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EVERYTHING MATTERS

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FRANCHISING UPDATE

Franchising into Australia

Griffith University's Asia Pacific Centre for Franchise Excellence released its biannual franchising Australia survey in October 2008. Importantly, the survey was conducted prior to the onset of a major global financial crisis. On release, many large economies around the world were already in, or heading for recession. At the time of the survey, Australia's economy was still expanding and this situation is reflected in the survey findings. At the time of data collection, franchisors weren't highly optimistic about the next 12 months. Despite this, the sector has continued to grow since 2006.

FRANCHISE SECTOR HEALTH

Total number of franchisors in Australia

There were 1,100 business format franchise systems operating in Australia in 2008 of which 91% were home grown systems. This figure includes several systems that offer multiple concepts under a single brand and these organisations were counted only once.

The growth rate of franchise systems from 2006 to 2008 was 14.6%, similar to a 12.9% growth reported for 2004 to 2006. This net growth accounts for both new franchise systems entering the sector as well those exiting.

Total number of units

There are an estimated 63,500 business format franchise units and 7,900 company owned units, producing a total of 71,400 units operating business format franchise systems in Australia. Most of these are classified as small enterprises representing some 3.7% of all small businesses, and an additional 8,000 fuel retail outlets and 2,500 motor vehicle retail outlets are estimated.

Growth of franchise units

A comparison of the 71,400 franchise units in 2008 with 61,860 estimated in 2006 indicates a growth unit rate of 15.4%. This is similar to 14.6% reported from 2004 to 2006. Hence, the sector continues to expand, but it is anticipated that any slow down in the economy will be reflected in the 2010 survey.

Turnover of the Australian franchise sector

Total sales turnover of business format franchise units was estimated at A$61 billion in 2007. Together with estimated motor vehicle sales of A$37 billion and fuel retail of A$32 million total sales turnover for the entire sector was estimated at A$130 billion. This represents approximately 12% of Australia's gross domestic product.

Profile of franchise systems

The majority of franchising continues to take place in retail trade, which accounts for 28% of franchisors and 17% of franchise units. Accommodation and food service, including 'fast food' franchises, represent 16% of franchisors and 23% of franchise units. Administration and support services account for 15% of franchisors but only 5% of franchise units. In general, franchise systems in the service sector are smaller than retail systems.

As with previous surveys, most franchise systems are relatively small, thus posing a challenge for sustainability. The median number of franchise units per system was 20, together with one company owned unit. Whilst there are some very large systems, half the sector holds 20 or fewer units. The smaller systems were also younger and they have been franchising for a median of five years compared with 13 years for larger systems.

The sector shows signs of maturity and experience. Franchisors have been operating their businesses for a median of 15 years and have been franchising for nine years. In general, concepts were pilot tested for a median of four years prior to reaching the franchise. However, about one-third of systems were franchised after operating for only one year.

Sector trends

There is a noticeable shift in emphasis to part time franchising. Slightly less than half the franchisors reported that they had appointed franchisees who work in a part time capacity of less than 40 hours per week. The franchising sector is thus catering for franchisees that require more flexibility.

The sector is moving away from owner-operator, single franchise concepts in an effort to stimulate system expansion. Master franchising is still used by just over one-quarter of franchisors to overcome agency problems associated with geographical disparate operations and to provide local level support for franchisees. Exclusive territories were offered by 43% of franchisors and multiple unit ownership is permitted in almost a third of franchise systems.

Franchising disputes and unit closures

Substantial disputes, being those referred to external advisors for action, were experienced by 17% of franchisors in the previous 12 month period, but most disputes were with only two franchisees. The proportion of franchisees in disputes is estimated at 2%. Franchisors in dispute tended to be larger and older systems involved in retail. This indicates that large retail systems may be more complex and have particular characteristics that lead to conflict in franchisor/franchisee relationships if not addressed early. The most common causes of disputes were related to system compliance and level of profitability. Fewer than 10% of franchisors reported that franchisees had associated for adversarial purposes.

