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Your Ref: Franchises (Supplementary Inquiry)

Quote in reply: Franchising Bill: 21000864

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Executive Officer
Economic and Finance Committee
Parliament House
North Terrace
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Attn: Dr. Paul Lobban

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Dear Economic and Finance Committee

FRANCHISES (SUPPLEMENTARY INQUIRY)

Thank you for the opportunity to provide comments on the Economic and Finance Committee's Supplementary Inquiry on *Franchises* and for granting the Society an extension of time to provide submissions on this issue.

This letter has been compiled with the assistance of the Franchise Law Committee of the Queensland Law Society.

The Queensland Law Society (QLS) is the peak professional body for the State's legal practitioners. We represent and promote more than 8,500 legal professionals, increase community understanding of the law, help protect the rights of individuals and advise the community about the many benefits solicitors can provide.

Our members and the members of the Franchise Law Committee represent a diverse cross-section of franchisors, franchisees including master franchisors, master franchisees, and other suppliers of goods and services to the franchising sector.

Given that QLS Members and members of the Franchise Law Committee represent a diverse cross-section of franchising parties, the Franchise Law Committee has been very active in making submissions on any proposed (Commonwealth or State) law reform in franchising. Please find ***enclosed,*** a copy of our letter to the Premier of Western Australia, The Hon. Colin Barnett MP dated 8 November 2010 for your information. It contains a number of important issues relating to state based legislation that should be considered by your Committee.

We understand that the Economic and Finance Committee is seeking submissions "on how the changes to the Franchise Code of Conduct have addressed the recommendations made by the Committee in its 2008 inquiry (no.65) *Franchises*."

1. Commentary on the changes to the Franchise Code and recommendations by the Committee

In the Committee's 2008 Report, a number of recommendations were made in relation the *Franchising Code of Conduct* (Cth) and ancillary property law issues.

The Society would like to comment on a few of the key recommendations from the Report.

Penalties for Breaching Code

7.2.9 The Committee recommends that the Franchising Code of Conduct be amended to introduce specific penalties for breaches of the disclosure requirements under the Code. (p. 42)

The recommendation does not appear to have been followed in the form suggested in the Code changes effective 1 July 2010 or in the *Trade Practices Act 1974* (Cth), now the *Australian Consumer Law* (**Act**).

It is however critical to appreciate the stated purposes of the Code, specifically as they relate to disclosure. Clause 6A of Part 2 of the Schedule to the Code makes it abundantly clear that the purposes are to enable a prospective franchisee or franchisee to make a reasonably informed decision about the franchise and to provide current information from the franchisor that is material to the running of the franchised business. It is suggested that the purpose is to facilitate informed decision making and not to randomly penalise breaches of the Code. To the contrary, the Society is of the view that penalties in the form envisaged in the recommendation may prove counter-productive and fail to enhance best franchise practice. As is, the Act and the common law provide adequate remedies to franchisees for damages suffered, strengthened by the ACCC 'class action' power.

In line with the Code's stated purposes, the Federal Government introduced with effect from 1 July 2010, amongst others, the following provisions to further strengthen these purposes:

- disclosure of instances of unilateral variation of a franchise agreement over a running 3 year period;
- disclosure of unforeseen significant capital expenditure;
- requiring fresh disclosure in cases of novation;
- disclosure of recurring or isolated payments;
- strengthening of the mandatory dispute resolution regime;
- mandatory disclosure of cost attribution;
- mandatory disclosure of confidentiality obligations imposed on a franchisee and specificity in respect of the matters to which the obligations will apply;
- fresh disclosure to an existing franchisee before an extension in the scope of a franchise agreement is granted;
- mandatory renewal notice by the franchisor requiring the franchisor to notify its franchisees of its intention to renew or not to renew the agreement or to agree to a new

franchise agreement at least 6 months before the expiry of the franchise agreement (or one month before the expiry of an agreement with a term of less than 6 months);

- obligatory upfront disclosure of end of term arrangements. This is arguably one of the most significant changes and goes into fairly minute detail as to what needs to be disclosed and covered in a franchise agreement. In summary, disclosure will be needed for:
    - the process that will apply or determine arrangements at the end of the franchise agreement including whether the franchisee will have an option to renew or extend the franchise agreement or enter into a new franchise agreement;
    - the process the franchisor will use to determine renewal, extension or granting of a new franchise agreement;
    - whether the franchisor will purchase the stock, marketing material, equipment and other assets and, if so, how the prices will be determined;
    - whether the franchisee has the right to sell the business at the end of the franchise agreement including whether the franchisor has the first right of refusal and how the market value will be determined;
    - details of any exit payments the franchisee will receive and, if so, how the exit payment will be determined or earned.

