising Code of Conduct, and to identify, where justified, improvements to the Code, with particular reference to:

1. the nature of the franchising industry, including the rights of both franchisors and franchisees;

2. 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 paragraph 51AC(4)(k) of the Trade Practices Act 1974);

3. interaction between the Code and Part IVA and Part V Division 1 of the Trade Practices Act 1974, particularly with regard to the obligations in section 51AC of the Act;

4. the operation of the dispute resolution provisions under Part 4 of the Code; and

5. any other related matters.

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Committee met at 9.07 am

GARDINI, Mr Robert Charles, Private capacity

CHAIR (Mr Ripoll)—I declare opening this public hearing of the Joint Committee on Corporations and Financial Services, the first of a series of public hearings the committee is holding to inform its inquiry into the Franchising Code of Conduct. The committee is to report on the operation of the Franchising Code of Conduct and to identify, where justified, improvements to the code. The focus of this inquiry is on addressing broad structural and procedural issues relating to franchising agreements in Australia rather than the details of individual disputes. The committee is investigating deficiencies in the operation of the Franchising Code of Conduct and related legislation and ways in which they might be improved.

I welcome you here today and I remind everyone that witnesses giving evidence to the committee are protected by parliamentary privilege. Any act which may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false and misleading evidence to the committee. Witnesses should be aware that if in the giving of their evidence they make adverse comment about another individual or organisation that individual or organisation will be made aware of the comment and given a reasonable opportunity to respond to the committee. The committee prefers to hear evidence in public but we may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date but we would consult the witness concerned before doing this.

Welcome, Mr Gardini. I invite you to make a short opening statement and then the committee will ask some questions. Thank you.

Mr Gardini—I should state that the views I express today are my personal views and not necessarily those of the legal firm I represent, HWL Ebsworth Lawyers. I welcome this opportunity to appear before you today in relation to my submission. My background in my career in the small business sector is that, other than the five years I spent between 1975 and 1980 as an officer of the then Trade Practices Commission and subsequently with the Trade Practices suboffice of the Crown Solicitor’s division of the Attorney-General’s Department, the rest of my career from 1980 has been representing small to medium businesses.

In respect of my submission today I would focus principally on my experience in dealings with the motor vehicle retail industry. The history of the development of motor vehicle dealer agreements is very different to that of retail business format franchises that are developed in Australia or have been imported from overseas. I understand from a number of longstanding motor vehicle dealers that some 40 or 50 years ago motor vehicle dealer agreements took the form of very short distributor type agreements where the key terms related to the sale of motor vehicles and parts. In the main I understand that these agreements were of very short duration and in some instances dealers had no formal written agreements.

Since that time I understand that dealer agreements increased in length and those that were oral agreements were transformed into written agreements. A characteristic of a significant number of motor vehicle dealer agreements was that they were originally evergreen; that is, there was no defined date when the agreement would end. The agreements that were not evergreen

were often of short duration and, despite this, it was industry practice and continues today that such agreements would be automatically renewed unless there was some default by a dealer. Accordingly there are numerous instances in the motor vehicle industry of motor vehicle dealers while nominally only having a short agreement of say one to three years have nevertheless been in arrangements with motor vehicle distributors for periods of 20 to 30 years. It is also a characteristic of motor vehicle dealerships that while motor vehicle dealers do not pay a licence fee at the commencement of their dealer agreement they incur significant expenditure in capital in providing dealership facilities for sales, parts and service of vehicles. By way of contrast, many retail business form of franchises impose a licence fee at the beginning of the franchise and in relative terms to motor vehicle dealerships provide significantly increased tenure.

In 1998 following the Reid inquiry the federal government introduced a mandatory franchising code under the Trade Practices Act and it also introduced section 51AC into the act to prohibit unconscionable conduct in small business transactions. Following these changes I observed that, while a number of motor vehicle distributor agreements have moved to adopt aspects of business format franchising in terms of franchise standards, they contain many of the features of the former distributor type arrangements in that the term of the agreement is mostly inadequate having regard to the level of investment made by a dealer in its business. In addition, a number of distributors retain the master-servant type approach in administering the dealer network in contrast to a greater emphasis of mutuality of interests that often exists in retail business format franchising. In my view many of the motor vehicle dealer agreements expose dealers to unreasonable risk in relation to the inadequacy of the term of the agreement and very often afford a distributor's right to terminate agreement at the will of the distributor notwithstanding that the dealer is not in default.

Despite negotiations between distributors and dealer councils in relation to new dealer agreements it is my experience that there is insufficient bargaining power by dealer councils and individual dealers to overcome serious commercial weaknesses contained in dealer agreements. This has the consequence that dealer agreements are very one-sided and dealers are therefore exposed to significant threats to their investments. In the absence of any adequate legal remedy either under the franchising code or under the Trade Practices Act, motor vehicle dealers are exposed to significant financial losses or, where some offer of settlement is made, they accept such on the basis that there is no other realistic alternative option open to them.

That leads me to now comment in relation to certain issues that I believe need to be addressed. In my submission I have raised a number of issues in relation to the inadequacy of the code as it currently stands. Particularly there are four key areas where I believe the code falls short of its purpose of providing adequate protection for dealers in relation to these four areas of concern. I propose four recommendations which I believe could remedy the inherent inadequacies that motor vehicle dealers are faced with. Firstly, I submit that the benchmark of section 51AC is too high as often there is conduct which will not satisfy the criteria to be deemed unconscionable conduct pursuant to the Trade Practices Act but is nevertheless conduct which is not in good faith.

In my experience there are many occasions where a franchisor's conduct will fall short of unconscionable conduct in its strict term. Senior counsel have confirmed this on a number of occasions. 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. For this reason I recommend that the code be amended to expressly prohibit dealer agreements from being terminated by a distributor other than for default by the dealer. I also recommend that the code be amended to include an express obligation that the parties act in good faith. If such a provision existed in the code distributors may be wary of terminating dealer agreements without adequate reason and dealers would have a greater capacity to seek remedy where distributor conduct was in breach of good faith.

My second submission is that there is no avenue for adequate redress where unfair contracts are entered into. Previously the issues of good faith and unconscionable conduct could be dealt with to some extent in the application of the unfair contracts provision in part 9 of the Industrial Relations Act 1996 of New South Wales. Remedies under section 106 of the IRA give the Industrial Relations Commission the power to vary or find void contracts which are deemed to be unfair. However, this avenue was significantly diminished when the High Court's decision in Fish v Solution 6 Holdings held that the jurisdiction of the commission only extended to contract disputes whereby a person performs work in an industry. Since this decision in 2006 the trend has been to exclude the application of section 106 to commercial contracts. This has meant that the majority of motor vehicle dealers in New South Wales who may once have been able to seek remedy through the commission will now have to use alternative recourse unless they can satisfy the requisite jurisdictional elements of section 106.

In order to address this concern and provide motor vehicle dealers with an avenue under unfair contract legislation, I recommend that the Independent Contractors Act 2006 be amended to ensure that it applies to motor vehicle dealers engaged in franchising agreements. This threshold must be met in order for a contract to come under the legislation. Although many dealer agreements would satisfy the contract for services threshold as distinct from an employee-employer relationship the law has not clearly developed an adequate distinction and the position remains unclear. It would be my recommendation that the Independent Contractors Act be amended in order to clarify any current ambiguity as to whom the legislation covers. This would give motor vehicle dealers the opportunity to seek remedy in the Federal Court of Australia and the Federal Magistrates Court of Australia and take advantage of the unfair contracts legislation.

My third point relates to the dispute resolution provisions currently ingrained in the code. In my experience there is a high number of settlements in motor vehicle dealer and distributors disputes. However, this trend towards settlement is by no means indicative of positive outcomes for dealers. In many cases the dealers are merely out-bargained in mediation and met with an offer they have little choice but to take in light of their inability to litigate the matter without sufficient financial means and where there are inadequate remedies. On other occasions some distributors appear to engage in the mediation as a means of going through the motions and commence the dispute resolution process with apparently no intention of resolving the issue with the dealer. In my view settlements and the dispute resolution would be significantly enhanced

where the parties had a positive obligation to mediate in good faith. If the code were amended to include such a provision there would be a greater chance of equitable settlements as both parties would have to make genuine attempts to reach resolution. Of course, effective dispute resolution procedures are dependent on the existence of adequate legal remedies. Without such remedies there is no incentive for the parties to settle.

Finally, I submit that the code creates some uncertainty at present with relation to the disclosure obligations of foreign franchisors. Prior to the March 2008 amendments to the code an earlier clause, 5(3)(a), exempted from complying with the code any companies domiciled outside Australia but granted only one master licensee in Australia. Now this exemption has been removed there is growing uncertainty around the obligation for foreign franchisors to provide disclosure documents to potential dealers in addition to or jointly with the Australia master dealer. In recent times I have come across two instances where distributors were providing disclosure documents from the Australian subfranchisor without any separate or joint disclosure from the overseas master franchise. The arguments being given from distributors are that where the Australian subfranchisor is a wholly owned subsidiary of the overseas distributor then there is no need to provide disclosure. As you can appreciate, this has practical consequences for motor vehicle dealers who are engaged in business indirectly with overseas distributors. It would therefore be my recommendation that the ambiguity in the code should be addressed so that dealers, master franchisors in Australia and overseas distributors can all be aware of the disclosure obligations relating to foreign motor vehicle dealer distributors.

As a final comment I would like to indicate that since regulation relating to franchising was introduced in 1998 and, despite concerns to the contrary, actually the franchising sector has flourished in that period. Certainly, I have observed a cleaning out of fly-by-night franchise operated systems. However, the concerns still relate to certain conduct that continues. In a public policy sense the challenge is to introduce minimum effective regulation that deals with the problem areas in franchising but which allows the sector to grow and flourish. Thank you.

CHAIR—I would like to explore with you a little bit more about unconscionable conduct and what you would define in your view as to what that constitutes and how we might work around defining that in terms of what happens in franchising?

Mr Gardini—It is a very challenging question in that, despite the existence of 51AC since 1998, there have been only a relative small number of cases. The issue in franchising, particularly motor vehicle dealer agreements, is that the test of unconscionability, notwithstanding the 12 or so factors provided to a court to take into consideration, is a very high threshold to meet so that ultimately in my experience the termination for example of a dealer agreement of 20 or 30 years standing where there is no default on the part of the dealer would not constitute unconscionable conduct particularly where there is a termination at will provision contained in the contract. The dealer has indicated that it has signed the dealer agreement that contains that provision. If in fact you have contractual obligations which permit that sort of conduct, then you do not reach the test of unconscionability.

As to the second part of the question as to whether a definition of unconscionability would provide some clarity both for the sector and for the courts, my view is that I very much doubt it in that unconscionability is a concept which has application to extreme situations. It grew out of the common law case of the NAB Bank v Amadio where basically the court defined the concept

of unconscionability as one where you have to act against all conscience. In that case the persons who took out a bank mortgage could not speak English and could not understand the nature of the document they were signing. That illustrates how in extreme circumstances you need to demonstrate unconscionability. I think unconscionability as in 51AC has a role to play because it sets a minimum standard, it reflects the common law and it applies to small business transactions, so it has a genuine role to play.

The next question is: does it adequately address concerns about conduct in motor vehicle dealer arrangements? The answer is no. I have acted for a number of dealers who have been terminated by their distributors and, despite exploring issues of lack of good faith and unconscionability, you are left with no remedy in the Trade Practices Act or under the franchising code. Because the code itself deals principally with disclosure, it impacts a little bit on conduct but really leaves 51AC to deal with conduct issues. In those circumstances to date for those dealers who reside in New South Wales the only relief that has been able to be obtained is through section 106 of the Industrial Relations Act but, as I have indicated in my submission, that relief has now been somewhat curtailed by way of the High Court decision in Solution 6.

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 33 years with that particular distributor. That distributor does not know why its dealership is not being renewed. I think that is a second area of priority.

The third area of priority of disputes is the primary market area that each dealer is granted. Dealers are granted primary market areas which are designated by post codes where they can actually market and develop their business. Most agreements provide that they do not have exclusivity in their own PMA and that the distributor has an opportunity to vary the PMA at its own discretion. That does lead to some situations where either the distributor appoints another dealer in the PMA, operates itself in the PMA or decides to vary PMAs to create perhaps a new PMA which can have a material impact on the dealer’s business. I think they are the three key areas.

CHAIR—Going back to the issue of termination and disputes arising, is the problem more focused on the fact that the contracts are silent on this or do not provide enough coverage to give any certainty? Is it that it does not specify a term? Where does that problem arise?

Mr Gardini—That literally leads I think logically to talk about 51AC, because basically the terms of the agreement are fairly clear both as to term, termination at will and the non-exclusive right to operate in a primary market area, PMA. The difficulty that arises is that, given there is unequal bargaining power either by individual dealers or by their dealer councils, dealers are left with an agreement that they signed but which in terms of the operation of that agreement during its term puts them at risk of certain conduct. You do not know about that conduct until it occurs. The difficulty with 51AC is that, as senior counsel has said on numerous occasions, you have already signed consent to those particular terms so how can that be that constitutes unconscionable conduct.

The problem arises that you never get anywhere near demonstrating that there is a breach of Section 51AC. You then say: the dealers need to negotiate better agreements. The reality is that I guess the only time you have really got to make a free choice about entering into business is the first time you invest in a particular dealership because at that stage there is an offering on the table of the terms. Once you have actually invested in the business, if there is inability by a dealer council on behalf of the dealers or by individual dealers to alter the terms of that agreement then you are left with the terms of that agreement which, as I say, in those three key areas put you at considerable financial risk. So, the question is: if that is not unconscionability, what remedy would actually give relief for what is essentially then an unfair contract or a contract which is applied in an unfair, unjust, unconscionable manner. There is of course considerable jurisprudence in the Industrial Relations Commission going back some 60 or so years of making sense of those sorts of contracts and indeed in relation to motor vehicle dealer agreements and in relation to service station operators. This is not unknown territory. Now at the Commonwealth level, which obviously has the advantage of providing national legislation, the Independent Contractors Act provides for a very similar regime of reviewing unfair contracts.

CHAIR—I just want to get a couple of things clear in terms of those contract periods. Are they all pretty much the same periods of time, between five- or 10-year agreements? Are they ongoing? Is there a period of time—

Mr Gardini—Most of them now are not evergreen. They are mostly all fixed terms, so dealers who entered into evergreen agreements are now often on fixed-term agreements, so the arrangement has actually changed during the course of their investment.

CHAIR—But is the expectation though that there is an ongoing commitment after that contract term? What is the expectation at that point? If it is a five-year agreement, is the expectation from both parties when they sign a five-year agreement that they just walk away at the end of five years regardless of investment, or not?

Mr Gardini—No. Industry practice and expectation has been to date that dealer agreements would be automatically renewed unless you are in default or have had some bad falling-out in the relationship. That has been industry practice. But now the agreements have actually moved to fixed terms; some of them are agreements of one year’s duration, which is a very, very short period of time having regard to the investment. Some are of three years’ duration. Many of them

are of five years' duration but then only offer renewal for a further five years providing you reach certain—

CHAIR—Are there options in those contracts? Are there options of five plus five, or a three plus three plus three?

Mr Gardini—They are not automatic. There are options but usually if you are given an option there is a very high threshold that you have to meet in order to actually be granted the further term.

CHAIR—Given the level of investment that someone has to make in a dealership, for example, would it not be unreasonable that they then enter into a short-term agreement based on their investment level to just say, 'That is unreasonable. I am not going to sign that standard form contract', or whatever contract it is. 'I need a longer period to be able to recoup my investment.' How does that work?

Mr Gardini—It usually falls on deaf ears. I negotiate for most of the dealer councils. In the last five years I have probably negotiated on behalf of 10 of the dealer councils in negotiations with distributors. Some of those negotiations can be of two or three months' duration. In one case it has been as long as two years. Essentially, occasionally it has been possible to negotiate a five-year term with a five-year renewal on certain conditions. That is about the best you can possibly get and I think that is probably a pretty reasonable outcome in terms of the level of investment, but a large majority of dealer agreements do not have that level of tenure. Despite those negotiations, most of them do not get anywhere near that level of tenure.

CHAIR—Can you just describe to us the point at which a distributor decides to no longer either renew or to terminate? What brings that on? Are they unsuccessful franchises? Are they successful? What happens to that particular business? Does that business disappear or is it taken over by the franchisor or distributor? What is the process? What actually happens in practice?

Mr Gardini—With termination at will, usually there is a notice towards the end of the term. There must be reasons. More recently now the reasons given are fairly general reasons that there has been a restructuring of the dealer network; it is very difficult to challenge that sort of reason. In one instance the dealer had been operating for something like 33 years and had built up two significant franchise outlets and the franchisor or the motor vehicle distributor desired to actually operate those sites themselves. It was basically saying, 'It is a very good business. There is no default. You are one of the best performing dealers in Australia but we want to operate those sites for commercial, strategic reasons.' A similar termination occurred on a truck franchise. It was a similar situation where the franchisor wanted to take back and operate the site. In both cases either there was no offer to actually buy back the goodwill, or alternatively in one case an offer was made but it was just a ridiculous offer having regard to an evaluation by independent accountants of the value of the business.

In other situations of non-renewal it can be that there is no need to give any reasons. In a non-renewal situation you just get a notice saying you are not being renewed. In relation to two dealers at the moment, they do not know what the reasons are. They have had no default notice. If you are in default under a dealer agreement, as required by the franchising code and by dealer agreements you must be given a notice of default and an opportunity to rectify the default.

CHAIR—But in the cases you are describing to us this is not about a default situation? You are talking about where it is strictly a non-renewal or just a termination on some reason apart from non-performance?

Mr Gardini—Exactly. Basically they can be the reasons. In some cases when you look at the reasons for a default it may be that they had not raised the issue. There have been default issues but no formal notice has been given during the term of the agreement. Therefore the dealer says, 'Look, we have had some conversations about improving sales and our concerns about lack of performance, but now we are receiving either a notice of termination or a notice of non-renewal and we have not been even been given a formal notice, an opportunity to rectify or an opportunity to go through if necessary the dispute resolution provisions.' You are left in a situation where you are being denied all that, although they are the real reasons.

CHAIR—But a dispute does not necessarily arise out of that?

Mr Gardini—No.

CHAIR—That is not necessarily a case for dispute?

Mr Gardini—No.

CHAIR—It is just a case of following through with whatever is contractual or their rights in terms of saying there is a non-renewal or a termination? It is not necessarily a case for a dispute in itself?

Mr Gardini—Exactly.

Senator ARBIB—Do franchisors use terminations as a way to put themselves in a better bargaining position for renegotiation? Do you see that?

Mr Gardini—No, I do not really see it that way. It is usually for other reasons, that they want to appoint another dealer or maybe because they want to close that primary market area site or combine it with another one. Obviously markets change. It is just the nature of markets. If there is a termination because of a re-arrangement of PMAs, the question is why does the distributor terminate one dealer rather than say to an adjoining dealer who is actually going to get that PMA, 'Look, you need to go and speak to the other dealer. The business had some goodwill. We are not going to terminate that business. You need to buy the goodwill of that business', so that the market can find a solution to the reality that markets change. But given that there is a provision there that permits termination at will, in my experience that can be used in a very harsh and unconscionable way.

Senator ARBIB—Okay, so it is not your experience?

Mr Gardini—It is not my experience that they use it as a basis to try to get a better deal; no, I do not believe that to be the case.

Senator ARBIB—I was interested about how limited the mediation process is and also in the bargaining position that the franchisee and the franchisor each have. Do you want to expand on that a little bit, please?

Mr Gardini—Yes, certainly. There are a number of aspects to it but there is no requirement to mediate in good faith. Parties can come along to mediations and, as I have said, really just go through the motions of it. Perhaps they do not have authority to actually negotiate fully at the mediation. Perhaps the requisite senior people are not present at the mediation. That is often an indication that they are going through the motions. Those mediations just do not go anywhere, principally for the reason that if in the event in this industry parties have access to legal advice if the advice is that the distributor believes that there is no legal action that can be brought, there is very little incentive to actually offer some settlement. The franchisee for its part realises on its legal advice that perhaps it is very difficult and very expensive to take any action, particularly if 51AC does not provide an adequate remedy.

At the mediation maybe all that is on the table for discussion is that the dealership is coming to an end; you have got stocks of cars; you have got parts and equipment. Maybe all that is the subject of negotiations is how you are going to end the relationship, not about any real payment of compensation for loss of goodwill. As a mediator who was first qualified in the mid-1980s and has conducted a number of mediations, what really works well in a mediation to bring about a settlement where there is some uncertainty on both sides as to an outcome is to say, 'Look, we are businesspeople. For whatever reason, can we either resolve our dispute and go on with business or, if we end up parting ways, can we come to some solution that will give us some commercial certainty in the very immediate future?' That is not going through costly litigation, distracting businesspeople from the things that they normally do. However, that approach is not facilitated where there is that absence of uncertainty.

Senator BOYCE—You mentioned goodwill in terms of termination a couple of times. The franchisors have argued in a number of submissions that the vast proportion of the goodwill would reside with the franchisor, not the franchisee. Would you like to comment on that?

Mr Gardini—I understand that point of view. I think that is reflective of a point of view in retail business format franchising where you are granted quite a significant tenure. The licence fee over that term is relatively modest. Over that period you have really exhausted, if you like, the goodwill in the business. By contrast, in motor vehicle dealerships you do not pay any licence fee but you have huge capital investments in these dealer businesses and—

Senator BOYCE—That being beautiful showrooms and the like?

Mr Gardini—Absolutely, and not one of the dealer's choosing, one of being in a franchise system where the requirements for the showrooms are determined by the distributor. You have enormous capital investment. In relative terms to retail business format franchising you do not have the relative tenure. In reality the market says—what does the market say—that these businesses are valuable, are traded. If a dealer wishes to assign their franchise, which happens very frequently and large amounts of money are paid for these businesses, they have to get the consent of the franchisor. The franchisor knows in this industry the amount for which these businesses are being traded, so there is goodwill. Through the court system certainly there is recognition in, for example, cases decided by the Industrial Relations Commission that you are

either compensated for loss of profits or the goodwill of the business and there are a number of expert witnesses who have produced evidence to the commission to value these businesses. As I say, they are traded—

Senator BOYCE—And apportion goodwill?

Mr Gardini—Yes, having regard to the financial nature of the business and the length of time.

Senator BOYCE—I am just trying to get a handle on the motor dealer industry. Am I correct in thinking at the moment it is currently a sort of hybrid between distributorships and franchises, moving towards more formal franchises?

Mr Gardini—Prior to 1998 there was the voluntary franchising code. The motor vehicle distributors were not signatories to the voluntary code and the government of the day in 1998 decided that motor vehicle distributorships—however you describe them, franchises—were really franchise businesses. The code when it was introduced defined franchise agreements to specifically include motor vehicle franchises. All motor vehicles now, including tractors and trucks and also motor boats, are included. Notwithstanding the way you structure your business, under the code you fall within the definition of a franchise.

Senator BOYCE—I notice at some stage in your submission you talked about dealers willingly entering agreements containing oppressive contractual clauses. Is that not the nub of the problem? How do we protect people from themselves?

Mr Gardini—I say ‘willingly’. It is sort of in inverted commas—

Senator BOYCE—I realise that, but nevertheless—

Mr Gardini—That is the issue.

Senator BOYCE—they are free individuals behaving freely.

Mr Gardini—As I said, you have the free choice when you make the first investment in the business. But if you have been in the franchise for 20 or 30 years, the terms of that agreement can obviously significantly change over time by way of the agreement itself. And it is not just the agreement; it is the standards and performance criteria that get altered over time.

Senator BOYCE—Is that by mutual agreement?

Mr Gardini—Often not. The agreements usually indicate that those matters—

Senator BOYCE—Take it or leave it.

Mr Gardini—are at the discretion of the franchisor. So you sign up at one point in time; you can look at all the standards and make a view about what is being offered to you, but over time if they are significantly changed that might have a serious impact on your business. Once you have actually renewed your agreement, essentially you have made your investment; if you cannot

negotiate a change to the dealer agreement, what do you do? Do you relinquish that investment over a considerable period of time and just walk away? I do not think that is acceptable.

Senator BOYCE—A number of submitters have spoken of using rolling renewal contracts that might go over 10 years, or whatever period you like really, but with rolling renewals in them. Would you see that as assisting in any way?

Mr Gardini—There is some benefit in that. However, you really need to balance the interests of the parties. I think from the distributor's side things do change over time and the distributor may not wish to have a relationship with that dealer forever and a day. I think to place some limitation on rolling agreements on a distributor may be excessive. Whereas I think what the dealers are really looking for is to say, 'Look, we are making this investment in our dealerships. If we are given a period of time which is reasonable to recoup our investment and we are given an option for a further term and we meet certain standards, that reflects a reasonable balance.' That is in contrast to the situation where you might nominally have a five-year agreement with a five-year option but if you have got a termination at will provision on 90 days notice, effectively you have got a 90-day agreement because you never know when that is going to be actioned.

CHAIR—Can I just wrap up your presentation with a quick question on the mediation process? Do you believe that a separate tribunal or a body further than just mediation would be helpful in trying to settle disputes as a follow-through process?