Data on franchise unit ownership changes provide evidence of stability in the sector. During 2007, the majority of franchise units (93%) did not change ownership. Of the remainder, most changes occurred when franchisees sold their franchises to incoming franchisees, or to the franchisor. Slightly more than 1% of franchisor units ceased to operate and less than 1% of units were not renewed. Across the entire population of 63,500 business format franchised units, this equates to approximately 825 unit closures and 90 non-renewals during a 12 month period. Typically, the term for a franchise agreement is five years, but franchisees on average remain in the system for a median of seven years.

International expansion

Slightly more than 25% of Australian based systems were franchising internationally in 2008. The majority were located in New Zealand, the United Kingdom and Canada. Despite Australia's geographical proximity to South East Asia, franchisors were targeting English speaking destinations for their expansion.

Most franchisors entered international markets within the last eight years and held a median of 20 units in the domestic market prior to venturing overseas. Master franchising is by far the most common arrangement used by franchisors to gain access to new international markets.

Conclusion

The survey results portray a sector that is continuing to grow, despite expected future economic downturn. Franchisor confidence is bordering on conservative rather than optimistic, but franchising is said to continue its growth, albeit at a slower rate. Despite uncertainty in global financial markets and expected future economic downturn, growth in franchising is likely to out perform other forms of doing business. Franchising will continue to remain attractive to both local and foreign franchisors provided they are capable of adapting to changing market needs and economic conditions.

COMPULSORY COMPLIANCE

Franchising Code of Conduct (Code)

The Code is a mandatory industry code, prescribed under section 51AD of the *Trade Practices Act 1974* (Cth) (**Act**).

Its provisions have the effect of deeming certain agreements to be franchise agreements, prescribing certain minimum content to them. It also requires a franchisor, before the franchise agreement is made or renewed, to disclose information about itself and the franchise agreement to prospective and current franchisees. Breach of the Code is a breach of the Act which enlivens a right to damages in favour of a franchisee or other persons who suffer loss or damage as a result of the conduct of the franchisor in contravention of the Act. In addition, it exposes the franchisor to civil penalties which can be levied against it by the Australian Consumer and Competition Commission (**ACCC**).

Code compliance became mandatory on 1 October 1998 and amendments have been introduced from time to time, the latest on 1 March 2008.

Background to the 1 March 2008 Code changes

The genesis of the Code amendments was a Federal Government initiative to review the Code in 2006. The Government appointed the Franchising Code Review Committee (**Committee**) as a special purpose committee to review the operation of the disclosure regime under the Code. In doing so, however, the Committee commented on and made recommendations about the entire Code, including recommendations regarding its application to foreign franchisors and on the content of the franchise agreement.

Application of the Code to foreign franchisors operating in Australia

One significant change was to the application of the Code to foreign entities that operate franchises in Australia.

Previously, clause 5(3)(a) of the Code exempted the Code from applying to a franchise agreement where the franchisor is resident, domiciled or incorporated outside Australia, and granted only one franchise or a master franchise to be operated in Australia.

From 1 March 2008, foreign franchisors that grant, and or have granted a single franchise or a master franchise to operate in Australia are now required to comply with the Code. The removal of the foreign franchisor exemption may require franchisors to amend the content of their existing master franchise agreements and to prepare and maintain a disclosure document to give to current and prospective franchisees. All new foreign franchisor entrants to the Australian market will have to carefully consider the provisions of a single franchise or a master franchise agreement, and prepare and maintain a compliant disclosure document.

The new burden of disclosure on foreign franchisors is only moderated slightly in the application of the rules regarding disclosure about the franchisor's finances (financial statements). In Schedule 1 of the Code (which sets out the form of the disclosure document), item 20 was amended to enable foreign franchisors to use their own local accounting standards and auditors in producing and providing the financial information. In master franchise arrangements, compliance by a foreign franchisor with its disclosure obligations can be achieved by either providing a prospective franchisee separate Australian disclosure documents relating to the franchisor – master franchisee (or sub franchisor) relationship, and the master franchisee (or sub franchisor) – franchisee relationship, or by providing prospective franchisees and franchisees with a joint franchisor – master franchisee disclosure document.