The Act has also been amended in material respects which also apply to the franchise relationship. Some amendments critically relevant to franchising include:

- introduction of civil penalties of up to $1.1 million for corporations and $220,000 for individuals on anyone engaged in unconscionable conduct or making false or misleading representations to franchisees;
- granting of specific random audit powers to the ACCC. It should be noted that the ACCC will not be required to have any belief about non-compliance with the Code before conducting an audit. The ACCC will be able to request a franchisor to produce copies of all documentation required to be held under the Code or the Act. The random audit powers are in addition to the ACCC's investigative powers under section 155 of the Act;
- the ACCC is able to issue substantiation notices, requiring franchisors to substantiate any claims they make in promoting their goods or services. This power extends to the franchise offering. These notices will likely be utilised by the ACCC to seek information which will assist in determining whether a breach of the Code or other codes or the Act has occurred;
- the ACCC is authorised to publicly 'name and shame' rogue or unscrupulous franchisors. This power enables the ACCC to issue advance 'warnings';
- the ACCC is empowered to institute a 'class action' on behalf of 'harmed' franchisees against a franchisor. This power envisages that the ACCC is allowed to apply to court for orders providing redress to all franchisees without the need for franchisees to be party to the legal proceedings. This could include orders for a franchisor to pay a pecuniary penalty for breach of the unfair practices and unconscionable conduct provisions of the Act. The reasoning behind the amendment is to assist 'harmed' franchisees unable to afford the cost of instituting legal action against a franchisor for redress;
- unconscionable conduct provisions of the Act have also been amended and are supported by a set of interpretative principles that will be used as an aid to interpretation. In essence, a court will consider the terms and progress of an agreement and systems of conduct or patterns of behaviour. Importantly, identification of a special disadvantage (as it applies in common law) is not necessary to attract the application of the provisions.

Whilst some of the above changes also address other recommendations relevant to the Supplementary Inquiry, it is the Society's view that the changes introduced have superseded recommendation 7.2.9. The Society is also of the view that the changes introduced to the Code and the Act supplement the Code's purposes and are more conducive to fostering growth and best practices in franchising than penalising breaches of the Code can achieve.

The Society also notes that the Committee's recommendation is limited to penalties for breaches of the Code's disclosure obligations. Section 14 read with the definition of 'SA Franchising Law' in section 2 (1) of the Franchising (South Australian) Bill 2009 (**Bill**) introduced in 2009 (which subsequently lapsed) will however if promulgated, result in penalties imposed for breaches way beyond the recommendation and cover any breach of the 'Franchising Code of Conduct', 'Franchising (South Australia) Code of Conduct' and 'SA Franchising Law', all as defined in section 2 (1) of the Bill. No explanation was given why the Bill by far exceeded the scope of breaches covered by the Committee's recommendation.

Statutory Definition of Unconscionability

7.2.10 The Committee recommends section 51AC of the *Trade Practices Act 1974 (Cth)* be amended by the inclusion of a statutory definition of unconscionability or alternatively by the insertion in the Act of a prescribed list of examples of the types of conduct that would ordinarily be considered to be unconscionable. (p. 46)

It appears to the Society that the recommendation has not been followed in its exact form or the alternative as suggested. Despite this, the recommendation and its alternative have attracted significant attention and research, culminating in sections 21 and 22 of the *Australian Consumer Law* (unconscionability in consumer transactions and unconscionability in small business transactions, previously found in sections 51AB and 51AC of the Act). Although sections 21 and 22 will be consolidated and become section 21 as a result of the *Competition and Consumer Legislation Amendment Bill 2010*, the consolidation will not affect the substance of sections 21 and 22 of the *Australian Consumer Law*.

The reforms introduced by sections 21 and 22 will deliver some significant benefits for businesses, including franchising, primarily as a result of moving to a consistent national framework and removing current inconsistency and duplication between Commonwealth, State and Territory laws. Critically, unlike section 51AA, and more expansively than section 51AB (sections 20 and 21 of the *Australian Consumer Law*), a non-exhaustive list of factors is provided with section 51AC (section 22 of the *Australian Consumer Law*) to assist courts in determining whether conduct is unconscionable.

A substantial alteration brought about by the introduction of the *Australian Consumer Law* sees consideration being extended to the terms and conditions of the agreement, the conduct in complying with those terms and the conduct of the parties after commencement of the agreement as the landscape within which the non-exhaustive list of factors specified in section 22 of the *Australian Consumer Law* should be considered. Also critical is the fact that there is no need to identify a special disadvantage to constitute unconscionable conduct.

The alterations brought about by the *Australian Consumer Law* follow upon the Federal Government's assessment of its Joint Committee on Corporations and Financial Services Report and the Report of the Expert Panel appointed by the Federal Government. In particular, the Expert Panel advised substantively on whether a list of examples constituting unconscionable conduct or an interpretative set of principles should be provided. After careful consideration, the

Expert Panel came to the conclusion that providing a list of examples may prove counterproductive because it is impossible to provide an exhaustive list.