Mr Gardini—There are a number of dispute resolution procedures, not just mediation. Some sort of tribunal or ombudsman type role is something to be considered. Perhaps the code could make provision for the opportunity for expert determination, which is another dispute resolution process. At the moment it only makes provision for mediation so it is somewhat restricted. I do see some role for expanding the code for when parties go to mediation but there is no settlement or agreement. How can that be? Is that because on a particular issue they take a diametrically opposed view? It could be on a legal issue or commercial issue. Why could that not then be referred by the mediator to say, 'If that is the impasse, why do we not appoint an independent expert to make a determination or provide a view as to the legal issue, or whatever that log jam issue is?' I do see some expansion of dispute resolution procedures, but moving to a tribunal or a franchise ombudsman may be just creating another level of unnecessary red tape and an institution that perhaps does not achieve anything better than is currently achieved. In a regulatory sense, let us get to the fundamentals: if we are striving for a minimum affect of regulation let us look at the adequacy of the code and whether we need a good faith provision in it, which I support, and whether we look at an effective remedy at law that deals with the small number of serious complaints that exist in this industry. I just have a hesitation about creating new entities that in fact may not deliver. Let's keep it simple. Let's provide an effective remedy, because if you do that then I think the result will follow that there will be realistic settlements or improved satisfaction through the mediation process.

CHAIR—Thank you very much for your assistance to the committee.

[9.57 am]

KONOPACKI, Mr Warwick, Joint Managing Director, The Cheesecake Shop Pty Ltd

MEAGHER, Mr David, Independent Director, The Cheesecake Shop Pty Ltd

CHAIR—I welcome representatives of the Cheesecake Shop. I remind you that witnesses giving evidence to the committee's inquiry into the Franchising Code of Conduct are protected by parliamentary privilege. Any act which may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as contempt. It is also a contempt to give false and misleading evidence to a committee. Witnesses should be aware that if in the giving of their evidence they make adverse comment about another individual or organisation, that individual or organisation will be made aware of the comments and given a reasonable opportunity to respond to the committee. The committee prefers to hear evidence in public but may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date but we would consult with the witnesses before doing so. If you could start by giving us a quick presentation or some opening remarks that would be great. But first, do you have any comments to make on the capacity in which you appear?

Mr Meagher—I was a practising lawyer for 25 years, mainly involved in franchising. We see the submissions by the two master franchisees to the inquiry as being, we think, opportunistic and based on a false premise. The premise is that the master franchisee has generated the goodwill. We do not see that. It has been our recipes, our systems, our IT, our marketing, our supply that the master franchisee has used. The master franchisee's role when we entered into this agreement 15 years ago was to find franchisees using our systems, using our marketing and using our manuals. It was then to train those franchisees, again using our systems, using our manuals and then to give ongoing support to those franchisees. So for a master franchisee to say in providing that service that he has generated the goodwill I think is a fallacy. The master franchisee relies on the support, and the continued support and continued system development, that the franchisor is involved with. It is not the master franchisee's role to develop the system, it is the franchisor's role. We provide it with all those systems and those benefits. As I said, I think the claim is based on a false premise to start with.

We see it as being opportunistic at this time because when we entered into the agreement 15 years ago we wanted the master franchisee to be successful and to generate franchisee inquiries and then to support those franchisees for a period of 15 years and to adequately recompense the master franchisee by way of a large royalty split. Our master franchisees received twice the royalty split that we did. Also, it was a free choice to enter into that agreement at the start. The master franchisee could do the numbers and assess 'if I am able to generate this number of franchisees doing this level of sales, my gross income will be X dollars', then taking out the limited expenses in supporting the unit franchisees they could make an assessment of their income, which was significant. We would only wish to reveal the actual income levels on a confidential basis because I do not think it is right for the master franchisees to do that, but they are significant.

Given the large level of support that the franchisor is involved with and the small amount of royalty that we receive—there is a royalty of six per cent to the master franchisee and three per cent to the franchisor—if there is a goodwill payment at the end of the term that means we will have less money to reinvest with the unit franchisees. There is only a certain amount of royalty that can be used to make sure that the franchisee is profitable and the franchisor is profitable and has the money to reinvest in the system. If the master franchisees then take a great chunk in terms of goodwill that will leave less money right now, or in a few years' time, for the franchisor to reinvest into the system.

In relation to a payment of goodwill to the master franchisees, if we had known that we had to do that we would query whether or not we would enter into franchising because it just leaves too little money at the end of the day and it would put at risk the model of franchising for the master franchisees. Right now we think that master franchising in our system is not the most efficient use of resources. It is not an efficient system because we are duplicating relationships. It would be easier to provide the support role ourselves. That is not to say it has not been successful for both the franchisor, the master franchisee and the unit franchisees because different commercial realities and circumstances existed 15 years ago when we entered into it. But now, where the bulk of the work is involved in supporting the unit franchisees, us supporting a master franchisee to support the unit franchisee is inefficient. There is also an element of loss of control in our system because the contracts with unit franchisee are with the master franchisee. We are a party as well; it is a tri-partite agreement, but the role of franchisor is performed by the master franchisee. That means that there is an element of lack of control. In today's retail environment, any inefficiency is not a good thing.

One of the more general comments is that the franchising code applies across the board to all forms of franchising across all industries. Different industries have different requirements. We see a real difference between the support role or service role of a master franchisee and the interests of unit franchisees. There are different interests in different industries. We just heard about the motor trade having different circumstances to a lot of retail franchises. It is different to real estate, where some real estate franchisors actually pay real estate agents to join their system. It is not the other way around. They will actually pay to re-brand. This question of goodwill payments if applied across the board will have some serious consequences for franchising and will cause companies to cease to franchise, or to seriously question whether they cease franchising, something which has proven to be an incredibly successful form of doing business in Australia in the last 25 years.

CHAIR—Probably your biggest issue obviously is the issue of goodwill and how that takes place at the point of termination. Could you just briefly describe to us at what point your organisation decides that a termination should take place. What drives that process?

Mr Meagher—Are we talking about the master franchisees?

CHAIR—Any termination either of a master franchisee or a franchisee. Obviously there is a split here between the corporate franchisor, your relationship with a master franchisee and then the subfranchisees under that master franchisee. From your perspective, as the corporation, what drives a termination? Or have you had any terminations?

Mr Konopacki—In the end it comes down to the franchise agreement, the document that we enter into at the beginning of the relationship; that dictates the time period for that licence arrangement.

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.

CHAIR—What drives a termination? What are the main causes of termination where you decide you no longer want to have a relationship with either a master franchisee or a subfranchisee?

Mr Meagher—If I can deal with both questions separately?

CHAIR—Sure.

Mr Meagher—There are master franchisees in different states. Two have terminated both for reasons of financial difficulty of the master franchisee for matters I think unrelated to the actual operation of the master franchise. They have since been operated profitably. That is why I say I think it was unrelated to the profitability of the master franchise itself. Those two were terminated. We have decided that we do not want to renew the master franchise agreements. They were for an initial term of 15 years with no right of renewal and with very clear terms as to what would happen at the end of the agreement.

CHAIR—In your contract you did particularly stipulate an end of contract termination process? It was clear to all parties that, yes, after that 15-year period we part ways?

Mr Meagher—Yes.

CHAIR—Also in your contract is there any mention or any stipulation for any goodwill at all, or is it just completely silent?

Mr Meagher—I would have to check but I am almost positive that it says that there is no goodwill on a termination.

Mr Konopacki—I can back that up. In fact, our agreements are very specific in relation to goodwill that if and when termination occurs the goodwill remains with the franchisor. There is no goodwill in a payment. We make that point explicit at the commencement of the agreement. In relation to master franchisees, we remind them of the end of the term and again the fact that there is no goodwill upon termination.

CHAIR—But there is compensation for parts of the business? In order to get this very straight, you are very specifically talking about not just an end of contract but an end of the business altogether rather than, say, the franchisor taking over that business or on-selling that business; is that right?

Mr Meagher—No, this is at the end of the term. That is all. I am simply saying that at the end of the last term, which is 15 years, there is no right of renewal and there is no goodwill payment at the end. The licence that we have given to be able to operate this business to provide the service to the unit franchisees ends. That means their right to receive royalty from the unit franchisee ends and the unit franchisees then enter into contracts, or we enter into contracts with them.

CHAIR—But there is still an expectation from your organisation and from the people you are dealing with and entering into contracts with that it goes on in perpetuity, as you said earlier?

Mr Meagher—The unit franchisees?

CHAIR—Sorry, yes, not the master?

Mr Meagher—Not the master. If I can clarify something, we renewed unit franchise agreements at the end of their 10-year period. They had two terms of five years and they had no right of renewal but in all states bar one the unit franchise agreements have been renewed.

CHAIR—I understand all of that. I understand the process. What I am trying to determine and get an indication from you is at what point do you decide you no longer want to do business? Is it because you decide you no longer want to have that particular shop operating at all, is it because you no longer want that particular person operating that shop, or have you decided that you want to corporatise that particular unit? Can you describe what drives that to us?

Mr Meagher—We have not done that with master franchises but what we have said is: we do not want to be involved in master franchising. At the end of the term we do not want to be involved in master franchising because it is inefficient. We want to have the contracts direct with the franchisees. I have acted for the Cheesecake Shop I think for about 10 years; to the best of my recollection with unit franchisees the only terminations have been for breach.

Mr Konopacki—If I can just back that up, if and when a termination occurs in those circumstances if you could determine by the market that that store is perhaps no longer viable, all parties see that to be the case and the agreement terminates, or the lease is not renewed and that is when the business terminates. From our point of view as the franchisor we would prefer a business to continue under some sort of arrangement, ideally with that individual because there are savings to be made in terms of training and so on.

CHAIR—Obviously, goodwill is a major issue for you guys and I would be very interested to see what your standard form contracts say specifically about goodwill, particularly if you say that there is no goodwill, and what that actually means in law. But very specifically, do you believe that goodwill exists at all? Everybody in some way contributes to goodwill. If somebody has a business for 10, 15 or 20 years and builds up a clientele and builds up a following around that shop because of their personality, because of the way they do business, because of their

demeanour, because they are a very active shop franchisee compared to somebody who may do the very least or minimum possible, is there not always some component of goodwill? The whole idea that the word even exists is about the recognition that in every relationship there must be some goodwill, be it small or large?

Mr Meagher—The answer to that is a qualified yes on the basis that what the franchisee has is a right to operate a business for a specific period of time so that goodwill arises out of that particular contract and the contractual rights that that franchisee has. That is where the goodwill is generated because that gives the franchisee the right to generate profit and, if the franchisee generates profit and that has a value and someone is prepared to buy it, then there is goodwill.

CHAIR—Is that also not attached to the fact that that person not only just rents from you or buys for a period of time that right to make a profit out of the brand but also invests substantial capital and time; the person not only uses the brand but invests of their own risk a substantial amount of capital, time and so forth and therefore generates something that does not necessarily just end on a particular day because they have invested on a long-term arrangement?

Mr Meagher—I think that is right. It may not end depending on how it has been generated. For example, if it is the site itself and there is site goodwill, it almost does not matter who is operating the shop if you have got the passing traffic it generates a certain level of turnover. If the site goes, the goodwill goes.

CHAIR—Is it really about the mutual responsibility not only of the brand itself, the entity, but also of the custom and practice, effort, investment and how much effort is put in by the franchise operator as well?

Mr Meagher—Yes, and in a lot of cases how closely the franchisee will follow the system that the franchisor has developed.

CHAIR—Absolutely.

Senator ARBIB—I understand you are saying in terms of your business goodwill does not exist. Outside of your business do you accept the principle of goodwill because I have to say we had a previous witness who talked about goodwill in the motor industry? There are numerous franchisees who talk about goodwill. Do you accept in principle that goodwill does exist outside your corporation?

Mr Meagher—Goodwill exists outside the corporation. Goodwill exists in many businesses. Is that what you are getting at?

Senator ARBIB—At the start of this the first thing you said was: goodwill is based on a false premise. You said goodwill is a fallacy. But in listening to your evidence at no time did you back that up except on economic grounds where you said: if we had entered into a contract with goodwill that would affect obviously payments in the way we deal with it. I am just trying to figure out whether you accept outside of your own organisation that goodwill exists as a principle?

Mr Meagher—I think I must not have made myself clear at the outset. What I was hoping to say was that I thought the master franchisee's suggestion or assertion that he was responsible for the goodwill that attaches to the master franchise as a result of his efforts is based on a false premise because it is not simply his efforts that have generated the significant levels of income for that master franchisee. It has been the fact that we have constantly developed the system, given them the manuals and made it efficient for him to be able to train franchisees and to give ongoing assistance to franchisees. The master franchisee has leveraged off the marketing that we have done, the marketing development and the brand. That has helped the master franchisee attract franchisees to join the network. For a master franchisee to suggest that he is responsible for the generation of the goodwill of that master franchise arrangement is a fallacy.

Senator ARBIB—But that is for your business? That is the way you regard it for the Cheesecake Shop, but outside of your business do you think that that principle flows on?

Mr Meagher—Absolutely. In franchising, that principle applies.

Senator ARBIB—Therefore there is no goodwill in all franchising?

Mr Meagher—Not no goodwill, but it is where that goodwill is generated from.

Senator ARBIB—Sure.

Mr Meagher—I think the goodwill generates so much from the actions of the franchisor. As the chairman was saying, some franchisees are better operators than others.

Senator ARBIB—I do have to say I do have a problem trying to get my head around this, because especially in the transport industry the term 'goodwill' is well established, particularly for independent contractors. There is also a financial obligation under contractor terminations for goodwill because it does take into account that such a person has built up a clientele and made investments in their business, so therefore a goodwill payment at some stage would be apportioned.

Mr Meagher—If we assume that there is a goodwill, one of the problems for franchising and current franchise agreements is that franchisors do not charge goodwill at the start.

Senator ARBIB—I am sorry to interrupt you. I think this is where what you have said has made the most sense, that in the end if a goodwill payment existed you would change the way you do your contracts.

Mr Meagher—Yes, absolutely because of the six-three royalty split. From the three per cent of the royalty from the master franchisees there is not enough money in the pie to pay a goodwill payout.

Senator ARBIB—In terms of goodwill payments in contracts, this is an economic argument?

Mr Meagher—Yes. That is one of the arguments.

Senator BOYCE—You have a quite specific model that, as you point out, is different from others. There has been a suggestion put to us that the standard contracts of each franchisor should be publicly available for potential franchisees to examine. How would you feel about your standard contract being publicly available?

Mr Konopacki—I believe it is part of our disclosure documentation. We are obliged to make that public, are we not?

Senator BOYCE—We are talking about on a website here. I mean quite publicly, not just to people who approach you as potential unit franchisees.

Mr Meagher—As long as it did not disclose some of the commercial arrangements and you had the actual terms of the contract, I do not think there would be a problem.

Senator BOYCE—Could you explain to me what you are mean by commercial arrangements? Are you talking about actual specific amounts?

Mr Meagher—Yes.

Senator BOYCE—But you would have no problems with all the clauses being out there, so to speak?

Mr Meagher—No, I do not think there is anything unusual in our unit franchise agreement that we would have a difficulty in publishing.

Senator BOYCE—I think the point, as you have already demonstrated, is that they are all different and that this is considered by some people to be perhaps a useful tool for people who were wanting to become franchisees.

Mr Meagher—What Mr Konopacki said is correct, that there is a requirement under the code to disclose it to a potential franchisee. Anyone who is interested will get a copy of the franchise agreement. In fact they now get a copy of the franchise agreement with all of the commercial terms because it has to be in the form that it is intended to be signed.

Senator BOYCE—But we are talking about a more publicly available comparison document here. Could you talk a little bit about your experiences with mediation and your views on the current mediation system as it exists?

Mr Meagher—I think the fact is that about between 70 and 75 per cent of disputes that are submitted to the Office of the Mediation Adviser are successfully resolved. Before the code was introduced people were saying that having compulsory mediation simply would not work. It has been phenomenally successful.

Senator BOYCE—You are happy with the mediation system as it currently exists?

Mr Meagher—Yes.

Senator BOYCE—Have you used it successfully?

Mr Konopacki—We have extended the principle to our own practices internally and where a situation arises that may lead to conflict, litigation or whatever, we tend to approximate a process internally before calling in an external mediator—

Senator BOYCE—Do you have an internal mediation process?

Mr Konopacki—Yes.

Senator BOYCE—Is that in the contracts that people—

Mr Konopacki—That is our own sort of attempt at facilitating the process. There is a mediation clause in the contract.

Mr Meagher—The mediation clause in the contract follows the code. There is a clause in our franchise agreement that requires franchisees to comply with our system and part of our system is a dispute resolution system where disputes get raised at various levels up the chain. The last is a meeting with very senior management and the legal compliance officer. If that does not get resolved it will then go to mediation.

Senator BOYCE—I can imagine that perhaps some unit franchisees may find this a somewhat intimidating process; is that the case?

Mr Konopacki—I would not think so. It really is about trying to facilitate where there is in fact a business relationship between two businesspeople.

Mr Meagher—When it gets to formal mediation, one of the roles of the mediator is to create an environment that is conducive to a settlement. The good mediators are able to do that. Sure, it is foreign to people, so they can be intimated to that extent.

Senator BOYCE—Could you give me some idea of how many disputes you may settle internally by mediation as opposed to externally then?

Mr Konopacki—Most, I would say—close to 90 per cent. In fact, I cannot recall the last time I went to a formal mediation process. You probably would.

Mr Meagher—It was last year I think there was one. There was one mediation last year.

Senator BOYCE—Are we talking about one in 50, one in 10?

Mr Konopacki—One in 200 franchises.

Mr Meagher—I am not sure what happened interstate, so one in 60. In New South Wales—

Senator BOYCE—One in 60, okay. One in 60 in New South Wales—

Mr Meagher—But I do not think there were formal mediations in different states; otherwise I think I would have heard about it.

Senator BOYCE—What would the Cheesecake Shop think about the insertion of an 'in good faith' clause into the code both in terms of negotiation and mediation?

Mr Konopacki—I am sorry, would you just repeat that again?

Senator BOYCE—I am raising the idea of putting the words 'in good faith' into the code in terms of mediation and in terms of negotiation of contracts.

Mr Meagher—From a legal point of view I do not think that would make any difference because I think the situation is that there is in fact an implied term to act in good faith.

CHAIR—It is already contained in the Trade Practices Act.

Mr Meagher—It is already implied in contracts. Where it would be good would be that it would clarify as to exactly whether or not that is the law.

Senator BOYCE—In that we have unconscionable conduct covered—

Mr Meagher—Unconscionable conduct is covered but as to whether there is good faith and fair dealing I think there is still some debate amongst the lawyers. It would clarify it.

Senator BOYCE—Would you be in favour of that?

Mr Meagher—It would not be a problem.

CHAIR—Do you believe that a non-renewal of agreement should be based on a good cause, that there should be a good reason, a good cause, as to why there is a non-renewal?

Mr Meagher—Across the board, absolutely not.

CHAIR—You do not believe there should be any need for any cause at all; it could just be the end of the contract, sell out?

Mr Meagher—Other than in specific industries covering specific issues. We are in the situation where we have got an inefficient model and we have to end that inefficiency. Is that a good reason in itself to end it, the fact that we have said at a certain date that is it. It is like a service industry. It is like contracts for service. Why is franchising different from any contract for service? If you start to say you cannot not renew other than for a good reason you will always have an argument as to whether or not it is a good reason, so to avoid the argument you pay some money. I think you will find if you do that franchising will cease to be used in those circumstances where there may be an obligation to renew because it is just too risky. Fifteen years ago if we had known it may be possible to always have this system we would not have had the system, because you do not know what is going to happen. You do not know what is going to suit.

CHAIR—On that thinking though you may not even have the successful business, and so forth, that you have got today.

Mr Meagher—Correct.

CHAIR—Given that every piece of that business has been derived because every piece is there and there has been the growth and a range of things around it. It just goes a little bit contrary to what was said earlier when you said you enter into these agreements with a view that they go on in perpetuity—

Mr Meagher—If I can clarify that?

CHAIR—Yes.

Mr Meagher—That is what some of the franchisees do.

CHAIR—You were referring to the master franchisee?

Mr Meagher—No, the unit franchisees think that. Our contracts are quite clear that they do not go on forever. The unit franchise agreements were five and five, to an end of 10. There was no right to renew but we did renew. It was in our interests to renew because we wanted franchisees to continue to run shops and be incentivised to run their shops.

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 if 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.

CHAIR—Do you believe that is commensurate with the investment and risk taken by the other party as well as your own?

Mr Meagher—In this case, yes. It was an investment—I think I can say this publicly—of $200,000 15 years ago. That was the maximum, I think. That is about $12,500 a year in licence fee to earn significant amounts of money which we can disclose in confidence.

CHAIR—Do you believe that it is unique to your system perhaps, that yours is different to other in that sense, that the investment is different, the upfront fee is different and the investment the person takes in itself does not then generate some further goodwill down the track?

Mr Meagher—I can say that I think it would be wrong to have our system to have to be renewed for other than good cause. I think that our situation would not be unique. It would not be uncommon. I do not know the extent to which—

CHAIR—What do you do though? If you do not renew what happens to either the master franchisee or franchise unit? What happens to it if you do not renew?

Mr Meagher—If we do not renew the master franchisees, we have told them and given them a couple of years notice to rearrange their affairs on the basis that they have to look for a new job.

CHAIR—What do you do? Do you then take over that particular store or do you on-sell it? Does anyone take the place of the master franchisee? What I am trying to establish is what do you do as a corporation when you decide not to renew? You have an entity. You decide not to renew that entity. Do you then take over that role? Do you on-sell that role? Do you have someone else fill that role or does it just disappear completely?

Mr Meagher—The master franchise will disappear and will be subsumed in our organisation. We will take it on. We will then enter into contracts—

CHAIR—It is corporatised?

Mr Meagher—It is corporatised. The unit franchises, as I said, other than in one state, we have always renewed. At the end of a term we have not said, 'We are not renewing.' There was one store that closed recently for poor performance. It just was not financially viable and that franchisee has ceased. We have not taken it over. A decision has to be made as to whether or not the sign will be taken down and de-branded and we walk away. We terminated another franchisor for a serious breach. With the code it has to be for serious breach. We then took over the store and built it up and I think we have on-sold it.

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?

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.

As I said earlier, with the real estate industry in which I have had some experience, in a lot of cases there is no restraint. Franchisors will pay to take on a particularly good real estate agent and get them into their network. On termination or non-renewal in the real estate industry what is acceptable and what is in good faith will be totally different to what happens in some other industries. I just think if it is prescriptive it will put at risk franchising in various industries

where it has been successful and various types of franchising. Franchising applies to the full format business systems to the man in the van. I have concerns about having one piece of legislation for all of that.

CHAIR—It needs diversity. There is no doubt of that. I thank you very much for your contribution.

Proceedings suspended from 10.36 am to 10.53 am

CASTLE, Mr Timothy David, General Manager, Business Development, and General Counsel, Competitive Foods Australia Pty Ltd

COWIN, Mr John James, Chairman, Competitive Foods Australia Pty Ltd

PARKER, Mr Ian, Group General Manager, Competitive Foods Australia Pty Ltd

CHAIR—I welcome Competitive Foods Australia. I remind you that witnesses giving evidence to the committee's inquiry into the Franchising Code of Conduct are protected by parliamentary privilege. Any act that may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false and misleading evidence to a committee. Witnesses should be aware that if, in the giving of their evidence, they make adverse comment about another individual or organisation, that individual or organisation will be made aware of the comment and given a reasonable opportunity to respond to the committee. The committee prefers to hear evidence in public but may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date but would consult with the witness concerned before doing so.

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 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.

The first point is the sector 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.

The second point we make is that 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.

So, wherever in our society and our community there is an abuse of power we do not recognise the contracts that result from the abuse of power. If directors breach their directors' duties, we do not honour the contracts. If corporations abuse their market power under section 46 of the Trade Practices Act, we do not enforce the contracts. The fundamental principle here is about abuse of power; it is not about freedom of contract. That brings us to this point. Imbalance of power is inherent—it is part of the DNA of franchising. Franchisors must have strong powers to control their systems. Every franchise outlet, whether it be Hungry Jack's, KFC, McDonald's, Ford Motor Company, BMW or whatever it happens to be—must conform to a particular image. The franchisor must be able to develop that image to react to market conditions and they must have power. If you give people power then you must be able to stop abuse of that power. What we argue for, with good faith and good cause renewals, is putting minimum standards, like a safety net if you like, to stop power being abused. There is all this talk about this affecting the free enterprise system and so on, but it is not in the slightest. Free enterprise works perfectly well with rules of conduct.

The third point that has been made is a point that you will hear a lot about. It has been written about a lot in the submissions. It is said that there are no endemic problems in franchise, and we agree. Most franchisors behave overwhelmingly ethically and appropriately most of the time. There is no endemic problem, but the problem is, as Mr Gardini touched on earlier, where you have serious breaches of norms and standards. There is not an endemic problem, but where is the protection where you have the serious breaches? It is very clear that franchising code of conduct does not contain standards of conduct.

I do not know whether any of the members of the committee know this, but Mr Gardini has a long background in franchising. He conducted a review for Senator Schacht back in the early 1990s into what was then called the voluntary code of conduct. The voluntary code of conduct had standards of conduct. The problem was it was a voluntary code. We moved to a compulsory code. Sure, it is a compulsory code, but it does not have standards of conduct. What the code of conduct regulates at the moment is pre-contractual disclosure. It does not deal with post-

contractual conduct, and that is the problem. If you put post-contractual conduct standards in the code there is a very powerful infrastructure in the Trade Practices Act that will give those standards real teeth.