Restrictions on the content of franchise agreements

Prohibition of general waivers of representations

A fairly standard provision generally included in most franchise agreements is that any oral or written representations made by a franchisor to a prospective franchisee before the written agreement was entered into (other than those contained in the disclosure document provided pursuant to the Code) are deemed to be of no effect and the parties agree that the written franchise agreement is the entire agreement between them.

A new clause 16(b) now prohibits the waiver of any verbal or written representations made by a franchisor. This applies retrospectively to existing franchise agreements entered into after 1 October 1998, meaning that any such provisions in existing franchise agreements are illegal and of no effect. A franchise agreement entered into on or after 1 March 2008 that contains such a provision may now constitute a contravention of the Code.

Clause 16(b) significantly limits parties rights to contract on terms of their choice. This means that from the outset (such as when recruiting or renewing franchises), any approach to a prospective franchisee (including emails and conversations) needs to be really carefully vetted to ensure inappropriate representations are not made.

Many informed franchisors already take care in this area by ensuring that the contents of, or conversations are documented. Franchisors would also be well advised to obtain a prior representation statement from a prospective franchisee. The statement requires the prospective franchisee to set out exactly what representations were made and on what representations (if any) the prospective franchisee relied for purposes of entering into the franchise agreement.

Franchisors also need to review their franchisee recruitment, renewal and disclosure processes to ensure that representations made to current and prospective franchisees are appropriate and well documented. Another sensible precaution is to review existing franchise agreements to ensure clauses dealing with wavier of representations are appropriate and operate only to the extent possible under the new regime.

Proposed prohibition on franchisors right to amend

The Federal Government has flagged its intention to modify section 51AC of the Act (which deals with unconscionable conduct), to remove franchisors right to amend franchise agreements without franchisee consent.

Clause 22 of the Code still allows a franchisor to terminate a franchise agreement in the absence of breach on 'reasonable notice' provided reasons are given by the franchisor.

The new Labor Government has commissioned a Parliamentary Committee Inquiry into franchising and a report to the Federal Parliament was released early December 2008. It is however unlikely that proposed changes to section 51AC will significantly alter existing business practice.

Good faith

Australian Courts (**Courts**) when called upon to interpret a franchise agreement already imply a 'good faith' duty on parties due to the distinctive close business relationship between franchisor and franchisee.

The Parliamentary Committee strongly favours an inclusion of an express 'good faith' duty into franchise agreements by amending the Code. In principle, the rationale cannot be faulted but it appears an unnecessary addition to the Code as Courts already imply a 'good faith' duty.

The Parliamentary Committee unfortunately failed to say whether it merely intends to codify current law or wants to attach a different meaning to 'good faith' that given by Courts when called upon to give effect to franchise agreements. Of concern is the perception that the Parliamentary Committee sees an express 'good faith' obligation as a magic wand capable of curing all perceived franchise ills. It overlooked the potential increase in uncertainty of what may be expected from franchisor and franchisee, the risk of increased disputes and the fact that often misguided franchisee expectations may increase believing they now are better protected by a 'good faith' obligation. They may even pay less attention to seeking advice, reading the franchise documentation and conducting due diligences.

Compensation at end of term

The Parliamentary Committee also recommended that a franchisor should compensate a franchisee at the end of the term of the franchise agreement.

The notion of compensating a franchisee, when an agreement comes naturally to the end of its term is foreign to common law jurisdictions and contrary to a fundamental principle of contract law that is the freedom of parties to contract on terms of their choice. The notion also appears to ignore a fundamental characteristic of franchising, that is rights granted to a franchisee are only for an agreed term and the franchisee obtains no right of ownership from the use of the rights granted during the term.

There are examples in civil law jurisdictions, particularly some US States and in the EU in relationships such as distributorships and agencies, which provide for compensation payable to the franchisee, distributor or agent at the end of the term. Importantly, these examples are primarily limited to compensation where renewal is unreasonably refused and the agreement provides for renewal or the grantor refuses to entertain good faith negotiations but intends to carry on business.