In essence, the Expert Panel provided three reasons why a list of examples for unconscionability would not assist. These are:

(i) Examples would provide a false expectation of hope in that small business owners would consider their own circumstances coming within the provide of what is illustrated and then be aggrieved when a court rules differently;
(ii) As the social context changes, the examples would become outdated and it would then be too considerable a legislative or administrative burden to change them; and
(iii) The examples may well allow the judicial discretion to be defined and confined by the provided examples.

The Expert Panel did consider that the use of test cases and the inclusion of interpretative principles would go some way to assisting interested stakeholders in understanding and enforcing section 51AC (section 22 of the *Australian Consumer Law*). This preference for interpretative principles was based on their ability to:

> *'… [assist] the courts and other stakeholders in interpreting the provisions. Principles of business conduct are closer to examples, which the panel has already examined. Guiding principles of interpretation provide an indication of the law's effect without unduly confining the law's development.'*

The Society supports the alterations brought about by the introduction of interpretative principles in the *Australian Consumer Law*. It is suggested that it is practically and legally almost impossible to define unconscionability exhaustively or to provide an exhaustive list of examples. The *Australian Consumer Law* should be given time to run its course and for the courts to apply the interpretative principles when considering unconscionable conduct matters.

Good Faith & Fair Dealing

7.2.13 The Committee recommends amending the Franchising Code of Conduct by inserting a provision imposing a duty to act in accordance with good faith and fair dealing by each party of the franchise relationship. (p. 66)

The recommendation has not been specifically followed. However, with effect from 1 July 2010 section **23A** was introduced to the Code, reading as follows:

> 'Nothing in this code limits any obligation imposed by the common law, applicable in a State or Territory, on the parties to a franchise agreement to act in good faith.'

The Society suggests that the introduction of section 23A to the Code adequately addresses the recommendation and the concerns raised during the Initial Inquiry. The Society is also of the view that previous Federal and State Government Commissions of Inquiry only cited civil law jurisdiction authorities as justification for the recommendation. It is suggested that this demonstrates a failure to appreciate that Australian courts applying common law have inherent jurisdiction to imply a good faith obligation into a commercial agreement.

It is also suggested that previous Federal and State Government Commissions of Inquiry may not fully appreciate that the franchise regulatory framework in Australia is amongst one of the most comprehensive in the world, backed by the Act and an effective regulator in the ACCC.

Australian courts by and large have ruled in favour of an implied good faith obligation. In *Burger King* [2001] NSWCA 187, the New South Wales Court of Appeal (Sheller, Beazley and Stein JJA) noted that there was increasing acceptance that a term of good faith was to be implied as a matter of law which approach was considered to be correct: at [164]. See also *Australian Competition and Consumer Commission v Simply No-Knead (Franchising) Pty Ltd* [2000] 178 ALR 304 and *Automasters Australia Pty Ltd v Bruness Pty Ltd* [2002] WASC 286. In these three cases, the respective franchisees succeeded against the franchisor because the franchisor was held to be pursuing more than the franchisor's legitimate interest, or, putting it another way, the franchisor was acting in a manner that would not be reasonably expected in the context of a franchise relationship.

In *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310, Byrne J noted that:

> 'There is to be implied in a franchise agreement a term of good faith and fair dealing which obliges each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and not capriciously or for some extraneous purpose. Such a term is a legal incident of such a contract'.

A balancing factor is, where the franchisor can demonstrate that it is seeking to protect a legitimate interest it will not be in breach of the implied obligation of good faith. See *Far Horizons Pty Ltd v McDonald's Australia Ltd*.

The implied obligation of good faith also does not require a franchisor to act in a contractually altruistic manner or in a manner akin to a fiduciary. Also, a franchisor is not required to subordinate its own immediate or longer term business or other interest to those of a franchisee or its franchisees. Our courts are aware and approach this issue on the basis that the franchisor's interests arise in the context of an independent, mutual relationship where the franchisee reasonably expects that regard will be made to the franchisee's legitimate interest. It is submitted that our courts are succeeding in balancing the rights of franchisors and franchisees adequately.

Given the nature of franchise agreements, franchisors normally retain a contractual discretion, but given the interpretation adopted by our courts, a franchisor cannot exercise that discretion in a way likely to cause the franchisee's rights to become 'nugatory, worthless or is seriously undermined'. As a result of this, the exercise of a contractual discretion is made capriciously, or for some extraneous purpose if there is no rational basis for the exercising of the right or no explanation for the exercise of the right that is in accordance with the parties' reasonable expectations. See *Far Horizons Pty Ltd v McDonald's Australia Ltd* [120].

In support, when arguing a breach of the implied good faith obligation, a franchisee can also rely on verbal or written representations made by the franchisor prior to entering into and during the term of the franchise agreement. Clause 16 of the Code removed any doubt by rendering a general release or waiver of any verbal or written representation made by the franchisor illegal.