I was heartened to hear that at least one franchisor—the ones that you have heard before—thought it would be a good thing to have good faith in the code of conduct because it would clarify things and it would create enforceability. That is the third point. It is not about endemic problems. It is about the underside—not the glossy side—of franchising.

The fourth point to make is that the Franchise Council of Australia say that good franchise regulation is built on what they call twin pillars. The first one is franchisee due diligence, and that is covered by the code. The second is what they call responsible franchisor behaviour. At the moment responsible franchisor behaviour is, firstly, voluntary; secondly, subject to the uncertainty of whatever section 51AC, unconscionability, applies; and, thirdly, implies duties of good faith. That is plainly inadequate.

I should refer you briefly to some statistics that are very helpfully collected in the ACCC submissions. Those statistics indicate that the ACCC has had in the last four years 2,000 complaints made by franchisees. It is a small number in terms of 66,000 franchisees, but it is still 2,000 individual complaints from a range of people, and that does not even include the people who do not complain. Seventy-five per cent of the complaints relate to post-contractual conduct. Only 25 per cent relate to disclosure issues regulated by the code. That bears out what was said by some of the earlier witnesses that the code has cleared up, I think the word was, fly-by-night operators. It has cleared up a lot of the disclosure issues. But 75 per cent of the complaints are post-contractual.

The ACCC has taken on only 15 cases in the last 10 years, and only five of those cases in franchising have related to unconscionable conduct. We would say that we have a huge problem out there, as recognised by statistics and the qualitative evidence that you hear, yet only a small number are taken to court. We think that will be fixed in large part by putting in standards of conduct. There is a lot in Mr Gardini’s evidence that we agree with. He stated that if you go into a mediation and the franchisor knows that the franchisee has an ability to go to court and hold the franchisor accountable you are likely to get a much better outcome at mediation.

A mediation statistic was bandied around. The ACCC’s evidence is that 75 per cent of cases where a mediator was appointed resulted in a successful outcome, but a mediator is only appointed in a third of the cases logged by the Office of the Mediation Adviser. They keep their own statistics. There have been something like 3,000 inquiries about mediation in the last 10 years under the code, and 940 mediators appointed. We would say that represents a clear upgrade in mediation of about 25 per cent, on that 3,000 figure. The statistics show that, although responsible franchisor behaviour, which we agree with, is a good ideal, it is not happening in practice at a certain level, and that is the level that needs to be dealt with.

Finally, we must say that there has been quite an attack made in various places about Competitive Foods in relation to our position, and various terms have been bandied around such as ‘financial leverage’, ‘transfer of wealth’ and so on. But the point is that, even though we are a very big company in Australian terms, relative to our franchisor we are very small. We have created jobs for 15,000 people through our Hungry Jack’s and KFC network and we operate

through just under 400 stores. We have 49 KFC stores now. The franchisor we are dealing with has 35,000 stores worldwide. It claims to be the world's biggest restaurant company. Notwithstanding our size, if you like, we suffer from the same imbalance of power in dealing at the end of our franchise agreements with renewal issues that any other franchisee deals with with its franchisor. The imbalance of power is inherent in the system.

In summary, we would say that there is a real problem that cannot be swept under the carpet and we have talked about it at length in our submissions. We have come up with a solution. We have put forward in our submissions, somewhat uniquely I suspect, draft provisions to go into the code of conduct, and in those provisions we have tried to indicate principles that can be used to resolve the disputes across-the-board. Attachment 1 of our submission relates to the two provisions that will deal with a lot of the issues. The first is good faith. Just to pick up a point raised by the last speaker, 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 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.

In relation to renewal, we have set out a good cause provision. To come back to your previous witnesses from the Cheesecake Shop, maybe it would be that they have good cause to get back the farm because of their contribution relative to their master franchisee. They can deal with what I call 'inefficiencies' in their marketing arrangements. Equally, it may not be good cause if the master franchisee side of the story is completely different. In other words, let us say the franchisor made a very minimal contribution to building up the farm. It would not be good cause in those circumstances. Our point—because we are both franchisor and franchisee—is to set more of a level playing field than exists at the moment, to do it in a principled way, and to do it in a way that represents or reflects industry practice and expectations.

I would like to finish this part of it by quoting from what appears on the Franchise Council of Australia's website about getting a PoolWerx Corporation franchise, which is a corporation associated with the chairman of the FCA. It states:

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

The view being offered by your previous witnesses from the Cheesecake Shop in respect of their master franchisees is in effect that they are buying a job for a period of time and when the job is over they have no expectation, no right, and nothing for what they have done. I suggest that what has been said in the PoolWerx publicity is what people believe franchising is about. It is more than about buying a job. It is about buying something that will have continuity. It is about trust. It is about working together. It is about good faith. At the moment none of that is enforceable and when problems arise everybody reaches for the contract, including at mediation, and you get a significant number of problems for which there is no remedy. People can get very emotional if they feel their trust is abused and if they feel they are helpless. I say that because there are other arguments that have been put in the FCA submissions about why people get emotional. People

get emotional because their businesses went down. They get very emotional and very upset, particularly smaller franchisees who do not have the resources that a large corporation like we have to defend ourselves, if their trust is abused, if power is abused, and they feel helpless in that situation.

That in a sense is our opening. I think you will have got the flavour of that from reading it. I do not know whether you would like to hear something directly from Mr Cowin. I think you all know Mr Cowin has been with franchising since its very start in Australia in 1969, when he opened his first KFC store. Mr Cowin represents all of the potential that the franchising industry can offer to people and, as I say, has created a huge number of jobs for people throughout Australia through the growth of the Hungry Jack's and KFC businesses. He possibly has some points that reflect his perspective or you might like to ask some questions.

CHAIR—Mr Cowin, if you would like to make a brief opening remark and then I might ask you a question that will give us a fair indication of where we think things are going.

Mr Cowin—As Mr Castle said, I have been in this industry for almost 40 years. From the time that I went into the business the connotation of franchising was to get into business for yourself but not by yourself. In other words, there was a support system that was behind the system. The main reason a franchisee gets into business for himself is to build the business. That is the primary driving force, to be in business for yourself and not to have a job; it is the independence that people seek. In the 40 years that I have been involved in developing three of the largest international systems in the world from a franchising point of view, there has been an unwritten understanding that, if you play by the rules, if you reinvest back into the business and if you do a good job, there would be an automatic renewal as part of the contract.

A couple of years ago a franchisor that we were in dispute with took the position that they did not wish to renew our franchises and, in my opinion, they broke this unwritten rule that had governed the industry, on the basis that their stated reason was that they did not renew because they did not have to. There was no obligation for them to have to renew. So, as a result of that, and in inquiring why they would make that position, which had been somewhat of an automatic basis, assuming that you do as the system requires you to do, there was no given reason. Since that time we have begun to understand that it is the corporate opportunism of being able to take on a successful business that the current legislation in Australia allows them to do because there are no provisions that explicitly forbid the franchisor from taking the action that they have. In the case of the Rockingham store that Mr Castle mentioned, they could do what they claimed to do.

From an experience point of view, that is what I can contribute. We have put in our submission a lot of the detail that Mr Castle has given a broad overview of. Why should Australia be different from other places in regard to renewal of contracts if there is not a just cause or reason? To me that is the primary issue that we have to deal with.

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 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.

Mr Castle talked about 2,000 complaints, but the reality is it has been a great industry and business. If the perception becomes clear to the public or to the franchise community that they are at risk, I for one would never have ventured into this business, because that was not the primary reason why I did it. I did it to create a business and not to gain a job; I already had one.

CHAIR—A couple of issues are key in today's discussions, including the issue of goodwill. We have already had some different views, but I would like to get your interpretation of goodwill and perhaps an indication of what proportions you would assign to either the franchisor, the master franchisee or a unit franchisee?

Mr Castle—A very good example is the Rockingham store. That 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.

In practice, the way goodwill is resolved in the industry is that franchisors stay being franchisors, they let their franchisees renew their agreements, the franchisees can then sell the business to somebody else who comes in as the new franchisee. That is how goodwill is recouped. Goodwill only becomes an issue if the franchisor wants to step across the line and, if you like, corporatise, privatise, remove inefficiencies, or whatever term is used, and cease being the franchisor of that business.

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? I appreciate I have not answered your question directly, but we have to look really at what goodwill is and how it operates.

Senator ARBIB—How do you deal with these circumstances with your own franchisees? Maybe this has not happened, but where you decide for a non-renewal, how does goodwill work in those circumstances?

Mr Castle—We have a situation at the moment with a franchisee. We have never been in the position of not renewing. In fact, our policy is to stay being the franchisor and let the franchisees develop and run their own business. We have a situation in Cairns Airport where what we are doing at the end of the franchise situation there is working with the franchisee to find a solution.

Mr Parker—The situation in Cairns is a good example where a franchise agreement has come to a conclusion. The airport is being rebuilt/redesigned. We have given the franchisee an undertaking that we will roll that over. He is still trading effectively outside the agreement and we are waiting for the new plans to be laid out of where the restaurant is going to be and where we transition that relationship going forward.

Bearing in mind that we are a franchisor and a franchisee, the outcome of this process we will live with in our component of our business, which is much more significant than the KFC relationship. Our biggest asset is motivated, well-resourced and committed franchisees. That is what we seek. Without those we effectively do not have a business. The issue arises when we start talking about goodwill. As has been argued by the FCA, the issue is that the franchisor owns the goodwill in the franchisor's business and the goodwill in the franchisee's business. Mr Castle and Mr Cowin have demonstrated that the franchisees have a completely different view on that. You could walk down Pitt Street, with a dozen franchisees between here and Wynyard, and ask every one of them whether they were aware that under the current franchise code their franchisor could take their business away from them. They would be horrified.

Mr Castle—The fact is that most franchisors do the right thing, but at the moment unless you put in this safety net, you have the temptation, if it is financially beneficial to do it, to remove 'inefficiencies', if that is the term, to take over an operation or for whatever the reason might happen to be, and to take the operation back in-house and take away that goodwill. It goes to the nub of our arguments about renewal provisions and good cause. What should really happen in this industry is that industry practice should be enforced in the code, and that way you solve the problems. The problems arise when franchisors do not want to be franchisors any longer and actually want to run the business as well. If they do that, they should pay for the business as if they were any other person coming to acquire the franchise business on the market.

CHAIR—Do you believe that the equation of the proportion of goodwill, with some belonging to the franchisor and some belonging to the franchisee, changes if the franchisor

wants to then buy that business? Do you think there should be a difference or no difference when selling that business to anybody else? What I am asking you is: has the franchisor contributed something above and beyond what a person on the street has in buying the business?

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.

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 and 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.

CHAIR—It is a transfer of ownership and title. The business model remains intact and it is a different owner.

Mr Cowin—That is correct. He gets paid his royalties and his fees upfront. I sell it to you and I keep the money. The franchisor has a right of approval that the new person coming in is an acceptable entity and will also maintain the contractual basis. However, as I said, the big issue becomes not what the split is but does the franchisor have the right say that it is zero, which is what the renewal issue brings to the fore, on the basis that we have no obligation to have to renew and as a result your portion of the goodwill is zero. That is the major issue that we have had to deal with.

Senator BOYCE—Just to play devil's advocate for a minute, Mr Castle, you said before that the franchisor had the potential to destroy the goodwill in a franchisee's business.

Mr Castle—That is right.

Senator BOYCE—Doesn't that capacity, in itself, suggest that they own the goodwill?

Mr Castle—No. It suggests that the goodwill is joint. It is like any partnership. With any partnership the partners jointly own all the assets of the partnership.

Senator BOYCE—Are you saying that one partner can trash the other partner's assets intentionally or unintentionally?

Mr Castle—Yes. That is right, but under partnership law that cannot happen.

Senator BOYCE—Not without penalty, anyway.

Mr Castle—No. Fiduciary duties stop that, but we do not have anything equivalent. I should add to my earlier answer that, if you get down into fine dissections—and as I said, I am sympathetic to the view that you make some allowance for what the franchisor has contributed—you have to bring into the equation how much return they already have through their risk-free royalty stream. The way royalties work in franchises, and certainly in ours, is that royalties come from revenue and not from profit. In other words, the first people you pay from your sales—a bit like paying your landlord—is the franchisor. They have already taken a risk-free revenue stream out of the franchising. That is how you create incentive in franchising. The franchisee then works harder for the next dollar. Once you have paid your fixed or variable overheads in this case, it is the end dollars that come to you as your profit.

CHAIR—What you are saying is that there is an equal relationship in terms of whatever proportion it might be—it is not an equal number—between the effort that is put in by the franchisee in that case to build up the business, which is duty paid as it were, and the effort put in by the franchisor, duty paid, with collection through the revenue stream, thereby meaning that at the time if there were to be a split it really is a case that the franchisor is in no greater position than anyone else buying the business? Is that what you are saying?

Mr Castle—If that position happened, you would actually remove the incentive for things like churning to occur and what that would mean is that you would really have a fair system where the franchisor would not be suddenly deciding, 'We like the fact you built up a successful business. We actually want it back now'—get the farm back. They have to pay for it. There is a bit of evidence about this in various academic journals and so on. The reality is that the franchisees who are most at risk are the successful ones, because if the franchisee is successful and establishes a good business and a good market they are the ones that are most at risk of the company saying, 'There is an opportunity. We gave away too much.'

When we come down to freedom of contract, the fact is that in our Rockingham situation the franchisor did not stipulate in its contract that it could get the businesses. It does not have a contractual right to get the businesses at the end of the franchise agreement. We suspect a lot of

franchisors know they have the economic clout at the end of the day to say, 'If you don't accept our offer, your business will shut and you'll get nothing.'

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.

Mr Parker—Classification.

Mr Castle—There is another point here, which we have not commented too much about. The other factor in this equation is that the franchisee is generally bound by non-compete provisions.

Senator BOYCE—For what sort of period?

Mr Castle—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. That is if those restraints of trade are legal and valid. That is a different legal argument. Here we are just talking about the contract or the system.

In our good cause renewal provision we have put in, as a matter of fairness, in 23B(2)(e), the opportunity at the end of a franchise term for the franchisor to pay fair market value to buy back the business. We are not suggesting that franchisors should be perpetual franchisors. Far from it. We are simply saying that the industry practice and the default position should be renewal. As Mr Cowin said, that was his expectation and we think that is the expectation of others. There are then a number of options as to what can happen at the end of a franchise agreement. If someone is acting in good faith, they are not going to be afraid to pay market value to take back a franchise business. It is when they want to try to get something at a discount. They want to try and, if you like, take a shortcut against accepted practice. They can go out and they can pay market price for it.

Senator ARBIB—That is where it starts getting complex again. It comes back to what you said earlier about goodwill be jointly owned.

Mr Castle—Yes.

Senator ARBIB—They would be saying, 'Why should we buy it at market value given half the goodwill is coming from us?'

Mr Cowin—Every contract I have ever seen gives the right to assign on a sale. I can sell the store to you. It cannot be unreasonably withheld. On that sale the franchisor does not have the right to be able to say, 'I own 50 per cent of this goodwill.' That to me is the definition. If I have the right to be able to sell the business and the franchisor does not have the right to be able to say, 'I own 50 per cent of this', then that is the way the industry has worked. There is a market out there with people buying and selling these businesses. The franchisor does not put his hand out and say, 'You and I can reach a commercial agreement as to what the business is worth.' That is what the buyer and seller exchange. The franchisor is getting paid his royalty and his fees that go with it. As I said, we have not dealt with that because on the renewal issue—

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.

CHAIR—We have heard already today that the idea of good cause for a non-renewal ought to be in some way defined, stipulated or part of the agreement, and that it is about a concept of operating in perpetuity even if there is a stipulated contract period. Can you make some comments about good cause and what you see as good cause for non-renewal?

Mr Castle—Good cause is standard in terms of industry understanding. As one of the previous speakers said, have they committed a breach of the agreement? Another good cause is where the franchisor offers an updated contract, which on its terms is reasonable—contracts change—and the franchisee does not want to take that change. That would be good cause. Franchisees have to be reasonable in this respect as well. There can be problems with sites. Sites may, for good reasons external to the franchise relationship, no longer be available, and that may be good cause. You cannot force someone to stay in a franchise relationship if the terms of the lease that underpin it are no longer available. All of these things which are in our draft provision have precedents. They have precedents in the oil industry in relation to petrol station franchises. We also see that they have precedents for discussions. There is a long history of discussions going back to 1976 in government reports and suggestions about how you deal with this. We think it is not a difficult concept and it really reflects either a codification of existing practice, or an indication of what would be desirable practice.

CHAIR—Do you see it as a reasonable position that good cause could be just because it is the end of the contract?

Mr Castle—No.

CHAIR—If it were a five-year agreement at the end of the agreement everyone walks away?

Mr Castle—Certainly not.

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 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.

Senator BOYCE—Do you see this as something that would be useful in terms of assisting the power balance between franchisees and franchisors?

Mr Castle—It would be useful, but we are not arguing that the Commonwealth should tell people what they should put in their contracts. If you set the structure right with a good cause renewal system that effectively enforces this default position of renewals, you will see contracts that start to look like the KFC US contract.

Senator BOYCE—That brings me to my next point. We have heard a suggestion that standard contracts of all franchisors should be publicly available on something like the ACCC website. The thinking behind this is that potential franchisees would then have a chance to have a look at what others are offering compared with what they might be considering themselves. What would your view on that be?

Mr Castle—That may be what we put in the basket of precontractual disclosure. This all comes back to a question you asked earlier about how you save people from themselves. There are undoubtedly things you can do at the precontractual stage, but even with the precontractual stage people still enter franchising with a huge degree of trust in the person they are dealing with, and it is the trust that is the issue that we are really focusing on, the postcontractual conduct. It is how people use their power and whether they abuse the trust. Say you have a long-term franchise contract of 10 years. The franchisor you trusted when you started the contract may not be the franchisor you deal with eight years down the track.

Senator BOYCE—That could be the same in any business relationship.

Mr Castle—It could be that the franchisor who you deal with in eight years time can say, 'I am just going to look at the contract', and so you need to have this legislative framework that accommodates the fact that people have gone into these standard form contracts relying on trust. The person has changed, but the ground rules have not, because the ground rules are enshrined in legislation.

That is the importance of having the legislation. You have standard form contracts that give the franchisors the power, necessarily we say, but you have minimum standards of conduct that supplement the contractual regime, and it does not matter if the franchisor changes. The one you liked and trusted may no longer be there, but the new one still has to act in good faith. The new one still has to give you renewals. The new one cannot just come and steal the goodwill, as we would see it.

I should just say one thing because I think we were at slight cross-purposes earlier. I talked about the goodwill being jointly owned. I think there was a bit too much focus on the word ‘ownership’. The goodwill is jointly created by the franchisor and franchisee. In a sense, nobody owns it. It is jointly created, but nobody owns it, although in practice what happens is that when you sell the business the franchisee is able to recoup the benefit of that goodwill.

Mr Cowin—One of the complaints is: 20 years from now when we enter into a contract what are the terms going to be? One of the things that has been part of our relationship is the payment terms and provisions of the contract. That agreement is live and keeps changing. For example, when we started we paid a three per cent royalty to the franchisor. Today we pay six per cent. If there are different focuses or emphases in the business, that contract will change. The franchisee has to accept that. It is part of the franchisor’s position to be able to set the terms. As I said, this agreement is alive and keeps evolving as the industry and the business change. It is not like this is a fixed contract that is locked in concrete for 20 years and never to be seen again. This is a business that is very fluid. There are changes at the renewal date that require that and, when it happens, the franchisee has to accept that. Our big objection has been to the ability to stay in business once you have made your investment and you are there. That is what is not covered. That is what we call the void in the current legislation.

Senator ARBIB—Could you update us in terms of where the Rockingham process is up to? Also, with respect to mediation there have been numerous submissions from franchisees suggesting that some of the processes could be improved. Can you give us your views on that?

Mr Castle—I will deal with mediation first. I have been a practising lawyer for 20 years in litigation areas and recently qualified as an accredited mediator. It is well accepted that people only mediate if they have something to mediate about. As Mr Gardini said, if one party believes that they do not face any realistic prospect of being taken to task in court, either because there is no legal obligation or an uncertain legal obligation, or because the other party does not have resources, mediation is not going to work.

If you look in the ACCC’s submissions, they talk in terms that there may be a bit of a practice happening in the industry of franchisors presenting take it or leave it offers at mediation and not in fact entering into what one might think is the true spirit of mediation. We would suggest that the real problem is that, if you do not have standards of conduct that can hold franchisors accountable, you will not have a successful mediation. On the other hand, if you put in standards of conduct, particularly for good faith, you may in fact nip a lot of big problems in the bud because people could then go to mediation quickly and easily on small problems. Franchisors could be held accountable because of their good faith obligations, and they could resolve their difficulties before it becomes a big problem. Our response to your question—and I understand there have been a lot of other responses—is that I think part of the problem is solved by putting in the standards of conduct. In relation to Rockingham, it still remains closed. We still remain in

negotiations with Yum! We could talk about that, but obviously that is a commercial issue. One thing that we are clear about is, irrespective of how that gets resolved, we will not shy away from the points that we are making now about what the right moves are for the industry. There has been some suggestion that this is just an attempt by Competitive Foods to get commercial leverage in those negotiations. We see that as being far from the point. We see this as being a question of principle about what should happen for good future regulation of the industry, and irrespective of what happens with our KFC business where we have 50 restaurants, we still have 300-plus restaurants in the franchising industry in a Hungry Jack's business. We are not going away from franchising, irrespective of what happens with the KFC business. We would reject the suggestion that has been made in various places that we are somehow motivated by some narrow sectional interest.

CHAIR—Can I have your view on the renewal period, whatever period the contract is for? People are most vulnerable in terms of renewal of contracts. Can you comment on the practice, the power advantage or abuse of power that might exist in those final negotiations?

Mr Castle—It has nothing to do with the rights under the contract. It has to do with the fact that the franchisor can bring the franchisee's livelihood to a very rapid end and is not accountable for it. The franchisee enters into this industry, often many years before, believing that they are doing more than just buying a job. They are putting in the effort. They are putting in the extra dollars of cash flow, as Mr Cowin has said, into building up that business because they believe they are building an asset for the future. They do it on an expectation of normal industry practice, which is renewals, and they do so on the basis of trust and relationship.

What the franchisor has is the opportunity to stop the franchisee from realising the benefit of that investment, because they can stop the franchisee having continuity which will enable that investment of time, money and effort to be realised. Whether it is churning, inefficiency or anything else, the franchisor has that power and the result is that the business closes. The franchisee knows that, and the franchisee is then very open to whatever the franchisor wants to put.

The funny point is that the Franchise Council of Australia has made exactly the same point in relation to retail leases, about the opportunities for opportunistic conduct, that we make in relation to franchising. They do not like it in retail leasing, but for some reason they oppose the arguments that we put in relation to franchising. I meant to say earlier in relation to Senator Boyce's question that it is not an answer, as some suggest, people should be more up front in their contracts about what happens at the end of the franchise term. We have had a look at our Hungry Jack's contracts in the course of this. Our Hungry Jack's contracts say the franchisee has no right to renewal at the end of the term. Franchisors, because they can write the contracts, can write in the most powerful statement, if you like, with no right of renewal, but that does not actually reflect the policy or the practice. One of the things that we are undertaking at the moment is a review of our contract to make sure it reflects the policy. But it is all too easy to put it in your contracts up front, because the franchisor has all the cards in formulating the contract. It has all the cards and so it is not an answer to say, 'Put it in the contract' or 'Have more disclosure. Have risk statements', et cetera. That might be useful to some extent, but it really does not deal with the problem at the end of the day where people enter into this industry believing what is said about it and putting their time, money and effort into it.

CHAIR—Thank you very much.

[11.55 am]

COCKBURN, Mr Milton, Executive Director, Shopping Centre Council of Australia

SPEED, Mr Peter Stuart, Solicitor, Speed and Stracey Lawyers, acting on behalf of Shopping Centre Council of Australia

CHAIR—Welcome. I briefly remind witnesses that giving evidence to the inquiry is protected by parliamentary privilege, but where any adverse comment is made about an individual or organisation those individuals or organisations will be made aware of this and given a reasonable opportunity to respond to the committee. In addition, while all evidence is given in a public format, there is the opportunity for confidential evidence to be given also, if that is desired, which could be made public after consultation with the witnesses. Would you like to make a brief opening statement?

Mr Cockburn—Thank you for the opportunity to make an opening statement. Mr Speed is here today because he was largely the author of our submission. Given that we are dealing with some highly complex areas, some of the legal questions you may have I will probably deflect to Mr Speed. Our submission relates specifically to two aspects of the committee's terms of reference, and that is whether an obligation for franchisors, franchisees and prospective franchisees to act in good faith should be explicitly incorporated into the code, and the interaction between the code with part IVA and part V of the Trade Practices Act, particularly with regard to the obligations in section 51AC of the act.