Franchising should however be distinguished from other forms of business relationships such as distribution and/or agencies. In these instances, the distributor or agent needs to use or develop its own systems and methodologies for doing business. In sharp contrast, a business format franchisee is obliged to adopt and use prescribed franchisor systems and methodologies. Franchisor control over systems and methodologies which include marketing and the like, in fact distinguishes franchising from other forms of doing business. In the franchisor/franchisee relationship, the franchisor grants the franchisee a right to use, for a limited period its proven and tested business concepts and systems. This fundamental difference makes it difficult to appreciate a rational basis for justifying compensation payable to a franchisee at the end of the term, as the franchisee never owned and does not acquire an ownership interest in the franchisor's system components, or broadly speaking, its intellectual property.

Some commentators suggest there may be merit for compensation if, for example, a franchisor unreasonably refuses to renew the franchise agreement. However, if the agreement provides for renewal on certain terms and conditions and the franchisor unreasonably refuses renewal, a franchisee will automatically enjoy a claim to damages based on the franchisor's breach of its implied 'good faith' duty, apart from claims for damages under the Act. Accordingly, even in this instance it remains difficult to appreciate why and on what basis a franchisee should enjoy a 'general' right to compensation.

If introduced into Australian and New Zealand law at some time in the future, it may well reduce the attractiveness of franchising as a method of doing business and increase franchisee costs. Franchisors will have to factor end of term compensation obligations into upfront and ongoing payments.

Contents of the Australian disclosure document

As noted above, a franchisor, including a foreign franchisor must prepare and maintain an Australian compliant disclosure document to sell franchises in Australia. However, the Code does not require registration of Australian disclosure documents.

Australia's standard disclosure document contains 23 disclosure items and mandates disclosure in a certain format following the sequence and numbering used in Schedule 1 to the Code. A copy of the Code can be found on the ACCC's website at www.accc.gov.au.

The ACCC is also the statutory regulator, but generally only conducts investigations on receipt of a complaint although, it is authorised by the Act to institute investigations of its own accord.

Code compliance is critical for preparation of Australian disclosure documents and franchise agreements as it is imperative for franchisors to comply with the Code's disclosure and other requirements under the Code and the Act. Even innocent technical breaches of the Code may expose a franchisor, including a foreign franchisor to claims for damages by franchisees and civil penalties under the Act.

New triggers, new disclosures and tighter time frames

Disclosure triggered on extension of the scope of a franchise

Previously, clause 6B(1)(b) did not require provision of a disclosure document when the scope of a franchise is extended (as distinct from extensions to an agreement term or period). Since 1 March 2008, the disclosure regime will apply, even when the extension of the franchise is just to scope (such as extension of a franchisee's site or territory, site operations and so on).

Many franchisors don't have processes in place to ensure that prospective changes in the scope of the franchise (not just the rules or changes to the type of the franchise) trigger the need for a new agreement and disclosure document. This is a concern, especially as the disclosure document and the franchise agreement need to be provided at least 14 days before any such extension.

Voluntary undertakings to be disclosed

Section 87B of the Act permits the ACCC to accept formal administrative undertakings in certain circumstances, for example, to settle or avoid proceedings for alleged breaches of the Act, or to obtain authorisations.

Undertakings provided by a franchisor to the ACCC may be as relevant to a franchisee or prospective franchisee as the existence of legal proceedings. Since 1 March 2008, the content of any section 87B undertaking must be disclosed by the franchisor to franchisees within 14 days of the franchisor giving the undertaking, and that information must now be included in the disclosure document.

Disclosure of materially relevant facts

A franchisor must provide a current disclosure document to a prospective franchisee at least 14 days prior to entering into the franchise agreement or accepting any form of valuable consideration. Additionally, within four months of financial year end, the franchisor must update and have the updated disclosure document available to be provided to franchisees upon request.

In addition, clause 18 previously required certain franchisor information to be continuously disclosed to franchisees within 60 days of it changing or becoming known. This continuous disclosure obligation relates to materially relevant facts. The subject matter of materially relevant facts is very diverse and includes changes in majority ownership, certain proceedings, judgments, changes in ownership of intellectual property and so on. Clause 18 contains a non-exhaustive list of examples of materially relevant facts.