Further, our courts have also ruled that a typical 'entire agreement' clause in a franchise agreement does not exclude the implied good faith obligation. See *Far Horizons Pty Ltd v McDonald's Australia Ltd* [123]. In *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* [2003] 128 FCR1, Finn J stated that he found 'arresting the suggestion that an entire agreement clause is of itself sufficient to constitute an "express exclusion" of an implied duty of good faith and dealing where that implication would otherwise be made by law' [922].

The prohibitions on unconscionable conduct contained in the Act and State Fair Trading Legislation operate effectively in the context of the franchise relationship and adequately enhance and support the implied good faith obligation accepted by our courts. Section 51AC in providing a non-exhaustive list of factors that can be taken into account to determine unconscionable conduct, include consideration of 'good faith' as one of many factors to be taken into account in determining unconscionable conduct.

For example, in *ACCC v Simply No-Knead (Franchising) Pty Ltd* [2000] 178 ALR allegations against the franchisor included, amongst other things, a refusal by the franchisor to discuss matters in dispute with the franchisee despite requests from the franchisee to do so, the exclusion of the franchisee from advertising literature of the franchise, competing with the franchisee, and the deletion of telephone numbers of the franchisee's business from directory information. Sundberg J described this conduct (at page 320) as disclosing 'an overwhelming case of unreasonable, unfair, bullying and thuggish behaviour in relation to the franchisee which amounted to unconscionable conduct'. In reaching this conclusion, His Honour noted that in his view, the expression 'unconscionable' in s51AC was not limited to cases of unconscionability as defined by the unwritten law or equity. The principle points to an enlarged notion of unconscionability in s51AC lie in the factors to which a court might have regard and the fact that these factors are not exhaustive. This should be read in context with the alterations introduced by the Australian Consumer Law.

It is suggested that the current state of our common and statutory law provide adequate protection and any attempt to introduce an explicit good faith obligation into the Code may not only be unnecessary but an unfortunate legislative indication that 'good faith' has a different meaning as currently understood, applied and continually further developed by our courts. It is also the considered view of the International Franchise Association that when legislatures go further to include an explicit duty of good faith and define good faith with words such as fairly, honestly, reasonably and cooperatively, more uncertainty and additional litigation result.

Goodwill

7.2.15 The Committee recommends the Franchising Code of Conduct be amended to include a provision mandating that franchise agreements must include the basis on which termination payments or goodwill or other such exit payments will be paid at the end of the agreement. (p. 75)

On its own, the recommendation appears to suggest that a disclosure document and franchise agreement should be specific on whether or not any goodwill/exit payment will be due and payable to a franchisee when the agreement terminates (at the end of the term or otherwise). To the extent something different is intended by the recommendation, it will be dealt with when commenting on recommendation 7.2.16.

It is the Society's view that the amendments to section 17, in particular 17C to the Code introduced on 1 July 2010 adequately accommodate and follow the recommendation. For ease of reference, section 17 is quoted below:

'17 Other conditions of agreement

17.1 References to the relevant conditions of the franchise agreement that deal with the following matters:

(a) term of the franchise agreement;
(b) variation;
(c) renewal, extension or extension of the scope;
(d) conditions the franchisee must meet to renew, extend or extend the scope of the franchise agreement;
(e) termination by the franchisor;
(f) termination by the franchisee;
(g) the franchisee's goodwill, if any, on termination or expiry.

17C Arrangements to apply at the end of the franchise agreement

17C.1 Details of the process that will apply in determining arrangements to apply at the end of the franchise agreement, including:

(a) whether the prospective franchisee will have any options to renew, or extend, or extend the scope of the franchise agreement or enter into a new franchise agreement and, if so, the processes the franchisors will use to determine whether to renew, extend, or extend the scope of the franchise agreement or enter into a new franchise agreement; and
(b) whether the prospective franchisee will be entitled to an exit payment at the end of the franchise agreement and, if so, how the exit payment will be determined or earned; and
(c) details of the arrangements that will apply to unsold stock, marketing material, equipment and other assets purchased when the franchise agreement was entered into, including:
    (i) whether the franchisor will purchase the stock, marketing material, equipment and other assets; and
    (ii) if the franchisor is to purchase the stock, marketing material, equipment and other assets — how prices will be determined; and
(d) whether the prospective franchisee will have the right to sell the business at the end of the franchise agreement; and
(e) if the prospective franchisee will have the right to sell the business at the end of the franchise agreement — whether the franchisor will have first right of refusal, and how market value will be determined; and
(f) whether the franchisor will consider any significant capital expenditure undertaken by the franchisee during the franchise agreement, in determining the arrangements to apply at the end of the franchise agreement.