We note that recent state inquiries into franchising have raised issues to do with the rights of a franchisee in a retail tenancy context, such as when the retail lease is held by the franchisor. We did not think this was relevant to an inquiry into the franchising code of conduct but, if this is specifically raised in other submissions and if it is the intention of this committee to explore this aspect as part of its terms of reference, we would appreciate the opportunity of responding to those submissions. We also note that, after we lodged our submission to this inquiry, the Senate Economics Committee has been given a reference to inquire into:

> The need to develop a clear statutory definition of unconscionable conduct for the purposes of Part IVA of the *Trade Practices Act 1974* and the scope and content of such a definition.

We will also be making a submission to this later inquiry—and we made the point in our submission to your inquiry—that if this committee were inclined to recommend amendment of section 51AC this should be the subject of wider consultation, since it has business ramifications that extend well beyond the franchisor-franchisee relationship. Since this matter is now being specifically considered by another parliamentary committee, we would urge this committee not to make recommendations in relation to part IVA of the Trade Practices Act, particularly in relation to section 51AC. We would appreciate some guidance from your committee, Mr Chairman, as to what ramifications this later inquiry will have for this aspect of your terms of reference.

In relation to any specific amendments to the franchising code this committee may recommend, we have recommended in our submission that, to avoid an excessive compliance and administrative cost burden for business and governments, any further regulation of the franchising industry should only be introduced to address clearly established problems and, even then, should be the minimum necessary. We have suggested some principles the committee might consider for assessing the regulation of franchisors based largely on the principles recommended by the regulation task force shared by the chairman of the Productivity Commission, Mr Gary Banks, in its report in January 2006. These are listed at section 2 of our submission.

In relation specifically to the second of the committee's terms of reference and the notion of good faith, we have recommended that an obligation to act in good faith should not be explicitly incorporated into the franchising code. Good faith describes a principle used in the construction and/or implication of contractual terms and is not a legal standard suitable for insertion as a statutory provision. Despite claims that the concept of good faith has received strong judicial support in Australia and has been defined with some precision, we have demonstrated in our submission that this is not the case. We have cited a number of authorities to demonstrate that neither in Australia nor elsewhere is there a clearly defined, well understood, overarching rule of law known as good faith. A statutory duty of good faith would be impossible to adequately define and would add unnecessary uncertainty to the already complex franchise relationship. Further, unless and until widespread problems are clearly proved to exist in the industry, such a broad remedy is not warranted and, in accordance with good principles for regulation, should not be introduced. Where an obligation of good faith is implied in a franchise arrangement, the content and import of that implied obligation depends on the express terms of the contract, the factual matrix, the parties involved and so on. It also depends on well established principles in common law of implication and construction. It cannot stand on its own. There must first be an agreement with an objectively ascertainable common purpose or purposes with respect to which the parties must be faithful and with which the implied terms must be consistent.

The principle of good faith being applied by the courts to fill in the gaps of contractual provisions is consistent with preserving the sanctity of contract. Those who describe good faith as something different and suggest that the concept would be one to make explicit the underlying ethical standards of the industry as a whole or that good faith could in some way address non-renewable issues are really talking about fairness and about interfering with the sanctity of contract. The inclusion of fairness as a legal standard in business-to-business transactions rather than as a desirable guiding principle has been thoroughly examined on many occasions and has been rejected because it would be so open to a variety of different interpretations that it would be inimical to the development of a coherent and clear body of law. Commercial parties need certainty. The Senate economics references—

CHAIR—Mr Cockburn, could I just stop you there? We have this on the record already, so we do not need you to read it again.

Mr Cockburn—Okay.

CHAIR—If you have some additional comments in terms of providing us with some opening remarks, we will then open up to questions. We have a limited amount of time, so we would rather explore some questions with you.

Mr Cockburn—That is fine.

CHAIR—I will begin by directing your attention to your comments regarding regulatory deficiencies and what you would define as unrealistic expectations on behalf of anybody in the franchising sector, particularly in cases of non-renewal.

Mr Cockburn—I heard the last part of the conversation that you had previously, Mr Chairman, and it seemed to me that Mr Castle made a very good point. Some of the bodies, such as the Franchise Council of Australia, have been arguing that they should have an automatic right of renewal, for example of retail leases, but they do not accept that that is the case in the franchising industry. We accept that. Our view is that the franchise agreement, like a retail lease—like any lease—is a contract for a specific period. The parties that enter into those sorts of arrangements are aware that they are for a limited period and are aware that there is no automatic right of renewal of that particular contract. It seems to me that one of the major issues that dogs both the franchising industry and the retail tenancy industry is this belief that there should be an automatic right of renewal of that lease or the automatic right of renewal of the franchising—

CHAIR—I have not understood from anybody or any submissions that we have received that anybody is arguing for an automatic right. There seems to be a different argument that—

Mr Cockburn—That is the extreme of it. The extreme is an automatic right of renewal—

CHAIR—I have not even seen—

Mr Cockburn—and then there are sort of variations—

CHAIR—Maybe you might be able to point to where—

Mr Cockburn—coming back.

CHAIR—people are asking for automatic right. I think what people are arguing, and certainly what we have heard to date in all the submissions, is that there is an implied expectation that there is a right of renewal unless there is a good cause where people are arguing that, even though a contract ends at a particular term, there is an expectation that the relationship will continue beyond the first contract period; that the time, effort and investment made go beyond that first contract period.

Mr Cockburn—Sure.

CHAIR—I am just wondering, again, according to your submission, what you see as the difference between the purely regulatory requirements or legal requirements as those differ from what would be the expectation of both parties, that if you are entering into an ongoing relationship it will be ongoing. I am not suggesting an automatic right.

Mr Speed—We are talking about good cause here in the sense that you renew unless there is good cause. I think that suggestion has certainly been made. The first premise that those submissions are made on is that there is an expectation of the parties that there will be renewal. I do not quite understand why there is that expectation. The term of the franchise, or if it is a lease

in our context, is for a period of five years or whatever is stated. If the parties were negotiating for a longer term or they had that expectation, then you would anticipate that the longer term would be included into the arrangement or there would be some option or other term that would allow there to be a rollover. Therefore, the premise that there is an expectation that there will be renewal is not necessarily well founded and it is not well founded from the franchisor's point of view. If you are talking about the franchisee, they may in their own mind have that expectation, but that is not necessarily something that has been agreed by the other party. What has been agreed between the two parties is the term of the arrangement that they have agreed to. I suppose therefore we cavil with the original suggestion that the parties have that sort of expectation. If they did have that expectation, why did they not negotiate it into the original contract?

CHAIR—I want to explore that, but it seems contrary to what is industry practice.

Mr Speed—Yes.

CHAIR—By and large in the franchising sector, which is very successful, there seems to be an ongoing in perpetuity type expectation from all players—that there actually is an ongoing business and there is mutual benefit for all players. Therefore, there is an industry expectation or an understanding that it does. If you are saying that there should not be or that there is not an expectation beyond the actual contract term, which is what you said, how is that clearly defined?

Mr Speed—I think we are probably at cross-purposes. If you look at the statistics, from what we understand in terms of franchising, clearly most franchises are renewed. In terms of our own industry, clearly most leases are renewed. So, in terms of what actually takes place as opposed to what expectations people are necessarily entitled to expect, what takes place is there is typically renewal. That I suppose goes back to the first point that we were making, that unless there is a problem why are we fixing it? There are renewals; they do take place; they are taking place in almost every instance. So, unless there is cause, why are we having regulation? That is just the usual first principle of regulation.

CHAIR—I can answer your question. It is quite simple. The basis—just so you understand my questioning—is not about trying to fix all the ones that are working, it is trying to put in place a fix for the ones that are not working. It does not matter whether it is 50, 80, 90 or 95 per cent that work; it is about trying to have a system such that the regulation is there to ensure that things continue to work. But that is not my point. I am talking about the expectation—and this is in your submission—and the difference between regulation and expectation. If there is an expectation at the end of a five-year term that there is no ongoing renewal or ongoing commitment—and that is the expectation of both parties—how is it clearly defined, how is it understood in the beginning, thereby creating no dispute at the end of that term, because that was the expectation? How is that defined in either the leases or clearly understood in any other franchise agreement?

Mr Speed—I think it is fairly clearly defined because the agreement terminates after five years. It is fairly clear in the document that the term is only for a certain period. That is the provision. You know if you are entering into an arrangement of this nature that it is for that period, that long.

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.

CHAIR—If you do wish. But the industry practice is that people who get into any type of franchise arrangement do wish it to continue?

Mr Speed—But the industry practice in terms of our industry or franchisors is the same in the sense that, when we reach agreement with a franchisee, we only sign up that person for a certain period and make our inquiries on the basis of whether we think that after five years, three years or whatever the term is that we are necessarily going to be bound to this person or have to show good cause to be able to pull out of it. Our expectation is, when we are signing up, for instance, someone with whom we have had very little experience, at least we have a term that is going to cease if they do not work out. We have those arrangements and we do not have to go justifying ourselves or argue about good cause or some subjective concept. We actually have some sort of certainty that we can enter into an arrangement with somebody who we may have less knowledge of or less experience with and that at least, without having to go through litigation or prove good cause or argument, it will finish in five years if it does not turn out. The sort of due diligence we are otherwise going to have to do because we may have an arrangement, from what you are suggesting, in perpetuity means that we are entering into a new relationship and a new arrangement. We would have to take different precautions to deal with that situation.

Mr Cockburn—It is also for the benefit of the franchisee. It may well be that the franchisee getting to the end of the franchise term may decide that this is not a business they want to stay in. They have the ability then to say, ‘Well, no, I don’t want to renew the franchise agreement.’ You talked in terms of expectation, but surely there is an expectation too on the part of the franchisee that at the end of the term they might want to walk away and do something different.

CHAIR—Absolutely. You talk about unrealistic expectations, and I am trying to establish what is unrealistic? In your submission you talk about that issue, about the expectation that people have in this relationship. Is it unrealistic? I am trying to get an idea from you guys as to what that is.

Mr Speed—Statistically, renewals take place more often—substantially more often—than not. They have the awareness of that statistical fact. They have the awareness of the knowledge that, from a landlord’s point of view or a franchisor’s point of view, they are better off having continuing relations with the franchisee. That is good for their business. That is good commonsense for their business. Franchisors prefer, if they can—because it is good for their bottom line—to renew franchises. However, if it is not good for their bottom line, it is unreasonable to expect—and people should not have this expectation—that they will be renewing.

CHAIR—Do you believe that in franchising—the relationship between a franchisor and a franchisee—there is goodwill and that that established goodwill then has a value attached to it? How do you see goodwill?

Mr Speed—It depends on what you are talking about really. Looking at franchise relations, say, you are talking about a McDonald's store. In terms of McDonald's, if you walk into one store as compared with another store, it makes no difference what the franchisee particularly is doing. The branding is such and the regulation is so strict that essentially you get the same product at any store. The goodwill of that store is referrable entirely to the franchisor from that perspective. If you are looking at other arrangements where you might have, say, a pool store, a franchisee may have a much greater role in terms of the product that is being offered and the service that is being provided. In that circumstance you can actually see that the franchisee has made a contribution, you might say, to the franchisor's business or reputation. In that instance the question becomes not who made the contribution but who in fact owns that goodwill. If you have an employment arrangement and someone develops a product, then invariably, if that was part of the employment contract, it belongs to the employer even though the employee was largely responsible. In a context of this nature, if the contract was drafted on the basis that the franchisor was the party to get the goodwill, that is the arrangement that pervaded the contract and the franchisor should be the party that has the goodwill. One of the submissions that I thought was particularly apt on this was the Cheesecake Shop's submission in relation to this, which basically said, 'If you change the terms of the deal such that we're going to have to pay for goodwill when we terminate, we are going to have to get higher rewards during the term of the contract and the term of the arrangement, because we entered into this bargain and seek the royalties that we seek on the basis of the goodwill of the business belonging to us', which then benefits all future franchisees and continuing franchisees and it benefits franchisees while they are earning their dollars.

CHAIR—Isn't what you have just said, though, an argument over percentages and numbers rather than either, firstly, the goodwill existing or, secondly, that it is mutually created, shared and otherwise owned? If you are agreeing with what they are saying, which is, 'Look, it exists and, if we have to pay it at the end, we will just have to change the numbers on the way through; but, yes, it is there', isn't it then just an argument over numbers?

Mr Speed—No, I would not agree with that. Regarding who it belongs to in the first place I go back to the employee-employer-type relationship—if it is being done, owned or developed throughout the process with the expectation that it goes to the franchisor, then it should stay with the franchisor. In terms of who it belongs to, from what I see in terms of goodwill, when an individual leaves a business why can't they take their goodwill with them? If it is referrable to their own personal skills et cetera, and the good relationships they have developed within the community, why can't they open up next door and take advantage of that goodwill, if that is their goodwill? That would be the only goodwill that I could actually see you would quantify or I would be able to identify, which is what you can take away with you, which is personal to you rather than to the brand, and you can already take that. If you are a good restaurant owner and you are competent and known in the community, you, the franchisee, are known in the community as that good, competent person, why can't you open up next door? Why don't the customers come to you? If it is an identifiable and quantifiable thing, why aren't you taking it with you? Why should there be compensation for something that you do take with you?

Alternatively, if it is referrable to the site, then it is goodwill referrable to the site. We would suggest that ultimately belongs to the landlord.

CHAIR—I think the answer to your question 'Why can't you go next door?' is because it is usually that you cannot open a competitive store right next door—

Mr Speed—You cannot if you are relying on the brand of the franchisor; then you are relying on the goodwill of the franchisor's brand. But you can certainly open up another restaurant selling hamburgers if it is a hamburger business that you are in.

CHAIR—Can I just ask you the same question I asked a previous witness just in terms of the goodwill. If you on-sell your business obviously you sell it for a market value, whatever that market value might be, that is then the value of the business. If you were to sell that business independently privately before the end of the contract term, why should it be any different? Or does the franchisor have a special relationship or right to that business at a different rate? How do you see that process? If somebody before their end of term decides that, through an arrangement or an agreement, they are actually going to sell that franchise and get a market value for it, why should that be any different for the franchisor?

Mr Speed—We go back to what we know best, which is retail leases. Invariably, if you sell a business in our area and you have three months left on your lease, you will have great difficulty selling that business because the business is only as good as the length of the lease. Invariably what would be necessitated for the sale is a renewal of the lease and new terms of the lease for a longer period. The value of the business is only as good as the continuing length of term of the relationship. That I think applies equally in terms of franchisors. In their circumstance, they can only sell a franchisee to the extent that they have a remaining term on their franchise arrangement or to the extent that they are able to renegotiate a new term. So, if you obviously are talking about a franchisor buying back into a business that has a term left, you would expect that the price paid for that would be referrable to the term that is left before non-renewal. If it is not renewed, you would expect there would be no payment. There is a distinction between franchisors and franchisees.

CHAIR—It is an interesting perspective you put forward that the value of the business diminishes as the remaining amount of time diminishes before the expiry of that contract or agreement. If that is the case, as you say, that that value diminishes the closer it gets to the end of the contract, following that concept, does the business not then value down to absolutely nothing on the day, if it is not renewed, and therefore the person holding that business is in a power imbalance in that the person holding that business has very little choice but to either get a renewal or face a 100 per cent loss of everything they have in that business—a walk away scenario? If, as you say, the value of the business decreases as you march closer and closer to end date, aren't they then in a more precarious position in terms of trying to renegotiate at any cost to get back in?

Mr Speed—Just in terms of describing the business, obviously the business includes the franchisor's business name, et cetera. That is not diminishing, because his brand is being maintained, et cetera, but it may be diminished if he cannot renew a lease, for instance, in the sense that you cannot open at that site again. But in terms of the franchisee's business, I suppose you could put it, looking at it from their perspective, really they will have fitted out or invested

in the business in the expectation—or they should have done if they are prudent—that it may well end on that date. There is a real prospect that at that date, if they cannot get renewal, which is obviously what people have the difficulties with, they may not be able to operate at that store at that particular location under that particular brand. That is the position that they will be in and they will be in a position where they will be keen to renew. But as we have indicated—

CHAIR—If a franchisee is compelled to completely refurbish a store, as is often the case, and do a brand style update of a particular franchise, let us say, very close to that expiry date, wouldn't that expectation then also be that there will be a renewal, as they make that further investment?

Mr Speed—I simply cannot respond from a franchisor's perspective. In terms of leasing, it would be unusual that you would have a contract term that requires substantial fit-out or other expenses to be incurred at the very end of the lease. That would be unusual. That would be a strange thing to have negotiated. The suggestion is somewhat strange. If that is what they are doing, in terms of the franchisor, it would be equally unusual in the context with which we are more familiar for you not to have negotiations at that time. Invariably it is impossible to get anyone to do that sort of work or make those expenditures without the guarantee or provision that their lease will be extended such that they can make good that. That is normal practice and normal expectation.

Mr Cockburn—In a retail leasing situation, the retail tenancy legislation in each state does protect against that. It actually says that a lessor cannot require a fit-out during the term of the lease unless it is specifically negotiated in the lease itself. Usually what happens is in relation to a renewal of a lease one of the conditions of renewal may be the requirement of a new fit-out. That is for the very same reason that the previous witnesses in reference to a question from Senator Boyce gave, that is, refreshment of a restaurant or refreshment of a retail shop is very important in terms of continuing to attract custom. That is why, on a renewal, part of the terms of the renewal may in fact be the requirement to have a new fit-out. But in terms of actually requiring a fit-out mid-lease that would be prohibited.

CHAIR—But this is specifically more in terms of retail leases rather than a franchise agreement itself.

Mr Cockburn—Yes, that is right.

CHAIR—So it is a different circumstance.

Mr Cockburn—Sure, but franchise terms would probably be longer than the standard retail lease, which is usually five years. There may be a requirement for a midterm fit-out. Obviously, if you have a much longer term, the chances are, by the end of that term, the place is going to look pretty crappy.

CHAIR—You have mentioned a number of times the employer-employee type relationship. Is that your view as to the arrangement that exists between a franchisee-franchisor, that it is an employer-employee relationship? Is that what you see as a definition of the relationship?

Mr Speed—No, not at all. It is just that simply, if the arrangement is that at the end of the franchise there is no option for renewal and there is no entitlement to goodwill or any compensation of that nature—that is the deal that is done—the circumstance is akin to an employer, where we more readily have case law in terms of where the property in the goodwill belongs. It is really in the context of where the agreement reached is that there will be no option for renewal and that, on non-renewal, there is no payment or compensation of that nature. That is the arrangement that you have. That is the deal the parties entered into and that is the basis that royalties have been payable and therefore it belongs to the franchisor.

Senator BOYCE—Could you first perhaps just as a start clarify for me the relationship between the Shopping Centre Council of Australia and the franchise industry?

Mr Cockburn—We do not have any direct relationship at all. We are two separate bodies, but it is the case of course that many of the tenants in shopping centres would be franchisees, although it would usually be the case that the lessor would probably be the franchisor.

Senator BOYCE—That brings me to my next question. One of our submissions, I think, contains about 10 different characterisations of those arrangements. Can you tell me what the experience of the Shopping Centre Council is in regard to who is the lessee?

Mr Cockburn—Yes. It would generally but not exclusively be the case that the lease would be with the franchisor. There are probably very good benefits in that.

Senator BOYCE—When you say ‘generally’, 90 per cent or 60 per cent?

Mr Cockburn—I could not nominate a figure, but I would have thought it would be of that proportion. It would generally be the case that, in the major shopping centres, for example, they would want the certainty of having the lease with the franchisor.

Senator BOYCE—Again, when you say ‘franchisor’, are we talking about the actual franchisor or an entity connected to the franchisor?

Mr Cockburn—It could be either, yes. There are some advantages in of course the franchisor holding the lease and negotiating the lease, because they obviously have a much greater bargaining clout than, say, an individual franchisee may have. It is usually the case that large franchisors are able to do multistore deals with shopping centre owners, for instance.

Senator BOYCE—The Shopping Centre Council’s interest in this is in terms of clients?

Mr Cockburn—Our interest in your inquiry is the fact that you had in there a term of reference in relation to section 51AC, which obviously has a much broader context for us than just the franchisor-franchisee relationship, and also the notion of the introduction of a statutory obligation of goodwill. I suspect if it was included in the franchising code it would only be a short step before there were demands for it also to be included, for example, in retail tenancy legislation. Those are the two major reasons why—

Senator BOYCE—Then you might like to talk me through why that would be a very bad thing from your point of view.

Mr Cockburn—I will pass that over to Mr Speed, but specifically in relation to the issue of goodwill?

Senator BOYCE—Yes, I am talking about good faith.

Mr Cockburn—Good faith; I am sorry, yes. I used the words ‘goodwill’, but—

Senator BOYCE—I am sorry; I misheard you as saying ‘good faith’.

Mr Cockburn—My apologies. I probably did, because we were talking about goodwill. It was in relation to the issue of good faith.

Mr Speed—Just finishing up on what Milton said, there is a provision, for instance, that there be good cause in automatic renewal. We want to know who we are dealing with and who is going to be there at the store et cetera. The ramifications—

Senator BOYCE—If there were to be a—

Mr Speed—If there were good cause—

Senator BOYCE—If you needed to show good cause before termination—

Mr Speed—Good cause has ramifications. When there are disputes of this nature we would like to know who the tenants are.

Senator BOYCE—That might change who you would give tenancies to?

Mr Speed—And we do not know. Yes, that has an implication. In terms of good faith, which is really what you are asking in relation to, I think Professor Terry put it very well in one of the submissions, which is that it means different things to different people and in different contexts and different times, depending on who you talk to and how you feel at a particular moment. A really broad concept of good faith is just fairness, and I think that generally viewed fairness has been dealt with before and has not been readily accepted because of the great uncertainty that it provides. Simply, what is fair to one person is not fair to another person. It is very difficult to form a judgment call as to am I or not being fair.

Good faith—I think most people are suggesting that the reason good faith is a new answer and something different to fairness is that there has been some recognition of it in the case law, most notably in New South Wales and in Victoria. But I think it is a big step to say that that ‘good faith’ has anything to do with fairness or is of that broad overarching nature. It simply is not. When you look through the cases, to the extent that it is clear—and it is not exactly clear how it is being implied or construed into contracts—it is a guiding principle to the implication of terms into a contract or constructions of a contract. Good faith as developed by the courts has been reasonably sporadic. People have very different views as to the extent of what it means.

Senator BOYCE—It has however been explored—

Mr Speed—It certainly has been explored, but it has been—

Senator BOYCE—in fairly great depth, hasn't it, over the years by the courts?

Mr Speed—In reasonably great depth. But then look at the legal commentators. The ACCC say they do not want it. But in terms of what the courts have said about it, you will see the commentators all say that it is greatly uncertain. As to the points that are clear, if you are talking about implication, there are a number of authorities on what are the requirements for implying a term. They are really whether it is necessary, whether it gives business efficacy, whether it is not contrary to the other terms of the contract, and whether you cannot really do without it. Essentially it is a necessary term; the agreement does not make sense to give effect, to what the parties intended, for this term not to be implied. To understand the cases you really need to understand what the law is in relation to the implication of the terms of contracts, and there are a number of steps that it is necessary to achieve. Therefore, in one context, when you look at a contract, you need to understand what the purpose was, what the particular provisions are, what all the express terms are and really implication fills in the gaps, and it only fills in the gaps where there is a gap and it is necessary for that gap to be filled. In that context, in some circumstances where there has been a broad discretion and it has been not been limited but was exercised in one particular way, that particular discretion is read down to give effect to what the parties intended, which is usually the modern approach to contractual construction and also the approach, when you are looking at the relevant tests for an implication of the term. Good faith, as developed by the courts, needs to be understood in that context, because it is only limited, it is only case specific and it is only in that context and it is not contrary to the express words. You need a surrounding contract and you need a common purpose to in fact imply such a term.

Senator BOYCE—But there will be surrounding contracts in the situations that we are talking about.

Mr Speed—There will be. But, for instance, the example that seems to be cited as the most common reason why you need good faith is this non-renewal point, except that, if your contract is terminated after six years, there is nothing for good faith to work on. Good faith does not come into operation, in terms of what is in the case law, until you have a contract, you have an arrangement, you have something to imply a term into, you have a context and you have a gap to fill. Therefore, it does not provide you, in terms of what the case law is, with a leg-up to say that good faith is an answer to negotiations precontract nor negotiations prerenewal. It only applies to fill in the gaps of existing contractual arrangements. Where people talk about good faith in a context that might have reference to prenegotiations or renewal negotiations, you are talking about something else other than the case law. They may have put the same title on it, but it is something different. You are talking about what I would describe as fairness.

CHAIR—Should parties act in good faith?

Mr Speed—As an overriding principle, it is like saying I should treat my neighbour as I treat myself. In terms of an overriding concept, sure. In terms of law, you cannot have judges determining whether something is in good faith, because they do not know what it means. That is the usual process of separation of powers.

Senator BOYCE—That is where we get to definitions, isn't it?

Mr Speed—Definitions. If it is to be the broad mechanism that some people seem to be suggesting for solving the problems, it will be necessarily vague. That vagueness creates uncertainty and it creates disputes, which are not what you would necessarily want or need, particularly in an industry such as the franchise industry where, if you look at the ACCC, they are getting a decreasing number of complaints and problems. According to the principles that we have been trying to expound in terms of regulation, it is only where it is necessary. Where the problem is particularly with non-renewals, the answer should be dealt with particularly on non-renewals. But in terms of a good faith overarching principle, it is not something that you can borrow from the common law in the context of what people are suggesting it might achieve, and you are really talking about that.