Materially relevant facts are clearly major issues in an organisation and disclosure of such matters to franchisees may not be front of mind when a franchisor is dealing with them. Since 1 March 2008, the time within which such disclosures must take place has now been reduced to 14 from 60 days. Continuing disclosures are a natural consequence of the obligation already existing in the Code, however the timing of disclosure (14 days) is onerous for some franchisors.

Franchisors now need to keep the continuing disclosure obligations to franchisees in mind when issues arise to enable them to comply with their obligation within the new 14 day period. In practice, many franchisors don't have processes in place to detect when a timely disclosure is necessary or even whether a fact is materially relevant within the meaning of clause 18 and will often have to seek legal advice on whether disclosure is triggered by clause 18 of the Code.

Other new disclosures

The changes introduced on 1 March 2008 now require additional information to be disclosed to franchisees, necessitating collection of information by franchisors and reformatting of existing disclosure documents. Previously, there was an obligation to disclose convictions for serious offences by franchisors or their directors. The definition of a 'serious offence' has now been expanded to include 'a contravention of any provision of the *Corporations Act 2001*'.

This provision has the potential to be onerous as disclosure is not limited to contraventions of important provisions of the Corporations Act and include minor contraventions (such as failure by the franchisor to submit its annual statement to the Australian Securities and Investment Commission (**ASIC**) on time.

Further, the name and contact details of past franchisees, those who in the last three years have transferred their franchise business or ceased operating as a franchisee must now be provided unless the past franchisee has requested that those details not be provided.

Some franchisors view this as potentially problematic as it will expose prospective franchisees to possibly disgruntled former franchisees.

The requirement to provide details of former franchisees also obliges franchisors to ensure compliance with state and federal privacy laws to ensure any necessary consent to disclosure are obtained from past franchisees.

Generally, franchisors that have not yet done so will need to update their systems for collecting information and consents from existing franchisees when their agreements expire, terminate or are transferred.

Franchise and associated agreements given with disclosure document

Under the new Regulations, clause 10 of the Code and items 17 and 18 of the disclosure document require franchisors to provide franchisees and prospective franchisees with a full copy of the proposed franchise agreement in the form to be executed, a copy of the Code and copies of all associated agreements and contracts (where available) when the disclosure document is provided.

Other related agreements are commonly leases, indemnities, guarantees and confidentiality agreements and so on that the franchisee or its related entities such as directors or shareholders need to sign.

This requirement may well trigger double disclosure if matter in the franchise agreement initially disclosed differs from that eventually agreed upon as the disclosed agreement will then not be in the form to be executed. The Code does not allow parties to waive compliance with the 14 day disclosure period and this can result in fresh disclosure, lost time and increased costs. It would have been more sensible if the Code required that the franchise agreement to be disclosed to be in substantially the form to be executed. Unfortunately, the Parliamentary Committee ignored representations to this effect.

Usually, well-organised franchisors already provide this information and may not find these changes onerous. Nevertheless, all franchisors should check whether they do, in fact, provide all relevant agreements, as well as the Code, as part of their standard disclosure process before finalising agreements (or renewing or extending them).

Conclusion

Generally, the new Regulations introduced on 1 March 2008 increase the burden of disclosure on franchisors and require the franchising sector to review current practices, processes and documentation.

The 2008 appointed Parliamentary Committee released its report in December 2008 making some 11 recommendations, which, if implemented will further increase the burden of disclosure. Details and a brief discussion on those can be found on DLA Phillips Fox's website at www.dlaphillipsfox.com.

The majority of these recommendations haven't been well received by the franchise sector and it remains to be seen which, if any, will be implemented. Once the Federal Government issues a response to the Parliamentary Committee's recommendations, an update will be published on the DLA Phillips Fox website.

Despite the fact that Australia has one of the most robust and comprehensive regulatory franchise regimes, franchising in Australia remains healthy and destined to continue its growth despite the global financial and economic crisis. Unfortunately, compliance costs and the risk of even inadvertent contraventions of the Code and Act are high, necessitating the need for professional advice from an experienced legal practitioner.

Note: The first section of this Update, Franchise Sector Health, is based on Griffith University's Asia Pacific Centre for Franchise Excellence biannual franchising Australia survey.

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