17C.2 If a franchise agreement is entered into in a financial year commencing on 1 July 2011, 1 July 2012 or 1 July 2013 — details of whether the franchisor has, since 1 July 2010, considered any significant capital expenditure undertaken by franchisees, in determining the arrangements to apply at the end of franchise agreements between the franchisor and those franchisees.

17C.3 If a franchise agreement is entered into in a financial year commencing after 1 July 2013 — details of whether the franchisor has, in the last 3 financial years,

> considered any significant capital expenditure undertaken by franchisees, in determining the arrangements to apply at the end of franchise agreements between the franchisor and those franchisees.'

The comments on recommendation 7.2.15 should be read with those on recommendation 7.2.16.

7.2.16 The Committee recommends that the exclusion or inadequate determination of goodwill or other such exit payments by a franchisor during negotiations with a franchisee regarding a franchise agreement constitute "unconscionable conduct" and should be included in any discussions regarding an amendment to section 51AC of the *Trade Practices Act*. (p. 75)

It seems as though the recommendation has not been followed to the extent that the recommendation read with recommendation 7.2.15 intends to mean that goodwill/another exit payment in an adequate form must be paid to an exiting franchisee and that a failure to do so will constitute unconscionable conduct.

The Society opposes any attempt to oblige a franchisor to pay goodwill/another exit payment to a franchisee at the end of the term. Legally and economically, such a payment notion lacks fundamentals.

Presumably, justification for a goodwill payment at the end of the term to the franchisee is based on the franchisee having enlarged the franchisor's goodwill or more precisely the value of the franchisor's intellectual property. Little if any justification has been advanced for this proposition.

Justifications cited are based on legislative intervention in civil law jurisdictions and draw on an analogy between franchising on the one hand and agency and distribution arrangements on the other hand.

It is suggested that the analogy is not well founded and, in fact, ignores the requirements of clause 4 of the Code. Before an arrangement can be considered a franchise, it must satisfy the definition in clause 4.

Critically, the one requirement of clause 4 generally absent in agency or distribution arrangements is a 'grant of a right to carry on the business of offering, supplying or distributing goods and services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor'.

The Federal Court has on two occasions in *Capital Networks Pty Ltd v AU Domain Administration Ltd* [2004] FCA 808 and *ACCC v Kyloe Pty Ltd* [2007] FCA 1522 relied on the absence of this requirement to distinguish distribution and agency arrangements from a franchise.

The absence of this element in an agency or distribution arrangement argues against any attempt to justify a goodwill payment to a franchisee at the end of the term based on agency and distribution practices in civil law jurisdictions.

By way of example, it is significant to note that Article 7:422 of the Dutch Civil Code which deals with goodwill compensation to which an agent is entitled in the event of termination of the agency agreement does not extend to franchising. In fact, goodwill compensation payable to a franchisee at the end of the term is nowhere applied in any EU country. The reason for this is clear. An agent or distributor does not have the benefit of offering, supplying or distributing goods or service using a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor.

Whilst it cannot be denied that the franchisee needs to apply a certain level of business acumen and skill, it does not have an obligation similar to an agent or distributor to develop the market using its own initiative, systems or marketing plan. Accordingly, it is difficult to appreciate on what basis, if any, a franchisee has contributed to or added to the franchisor's customer base using its own systems, marketing plan and the like, and thus goodwill. Clearly, this would be the only basis on which a franchisee may arguably be entitled to some goodwill compensation because for the balance, the franchisee relies upon and uses the franchisor's intellectual property. By operating a franchise under an agreement, using the franchisor's intellectual property cannot entitle a franchisee to a proprietary interest in franchisor intellectual property convertible to a dollar value.

The concept of a franchisee, or for that matter, an agent, distributor and the like having any residual goodwill claim on termination of the agreement is foreign to Australian Law and in fact foreign to the common law jurisdictions.

To provide for some form of goodwill compensation at the end of the term will in addition invite disputes and increase franchising cost which may adversely affect the viability of franchising as a feasible business model/method of doing business.

The payment concept whether termed goodwill or exit payment is closely related to the notion of good faith or just cause in particular when it relates to end of term arrangements.

An analysis of franchise legislation in the United States reveals that although some individual States have enacted laws relating to renewal of franchise agreements very few have done so in recent years. In States where the franchise relationship is regulated there are a number of different approaches to the question of renewal which can briefly be summarised as follows:

- four States (Arkansas, Hawaii, Indiana and Nebraska) permit non-renewal if the agreement provides for it, or if the non-renewal is in accordance with the current policies, practice and standards applied non-arbitrarily; sometimes, notice is required;
- three States (Delaware, Mississippi and Missouri) permit non-renewal with 90 days advance notice, and no other relevant conditions;
- Michigan requires, in the event of non-renewal, a buyback of the franchisee's assets if, the franchise has a term of less than five years; and the franchisor provides less than six months notice of non-renewal or seeks to enforce a restraint of trade;
- two States permit non-renewal with advance notice, but with other relevant conditions. Minnesota requires notice of six months, but requires that the franchisee operate the franchise for a sufficient time to recover fair market value of the business as a going concern. California requires notice of six months and either (i) the franchisor must permit the franchisee to sell to a purchaser meeting the franchisor's then current requirements; or, (ii) if the franchisor offers a standard form renewal franchise agreement and the franchisee refuses to sign same;
- Illinois requires compensating the franchisee for the diminution in value of the non-renewed franchise if: the franchisee seeks to enforce a restraint of trade; or the franchisor provides less than six months of notice of non-renewal;
- the State of Washington requires that: in the event of non-renewal, the franchisor must compensate the franchisee for the fair market value of inventory, supplies and

furnishings purchased from the franchisor; and requires compensation for goodwill unless there has been advance notice of one year and no enforcement of a restraint of trade;

- three States (New Jersey, Rhode Island and Wisconsin) require good cause; which must be based on a contractual default;
- similarly, Connecticut requires good cause, which is defined to 'include but not be limited to' a contractual default. Iowa requires good cause, which is defined to mean 'cause based on a legitimate business reason';
- only Porto Rico requires 'just cause'.

Only a minority of US State statutes condition the right to refuse renewal on the existence of 'good cause', and none of those States define 'good cause' as sweepingly as the obligation to 'act in good faith'. As is evident from the above, a requirement for compensation in whatever form upon a termination or non-renewal is largely absent in all US States except in most extreme circumstances.

Independent economic research also confirmed that regulation of the post-sale relationship can have a dampening effect on economic activity and employment in industry sectors where franchise businesses operate. In a December, 2006 paper, entitled 'The Effect of Contract Regulation: The Case of Franchising' co-authored by Jonathan Klick, Bruce Kobayashi and Larry Ribstein (full text available online at http://www.law.gmu.edu/pubs/papers/07-03) the authors examine the impact of contract regulation and termination restrictions upon economic activity and employment in franchise businesses. The authors conclude that the net result of such regulation is likely 'negative'.

It should be of particular interest to lawmakers that the authors specifically examined the impact of the 1992 Iowa statute, concluding that 'the passage of this statute led to a reduction in both the number of franchised units and the total number of chain outlets. That is, the increase in the number of franchisor-operated establishments was not sufficient to offset the decrease in the number of franchise outlets caused by the franchise regulation.' In other words, not only were franchised opportunities constrained by the regulations but overall employment likely suffered as well. Research revealed that after Iowa passed its burdensome post-sale relationship law in 1992, more than 130 franchisors eliminated or significantly reduced their franchise operations in that State, costing the State approximately US$226 million in lost tax revenue. Since its passage, parts of the Iowa law have been declared unconstitutional, and the legislature has amended it twice to make it less onerous.

Enclosed, as Annexure A, an analysis on ownership of goodwill in a franchise. The analysis was prepared prior to the Federal Government's response to its Parliamentary Joint Committee on Corporations and Financial Services' 2008 Report. However, the issues raised in the annexure are relevant for consideration by your Committee.

2. Observations and recommendations by the Queensland Law Society

- The Society is of the view that most of the recommendations, in particular, those of major relevance to the Inquiry have been sufficiently addressed by amendments introduced to the Code and the Act subsequent to the Inquiry's 6 May 2008 Report.

- Whilst the Society's comments are limited to particularly relevant recommendations, the Society's submissions of 8 November 2010 to the Premier of Western Australia should also be considered as the gist of the comments contained in that submission equally apply to franchising in South Australia.

- Economic rationale dictates that fragmenting franchise regulation on a State and Territory basis may be costly to all concerned. It is common ground that for any franchise system to operate economically and beneficial for a franchisor and its franchisees, critical mass must be achieved. If each State and Territory introduce its own layer of regulation for the franchise sector, it may necessitate operation of multi-layered systems to accommodate one franchise brand to comply with different regulatory regimes. Potentially no State or Territory has sufficient population or demographics to sustain multi-layered systems. To this extent, Australia is vastly different from the United States where franchise regulation on a State basis is constitutionally and arguably demographically justifiable. It is also worth noting that in the EU, there are continuing attempts to unify franchise regulation in all EU member countries. Australia and its States and Territories should learn from this experience.

- All Federal and State based Inquiries unequivocally acknowledged and accepted the need for a uniform regulatory scheme to apply in each State and Territory. To the extent that the South Australian Government or any other State or Territory Government may perceive a need to change the Code or the Act, COAG presents an ideal conduit to do so.

If you have any queries regarding the contents of this letter, please do not hesitate to contact our Policy Solicitor, Louise Pennisi on 3842 5872 or l.pennisi@qls.com.au.

Thank you again for the opportunity to provide comments to the Supplementary Inquiry.

Yours faithfully

Bruce Doyle
President

ANNEXURE A

WHO OWNS THE GOODWILL IN A FRANCHISE?