Senator BOYCE—We have good cause and good faith thrown into that basket at the moment. I have been asking this of most witnesses. We have had submissions suggesting that the basic standard contracts of all franchisors should be publicly available on the ACCC website, allowing people to do some comparison. You have made some fairly strong suggestions about the education of franchisees, prior education and so forth. What would your view be on public disclosure?

Mr Cockburn—As a policy we support the registration of retail leases, which means that they are publicly available.

Senator BOYCE—But you do have to go hunting, don't you?

Mr Cockburn—Yes, but there are—

Senator BOYCE—What about a system that would mean you would not have to go hunting?

Mr Cockburn—Actually these days you realistically do not have to go hunting. The only two states that effectively require registration of leases are your state and Senator Arbib's state.

Senator BOYCE—That explains my views on it.

Mr Cockburn—Yes. For the payment of a very small fee you can search these leases. But these days you do not even have to do that. There are now firms that have grown up that effectively do nothing else but search the lease for you. For example, if I want to be a tenant in a shopping centre I can go along to one of these firms and say, 'I'd like to know what everyone else in that shopping centre is paying. I'd like to know what the major terms of those leases are', and for a very small fee that information is available to you. We actually think that equalisation of knowledge, if you like, would be an improvement in our industry and that is why we have advocated the compulsory registration of leases around Australia. By implication from what I am saying to you, if leases are publicly available, then I see no—this not being my industry—reason as to why a franchise agreement should not be publicly available as well.

Senator ARBIB—I want to get your opinion on how the mediation process works at present and ways you think it could be improved.

Mr Cockburn—Unfortunately, I do not know sufficient about the mediation processes to say whether they are working effectively or not.

Mr Speed—And similarly, in terms of mediation and retail leasing to an extent for franchisors and how it is working, we have not sought to address that.

Senator ARBIB—I know we have had a long conversation on good faith. This morning all of the franchisors we spoke to referred to unethical conduct in the industry. Of course, only a minority engage in this sort of conduct. All of the franchisors believed that adding a good faith clause into the standards/code would actually be the best way to deal with unethical conduct. Can I have your views on that?

Mr Speed—It depends. Being a litigator, I tend to look at it from how you would determine or fight that sort of case in the sense of run, fight or adjudicate on it. I simply do not know what measure you would be going against to determine that issue; it is such a vague term. If you look at the various commentators, the one thing that they are uniform on is that they are in disagreement as to what it means, and that is not even in a particular circumstance. Some advocate that good faith is very broad and some that it is far less broad. From a perspective of trying to advise a client whether they have acted in good faith, I think that would be extremely difficult. How to defend it, what evidence you would need to put on it and how the judge adjudicates on it is extremely difficult.

Senator ARBIB—So your view is that, if good faith is an area that is to be pursued, there needs to be more work done in terms of defining what good faith means?

Mr Speed—I think that, if it is fairness, let us talk about fairness and we will express our views on that. If it is something that is much more limited and designed to deal with a particular problem, we can talk about that. But until we know what we are actually talking about, it is a bit difficult. Certainly some people are suggesting that good faith—and they are trying to use court cases as a leg-up to say this—is something established. I do not see that. I do not see that the court cases in any way establish that there is this recognised principle that could give rise to any overarching statutory duty. What is done in the authorities is highly dependent upon the common law principles governing construction of contracts and the implication of terms under contracts. You cannot really understand good faith in the authorities without understanding that in the context of the arrangements.

Mr Cockburn—Did you say it was the franchisors who said that or the franchisees?

Senator ARBIB—The franchisors.

Mr Cockburn—I think the ACCC made the point in its submission that there is nothing to prevent a franchisor inserting an obligation to act in good faith into the terms of the franchise agreement. As Mr Speed has said, it does make some sense in that it fills in whatever gaps might appear in terms of the franchise agreement. But as Peter said, to take it outside the specific terms of the franchise agreement and have it as an overarching legal principle probably does not make a great deal of sense if you are not able to define it in that context.

Senator ARBIB—I am sorry, I do not understand that. If the ACCC believes that you can define it in terms of a contract, then why can’t you define it outside of a contract?

Mr Cockburn—Only in terms of the specific terms of that contract.

Mr Speed—If you have a term in the contract where you are defining a discretion and the discretion is, for instance, that you can terminate the lease and it simply says you can terminate and it has nothing about notice, nothing about the conditions or the requirements on that and it is simply at a whim, the cases talk about that. The courts will imply a term of good faith in that context; it would be relevant to the purpose for which they originally entered into the arrangement because it is so broad and wide. Therefore, you can define it. In a context or a specific discretion, you could identify it, like the courts do, that there is good faith in that context in that contract to deal with the problem. It is a term that in a particular context can mean something but as an overall principle or an overall concept as a statutory duty it is taken out of context. What does it mean? If you are talking about particular circumstances, particular provisions, then you might be able to draft it into a contract. The franchisors might wish to do that and might think that is a good idea. I would suggest a better way would be in fact in, say, a termination to say, 'You do actually get a certain period of notice. Here are the described circumstances.' That provides clarity. But if they want to fill a gap by putting in a provision that is vaguer, such as good faith, they are entitled to do that. But it will actually have some meaning because it will be somewhat more contextual. You will see, for instance, in the submission that, with what we were talking about, our main objection was what we called overarching or overriding good faith, because that just does not mean anything.

Senator ARBIB—Just on something you said, given there is an uneven balance in terms of the power in a relationship between a franchisee and a franchisor, how do you then deal with unethical conduct? If you do not use good faith, how is that done?

Mr Speed—We are not just talking about good faith in a vacuum. We are talking about an industry, particularly in terms of franchising, which has a code, which has section 52 and section 51AC. Invariably if you have unethical conduct, the most common cause of that unethical conduct is misleading and deceptive conduct, so you have section 52 to cover that. If it is an arrangement where you are taking advantage of an imbalance in power, section 51AC was deliberately enacted to provide that relief. It is a provision that at least has the benefit of the courts knowing it when they see it and it has the benefit of case law, which, yes, applies or was more developed in terms of where there was a different type of special disability. But you do have something there that provides some protection that takes into account all of the circumstances. I am talking about section 51AC.

Senator ARBIB—But you just said a second ago, in answering my previous question, that you thought that, other than good faith, you could bolster I guess securities for franchisees by putting something in place. What did you actually say? You said you could put in place letting people know when the terms of the agreement are coming forward and in terms of terminations.

Mr Speed—I was simply indicating that, if you are negotiating a contract and, say, you have a discretion negotiated into the contract dealing with termination, you could use a vague term such as good faith, which I would suggest is vague and not ideal. But if you were negotiating a contract, a more normal form and a more sensible thing to do would be to actually say how much notice you need to give, the period that needs to be given, the circumstances in which termination can take place. So being far more prescriptive than vague. I am suggesting that you could—

Senator ARBIB—So you are saying prescription?

Mr Speed—Prescription when you are negotiating a contract, reaching agreement as to something that is more prescriptive.

CHAIR—Just to wrap up perhaps, in your submission you have suggested that the best way to counter power imbalances is through a process of education.

Mr Speed—Yes.

CHAIR—Could you describe what you mean by that? Could you elaborate on that and how that would particularly work again in terms of what we were discussing earlier about the diminished value of the enterprise as it gets closer and closer to termination date, and the power imbalance at that point? How would the precontractual education help at that 15-year mark?

Mr Speed—Obviously a better advised franchisee is in a better position to deal with a franchisor. In those circumstances, where you are getting towards the end of term and you know from the outset that you are only entering into a five-year deal, whilst normal practice may be renewal, you do not have any guarantees in relation to that. With the knowledge that that is the likely circumstance, you are unlikely to be doing fit-out or doing major expenditures in developing the business towards the end of the term without simultaneously talking to the franchisor and seeking a renewal and extension of the term. The education will assist in making you not have errors of judgment in spending great amounts of money at the very end of a franchise relationship, bolstering that business, when it may finish tomorrow. It is a matter of being aware of what might happen and then putting in place the negotiations or speaking to the franchisor and saying, ‘Is this one going to be renewed?’, and the franchisor may be telling you that for particular reasons ‘We’re not renewing that one.’ There may be good reasons and obviously you would want to know that as soon as possible if you are contemplating spending substantial amounts of money. You may know that you might be then better off asking, ‘Should I ask the franchisor for a new franchise somewhere else?’ Or, ‘What should I do?’ That is where the education comes in; forewarned is forearmed.

Senator ARBIB—Doesn’t that undo the whole franchisee-franchisor relationship? What is the use of investing money in a business and building it if the contract is for five years and then it is over?

Mr Speed—But that is not the situation; as the statistics show, there are typically renewals. That is typically what occurs. But a franchisee needs to be wary that he has only signed up for, and the deal is only for, a six-year term. The terms could change. It may be, for instance, not an outright refusal; it may be that the franchisee does not think the new terms of renewal are as good as he would like. You want to know when it is not going to be renewed or, alternatively, when the terms are not going to be as favourable as you would like. Prudence indicates that, if you are going to be investing substantial amounts of money into that, when you are approaching the end of the term you would be speaking to the franchisor and asking whether you are going to be. Obviously, education comes into it, because you know that, at the end of the term there are no necessary rights, no automatic rights or no obligations on the franchisor to renew and, therefore, you need to be aware of that and invest and do your business or perform your business with that understanding. That is where education comes in.

Mr Cockburn—I am not as familiar with the disclosure statement in the franchising situation as I am in relation to the retail leasing situation. With every review of retail tenancy legislation, a major focus is always on that disclosure statement. What information can we include in that disclosure statement to ensure that the tenant is better informed in terms of the decision they are now about to make? When I talk about education it is really that sort of information that I am talking about there. The better informed a franchisee and the better informed a retail tenant, the less chance there is that that agreement or that lease is going to end in dispute. In light of the fact that the Senate Economics Committee is now looking specifically at part IVA, does that have any ramifications for your terms of reference at all?

CHAIR—What other committees do is not the business of this committee. Thank you very much for your evidence today.

Proceedings suspended from 12.49 pm to 1.39 pm

PENGILLEY, Professor Warren James, Private capacity

CHAIR—Welcome, Professor Pengilley. I remind you that witnesses giving evidence to the committee's inquiry into the Franchising Code of Conduct are protected by parliamentary privilege and any act that may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false and/or misleading evidence to the committee.

Prof. Pengilley—My qualifications are set out in my submission. I consider my appearance to be a disinterested act of benevolence in an attempt to get the definition of 'franchising' right. This has been an attempt of mine over a decade or so, which has been fairly consistent over time. In the interests of time and in the interests of concentrating on what I think is most important, I will talk just about the definition and, if there is anything else I can add, that is well and good. Basically, I am talking about the definition of a franchising agreement.

Firstly, most times when you start trying to change some law you assume that the present law is good, has been rationally reached and has been the process of some cerebral involvement. The present definition of franchising is not any of those things. The definition started off with the Reid committee, which refused to define franchising. It just said that the definition was not too hard, 'We will get one later. Hurry up and legislate.' The definition was then proclaimed with virtually no public debate at all and, in my view, it is completely wrong, and that is what I am arguing.

What we have in franchising is something like this. We have a concept which is pretty much misunderstood by lawyers and others alike because it does not fit in with the concepts that we teach in law schools or law practices. It is part contract, employment law, trade practices, trademarks and part licensing. It partakes of all these things, and yet is covered by none of them.

We have a definition of franchising—which as far as it goes is a start—that talks about the concept of giving a right to sell and so on, but it is not the end, because within that concept you have things that in many ways resemble simple contract and yet they are within the current definition. The argument I put and which I have heard argued and seen argued in private practice is something like this. The present definition can cover, say, a restaurant when it enters into a deal with a wine company. The wine company obviously has trademarks on its wine. It puts advertisements around the restaurant, has a marketing plan and no doubt they have a trade dinner sometimes, so there is a franchising fee and that is a franchise. That is taking it a bit to extremes, but under the present definition it has been argued—I can assure you—and it can be argued, and the definition, of course, has all sorts of repercussions in terms of inter partes rights and liabilities.

What we have to do is work out what we are trying to regulate because, if we do not get our definition right, we do not get the regulation right. Because of the somewhat onerous disclosure requirements it means that this can be a real cost on business when maybe it is not needed. I suggest to you that the appropriate definition has to have in it the concept of a long-term

relationship or some more than passing relationship, dependence on a trademark for the overall business of the franchisee, and a power-dependence relationship, so that we have the proper regulation of things such as Dymocks, Dick Smith, Tandy's, McDonald's, Pizza Hut, KFC and so on, but we do not have the regulation of something that is basically contractual, such as—and I can assure you these have all been argued—a lotto in a newsagency, a Darrell Lea chocolate stand in a retail outlet or a weight loss system in a pharmacy. All of these are things where there is no overall dependence. There is no overall reliance. They are matters of contract and they are very simple.

However, it is quite different when you have the other franchisees I have noted, where you do have very much power dependence. It is the latter, not the former, that we want to regulate. We are only over-regulating and we are only incurring costs on business that are totally unwarranted if we bring the others into the regulatory net. The technical ways of how this has been achieved are in my submission and I will not go over them. Have members of the committee got my submission with them?

CHAIR—Certainly.

Prof. Pengilley—I will refer you to page 29, which is the second last page. On page 29 I refer to the prior definition under Corporations Law. You will see there that it has four bits. The first one is the one that we have in the present regulatory definition, agreement or arrangement to exercise a right to engage in the business of offering, selling et cetera. That is the only definitional reference in our present franchising code.

Regarding (b), (c) and (d), that the person must be associated and identified by the public as being associated, and a significant degree of control and that the person carrying on the business will be substantially dependent on goods, those three things have been dropped. For the love of money I have no idea why. It is contrary to the Swanson committee and the Blunt committee—and their suggestions are both set out there—and it is contrary to most definitions as I understand them. I do not claim to have gone through them all—I did some years ago in America. They are contrary to all of the concepts there. It just seems to me to be quite wrong.

The problem is, of course, that you get people arguing in inter partes cases that the definition is wide because they are arguing benefits for themselves. You get the regulatory authorities having some difficulties. I have had it said to me, 'Really we are only concerned with McDonald's, Pizza Huts and what have you', the publicly identified franchisees, 'and therefore the definition does not need amendment', but I just think that is teaching disrespect for the law, and it is having its problems with the inter partes position.

The initial guide to the franchise legislation issued in 1998 by the ACCC said, 'If you are a franchisee, then …', but it completely failed to tell you what a franchisee was, and the reason was that there was a demarcation dispute—that is not the right word—or some sort of dispute between those that wanted to interpret it narrowly and those that wanted to interpret widely, so the conclusion reached was that we will not say anything and let people work it out. The present statement by the ACCC, in its regulatory book, which I only read after writing this submission, is:

Franchising as a business system involves one party, the franchisor, granting the franchisee the right to operate a replicated franchise business.

Where the term ‘replicated franchise business’ appears in this definition I do not know. It is a commendable idea of the regulator to try to get the idea of a publicly associated franchise arrangement and something that is associated with the franchisor. I think as a matter of regulation that is commendable, but it is completely outside the law. My view is we should bring the law into accord with what the regulator is saying to be their particular position being a replicated franchise business. If it is going to be a replicated franchise business, according to the regulator, then maybe we should bring in and bring back the other two positions, which I referred to earlier on in page 29 of the submission.

I tried to convince the committee that was established in the year 2000 that the most important thing was the scope of regulation; that what is regulated is totally subservient to the scope of the regulation. The committee gave me quite a reasonable amount of press but then said, ‘This is a legislative matter and of course we cannot talk about legislative matters, we can only talk about regulatory matters.’ I urge this committee not to adopt the same view, because it clearly is a regulatory matter. The whole code is a regulatory matter. It just seemed to me that was just a Pontius Pilate act, with great respect, and it did not want to do anything about it because the code had only been in for a couple of years.

The simplest change is to say, as I suggested to this committee, that instead of saying the business of the franchisee is the relevant thing is to say that the overall business of the franchisee is. That is the simplest ‘political’—in the widest sense of the term—way to change it without changing the whole definition. But I would suggest that the whole definition could be changed and looked back to the prior definition under prior Corporations Law to which I have referred.

One thing that does concern me is the concept of a franchise fee. The franchise fee concept can be used to exclude franchise agreements, which should be within regulation. If you do not pay a franchise fee, then you do not have a franchise, for purposes of the code. People have argued—and I think the argument is valid—that if they have, for example, a trade name and you lease that trade name on so much a month, with nothing to do with profit, it may well be that the arrangement, which should otherwise be regulated, is outside the concept simply because of the franchise fee and structuring a way to get out of it. I do not think a franchise fee has any relevance if you have an ongoing relationship which is power dependent and relies on a trademark and is controlled by the franchisor. You do not need a franchise fee in those circumstances. You have the dependence position and that is all you need. The franchise fee, if the franchise arrangement is redefined as I suggest, is redundant and not necessary at all.

CHAIR—My interpretation of what is out there in the marketplace is that most, if not all, people who are either a franchisor or a franchisee understand that they are. There is a given acceptance that people know by their own definition whether they are in a franchise or not. It does not seem to have appeared in any other submission or anywhere that I have found that people are not sure what they are. That is one point, but if you are saying that the definition itself of a franchise is an issue, then what importance does that have in terms of any disputes that are out there or any regulatory impact? What is the central theme of the point of the definition of a franchise?

Prof. Pengilley—It is relevant when lawyers are looking around for a way to fight cases. Someone will say, 'We have a franchise agreement. You didn't comply with the pre-disclosure requirements' and therefore various things follow. Already it has been argued—and it was highly doubtful until recently when the High Court said this—that if you did not comply with the agreement the whole agreement was void, and so it has had repercussions for franchisees and franchisors.

CHAIR—That is obsolete because the courts are now saying differently.

Prof. Pengilley—That is not so long ago. I still think there are other fertile grounds for tilling in relation to remedies and the like. What we should do is define the thing. We need to ask the question: what are we trying to define? Are we trying to define the wine in the restaurant, as I was talking about, and then define it out of that, or do we leave it open for the lawyers to have their arguments?

Senator BOYCE—Are the lawyers having arguments?

Prof. Pengilley—I know of a few, but I do not know how widespread.

Senator BOYCE—There are cases where what you would perceive to be marketing arrangements are currently before some sort of judicial body because someone is arguing that they are a franchise and not a marketing arrangement?

Prof. Pengilley—As I understand it, there are some, but it is not only cases before the court. They are only the tip of the iceberg, so to speak, and long negotiations often go on that never hit court. I cannot give you a statistical figure. I don't know. But I know there are some because I have been in some.

CHAIR—What you are claiming is that there are some people who say, 'I am a franchisee under an arrangement', but the person that they have an agreement with says, 'I am not a franchisor and you're not a franchisee.' Be it all other things, the dispute is what their relationship is?

Prof. Pengilley—Yes. That they comply with the code, for example, and that they have to have pre-disclosure. One argument is, 'I am a franchisee. You haven't disclosed all these things.'

CHAIR—Would that not be part of the original agreement that is entered into, that it says, '... as the franchisor, and you, the franchisee, we agree on X, Y and Z'? Is that not part of the original contract, or does the contract say something completely different?

Prof. Pengilley—As to the original contract in these circumstances where the franchisor does not think it is a franchise agreement and the franchisee does not argue, it is only when they have the dispute that the franchisee, on legal advice probably, says, 'By the way, I was a franchisee and you did not disclose all of that stuff.' That is when the argument comes up. Therefore, as was argued recently, the arrangement is void.

CHAIR—Would that not be taken care of in the definition that currently exists, where it says, '... party to the agreement or arrangement ... the definition of a franchise authorises, permits

another party …', and so forth? Does that just then cover that? If two people get to a point where there is a dispute and it is not written in any contract that either party is a franchisee or a franchisor but it is implied in the type of arrangement they have or agreement to provide a service with a particular brand, trademark and so forth, is that then not implied even if it is not written in contract?

Prof. Pengilley—I am sorry, I am not quite with you.

CHAIR—Say two people have an agreement where one person sells to another person a right to do something on their behalf. Even if in that contract agreement it does not use the specific words 'franchisee' or 'franchisor', is it not implied in the terms of the definition that currently exist?

Prof. Pengilley—Yes, that is the problem; the definition as currently exists applies too widely. With the example I used of wine in a restaurant, I do not think anyone would say that is a franchise agreement. When you have a fight it might be alleged it was.

Senator BOYCE—Do you have any real cases that you can talk about where this has been a matter of dispute, with a particular marketing arrangement or style of marketing arrangement?

Prof. Pengilley—No, none that I can talk about. When the committee met in 2000 there was a paper produced for it, a briefing paper, and one of the examples used in that was lotto in a newsagency. Another one was how people were structuring agreements to overcome the possibility of being a franchise by defining the franchise fee in a certain way and so getting excluded in that case, not included. I cannot remember what else was in it. There are a couple that are on record.

CHAIR—Is the further problem that no matter how you define it, if people do not write it in the first place you still have to have a dispute and an argument over whether it is or is not?

Prof. Pengilley—They should know beforehand whether it is or is not.

CHAIR—Isn't that definition the whole problem?

Prof. Pengilley—My point is that a lot of them do not think they have a franchise agreement so they do not pay any attention to the code. As far as they are concerned, it is a simple contract. Then when they have the dispute that is when there is a problem.

CHAIR—How does changing the current definition prevent that problem from arising? If people are ignoring the definition now, won't they ignore any definition no matter how broad you make it or how detailed you make it?

Prof. Pengilley—The definition by the prior committees and the prior Corporations Law—and the definition I am espousing—is that clearly some things are not franchise agreements and therefore they can do their contract with faith in the contract and when a dispute arises a person cannot raise the possibility that it is a franchise agreement. Taking my wine example again, which I know is an extreme example, there would be no question there that it was a franchise, because it would not be capable of being identified by the public as being substantially

associated with the trademark or the franchisor not exerting a significant degree of control, or it would not be believed that the person was substantially dependent; it was just a bit of his business.

CHAIR—Do you believe you could define it to a point where there would be no disputation at all?

Prof. Pengilley—I reckon it was defined before in a situation where there was very little disputation.

CHAIR—Very little, but still some.

Prof. Pengilley—I can't say none or—

CHAIR—I am just trying to get a point. Does this fix the problem or does the problem continue regardless of what you define?

Prof. Pengilley—You could define it in the way the prior Corporations Law did and there would be minimal dispute, because there are only a certain number of franchisees that would fit that definition. That is all we are trying to regulate, the McDonald's, the Pizza Huts or whatever. We are not trying to regulate inter partes agreements. We are not trying to say that everyone who enters into an agreement with a trademark should have to go and disclose all of these things. Turning a licence agreement into a franchise, which many fear. Again, I do not know—I have nothing to back this up—but my guess would be a number of people who are potential franchisors might well run a bit scared on the present definition if they enter into the most simple agreements, as distinct from a franchising system.

CHAIR—What is the risk in that?

Prof. Pengilley—I should imagine there is a possibility that people will not enter into certain agreements if they have to go through the predisclosure requirements.

CHAIR—Would that not be a good thing?

Prof. Pengilley—It is not a good thing if the agreement is purely and simply on-selling a trademarked item.

CHAIR—Are you saying that because of that people will not want to enter into that agreement? Is that not because that agreement does not suit them and they do not want to because they see some disadvantage in that agreement? Is that a good thing that they do not?

Senator BOYCE—Or is it complexity and cost?

Prof. Pengilley—I do not think so.

CHAIR—I am just pursuing where you are trying to drive us to in the change to the definition.

Prof. Pengilley—I follow what you are trying to say. I do not think so. If someone wants to have a distribution agreement and they run scared because of all the disclosure requirements, which is a pretty costly thing—again, do not ask me for a figure—

Senator BOYCE—For a distributor or manufacturer?

Prof. Pengilley—Yes. If they feel scared to run a simple distribution agreement, for example, because of the wide definition in the code, I do not think that is a good thing.

CHAIR—Is not this whole issue of disclosure and costs part of doing business and of the franchisor wanting to expand and grow and enter into particular arrangements with people as part of the cost, but if that cost then is something they fear or do not want to participate in, then perhaps they should not be there in the first place? They will continue doing what they are doing without going into a type of franchise arrangement? The idea of disclosure is that in the absence of disclosure you have non-disclosure and non-disclosure creates a whole new set of problems and circumstances?

Prof. Pengilley—In the absence of disclosure you have non-disclosure perhaps, but non-disclosure is a normal contractual thing. I am not acting for these guys or anything, but I will use the example of a Darrell Lea chocolate stand in a retail shop. What disclosure is there? Either the thing goes or it does not go. You have something in a contract that probably says if it does not work after a year it will be terminated. There is no dependence. It is a simple contract like me buying a newspaper. The person's business does not depend on it.

The problem with franchising arrangements is that the whole franchisee's business depends upon the trademark, the backup, dependence on supply and so on. If that bellies up in some way, and that may well be the franchisor going bankrupt, then of course the franchisee goes down with them as well. In my example, if the franchisor, Darrell Lea goes bankrupt—and I am not suggesting it is; I hope this is not a privilege infringement or anything—then what do you do? You chuck out the store and that is it.

CHAIR—It is hard for me to draw the line with the comment you just made about 'It's just like me buying a newspaper', in terms of the contractual arrangement between your handing over $1.30 and receiving a paper in return and the contract ends there, and a franchisor failing.

Prof. Pengilley—My example is a bit extreme, but it is just like a newsagent might have a dozen distribution arrangements. He sells Parker pens, newspapers, Playboy and Darrell Lea chocolate. If they have a bad relationship then that is it.

CHAIR—None of those are considered to be a franchise owned by the newsagent?

Prof. Pengilley—You can well argue that the chocolate arrangement would be a franchise.

Senator BOYCE—Under the current definition?

Prof. Pengilley—Yes, under the current definition. Whether it is good or bad, whether there are complaints or no complaints, or whether there is history on the record or not, we should regulate only what we really want to regulate.

CHAIR—In law, though, you could really argue whatever you wanted, but in the end no-one argues that because that is not how it is defined?

Prof. Pengilley—It is not true that no-one argues it. Someone has obviously argued that the agreement was totally void. It went all the way to the High Court. Someone has argued it.

CHAIR—Which case are you referring to?

Prof. Pengilley—The name escapes me.

CHAIR—The Masters Education Services case?

Prof. Pengilley—That is right. Someone argued there that it was void.

CHAIR—They were arguing under the code.

Prof. Pengilley—Yes.

CHAIR—We know the outcome of the case and the appeal.

Prof. Pengilley—After all, why do we have to have someone fearing a significant cost? Each franchisor has a first business cost. When they have established 100 outlets it may be minimal, but the first cost is fairly big. Why should we have the regulation of all that when we do not really want to regulate it? No-one else regulates it. We have not until this code came in.

Senator BOYCE—You are saying that we do not want to regulate marketing agreements?

Prof. Pengilley—Yes, that is right.

CHAIR—I do not know if there is any intention for us to regulate marketing agreements at all. Senator Boyce?

Senator BOYCE—As I understand it, what you are saying is that we may inadvertently be providing the wherewithal in the current definition for marketing agreements to be regulated in the same way as franchises. Is that right?

Prof. Pengilley—That is right. We are giving ammunition to people for dispute resolution.

Senator BOYCE—Do you think we should tighten up the definition of franchise?

Prof. Pengilley—Yes, tighten up the definition, so that someone like an investor from overseas cannot look at it and say, ‘If I do this I have to have all these requirements.’ They really should just have a licensing agreement.

Senator BOYCE—We do have the problem that you are the only submitter who has raised the issue of the definition and there is certainly going to be that very strong ‘if it ain’t broke don’t fix it’ argument. What would be your response to that?

Prof. Pengilley—I would argue that it was not broken before, apart from the fact there was a voluntary code, as distinct from a mandatory one. There was nothing wrong with the definition before. It is the definition that has been found by the Blunt committee, the Swanson committee and the prior law, and they are the only committees that have examined it in detail in Australia so far as I am aware. The government at the time did not give any time at all for anybody to comment on the definition. It was merely promulgated within 11 days.

Senator BOYCE—Should we reinstate the more correct definition that existed—

Prof. Pengilley—We should reinstate what was there. 'If it ain't broke don't fix it' probably means that it is working all right. We have not had a dispute yet. All we need is one and we will see how broke it is. Again, why are we trying to regulate marketing agreements when we do not have to?

Senator BOYCE—I do not think there is any intention to regulate marketing agreements. I wanted to move on to the suggestion we have had from numerous people about putting in a clause that requires people to negotiate in good faith within the code, both in a general sense and in terms of contract renewal. What would be your comment on that?

Prof. Pengilley—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.

My big problem in my early days as a commissioner with the Trade Practices Commission, which is going back three decades now, was to do with the squeals that came out about section 52, about how vague it was, how no-one would know et cetera. The advantage of section 52 was that it caught things that you cannot catch in black-letter law. It does not matter how smart the parliamentary draftsman is, things will be missed. Section 52 had the advantage of bringing into a net things that were missed and I think this would have the same advantage on franchising obligations. I put in my submission that I think it is a fair thing. I am not quite sure about the definition. I put in my submission a suggested definition taken from America. That may need some fine-tuning. I do not think that it is bad faith not to renew an agreement if it is made clear. The problem that I think might happen—and I have not a great deal to back this up apart from hearsay—is that a franchisor says, 'Yes, we will renew your agreement', and then does not, and so the conduct then is bad faith. If they say all the time, 'At the end of five years you are out' unless we do something, I do not think it is bad faith then to throw them out. It is a question of disclosure. It is the same as section 52. Section 52 does not stop you doing most things, but you have got to say what you are doing and you have got to disclose it.

CHAIR—Just on the concept of good faith and whether it is clearly understood that after, let us say, a five-year period, if we are using that as an example, it is all over, that people walk away, and that in good faith that is done correct and is not an issue, does that go back to the expectation? The expectation always was that it would end and everyone would walk away at the end of five years, or if the expectation is different, in the absence of anything else happening, ongoing in perpetuity?

Prof. Pengilley—It is an elusive concept, expectation, and of course you are only going to find it out on a case-by-case basis. In section 52 you have cases where people have led them down the garden path, so to speak, and then changed their mind to their detriment. If there is an expectation that it is going to be renewed and then suddenly it is chopped off, then I would suggest that is bad faith. If there is no expectation or it is clearly stated you might not be renewed, then fair enough. The problem might be that they say, 'We will renew you', and then they do not. That seems to me that you cannot cover anything by black letter law. You have just got to cover it by the good faith provision. I might add that there are few comments I have made on mediation that might be of relevance to the committee.

CHAIR—Sure, if you would like to make a comment there.

Prof. Pengilley—I have to write a paper on definition for Bond University, and this is coming up in a month or so. I will be happy to table that paper provided it is given confidentiality for a month. I am not worried about the contents, but I do not think it is quite right to release it.

CHAIR—Do you want it embargoed until the release date?

Prof. Pengilley—Yes. It is a speech and it has a bit of editorial freedom in it. It is a bit easier to read than perhaps the submission.

CHAIR—We will be happy to accept it and embargo it until you release it. Can you give us a date that you will be releasing it?

Prof. Pengilley—Yes. I've got a letter with it.

CHAIR—So is it contained in there?

Prof. Pengilley—It is 23 November.

CHAIR—Thank you for your time here today. The committee appreciates it.

[2.15 pm]

TERRY, Professor Andrew, Private capacity

CHAIR—Welcome, Professor Terry. The same rules apply in terms of parliamentary privilege and protection regarding the evidence that you give. Would you like to make a brief opening statement?

Prof. Terry—Yes, thank you. I do not have a prepared opening statement, but I would appreciate the opportunity to make a few brief comments. Most of them are in my written submission. The fair trading report in 1997 that led to the Franchising Code of Conduct was prefaced with a statement that I made during my evidence to the Reid committee:

> Good franchising is very good. It is undoubtedly the most efficient, effective distribution system ever invented. It is the greatest invention of Western capitalism since the invention of the corporation. Good franchising is so much better than independent small business operation, but bad franchising is so much worse.

I am disturbed by comments, such as the one by Mr Rau in South Australia, who said:

> In a perfect world we would not have franchises at all because I think they are all nonsense.

That sort of comment is not helpful, not right and does not add anything to the debate. Franchising is undoubtedly a magnificent business strategy that has added so much value to the business community, both to entrepreneurs from the franchisor side and from the franchisee side, to the consumers who benefit from the high quality standards and systems, to the government, to job opportunities and to everything else. Good franchising is very good, so much better than an independent business operation, but bad franchising is so much worse. I would hope that the committee is starting from the proposition that franchising is a great business strategy and we should work to make it a better strategy.

The second preliminary point was that so often in my writing on franchising and franchising regulation I have cited the submission of COSBOA, which is a small business organisation, back in 1986. In 1986 we were very close in Australia to having a franchise agreements act. We had two drafts of it. The franchisor lobby, which did not want regulation at that stage, was successful in persuading the government that regulation would not be good for the sector, and the proposed 1986 legislation went away. I cite often the statement of the small business association:

> Entrepreneurship and business creation in free enterprise society such as ours necessarily include an element of risk and it should certainly not be the role of Government to remove it. Nevertheless, in the particular circumstances of franchising there are elements quite different to normal business development because of overriding risk for other than purely business or commercial reasons. Those special additional risks arising in part because of the balance of power in the franchising relationship should be minimised while leaving the commercial risks and decisions to be handled by the parties concerned.

It is important that we realise that risks in franchising arising from the normal commercial risks, the risks inherent in a free enterprise economy. The events that we have experienced lately are an

example of risks that apply to one of the risks of doing business. However, there are risks, as COSBOA states, that arise from the nature of the franchising relationship. It is a relationship characterised by an information imbalance. It is a relation characterised by a power imbalance. Particular risks that arise from that information and power imbalance are the risks that regulation has an appropriate role in trying to address.

In Australia we address these by the Franchising Code of Conduct, which I should point out to the committee is undoubtedly the strongest regulatory instrument in the world for protecting franchisees. Up until a decade ago franchising regulation hardly existed outside the United States, where it has long been an entrenched feature of the American scene. It was not until the late eighties that franchising regulation started appearing and it has appeared quite regularly since then.

About 30 countries regulate their franchising sector today. There is no one formula for it. Prior disclosure to address the information imbalance is the most common feature of the 30 regulated regimes, but it may surprise the committee to learn that there are about five or six regimes that regulate franchising without a prior disclosure requirement, which is strange and unusual to me.

Of the other regimes, there are 10 to 15 of them that we could put to one side as being very minimalist regimes. 'A franchisor should disclose such information that a franchisee needs'—that sort of thing, which is such light-touch regulation that it probably does not deserve to be called regulation. Of the other ones, prior disclosure is most common. With respect to mediation, there are only two counties in the regulated sectors that impose a mediation requirement, as we do under the Franchising Code of Conduct, as a prerequisite to arbitration or to litigation. Dealing with the power imbalance is more unusual than usual. UNIDROIT developed a model franchise law a few years ago. For example, its focus is exclusively on prior disclosure. Canada is active in franchise regulation amongst its provinces. That regulation is purely prior disclosure regulation. Our regulation, of course, goes further in dealing with the conduct or dealing with the actual relationship in terms of mandating against transfer except on reasonable grounds, and prohibiting unilateral termination without due course—those sorts of factors.

The Franchising Code of Conduct is the strongest regulatory instrument in the world, but I am not suggesting by that that we should not try to make it better. That is information that is important. It is important that the committee realises that. The final introductory point I wanted to make was that, while regulation is probably the most vital ingredient of a protective package for franchisees, the committee needs to be aware that regulation cannot solve every issue. We need better education of franchisees, with franchisees taking responsibility and exercising due diligence. These factors are just so important.

I know the difficulty of these. My mission in my professional life has been education, particularly franchise education. The diploma of franchising had its origins in courses that I developed at the University of New South Wales and offered through a centre for franchise studies to the franchise sector. Franchisors would enrol in the certificate courses. The people that I really wanted to attract to these were the franchisees, because they were the ones most in need of education. They are a very difficult audience. This is why in my submission I do challenge the committee to consider the analogy of the driver's licence. We do not need somebody on the road without a driver's licence. Perhaps we should not let somebody become a franchisee until they

have at least ticked some boxes that they have been to a course or they have been exposed to information.

CHAIR—Do you think that should equally apply to a franchisor?

Prof. Terry—Yes. Of course I do not have a problem with that. I would have thought they were franchisors. No-one is going to be offering a franchise without knowledge of the code and that sort of thing.

CHAIR—Why do you say obviously no-one would?

Prof. Terry—Listening to the previous witness, I agree that to the extent that we have a problem with the definition of 'franchising', it is not that it does not catch franchises. Everything that you and I and everybody in the community would understand as a franchise is caught under the Franchising Code of Conduct. The problem with the definition is that it catches arrangements or has the potential to catch arrangements that are not intended to be franchised—trademark licences and the distribution agreements. There has been quite a lot of litigation on it. Most of the litigation on the code, with the exception of Ketchell's case, which addresses a particular point of disclosure receipt, has not been on the substance of the code. It has not been on disclosure, termination, transfer and so on. It has been on the definition of franchising. This has not been the case of a traditional franchise. In a traditional franchise we all know we are franchises and everybody knows that. We have probably wasted a lot of ACCC and court time and energy on that. That is simply what I mean by that.

CHAIR—You are saying that the ones that have been in dispute are the ones that would not necessarily fit in under the code of what a franchise is?

Prof. Terry—Yes. Some of those have been held to be franchises and some have been held not to be franchises. Most of them have been held not to be.

CHAIR—Hence, therefore, why the code does not apply?

Prof. Terry—Yes.

CHAIR—You have probably argued universally with a whole range of people in the sector that there are two mutual things that exist at the same time. Firstly, Australia is one of the most highly regulated countries in the world in terms of franchising; it is also the most successful in the world at franchising. Certainly all the evidence that has been presented to us and all the research that I can find, and every submission, travels down those equal paths at the same time. We are the most regulated in the world and also the most successful. Do you believe there is a link between that?

Prof. Terry—Yes. I would just sum up my submission again. At the time of the introduction of the Franchising Code of Conduct, Martin Mendelsohn, who was generally regarded as the leading franchise authority in the United Kingdom, commented:

> The proposed new Australian regulation makes Australia the least desirable destination in the world for franchise systems … [Franchisors] should avoid Australia until they have nowhere else to go and even then it would be a close call.

CHAIR—That seems to be the opposite to what actually happens in reality.

Prof. Terry—I am grateful to Martin Mendelsohn for that comment, because it has given me the opportunity in hundreds of forums to put this up and cut it down.

CHAIR—Absolutely.

Prof. Terry—With respect to the Englishmen in the room, to have an Englishman telling us how to franchise is absurd. We are probably the most successful franchising nation in the world. It is easier to put a McDonald’s in the western suburbs of Sydney than it is in a medieval village in Surrey. I understand that, but we are a new country. We are receptive to new ideas. Franchising fits our psyche. The article I want to write one day is called the Australianness of Australian franchising. What is it within our character and personality that makes franchising so much more successful in Australia than anywhere else? One of those reasons is undoubtedly regulation. I have just come back from China and Vietnam. Australian franchise systems are generally welcomed in Asia because our franchisors have to cross a much higher bar than franchisors from unregulated areas.

CHAIR—They are well regulated, well governed and well run.

Prof. Terry—Yes.

CHAIR—I would like to take you back to some of your opening remarks. You were talking a lot about risk. I suggest to you that we are not trying to remove risk. People take risks in all different forms. It is about removing or curbing the abuse of power. It is not so much about the risk. Everybody in business takes some form of risk. It is about the removal or curbing of the abuse of power. How do you best see that we do that? You talk particularly about disclosure and pre-contractual arrangements. How do you remove abuse of power through that mechanism? Is it purely just through education?

Prof. Terry—Yes. I should have made the comment earlier that our Franchising Code of Conduct is supplemented by the most powerful provisions on misleading conduct. New Zealand has a similar provision. Section 52, the prohibition on misleading and deceptive conduct, is virtually unique in the world. We have our provisions on unconscionability, which exist in some other countries but not in all countries. I criticised section 51AC. I thought it was irresponsible of the government to introduce an unconscionability provision without really defining what unconscionability is.

CHAIR—By that, do you mean that it is hard to follow through or act on that unconscionability if it is not defined?

Prof. Terry—To mislead or deceive means to lead into error, to cause or to err. There is a line and you cross that line and you have misled. We had section 51AC and the unconscionability stuff. We have Victoria with its unfair contracts act. We throw a whole lot of terms around—unfair, unconscionable, unjust, burdensome, oppressive, harsh. We know there is a continuum and we know that unconscionability is at the really bad end but apart from the discretionary factors to take into account which do not define unconscionability, I think the government or parliament would have better served the franchising and other communities if they had defined

what unconscionability is. This is my real concern with good faith. We all agree that franchisors and franchisees should act in good faith towards each other, just like we all agree that franchisors and franchisees should not act unconscionably towards each other.

If there is to be an obligation of good faith enshrined in the Franchising Code of Conduct, I strongly impress on the committee the importance of trying to spell out what good faith means rather than just throwing the general motherhood, feel good sort of statement up there and probably giving false hope to a lot of franchisees that now they are protected by an obligation of good faith and can pay less attention to education, due diligence or talking to other franchisees.

CHAIR—From most of the submissions we have received there seems to be a fair degree of operational efficiency in the precontractual arrangements in disclosure, things contained in the code, and people's understandings of what they are getting into; the disputes tend to arise at a later point and normally towards the end of a contract term or agreement or to do with renewal. What is your view in that area?

Prof. Terry—That is a big question.

CHAIR—Just simply, most disputes tend to arise out of a situation where there is a non-renewal, so simply where the franchisee does not get a renewal of their agreement, or where there is some sort of abuse of power in that renewal period where it would seem that the franchisee is at a power disadvantage, because they need to have that renewal take place or else they have no business at all. What is your view in terms of your work and research in that area?

Prof. Terry—I was a member of the Franchise Consultative Committee of the ACCC until this year and we got regular briefings on the cause of complaints. I was not aware that those were the biggest cause of complaints when I was on the committee.

CHAIR—Which are the biggest causes of complaint?

Prof. Terry—They were misrepresentation type complaints, which can be dealt with by the misleading or deceptive provision. What are the risks that arise from the unique nature of a franchising relationship? It is the information imbalance and the power imbalance. The information imbalance can be addressed through prior disclosure. That can be tweaked, made better and more effective, but that is an easier problem to address than the issue that you are asking me about now, about aspects of the power relationship, of course. Can I ask you to pose the question again?

CHAIR—It appears, from submissions that we have received, that a lot of disputes are generated towards the end of a franchise agreement. There seems to be a negotiation period towards the end of the franchise agreement and disputes arise out of that. There are simply non-renewal issues or other issues around the end-of-contract arrangements.

Prof. Terry—I am not in a position to confirm that.

CHAIR—That is fine. I am just asking the question. I am not asking you to confirm—I am asking for your view.

Prof. Terry—If I was a franchisee I would be starting to get nervous at the end of the period, hoping that my franchise agreement would be renewed.

CHAIR—Why is that?

Prof. Terry—A franchisee has some costs in the franchise investment, of course, and the issue of renewal is going to be important, just as it is for a lessee in a shopping centre. Certainly in my experience the hardest thing for franchisors these days is getting good franchisees. Franchisors work very hard to obtain good franchisees. You cannot have a successful franchise operation without a proven successful system. The best system in the world will not work without good franchisees.

CHAIR—That is an interesting view, which is at odds with some other submissions that we have had that even a good franchise system will not work without good franchisees. That lends itself to the view that it is the franchisees that build up that business. It is not just the franchise system. It is much more than that. It actually is the people that operate it outside of the system as well. You cannot have a good franchise system without good franchisees and, as you say, that is why franchisors go to a lot of trouble to find good franchisees. They need good franchisees.

Prof. Terry—You have heard the concept that franchising is a classic relational arrangement. It is a relationship involving trust, confidence, communication and longevity. This is why the term 'commercial marriage' is used in relation to franchising. It is different from an exchange.

CHAIR—It is not just a simple case of an employee-employer relationship where you are simply just buying for a period the right to operate a brand, and at the end of that time you just walk away?

Prof. Terry—The reality of franchising is that franchising is effectively leasing. It is not the way that lawyers explain this, but with franchising you are effectively leasing somebody's system for a period.

CHAIR—Isn't that what Professor Pengilley was talking about as well, the definitional issue; that franchising is not leasing because they are two separate things?

Prof. Terry—I am using 'leasing' in inverted commas.

CHAIR—It is very specific what a lease is as compared with what a franchise is. I know the difference between the two and I am sure you do as well.

Prof. Terry—I am not using the term in a technical sense. I am saying effectively a franchise is acquiring the right to use somebody else's name and system in a particular place for a particular time. The reality is that some franchise agreements are 20 years long. The most common in Australia is five-plus-five. There are different times. They sometimes have renewal rights. They sometimes do not. Sometimes renewal rights are automatic and sometimes they are not. Sometimes they come along with another right to renew and sometimes they do not. But at the end of the day the reality of what we know as franchising is that it is not a relationship that last in perpetuity. Some agreements are infinite in the sense that they do not have a term, but the vast majority of franchise agreements in Australia, and indeed around the world, are for a certain

period. My preamble about good franchises is that it is unusual for a franchisor not to grant a new period to that franchisee if that franchisee is a good and successful franchisee.

Senator BOYCE—We have had some earlier evidence both ways in terms of where the goodwill resides within a franchise operation. In your opinion, does it reside with both the franchisor and the franchisee or one party more than the other?

Prof. Terry—I am not trying to avoid the question. I wrote an article some years ago, which I included in my CV with my submission, on goodwill in the franchise system. Goodwill is one of the most notoriously difficult concepts that exist in the whole of the law. In a concept like franchising there is goodwill in the brand, the system, the site and in the operator of that site. When I wrote that article, before the Franchising Code of Conduct, my argument was leading up to recognition that franchisees have a right to sell their franchise. The fact that a franchisee has a right to sell a franchise acknowledges, in itself, that they can benefit from the sale of the business as well as from their trading.

Senator BOYCE—That it has a value. Both on a varying scale; is that a reasonable synopsis of your answer?

Prof. Terry—Yes. I am getting drawn into an area here that is very difficult. If you are putting the question directly 'should franchisees have any right to goodwill on termination of that agreement or expiry of that agreement?', I would not be putting that case.

Senator BOYCE—That was going to be the next question. Could you explain what you mean?

CHAIR—If the week before, when they sell it, it has some goodwill attached to it but the week after, when it is terminated, it does not, why is that the case?

Prof. Terry—The main part of the goodwill in that system resides in the name in the system and probably in the site. Invariably if there is a good retail site it is controlled by the franchisor and not the franchisee. The franchisee's goodwill can be recognised on a sale of that franchise.

CHAIR—I understand there are quite a few contracts and arrangements where it is the franchisee's responsibility by taking up the franchise to not only select the site but to purchase or lease the site, to build, and to take care of hiring staff, et cetera. Is that something that should be taken into consideration?

Prof. Terry—Of course. If the franchisee owns that site and has the ultimate occupation of that site, that is going to make a difference. If the franchisor then wants that site, the franchisor effectively has to negotiate with the franchisee to take control of that site.

CHAIR—That is central to disputes and problems in those areas, where as you have just stated the franchisor should negotiate for basically the purchase of that site. Of course, they do not have to; they can just end the contract and take the site?

Prof. Terry—It all depends on who holds the occupancy rights in respect of that site.

CHAIR—It is not about occupancy rights, though, is it? As you are saying, it is about the brand and you cannot operate it if you do not have the brand. We can take an example of any well-known franchise operation. You cannot operate under that franchise unless you have an agreement. The evidence presented to us is that, if the agreement is terminated, you can no longer operate at all.

Prof. Terry—This is why in the vast majority of systems that are site specific franchisors will control that. Franchisors may sublease or license to a franchisee, but ultimately if the franchisee goes bad, if the franchisee cannot pay the rent, and if the franchisor controls the site it is the franchisor who has the responsibility for that site.

Senator BOYCE—Are you arguing that in most cases the vast majority of the goodwill belongs to the franchisor, although they might sometimes allow the franchisee to appear to own that goodwill by selling it to a third party; if it were the franchisor taking back the property, the value of that goodwill is different? I am trying to understand the difference between selling to a third party and the franchisor taking back the goodwill. I realise that the value and the proportion of this is going to change dramatically from business to business, but you seem to be saying that the franchisor need not pay for goodwill from the franchisee but that others should?

Prof. Terry—During the term of the agreement franchisees under the Franchising Code of Conduct have a right to effectively sell the franchise. They did not have that right at common law. They did not have that right until it was given to them by the Franchising Code of Conduct. During the term of the agreement the problem has been solved by that, but it is what happens at the end of the agreement that we are talking about. In the vast majority of cases, if the parties want it to happen, that franchise agreement will be renewed. If it is renewed there is no problem, of course, because we have then started again and the franchisee has the right to sell.

Senator BOYCE—Some franchisees might argue that there is a problem in that they feel they have to take the terms offered to them by the franchisor because the only other option is to walk away empty handed. They would see that as an imbalance of power.

Prof. Terry—I can tell you that you are talking about what I think is the difficult issue in franchising here. Franchising, as we know it and understand it, is leasing or renting somebody else's system for a certain period. That is what franchising is. If a franchisee has a right in perpetuity to it, if a franchisee has a right to participate in goodwill—and how you would measure goodwill in this situation I have absolutely no idea—

CHAIR—Would that just be the market value? Would it be as simple as you put it on the market and it has a value? That is done every single day of the year.

Prof. Terry—Effectively that is what happens with most franchise systems.

Senator ARBIB—Is that not a contradiction? You say that it is renting or leasing, but then the franchisee still has a right to sell that business?

Prof. Terry—I shouldn't have started using that—

Senator ARBIB—You are not saying that as a fact but as a general principle. What I am asking is: as a general principle how does that work, given the franchisee can sell their business?

Prof. Terry—They can sell their business because the Franchising Code of Conduct mandates that right. Until the Franchising Code of Conduct came along a franchisee could only sell the business.

Senator ARBIB—Does that not show that it is more than just renting or leasing of the business by giving some that right?

Prof. Terry—It may and it may not.

Senator ARBIB—We are trying to work out in the end where goodwill stands. That is where this leads to.