Introduction

1 On 1 December 2008, the Parliamentary Joint Committee on Corporations and Financial Services (**Committee**) reported on its inquiry into the Franchising Code of Conduct (**Code**) conducted earlier in 2008. Unlike the 2006 'Matthews Report' which focussed on franchisor disclosure, the report represents a detailed review of the Code in the context of the franchising sector generally.

2 The Committee made 11 recommendations in their report, one of which relates to disclosure of 'end of term' arrangements. Critically, it envisages that a franchisor should compensate a franchisee at the end of the term and that such compensation should be based on the value of the franchised business as a going concern.

The Committee's reasoning

3 The Committee noted that end of term arrangements were one of the most contentious areas of dispute in franchising.

4 It rejected an automatic right of renewal for franchisees as well as an obligation for franchisors to show good cause for not renewing in the absence of a contractual right to renew. In doing so, it acknowledged that franchisors should be entitled to decline to renew franchises on their expiry.

5 However, the Committee stated that franchisees should receive reasonable notice from a franchisor of any decision not to renew the franchise agreement, despite the absence of a contractual right to renew. More importantly, the Committee considered that franchisors must be more transparent regarding end of term arrangements and better manage franchisees' expectations. In doing so, it considered that the pre-disclosure documentation should deal with the transfer process that will apply to equity in the value of the franchised business as a going concern on expiration of the franchise agreement.

6 Of particular concern for the franchise sector is the inherent implication in the Committee's statements that all franchisees will have some 'equity interest' in a franchise notwithstanding expiry of the franchise agreement. The Committee was unable to find any support for the 'equity interest' principle in common law jurisdictions.

7 In its most simplest form, buying a franchise amounts to buying an income stream for a pre-determined period. In this sense, a franchise displays some similarity with agencies and distributorships as rights granted to an agent or distributor are invariably also for a pre-determined period. This characteristic often leads to confusions and treatment of franchising analogously with agencies and distributorships despite all three being totally different legal concepts.

8 Examples include civil law jurisdictions such as Germany, Austria and Belgium which recognise an agent's right to be compensated for the termination of an agreement and by analogy, distributors and franchisees are treated similarly. In other civil law systems such as France, Italy and Switzerland the right of agents and distributors to compensation on termination is recognised but not extended by analogy to franchisees.

In those jurisdictions where compensation applies, the structure and calculation vary significantly.

What is franchise and distribution goodwill?

9 Some commentators and jurisdictions draw a distinction between customers and goodwill. It is a term which requires great care in its interpretation. Goodwill has different meanings and outcomes in an accounting v tax v legal v its commercial or common usage.

10 Customers are said to represent a set of opportunities for concluding business transactions. This refers primarily to regular customers with whom business transactions are expected to be concluded in future and who have to continue to generate profit for the business over a long period of time. Accordingly, customers represent pure economic value. In this vein, the Italian Constitutional Court previously said that customers in the sense of economic value is not delayed payment of commissions to the agent, but the benefit the agent has brought to the principal's business for which it cannot be said to be compensated with commissions earned and which consist of identifying and keeping customers that will remain with the principal after termination of the agency.

11 It is said that goodwill represents intangible assets, normally defined through the expectation of a continuous positive consumer perception of the business. Accordingly, it represents every advantage acquired by the business holder in the course of running a business, be it in relation to the business premises, the business name or any other element favouring the business. Goodwill is also often expressed as the capacity to generate profit in access of a standard or average profit due to superior managerial abilities, marketing position, new product technology and the like.

12 Despite nuance differences, it is evident that the notions of customers and goodwill are basically synonymous and their scope coincides. Goodwill is a common law term more frequently used and ascertained through numerous judicial definitions. From a practical and accounting point of view, it can be said that goodwill represents the sale value of a business. That is the difference between a total potential sales price and the sum total of the business's tangible assets.

13 Despite this, goodwill is incapable of precise definition. In the words of Lord McNaughton:

> 'Goodwill consists of several elements. Its structure varies in different economic sectors and different jobs within the sectors. One element can prevail here, another there.'

To whom does goodwill accrue on termination?

14 Proponents of the analogy between distribution and franchising generally rely on the following similarities:

- Continuity of co-operation between independent parties with a view to distribute/market goods.
- Both distributor and franchisee invest resources in order to create or capture market share for particular goods.

- Both tend to develop 'goodwill' for the trade mark under which the goods are distributed or marketed.

- Both establish or improve a customer base which at the end of the agreement term becomes part of the other contracting party's assets.

- If they wish to retain the customer base they will have to engage in competing goods and invest additional effort to sway customer affinity to those goods offered under a different trade mark. In itself, this will be difficult and complicated; especially if post agreement restraints of trade apply.

- Equity demands that the supplier or franchisor should not gain from the distributor or franchisee's efforts while the distributor or franchisee must start all over again.