Senator BOYCE—You were commenting about what happened before the code became mandatory? What did happen?

Prof. Terry—Before the code became mandatory a franchisee had the right to use the franchisor's name and system for the term and any renewal period granted.

Senator BOYCE—If they wanted to get out after two and a half years they were effectively breaking their contract?

Prof. Terry—Yes. Similarly, they had no common law right or legal right to transfer or assign the franchise to somebody else. Franchisors had two options. They could say, 'Yes, we will allow you to do that' or 'No, we will not allow you to do it.'

CHAIR—What has changed?

Prof. Terry—What has changed is that the Franchising Code of Conduct now mandates the right to.

CHAIR—Mandates the right to?

Senator BOYCE—To sell.

CHAIR—What I am trying to point out is that the dilemma in what you have presented to us is that you now have the right to sell, but that right is diminished by the fact that, if your contract is not renewed, you have the right to sell nothing. You sell something that is worthless. This is the problem that Senator Boyce was raising. The dilemma is that if, at the end of the contract, you are not renewed then you have nothing to sell, because you cannot sell something you do not have a right over because you no longer have a contract. Or if you knew it was not going to be renewed you would have to sell earlier when it still had some value or take the risk and disclose. Is this not the whole dilemma?

Prof. Terry—Franchising is what franchising is, and that is why it is important that the franchisees get advice and understand exactly what that relationship is. I venture to suggest that,

if it were otherwise, franchisors would be more reluctant to franchise or you would see franchise fees, establishment fees and royalties increase quite significantly.

Senator BOYCE—To cover the potential cost of goodwill?

Prof. Terry—This is why I made the opening statement that I did. I am a passionate believer in the franchising system. I am a passionate believer in good franchising, and I will do anything in my power to restrain bad franchising. The committee has to be very sure that individual failures are not systemic failures within a system or they are not systemic failures of a regulatory system. We are a free enterprise system and success is not guaranteed. There are going to be unfortunate stories. But the committee has to be very sure that these are part of a systemic general problem and not isolated instances.

I do not know enough about the cases that I see mentioned in the debate on Mr Randall's motion in the parliament. However, as we all know, when the ACCC got stuck into the Baker's Delight case, for example, after exhaustive inquiry and despite the power of misleading conduct, the power of unconscionable conduct and the other actions available to the ACCC, no action was taken in those cases. This is a massively difficult area that you are dealing with. There is no way of saying that in an ideal world this would not happen because franchisors would always renew franchisees unless there were reasons not to. This is why in my submission I said that if there are specific problems they should be dealt with by specific solutions and not by a hope that a general concept of good faith is going to solve anything.

Senator ARBIB—You also make mention of a franchising ombudsman and a specialist committee. How does that fit into the mediation process?

Prof. Terry—Mediation is a very significant part of the Franchising Code of Conduct. I am not sure that there is a very high success rate for mediation in terms of settlements that arise out of it. Because of confidentiality you do not know how many of those franchisees are entirely happy with the settlement or felt like they had no option but to make a settlement with the franchisor. I would have thought there is a role for an industry ombudsman. There needs to be someone who by their experience and the authority of the position can attempt to have some influence. I would have thought there would also be an argument for a specialist tribunal.

Senator BOYCE—Would this be a judicial tribunal?

Prof. Terry—A tribunal like a consumer claims tribunal that sits out of the court structure with limited appeal rights on law back into the court structure. A mediator is not empowered to give a decision, of course, and nor would an ombudsman be, but a tribunal would have the power to make a decision in cases under a certain threshold. The other thing, which I have argued very strongly for a long time, and not always with the support of colleagues within the franchising sector, is that there should be a filing of disclosure documents.

CHAIR—Do you mean registration with the ACCC?

Prof. Terry—Not necessarily registration. 'Registration' is a word that scares people, because registration can mean an audit and that sort of thing. I am not suggesting a full auditing process

that exists in 14 of the 50 states of the United States. I am suggesting something a bit simpler where a disclosure document has to be filed. It may or may not be the ACCC.

CHAIR—Centrally held?

Prof. Terry—Centrally held.

Senator BOYCE—For what purpose, though, if it is not to be audited?

Prof. Terry—I will give you three reasons. Firstly, we do not know how many franchise systems we have in Australia. I notice that tomorrow you are talking to Professor Lorelle Frazer, who conducts the franchising survey for the sector every couple of years. She will tell you that she tries to identify franchise systems from the Yellow Pages, advertisements and franchise magazines. There is one consultant in Australia who says we have 3,000 franchise systems. We actually do not know how many franchise systems we have. It would be much easier to give better responses to your questions if we knew what percentage of franchisees were not renewed and what percentage wanted to be renewed. We do not know that. We would know that if a committee like yours could look at the disclosure documents.

CHAIR—What we do know from all the submissions we have had, in talking to the industry and those that claim to represent the industry as it stands today, is that on the whole franchises are generally renewed, and that generally the sector operates quite well. It is quite healthy and strong and, from all the evidence we have, it is quite successful. It is not so much about dealing with those because those people work within the current frameworks. It is for the ones that do not where there is an abuse of power, that imbalance that you talk about, and how we actually deal with that. Professor, if you have one final statement before we break for a few minutes that would be appreciated.

Prof. Terry—If I can finish my answer to Senator Boyce—registration and full audit is a possibility, but I am not suggesting that. If disclosure documents could be recorded, you can mine those disclosure documents for the most incredible information, because a disclosure document details how many were cancelled, how many were transferred, and how many were renewed or not renewed. That is the sort of information that the franchising sector needs as well as your committee in considering how to deal with it.

Senator BOYCE—We have had some evidence suggesting that there is no requirement for people to enter mediation to gain a result, that parties come to mediation with no intention of wanting to settle, and that there should be stronger requirements around parties going to mediation. Is that a step we should be taking before we look at tribunals and an ombudsman or should we be looking at the whole lot?

Prof. Terry—The beauty of mediation, but also the limitation of mediation, is that it is a consensual process. You can require mediation in good faith, but you cannot make somebody come to settle a case that they do not want to settle. That is the limitation of mediation and that is why I think a tribunal that hung off it as a pre-requisite would be an option.

Senator BOYCE—It has been put to us that some franchisors deliberately would not want to have the mediation succeed because their view is that they have deeper pockets than their

franchisee adversary and therefore the franchisee is more likely to accept a lower settlement at mediation because they can see that the franchisor is prepared to go, for instance, all the way to the High Court and they simply cannot afford that.

Prof. Terry—That is true, but if we had some more test cases or some guidance on unconscionability that would be fairly good.

CHAIR—Does there need to be a strengthening in that area to give more guidance?

Prof. Terry—I would have thought that is a fairly good balance. An obligation of good faith would do the same thing, but an open-ended obligation of good faith is really going to invite disputation. Most people who argue good faith do not realise that there is no scope for good faith in the face of express contractual provisions. Good faith basically hangs off contractual provisions to make sure that those contractual powers are not exercised in a capricious manner. Good faith is not going to solve the problem. The essential thing that we have talked about is, if a franchisee has a right to renew, perhaps some of these goodwill problems are not as significant. An obligation of good faith is not the same as conferring a right to renew. If the committee decides that the right to renew is the problem, a right to renew should be spelt out rather than just left as some vague concept of good faith.

CHAIR—Thank you very much for your time, Professor Terry.

Proceedings suspended from 3.04 pm to 3.18 pm

BUCHAN, Ms Jennifer Mary (Jenny), Private capacity

CHAIR—I welcome everybody back to the hearing and remind witnesses that the same rules apply as earlier in the day. Welcome, Ms Buchan. Would you open up with a brief statement, please?

Ms Buchan—Thank you for the welcome. I am here in my own capacity. I am an academic at the University of New South Wales. Prior to joining the academic world I had 19 years in private practice as a lawyer. The latter half of those years I advised, variously, landlords like AMP, master franchisees like Mobil Oil and lots of individual franchisees and a number of individual franchisors. Since I have been in academia I have started to investigate lots of the assumptions which underpin franchising. The previous two witnesses talked about the challenges of who the people are. The law is very much line of sight stuff. So, you have privacy of contract and you have a number of concepts that really are fully challenged by the franchising network and the various ways franchisors, particularly, but also franchisees structure their commercial arrangements and their legal arrangements.

My research has been concerned with franchisees compared to employees and suppliers, intellectual property ownership within the franchise network, retail leasing patterns which are incredibly varied and can be very complex within franchise networks, whether section 51AC has been effective, and I suppose my current consuming passion is franchisor failure and its impact on franchisees. So, that is me. Do you want to ask me questions?

CHAIR—Absolutely. Perhaps just start with the way that you see the precontractual education and involvement of potential franchisees and how effective that is under the current regulatory regime in terms of a successful franchise operation.

Ms Buchan—I have written and presented a paper recently on asymmetry of information. In writing that paper I looked at each state and the federal government's information available to franchisees from the public domain. For example, the federal government has a terrific online business information service. I have looked at the Franchise Council of Australia's education package and nowhere, anywhere, without exception, does it mention that a franchisor might fail. So the notion that a franchisor has got a pretty good system that is pretty robust is perpetuated throughout the information that is available to intending franchisees. Clearly that is incorrect so from that perspective I would have to say that the education could be better and it could be more comprehensive. However, even if you do educate people about some dire consequences, once you have entered a relational contract as a franchisee, regardless of the amount of information you have received you can sometimes find yourself in a situation that no education in the world could have prepared you for.

CHAIR—That is actually my follow-up question. Given that, in the end would any amount of education or precontractual disclosure and knowledge have had any impact on current failures? Would it have made any difference if there were more education or more disclosure in any current failures or disputes?

Ms Buchan—In my opinion there are two ways in which it might have made a difference. When I was researching early, CPA Australia funded me to do some research on franchisor failure and the impact on franchisees. I discovered one Traveland franchisee who had had written into his contract a special provision that if the franchisor failed—and this is Traveland and Ansett, so he was a pretty gloomy kind of guy.

CHAIR—Visionary.

Ms Buchan—Yes. He actually had written into his franchise agreement that if the franchisor became insolvent he could walk, and he could, and he did. In his case prior experience informed his request. I am sure that Traveland thought he was insane and probably just went along with it because he had been a travel agent previously and he was a good franchisee. However, even with the education it would be extremely rare for a franchisee to be able to successfully request an amendment to a standard form contract. In some ways that is fair enough.

Senator BOYCE—That would not become public either, would it?

Ms Buchan—No.

Senator BOYCE—You are suggesting that it would be a standard form contract that is on websites.

Ms Buchan—Yes, absolutely.

Senator BOYCE—Not amendments.

Ms Buchan—No. The second thing is that it fleetingly passes my mind every now and then, a bit nervously, that if franchisors are obliged to set out the consequences or the potential consequences of the franchisor failing, that might set the liquidator up with a great defence to a section 52 action such as, 'We told you this might happen. You were forewarned. So we didn't mislead and deceive you.' That would, obviously, be a really perverse twist of the law but—

CHAIR—It would, but a failure in itself would not mean that anyone has misled anyone else. A failure can just be a matter of just circumstances and failure.

Ms Buchan—Well, look at Ansett and Traveland.

CHAIR—Yes.

Ms Buchan—Things happen that are extremely beyond anyone's control.

CHAIR—Do you see that the standard form contract cannot, in all circumstances, account for everything that might happen in the franchise relationship?

Ms Buchan—Of course it cannot. When I have advised clients, I suppose my dream scenario has always been to identify the big commercial things that could happen that could absolutely bring this deal to the knees and let us cover those things. You could worry about everything into infinity, so let us not worry about the things that actually will not bring the deal to its knees.

However, strangely enough in franchising that does not seem to be what happens because the very thing that does bring the entire system to its knees is not discussed or included in the contract, which is, of course, franchisor failure. I think the reason for that is that there is not any incentive for a franchisor to admit that it might fail because a prospective franchisee reading those agreements would say, 'Cripes. How confident are you in your product when you're putting this in, whereas the competitor offering that I am looking at does not mention failure. They must be more confident.' So, I can understand that a franchisor has no incentive at all to put clauses in its standard agreement that might allude to its own failure.

CHAIR—Or deal with circumstances around non-renewal, other issues, end of term or anything else that might be at end-of-contract arrangements.

Ms Buchan—Indeed. I think there is an incentive issue. You have got to have an incentive and I do not think the incentive is there in a standard form relational contract.

CHAIR—So are you saying by that then that the focus—whether it is standard form contract or the whole educational process and disclosure process—is really about, in the first instance, getting people into the system with far less consideration given by anybody, really, as to what happens towards the maturing years of the system?

Ms Buchan—Currently, I think that is what happens. Education is very valuable. Let us not discount it because it is very valuable and some people in fact decide that they do not want to proceed or they would prefer to buy a standalone business. In the United States, for example, there are some really good education programs for people potentially involved in franchising and they are open to franchisors and franchisees. They are run by universities but I think they are funded by state governments. They invite a franchisee and a franchisor along—they invite a range of players along—and the outcome is that people are more savvy about what franchising is. They keep statistics about how many then go away and decide that, actually, they would prefer not to be a franchisor because it is a real hassle having franchisees, or they go away and decide, 'Yes. I do want to be a franchisor', or 'Yes. I do want to be a franchisee', or, 'How quickly can I extricate myself from the contract which I have provisionally signed up for?' So there are some very good programs. Now, one of those programs is, itself, franchised into Eastern Europe to help the Eastern Europeans come to grips with what this is all about and what is involved. So, I think education is extremely valuable, but it has its limitations.

CHAIR—How much of that risk that everybody takes—whether it is the franchisor or the franchisee—is transferred in the way that the standard form contracts are set up in terms of who takes the risk at what point? I am talking about risks such as the risk of failure and the risk of not continuing.

Ms Buchan—In all of franchising there is a serious dearth of hard data. The franchisor will shift as much risk as it possibly can to the franchisee. I suppose that is normal. There is every incentive to do that. I was surprised when I found that franchisors actually get franchisees, in some cases, to provide the rental guarantee for the franchisors' head lease. When you take a retail lease you are required to provide a rental guarantee or a directors guarantee. The franchisor requires the franchisee to supply that guarantee so if the franchisor does not pay the rent—which is what happened in the Kleins situation; the franchisor was very behind on rent in a lot of its shops—then the landlord can go direct to the franchisee who for example, in the Kleins

situation, can simultaneously have lost the right to occupy because the rent has fallen behind and the landlord has terminated the lease. So, to return to your central question, shifting of risk occurs in numerous guises and can have extremely serious impact on the franchisee, and the franchisee really has no ability to protect against that.

Senator BOYCE—Would you say that a basic due diligence of that Kleins contract, for instance, would have forewarned a franchisee that this was, perhaps, not the best model to be looking at?

Ms Buchan—My understanding of Kleins is that they had been operating as a business for over 30 years and that they had a reasonably high profile. My understanding is that, originally, they identified that current employees would make really good franchisees because they were in love with the concept of what being a Kleins jewellery retailer entailed. At that level that is probably correct. They knew the product. They knew the market. Why not become franchisees? So my understanding is that Kleins said, 'We understand that it is really expensive to operate in a retail centre so we will enter into this very extraordinary arrangement for franchising. We will provide you with a guarantee so if you do not make a particular amount of turnover, we will pay you dollars at the end of the year,' which is really unusual in franchising.

Senator BOYCE—So, there was a sort of a quid pro quo.

Ms Buchan—Yes.

Senator BOYCE—Virtually in the contract, was it not?

Ms Buchan—So there was an insurance policy, really. Kleins sort of underwrote their own franchisees.

Senator BOYCE—So being prepared to guarantee the rent may not have seemed such an extraordinary thing to do in that situation.

Ms Buchan—It would have seemed as if the franchisee was in fact being exposed to a lot less risk. With regard to your question about would due diligence have helped, due diligence would not have enabled the franchisee to understand that the franchisor's finances were in a dire situation.

CHAIR—Following on from that, would a situation of continuous disclosure have helped, where Kleins was compelled under the code or some other instrument?

Ms Buchan—Kleins had 14 companies. Some of those would be superannuation companies, some would be training. One was the importing company. Only three were actually wound up or went into administration, so there were another 11 or 10 companies—I am not sure but it was a huge number—who had roles in the bigger picture but it is very expensive to do due diligence on all of those. One of them, at least, was a trust within the Kleins group and it is impossible to do due diligence on a trust. If you search the asset records you cannot find out anything about a trust. About 10 per cent of franchisors, according to the Griffith 2006 survey, were trusts. So, in about 10 per cent of those franchisors—that is, of the 900 franchise networks in Australia, 90 franchisors—the franchisees have to simply accept the information that they are provided with

through the disclosure and make an assessment as to whether that is good enough for them to go ahead on or not.

Senator BOYCE—So should something be done about that, in your view?

Ms Buchan—I am all for people being able to operate how they like but the economists have got a theory that you should disclose what it is very expensive for people to find out otherwise or what it is not possible for people to find out otherwise. I suspect that we should move a little bit nearer to that thinking.

Senator BOYCE—How would that work in practice, in your view?

Ms Buchan—I have not actually worked that through. I have not given it great thought but I think the general concept is right. I mean, why tell people what they can find out from the public record? One way that would be helpful is if you had to list all of the players in the network, all of the franchisor related players and the companies that own the franchisor. Lorelle Frazer's next survey is going to be launched next week so we will have really up-to-date 2008 data to the extent that she is able to give it to us. That will be able to tell us, for instance, how many public companies own franchised networks.

So when you are talking about the franchisor, they themselves may not be the senior player within the network. I think that it would be beneficial for franchisees to be shown the organisation chart, shown where the franchisor sits in that organisation chart and have the legal identity of all of the participants in the organisation listed. Because you saw on my submission, I have got all these question marks at the back and you will also probably notice that I actually only put the trade name of the individual franchise networks that had failed. I have got another column that has got the legal entity names and in some cases those are blank. So in some cases it is not possible to discover in the public record who is the entity. So I do support Professor Terry's proposal to have a public record of who the entities are.

Senator BOYCE—Could you explain that again? You are saying that people are signing contracts with a trade name, for instance, without knowing who the legal entity behind that name is.

Ms Buchan—No. People are signing a franchise agreement with a franchisor. The franchisor's legal name, their entity name is on the franchise agreement but—

Senator BOYCE—And who the beneficial owner of that franchisor is.

Ms Buchan—Not necessarily.

Senator BOYCE—No. Not even that.

Ms Buchan—It could be a trust. A trustee can be a company. So, you can sign an agreement with what you think is a company, and it is a company, but it is actually a trustee for an unknown beneficiary. That unknown beneficiary is, in fact, in 10 per cent of the franchise networks, a trust.

CHAIR—A trust.

Ms Buchan—And you do not know who you are actually signing an agreement with. That is a problem for me. I think that is a lack of transparency. There is one of the cases that the ACCC has pursued—it is in my submission—where the judge's comments are written that nobody could ever have known that Mr Foster was involved in this arrangement. I think that if franchisors were required to place their franchise disclosure documentation and their standard contract on a public register, franchisees—but more particularly, their advisers—would be able to conduct a more thorough due diligence. They would be able to look and say, 'Well, this contract that I've got on my desk is exactly the same as what they normally give all of their franchisees, so if you go and talk to another franchisee you'll find how they're going operating under this contract.'

Senator BOYCE—Or you could be saying that McDonalds contracts are better than Hungry Jack's or vice versa or something.

Ms Buchan—Indeed. Yes. You might think, 'Well, how come it's different from all the other dog-washing contracts? Do you like what they have or do you think it's not so good and you'd rather go to one of the others?' And I think practitioners—lawyers, accountants and advisers—who are out of the main centres and who are out of basically the big end of town would find it incredibly valuable to be able to advise with a more comprehensive base of information available to them.

Senator BOYCE—We have also had the proposition put to us that we need some sort of a low-cost judicial system like a tribunal or something that sits above the current mediation system. What is your view on that?

Ms Buchan—I think the Federal Magistrates Court is probably an interesting forum. I understand the reason that having a low-cost tribunal is attractive. I have hesitation, though, about dissipating the judicial or quasi-judicial expertise too broadly. Currently, the understanding of what is a functioning franchise essentially sits in three places. It sits amongst the mediators. It sits in the Federal Court; some Federal Court judges are gaining a pretty good idea of what is a functioning franchise. And it sits in the Industrial Relations Court in New South Wales. So, I think when you are thinking about a tribunal or another potential avenue of dispute resolution you do need to consider how broadly you want to dissipate the understanding of what is a franchise.

Senator BOYCE—You think such a mechanism should exist, though, for something above mediation other than the regular system?

Ms Buchan—Mediation is not perfect. I made a couple of submissions about how the data coming out of the mediation could be richer without compromising the confidentiality of the process. There is anecdotal evidence that whilst mediation is very good, when franchisors—or franchisees, I presume—do refuse to mediate or do treat it like a fishing expedition and basically attend in bad faith, or do not attend at all, no repercussions flow. So, maybe there is room for more comprehensive reporting and identifying the franchisors who consistently refuse—or who have refused in any six-month period—to deal with the process in good faith. Again, it is all

incentives. You do not want to disincentivise people from using the process. As to a tribunal, I am not sure that the current system is such a disaster. I think it could be tweaked a bit.

Senator ARBIB—You mentioned good faith. That has been one of the big issues today. There have been arguments and counter arguments. One of the issues in terms of good faith is interpretation.

Ms Buchan—Yes.

Senator ARBIB—In your submission you go into good faith?

Ms Buchan—Yes. I do, briefly.

Senator ARBIB—Could you just outline that for us?

Ms Buchan—This is Bill Dixon's doctoral thesis on good faith in relational contracts. Bill Dixon is a very highly regarded academic at QUT. I can easily send you a link to this. He goes into good faith in franchise agreements and lease arrangements, and his proposals have been adopted by the courts. So, there is a doctrine of good faith alive and well and Bill is certainly the authority. I think that good faith is really important. The Uniform Commercial Code talks about good faith in the states and the ACCC has made reference to good faith in their submission. For me there are risks in inserting good faith in the code and I suppose the risk is that, in that twisted way that we lawyers operate, it might be interpreted that it is not so important in non-franchise agreements.

Senator ARBIB—Do you mean that its omission may then mean something?

Ms Buchan—Yes. There is a live debate as to whether the code applies to administrators. My belief is that it should but I know that the administrators for Kleins received legal advice that the code did not apply to administrators. Now, I think the authority is flimsy but there is a group of administrators who believe that there is legal authority to say that the code does not apply to administrators. So, if you put good faith in the code and it does not apply to administrators, then that is a pity because the process of administration—I hope I am not telling you how to suck eggs—is kind of like the ICU of the hospital. There is still life and there is a hope that you will be able to revitalise the company and put it back on its feet. So, if you are trying to revitalise a franchise network, you do not want to deprive the franchisees of the rights that they have under the code. So, in terms of policy I do not think it is very tenable to say that the franchise code does not apply to administrators, but I think that there is room for clarification. I am pretty sure it does not apply to liquidators because at that point the Corporations Act takes over.

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 sell 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 obligation of good faith along the model that Competitive Foods have proposed in their submission to the committee. To me, it was a shame the franchisees in that instance did not appeal, but you have only got so much money and sometimes you just want to get on with your life, so it is understandable as well. Does that help you?

Senator ARBIB—Yes. That is good. The other big issue today, the vexed issue, has been goodwill.

Ms Buchan—It is a really tricky one.

Senator ARBIB—I think you heard the previous witness, Professor Terry.

Ms Buchan—Yes. Goodwill is difficult, isn’t it?

Senator ARBIB—Yes. The more you talk about it, the more difficult it gets.

Ms Buchan—I am sure accountants can work out goodwill but then even in accounting terms it is not that straightforward. I wrote some notes about goodwill and there is quite a lot of material about goodwill in the South Australian Parliament’s review. You have got site goodwill, you have got product goodwill and you have got operator goodwill. That is brand goodwill, location goodwill and then personal operator goodwill.

Senator BOYCE—Of those six areas of goodwill is that an agreed—

Ms Buchan—No. There are only three, I am sorry.

Senator BOYCE—But is that agreed an extensive list of goodwill?

Ms Buchan—Yes. Basically goodwill fits into three categories. It fits into site goodwill, brand goodwill and individual operator goodwill. That is generally in the law. Anybody is free to correct me, but my understanding is that when you are looking at goodwill from a legal perspective you are really looking at those three things. Operator goodwill: the personal goodwill is really the goodwill that is up for grabs. Site goodwill: if there is a site—not all franchise systems operate with a site—in most cases a franchisor will seek to retain that if it is a good site, even if the franchisee has identified it and invested the sunk costs in developing the site. Ultimately it will be understood that that site stays pretty much with the franchisor.

The brand goodwill is obviously the area that accountants have unbelievable difficulty valuing. That is the one which the international accounting standards have within the last three years had some thoughts about because previously a franchisor or any corporate entity or any owner was free to just allocate whatever value they thought for their brand goodwill. To use an example, Danoz Direct, which is another failed franchisor, said that, even though they had only been trading for a couple of years, their one trademark was worth $7 million and they entered it in the books of their public company at $7 million. We are not talking about the golden arches

here. We are talking about one name, one registered trade mark with basically very limited understanding of what on earth was behind it.

Since that time there have been some changes in accounting standards which I think probably mean they would have to justify that value now. But franchisors with that kind of value on their books for their trademark will still be around because this was only in 2004 and a franchise agreement, as you have already heard, can last from one year to an infinite time.

The individual personal goodwill is a really difficult one because it can vary massively. If you get your lawn mowed by somebody and they are a lawn-mowing franchisee and you like the way they cut your lawn then you will repeat the business. But if a new person takes over that franchise and you do not like the way they cut your lawn you are not going to be loyal to the brand, you are going to go and find a person who you like the way they cut your lawn. There is a lot of personal goodwill attached to the individual franchisee when they are rendering a personal service. But when they are rendering a service like running a McDonalds you probably do not even know who the person is. They are actually operating a very narrowly defined set of running rules and basically the dead dog on a stick analogy almost applies. You can almost put a dead dog on a stick and they can run the McDonalds and it will run beautifully. It is arguable that in fact the franchisor should be entitled to the lion’s share of that goodwill, if you follow that way of thinking. Goodwill is really, really complicated. It is how near to the end of the term are you? Do you have a right to roll over to a new term? Is it even fair? Is it appropriate that you should have a right to roll over to a new term or should it be a right that you only lose by doing something silly?

CHAIR—You have provided us with some wonderful information. Thank you very much. We really appreciate it.

Ms Buchan—Thank you for the opportunity.

[3.54 pm]

McCALL, Mr James, Chief Executive Officer, Motor Traders Association of New South Wales

ROBINSON, Mr Andrew, Consultant, Motor Traders Association of New South Wales

SMITH, Mr David, Senior Manager, Divisional Services, Motor Traders Association of New South Wales

WAY, Mr Nicholas, Consultant, Motor Traders Association of New South Wales

CHAIR—I welcome representatives of the Motor Traders Association of New South Wales. I ask that you open with a short set of remarks.

Mr McCall—Our association is almost 100 years old. We represent some 5,000 small businesses in the motor trades in New South Wales, including approximately 500 new car dealers. The industry in New South Wales is a very vibrant and very extensive industry. Last year there were 320,058 new motor vehicles sold in New South Wales. Dealers had a $20 billion turnover and employed 35,000 workers, including some 4,000 apprentices.

On a wider note, and I think it is important to mention this, the motor trades across Australia are made up of some 109,000 small to medium businesses that have a turnover collectively of $158 billion and they employ 308,000 workers. That does not include the manufacturers; I am speaking of the motor trades. The dealerships are the heart of the motor trades. If the dealerships fail or get into bother then that has a ripple effect that is crippling for the rest of the industry.

The problems that dealers face surrounding their relationship with the franchisors are that they are subject to very oppressive contracts. They are unique as a franchisee because they do not market one brand of product. A dealership may have 14 or 15 different manufactured vehicles from different manufacturing companies. They might have 14 of 15 different franchise agreements or contracts. These contracts are extremely harsh and these dealers have no recourse against unfair contracts that are imposed upon them by manufacturers. Dealerships work on a very small margin, less than one per cent. They are required by these franchisors to inject in many instances millions of dollars into their dealership and are given no security of tenure. They are given three-year contracts where they often cannot possibly recover that sort of capital within that period of time.

Until a short while ago they had some recourse in New South Wales under section 106 of the Industrial Relations Act that dealt with unfair contracts. The last dealer who went to the Industrial Relations Commission on an unfair contract incidentally cost him $1.2 million in legal fees before he walked in the door of the commission. It was an avenue that was available to a few dealers but very, very few could afford that sort of money. However, a recent decision of the High Court rendered their status before the commission under that section as invalid and they no longer have that as a recourse. The ACCC will tell you that there are very few complaints made to them by dealers. I will tell you why. It is because there is a widespread belief in the motor

industry that the ACCC is a pretty useless organisation. It is probably useless because it does not have legislative backing to be able to resolve the issues that confront motor dealers. Those few that make complaints get nowhere with their complaint anyway, so it is a waste of time burning up a lot of energy, and sometimes a lot of money, in preparing a submission to the ACCC in respect of a grievance that you feel you have.

These dealers are in a situation where they have no recourse at law. Section 51AC talks about harsh and unconscionable conduct. The definitions or rulings of the court in terms of the interpretation of those words are so narrow that it makes it impossible for any dealer to go before the court under that section and have a grievance dealt with. The situation in the US is quite different. In 40 of the 52 states of the US there are specific motor dealer and manufacturer legislation that specifically deals with these issues and provides in most instances some sort of cheap tribunal that a motor dealer can go to to have a contract reviewed and a determination made as to whether the contract is fair or not. We have nothing in Australia that addresses, in this state anyway, the concept of an unfair contract. This is what we would be seeking from today's meeting. I would ask my colleague Andrew Robinson to conclude our address, if I may.

Mr Robinson—It is opportune that this review is taking place, particularly in relation to the motor vehicle industry at the moment. It is an industry that is coming off what has been a highly publicised 10-year high. The statistics that have been released for August indicate that the industry as whole is down 14 per cent against last year. Anecdotal evidence from the members indicates that September is going to be a lot worse. It is a period where there are going to be increased stress levels in the relationship between dealers and manufacturers, or dealers and factories, that have not been present in the last 10 years while, quite frankly, dealers were making hay while the sun shone.

For the reasons Mr McCall gave the primary submission of the MTA is that the motor vehicle industry in Australia is so significant that it warrants separate legislation in much the same way that such legislation has been introduced for over five decades in America and in most of the European Union countries. Understanding that that is probably a quantum leap in terms of Australian legislation, as a minimum the MTA believes that the framework needs to be changed in three respects. There has to be a concept introduced to make contracts fair, there has to be a concept introduced so that the administration of contracts are subject to good faith and there must be a quick, economic and efficient resolution of disputes. I seek your leave to tender an exhibit on a confidential basis at this stage.

CHAIR—Could I ask you to hold that document until the end of your presentation and then present it to us at that point? Continue with your presentation now. We certainly have got your confidential extracts from the exhibit here. So if we could do that for a matter of process.

Mr Robinson—If I could just for a second talk about legislative philosophy, for thousands of years Christian democracies have built laws on the basis of generating ever expanding lists of proscribed conduct that is prohibited and prescribed conduct which is mandatory. This has taken place in an effort to make the law as objective as possible and to remove interpretation. But as business dealings have become more complicated and technical what has happened is that our original 10 commandments have now become a million commandments and each of us is forced to make some form of interpretation in relation to the commandments. At the risk of giving a slight theology lesson, perhaps we got it wrong because you will recall, if I can paraphrase the

section in the gospel according to Matthew, when a person—who I understand to have been a lawyer—tried to trick Jesus and said, ‘All of these commandments are fine but which are the important ones?’, and you will recall Jesus turned around and said, ‘There are only two. One is, “Love God with all your heart, your mind and your soul”, and the other one is, “Love your neighbour as yourself.”‘

Somehow that concept of mutual fair dealings and respect between people has been supplanted by this perennial system of legislating by lists. I think what we need to do is to go back to start imposing some of the things that we were given guidance to thousands of years ago. The document I seek to tender is a very current franchise agreement in relation to a very low volume motor vehicle that has been issued in the last few months and so you have to assume that it is current and up to date. It has been issued on behalf of a factory which last year turned over US$119 billion. It has been drafted by one of the very large national Australian law firms. While I will not tender it, that is the size of the document for a very low volume, specialist industrial motor vehicle. For ease of reference I have handed up extracts from this document and the MTA puts this document forward as a clear and practical illustration of why current legislation is not working.

Obviously, the MTA has not done the exercise but, given the pedigree of that document, we sit here assuming that it complies with all relevant disclosure aspects, that it complies with the Trade Practices Act and with general law. Like all franchises this document both allows and compels a franchisee to make business plans and incur substantial expenditure in the expectation of business. Of course the first impression is the sheer size of this document is oppressive. Legal costs involved in reviewing a document would be massive and the person who gave me this document has indicated that the first lawyer he spoke to about reviewing it said that he would charge over $10,000 to read it. Notwithstanding its massive bulk, the essence of the agreement appears in just two paragraphs. If I could take you to the second page of the extract, under clause 3.1(a), as in all franchises the factory appoints the dealer to distribute its product. That is the most important part of a product franchise agreement. However, then you go to paragraph (b), which says that the distributor may at any time in its absolute discretion vary the products. On the one hand you are given the right to sell products and in the very next sentence the right to vary or take away that right is given to the factory.

The second aspect is territory. Under clause 3.2(a) the dealer acknowledges that while the distributor does not control the areas in which the dealer sells products the distributor agrees it will not appoint any other dealer to sell products or to provide service in the PMA. So you say, ‘Good, there is a protection for the franchisee.’ Then you read the next paragraph which says, ‘The dealer acknowledges the distributor may amend the Prime Market Area at any time at its absolute discretion.’

A franchisee is given a document which might, for example, have 50 postcodes attached to it as its relevant territory. By an express and presumably accepted term at any point in time the factory can turn around and say, ‘As of tomorrow your PMA constitutes eight postcodes.’ On the one hand the rights are given and then the document takes them away. Why that is relevant is that when you look at concepts such as good faith dealings, the courts, in particular the High Court, have always said the starting point has to be what the contract says; we have got an obligation to hold up the bargain; if there is a reason we should not hold up the bargain then we will look at it, but the first point of call is to look at the contract. The High Court in particular

has consistently said before they are going to invoke concepts such as unconscionability or bad faith they have got to find something that is in the nature of a disproportionate power balance or something. It is very difficult to invoke that kind of concept where you have an agreement such as this that gives a factory an express right to do something.

If the franchisee, the dealer, agrees to the factory having that right he is behind the eight ball going to court saying, 'Notwithstanding the fact that I agreed—maybe because it was too expensive I did not get legal advice but I did sign this document—and notwithstanding that I agreed I want now to say that it is unfair for the factory to exercise a right which I gave them in the original bargain.' I am sorry, I should say that although I tendered this document I am not tendering it on the basis that this document is unusually harsh or oppressive. This is a document such as is being issued to basically every dealer by every factory in Australia. I am not putting this up as an unduly oppressive document. To me it is very similar to most documents I have seen.

CHAIR—It is a standard form contract.

Mr Robinson—Very standard.

Senator BOYCE—If were to say, for instance, that there should be a standard form contract available on the ACCC website this would be one of the ones that would be there?

Mr Robinson—Yes. And if you look at other makes the provisions are essentially similar. There is an insidious drafting technique in these documents that you will find in clause 10.4, which is the next highlighted section. What this says is that the deal will at all times comply with distributors' plans, distributors' policies, distributors' bulletins and distributors' operations manuals. It means that even if you did actually go through this document, understood what it meant and signed it, if you then go to the next two pages that define each of these four instruments you will see that they are documents that the factory can generate at its absolute discretion at any time during the course of the franchise. 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.

Again it is a very similar technique adopted in a lot of motor vehicle dealerships. In return for that set of rights, which I submit are significantly illusory, the obligations that the dealer takes on however are very strict and very concrete. The next page I have given you is the one issue that is very difficult for dealers and that is the initial construction and then the constant upgrade of their dealership facilities. As Mr McCall has said, in most cases this generates a multimillion dollar expenditure. As has been referred to in previous submissions, there are then restrictions on other vehicle dealerships that the dealer might be able to take on and finally very, very significant restraints of trade. Of course, once the dealer commits to such an agreement and spends millions of dollars building the facilities it is in a very vulnerable position as a party to such an agreement.

If the dealer does not behave it can find itself on the wrong end of a policy bulletin statement, or whatever, such as for example occurred in case study number one. Again, I will not identify the parties but you will remember that that related to a factory that walked in one day and said, 'We are abolishing all independent dealers' in a large metropolitan city. It also said, 'None of

your agreements are being renewed. We are coming in, confiscating your goodwill and appropriating all the business for this city.' That for instance could be a plan that could be adopted under a document like this, served on the dealer and the dealer has insufficient recourse in terms of appealing the concept of unconscionability and good faith unless there is also an obligation for contracts in relation to franchises to be fair.

I wish to make two other submissions that occur from things that I have heard while I have been sitting here today. I have essentially been in a litigation practice for 26 years now. I think I can say with confidence that I have appeared in just about every form of court, adjudication, mediation, arbitration, whatever, certainly in New South Wales. It is my experience that the problem you have with mediation is where one party has a level of certainty. I have heard people talk about franchisors using mediations as fishing expeditions and so on. If a franchisor walks into mediation very comfortable that he has the legal rights to do something, he is more likely to do that. But from practical experience I can tell you the greatest help that a lawyer has to settle a case is uncertainty. If you can get two people in a room who have a level of uncertainty about the outcome, that is when you will get a settlement.

The problem we have at the moment is that the arguments that occur when mediation takes place largely relate to contract issues. If there were concepts of fairness, good faith, then what lawyers would have to say is, 'Yes, that is what the contract says but understand there is also a subjective element in this and we cannot guarantee you success.' I would be very confident in predicting that if there were that level of uncertainty introduced into any dispute resolution involving particularly the motor vehicle industry, a lot of cases would not go to court.

The other point I would raise is that there has been some talk of course about alternative dispute resolution. We have included in the submission the model adopted in Texas. One thing that I could commend to the committee is that, for example, the issue about termination and non-renewal I think is dealt with very intelligently in that legislation. It is tempting to adopt the provisions such as under the Retail Leases Act where you say, 'What we need is a minimum term.' 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 non-renewal. Thank you.

CHAIR—Thank you for your very thorough presentation which makes it all the more difficult sometimes to ask questions. I believe from a lot of submissions we have received that Australia is the most highly regulated market in the world and that that is an effective mechanism by which franchising is successful. That may or may not be different in the motor trades specific area, but do you see that that is the case, that we are the most heavily regulated in

the world or are there other markets as you have just described in Texas in the USA where there is better regulation?

Mr McCall—I would say that the regulation that is imposed on small business is the most onerous of any country in the world. The regulations that are placed on big business are probably amongst the slackest of any country in the world. There is regulation and regulation, and certainly I believe small business is the backbone of Australia. I believe that small business is very, very heavily regulated by comparison to European countries and the United States. The consumer gets a fair go in Australia in terms of regulation. There is myriad legislation that is there to protect consumer rights, and so it should. I do not think anyone should contest that. But when it comes to small business, successive governments over the last 50 years have completely ignored them in terms of providing them with the legislative and regulatory framework that will give them a level playing field out there in that marketplace. Yes, there are certain areas I believe that are probably overregulated but certainly not in relation to small business and their operations in the marketplace.

CHAIR—Is it your view that whether it is the best regulated or the most regulated, either way, it is certainly not the most effective regulatory system in terms of—

Mr McCall—Absolutely.

Mr Robinson—It is certainly not the most effective regulatory system and in terms of the automotive industry our submission would be it is far less regulated than almost every state in the US and most of the European Union countries. For example, in the Texas model, factories are not allowed to sell at retail in Texas. The law is so strong that the Texas board took Ford to court over internet advertising for their cars and won an injunction stopping the Ford Motor Company advertising cars on the internet in Texas. Their regulations are much stronger than anything we have in Australia in the automotive industry.

Senator BOYCE—Do we currently have manufacturers selling direct?

Mr McCall—Yes. There are a number of dealerships that are owned by manufacturers. Of course, the manufacturers sell direct to fleets as well.

Senator BOYCE—But they would point out that that is not an uncommon model within the franchise area, is it, where the franchisor owns some outlets as well as franchisees?

Mr Robinson—That is right. It is not a universal model and as far as the MTA is concerned it is a model that generates an inherent conflict because you have got one retailer taking two levels of profit competing with another dealer who only has one level of profit.

Senator BOYCE—I do not know if you were here when Professor Pengilley gave his evidence earlier and mentioned his great concerns about the current definition of what constitutes a franchise. I was a bit surprised to hear you mention that some of your dealerships would have 14 or 15 franchise agreements. Are they with 14 or 15 brands, or 14 or 15 items, so to speak?

Mr McCall—Fourteen or 15 brands.

Mr Robinson—Sorry, if I could say both. The automotive industry dealerships are divided essentially between two or three groups. There are a few very large public companies, one of which I think controls 17 brands over 30-something locations. Another public company does the same. There are then a number of large private operations that have up to 15 separate brands. Then I think I would be right in saying that the vast majority is then a very large step down to—

Senator BOYCE—Two or three?

Mr Robinson—But there are very few, if any, that are single franchise operations.

Mr Smith—Motor vehicle dealerships by definition are mandatory under the code as mandatory franchises so we do not experience that problem But that shows and reinforces our view that motor vehicle dealerships are different by their very nature of their business and back in 1998 when the code came in it was deemed by the legislators that they should be deemed to be a franchise.

Senator BOYCE—There is no concern on your part that a change in the definition could affect your treatment under the code?

Mr Smith—It would not affect our motor dealers. That could affect some of our other members though, like mechanical repair businesses and things like that that operate under a franchise agreement. Also, when some of the businesses are developing anew—babies, if you like—as they grow and develop that is where I would agree, yes, you do get that problem with the definition of the franchise. When it starts out it is very small and, no, it probably is not a franchise.

Senator BOYCE—If you have got 14 or 15 franchise agreements, it is hard to see how your business could be characterised as dependent on that agreement.

Mr Smith—True, but some of those brands are very low volume and they can only be operated under the requirements of the franchise agreement with the bread and butter brands. I am not here to mention brands, but I am sure you can imagine your top ones, you are not going to sell—

Senator BOYCE—You might have three or four that you could not live without. The others—

Mr Smith—Yes. You need those smaller ones—

Senator BOYCE—would be a different matter.

Mr Smith—Correct, yes.

CHAIR—Would you also say that out of, say, 15 different brands there might only be two or three owners and therefore you could not really discount one brand because it would affect the ownership and the franchise agreements you have with a whole range of other brands?

Mr McCall—There are different factories.

Mr Smith—Various things are used as discipline, such as targets. They have like KPIs, so they have targets. If you are not within target then you are in breach. The manufacturers will use that as discipline, knowing that there is a three-year agreement and knowing that you are sitting on an $8 million investment. It is sort of quietly said, ‘Look, if you take on this franchise, for instance, then you can forget ours.’ There is a lot of that that goes on, so who is going to stick their head up on the chopping block and say, ‘This is what has happened to me.’

Senator BOYCE—I am sure you must have misunderstood!

CHAIR—Can I ask you a difficult question. You have raised a number of times the concept of fairness and how that might apply. I have heard a range of different views on fairness and I have read a number of submissions and spoken to a number of people, but fairness in itself is not necessarily the objective; it is about an agreement and a contract and it is about people taking a known advantage or an agreed advantage that makes it very hard to decide what is fair. How do you work on that principle? How do you define what ‘fair’ is?

Mr McCall—The Industrial Relations Commission have been arbitrating on fair contracts in New South Wales since I think 1946 when that section 106 was introduced. I think there are a lot of precedents but Mr Robinson would know—

CHAIR—I am referring specifically about how you would slot fairness into the Trade Practices Act and the code in terms of franchising.

Mr Robinson—At the risk of talking against my profession I think there is a huge risk in trying to overdefine those concepts, firstly because I do not think you will ever be able to define them properly and, secondly, I think we regard them as dynamic definitions, not static, and therefore whatever you do with them has to be capable of adapting to changing circumstances. What we suggested, mimicking the experience overseas, is that if these concepts are put to a board with power to either refer back a mediation or to actually make a binding decision very quickly only its own—

CHAIR—It could be a tribunal of some sort of expert panel, maybe an ombudsman-like—

Mr McCall—Yes, and you could get access to that through the CDT. A consumer with a complaint could go before the tribunal and the tribunal would determine whether or not they have been dealt with fairly.

Mr Robinson—If that tribunal is represented, for example, by a member franchisor, a member franchisee and a lay person, I think those people will very easily come up with definitions of what is fair. If I can say by reference to the agreement that I have just tendered I do not think there would be any doubt that those three interests sitting together would consider that those two clauses removing rights would be unfair. My problem is that the minute you try to define it the lawyers will get hold of it and they will squeeze a relationship in that just skirts the definition and then we are off to a $300,000 or $500,000 case in the Federal Court again.

CHAIR—Is another way of describing the fairness you refer to as good faith—acting in good faith, acting in a fair manner?

Mr Robinson—I think it is different for the reasons that I have highlighted in this contract. If you were to sign that contract I think it would be very difficult to argue that a factory that seeks to invoke and express a very clear clause can be said to be acting in bad faith. That is why the MTA suggests that just the obligation to act in good faith is relevant once you have got the agreement in place that you must act in relation to the contract, but to actually get into the contract in the first place there has to be an element of fairness of the contract.

Senator BOYCE—You are saying you work on margins of less than one per cent. That is a standard contract. Why does anyone sign one?

Mr McCall—They destroy your life if you do not. You do not have a contract; you do not have a franchise—

Senator BOYCE—No, but is the industry so mature that there are no new people coming in now?

Mr McCall—A lot of these arrangements are in place. If you take a bigger Sydney firm, Suttons, they have been in business since 1960. These started off with an arrangement with the manufacturers and the arrangement has existed ever since but this contractual arrangement, this franchising that they call it, has crept in at a later stage and it has become progressively more onerous over the last decade and a half, I would say.

Mr Robinson—I think the second case study that we quoted actually talks about another well-known dealer on the north shore who has been around for many decades.

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 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. In case study one which we referred to in the written submission, a very large factory fired all of the capital city dealers some of whom had only recently bought their businesses on the faith that their dealership would be rolled over. It meant little when the muscle of the international company came in and said, ‘We are not renewing. Here is notice of termination.’

Mr Smith—The expectation also comes up on what your development of your facilities has been so if you spend that money on your facilities then you would have that expectation that the agreement will be renewed. The shopping centre council said that the fit-out is dependent on a renewal, so if you are you going to fit out a shop then you get the, ‘Yes, we are going to get a renewal before we do the fit out.’ Whereas with our guys it is quite the contrary, ‘You will get a renewal if you upgrade your facilities.’ In fact, it is exactly the opposite. I actually even wrote it down to mention that because that is just what happens with us.

Senator BOYCE—Is one of the concerns as you see it perhaps that simply the distributors do not have enough reputational capital at stake if they treat your members poorly?

Mr Smith—Basically, yes, because it is not their money.

Senator BOYCE—But they run the risk of damaging their reputation, do they not? Is there a way of highlighting that more? Does that make sense?

Mr McCall—To make the contracts public, I think that would be a first step. That would be a very, very sensible step because then there may be some public awareness. I think one of the difficulties is that the public generally believe that motor dealers are very wealthy people and they are all living high on the hog and why should you worry about them. I can assure you that is not the case. There are some dealers who are fairly wealthy but they have not made their money out of selling motor cars, they have made their money out of the land that they have purchased over quite a number of years. I think the public perception of dealerships that has grown over a long period of time is very, very difficult to overcome and I do not think the public are much interested in the relationship between a dealer and a manufacturer.

Senator BOYCE—I think you are right about that.

Mr McCall—Every year I get called by a radio station when they do the survey of the most detestable occupations and unfortunately car salesmen—

CHAIR—It is a competition between us, isn’t it?

Mr McCall—I have to defend them very heavily. But I can assure you it is not easy.

CHAIR—It is a competition between us, there is no doubt. I accept that you have given us a lot of information. There are quite a number of issues that we will have to spend some time reading and thinking about. We will also accept the document that you are presenting in camera. If you have got any closing remarks we might just do that before we conclude.

Mr Smith—I would just like to highlight one thing because, as you have probably seen, I have been sitting here a lot today and there has been some mention about the tenure of the agreements. I know some witnesses have said, ‘But with the bigger businesses they actually get quite a long tenure.’ With our guys, three years has been the norm. One or two brands have just moved to a five-year agreement. That is the longest that I have known about. There is no five by five by five or anything like that. I think that is important from our industry’s point of view that, relative to the capital investment that these guys are making, they are running with a three-year agreement. I would just like to highlight to the committee.

Mr McCall—We had an example from a dealer in Wagga that I spoke to yesterday morning. The manufacturer has told him that he has got to have a separate showroom for their brand which will cost him upward of $1 million and they will give him a one-year contract. How can you get that sort of capital back in a year in a country town? It is just impossible.

Mr Robinson—There is just one other document apropos that comment that I would like to tender with your agreement. I do not know whether any of you have travelled up the Pacific Highway recently north from Sydney but there is an empty Audi showroom there. One of the real problems that has developed in motor vehicles is that they decided to generate very distinctive architecture that is putting them pretty much in terms of geographic realisation almost like a McDonalds or a Pizza Hut. The problem is, as you will see in the photo I am going to give you, that when that gets terminated what do you do with a building that has been built to this kind of specification? You cannot turn around and make it into a residential apartment or an office block. What that does of course is that it makes your mortgagees nervous so when the dealer goes to get finance to build something like this the mortgagee says, 'Hang on a second. If you are ever terminated what am I going to do with this?' That is why this building has stayed vacant for a long time and as of when I took this photo a few weeks ago it was still vacant.

Mr McCall—Thank you very much for your time today. We really appreciate it. If there is any further information we can put forward to assist your committee we would be happy to do so.

CHAIR—We thank you for that. The committee has agreed to receive your document in camera. However, you should be aware that the committee has the power to publish confidential evidence at a later date should there be a compelling reason to do so. You will be informed of such a decision prior to its publication to go ahead. Could I thank you for presenting. I also thank Hansard and the secretariat for all of their work and members of the public who have attended today.

Committee adjourned at 4.35 pm