15 Those advocating against a goodwill payment to a franchisee at the end of the term generally rely on the following arguments:

- There are virtually no similarities between a service franchise and a distribution arrangement. The fundamental nature of the former is the provision of a service according to the franchisor's business concept while the sale of goods through a distribution network is merely ancillary to their production by the supplier.

- There are similarities between a goods franchise and a distribution arrangement. In this instance, the franchisee purchases and resells the goods just as the distributor would, but using the franchisor's selling concept (marketing and know how), as well as its trade mark, assistance, control and the like. These are elements of a franchisor's goodwill. In franchising, critical elements of such goodwill include intellectual property rights, business systems, locations and relationships with suppliers.

- In contrast, the distributor operates under its own trade mark, using or attempting to develop its own distribution goodwill. Whilst the elements of goodwill may be similar to franchisors, such goodwill belongs to the distributor.

- The distributor uses its own intellectual property rights, business systems, distribution channels, location and relationship with customers which it can continue to use even after the end of the term of the distribution agreement by distributing other or competing goods.

- Consumer perception dictates that franchisor goodwill is exclusively associated with the franchisor and more often than not, the identity of an individual franchisee is unknown or irrelevant to the consumer. It is often said that in a franchise system, the franchisor's goodwill, in particular its intellectual property rights such as the McDonalds 'Golden Arches' are the driving force behind attracting custom to a franchise outlet.

- The distributor develops a great deal of marketing know how on its own, while the franchisee obtains it from the franchisor in the form of a business system. Through assistance, control and continued development, the franchisor keeps the system at the cutting edge of competition.

- Upon termination of the distribution agreement, the distributor retains its goodwill independently of the supplier. To the contrary, the franchisee knew from the outset that its status in the franchise system is not everlasting and this is underpinned by consumer perception associating franchisor goodwill with the franchisor and not the franchisee.

- A franchise agreement ordinarily stipulates that goodwill belongs to the franchisor and accordingly the issue of compensation for customers is not taken into consideration because the franchisee assumed from the outset that there is no such compensation.

- In the eyes of consumers, the goodwill of the franchise system demonstrates corporate homogeneity and their loyalty are attached to the franchise system and not the individual franchise owner. The advantage of developed franchise systems lies exactly in the fact that, by entering the system, the franchisee benefits from the franchisor's goodwill from day one. This is illustrated by people queuing up in the first days of opening McDonald's restaurants in Moscow, Belgrade and other places. In less known franchise systems, this may not be the case but generally, agreement terms are more favourable for franchisees compared with developed franchise systems.

- Arguably, each franchisee contributes something to the franchisor's goodwill, but the franchisor's contribution is by definition and most often in a practical sense the greatest. The franchisor is the developer, initiator, organiser and controller of the entire system and it is accordingly reasonable, and this is reflected by decades of jurisprudence to consider that the goodwill belongs to the franchisor.

16 Room for arguing compensation payable to the franchisee is further narrowed because franchise agreements invariably stipulate the term of the agreement and any renewal terms and conditions that apply to a franchisee when exercising renewal options. Arguably, adequate remedies already exist if a franchisor fails to renew a franchise agreement if the franchisee complied with the conditions for renewal. Unlawful refusal will amount to a breach of the agreement by repudiation. However, if the agreement does not provide for renewal, the franchisee knows up front that its rights under the agreement will terminate on expiry of the term in which case it should not be entitled to compensation.

17 The above begs the question: which elements of goodwill can be given back to the franchisee as its own, or alternatively can be 'sold' to the franchisor?

Conclusion

18 It is not clear upon what underlying basis the Committee' recommendation was founded. The right to 'sell' a business as a going concern is legally and economically dependent upon the 'seller' being the legal and beneficial owner of the business. A franchisee who, from the outset only acquired a right or license to operate the franchise for a predetermined term, cannot, upon expiry, be considered the legal and beneficial owner of the franchised business. If a franchisee wanted that benefit, it had the choice to commence business independently.

19 Comparing for and against arguments, it can be fairly concluded that there is no legal or economic rationale for recognising payment of compensation to a franchisee when the agreement naturally comes to the end of its term.

20 Time will tell how this debate will unfold, but one can only trust that Government will seek a more fundamental appreciation of the considerable issues involved, retain the distinction between franchising and other methods of doing business such as distribution and agency and not implement the recommendation.

21 If accepted, this recommendation may have significant legal and cost implications for franchisors and franchisees alike. Inevitably, compensation payable will be factored into upfront and ongoing franchise fees payable by a franchisee which will adversely affect the attractiveness of franchising as a business model.

22 Opposing payment of compensation at the end of the franchise term does not invite franchisors to act unreasonably. A franchisor must abide by the terms of the franchise agreement including the provisions governing renewal if the agreement provides for one or more renewal terms. If it fails to do so, the law already provides remedies to a franchisee.