Franchise networks- managing change and reform

By Allison McLeod

Change is the law of life. And those who look only to the past or present are certain to miss the future - John F Kennedy

Change. It can be a scary thought for some, but the capacity to change is a crucial element for not just the growth, but also the survival, of all franchise networks.

However change management is complicated. Not only do most humans fear change, but various studies indicate that people believe that when they have been doing something a particular way for some time, it *must* be a good way to do things. And the *longer* they have been doing it that way, the better it is. Important motivating factors for franchisees when buying a franchise are certainty, and to some degree protection from change. They buy into a "proven system", are signed up to a long-term contract, and then trained to do things a certain way in accordance with the franchise system. So additional structural and psychological barriers to change exist within franchising that need to be considered when effecting change.

For franchise networks to remain relevant and competitive, the systems that underpin those networks need to be continually changing and adapting to reflect changes in, amongst other things, the consumer environment, customers and technology. Gradual changes – new products, new services, enhancements to systems – are commonplace, and usually cause few issues. However, change in a franchise network can sometimes be controversial and disruptive, or require significant new capital investment. For some franchisees, particularly those that operate in rural or regional areas where the threat of competition is not quite as strong, the reasons for change may not be as compelling. Accordingly change can often give rise to disputes between franchisors and franchisees. For this reason, change management needs to be very carefully managed.

In this paper, we will consider the concept of change within a franchise network and the key issues that franchisors need to consider in implementing changes within their networks.

1 Types of changes in franchise networks

The types and size of change that a franchise network may seek to implement can vary significantly. Examples of major changes that we have seen franchisors make (or seek to make) over the past 10 years include:

(1) fundamental changes in the product offering/pricing;

(2) winding down the network completely;

(3) increases in royalty/marketing fees;

(4) adopting more robust approaches to refurbishment (including enforcing requirements where previously enforcement was lax and/or increasing quality/cost of fit-out than was previously required);

(5) introducing new technology, software or hardware;

(6) introducing online sales;

(7) implementing significantly different marketing strategies: eg new loyalty program, new promotional prices; and

(8) significant other changes to franchise agreement terms – eg removal of exclusivity.

This list is certainly not exhaustive but clearly illustrates that the changes that a franchisor may seek to make may be many and varied.

While there is no one size fits all change strategy, there are a few key things that a franchisor should consider before embarking on any change strategy.

2 The Capacity to Change

2.1 The Franchise Agreement and Manual

The starting point for any franchisor is the franchise agreement. The key question – what, under the terms of the franchise agreement (and potentially the operations manual), is the franchisor permitted, contractually, to do? Stating the obvious, if a franchisor has no capacity to implement change there can be serious impediments to any change management strategy.

Franchisors should have an understanding of what they can and cannot do under the terms of the franchise agreement before they spend any substantial time considering changes.

Otherwise they may end up making commitments or statements which are inaccurate or create future problems. Or, worse still, embark on a change process only to find that they have no capacity to enforce compliance.

In regard to franchise agreements, obviously the terms of such documents vary from network to network. However it is not uncommon to find terms in a franchise agreement that permit the franchisor to make changes to, or require changes to:

(1) Products/services for supply in the business;

(2) Fees;

(3) Premises (eg refurbishment requirements);

(4) Marketing; and/or

(5) Technology.

Usually (particularly in light of the introduction of the unfair contracts legislation) the rights of the franchisor to implement change are not unfettered – so, as noted above, it is important to check the franchise agreement before spending too much time or money developing, and then seeking to implement, a change.

Another relevant factor in reviewing the franchise agreement is whether there are any *triggers* that the franchisor can rely on to seek a change. For instance, in some cases a franchise agreement provides, as a condition of renewal, that the franchisee must refurbish the premises to the then current standard. The inclusion of such a clause may be relevant to the franchisor's decision as to how to roll out a refurbishment strategy.

It is also important to keep in mind some practicalities such as what is the tenure on the agreement? If the remaining term of the franchise agreement is short, franchisors may need to exercise caution in introducing change, particularly where that change will cost the franchisee a significant amount of money which they may not be able to recoup in the remaining term of the agreement.

2.2 The Franchising Code of Conduct/*Competition and Consumer Act 2010* (Cth)

The Franchising Code of Conduct (**Code**) may inhibit the capacity of a franchisor to implement change, particularly if a franchisor has failed to diligently comply with its disclosure obligations. Item 17 of Annexure 1 (disclosure of unilateral variations) and clause 30 of the Code (prohibition on significant capital expenditure) need to be considered.

It is also important to consider, in respect of contracts entered into or varied after 12 November 2016, if the unfair contract terms legislation in the *Competition and Consumer Act 2010* (Cth) will apply. For instance, unilateral variation clauses have been noted by the Australian Competition and Consumer Commission as terms that could potentially be unfair contract terms.

3 The rationale for change

An important aspect that needs to be considered when seeking to make change is what is the reason for change? Change for the sake of change is unlikely to be viewed favourably by franchisees. However if there is a compelling reason for a change then most franchisees will be more willing to accept and adopt that change.

So what is the reason for change , and how compelling or persuasive is the business case? This is something that the franchisor should consider in detail prior to announcing or rolling out any changes and, to the extent possible, the franchisor should also consider what external evidence it can provide to support its business case. This is considered in more detail below.

Ultimately, there are a variety of reasons why a franchisor might want to make changes to the network, some of which are more compelling, and will resonate more with franchisees, than others. For instance, changes to:

(1) the product range might be necessitated in order to adapt to a competitive landscape and to keep ahead of competitors;

(2) pricing might be needed in order to compete with competitors;

(3) the premises might be required in order to update the brand and present a more modern and appealing customer proposition;

(4) fees might need be needed to reflect rising costs; or

(5) the overall model might be needed in order to modernise the franchise offering to make it more appealing and to ensure that long term viability of the brand.

Obviously, the reasons for change are many and varied. However usually the more compelling the business case is for the change, the easier it will be to convince franchisees to accept the change. Franchisors should also keep in mind clause 30(2)(e) of the Code. This clause requires a written statement to be provided to each franchisee setting out the rationale, amount, anticipated outcomes and benefits and expected risks if a franchisor is

seeking to avoid the prohibition in clause 30(1) (which prohibits a franchisor requiring a franchisee to undertake significant capital expenditure during the term).

4 The communication strategy

Once a decision has been made to introduce a change, it is critical to consider how, and when, the change will be communicated to the network. This step is often overlooked (or not given proper consideration) by franchisors.

It is important to remember that a core aspect of franchising is the relationship between franchisor and franchisee. So in developing a communication strategy, that relationship should be kept in mind. It is also critical to consider at what stage you will start engaging with the network about the proposed change. Sometimes, this is done very early on in the process in order to get franchisee buy-in and commitment from the beginning. In other instances, the change is announced once the decision has essentially been made.

The circumstances surrounding change differ from case to case, so there can be no one size fits all communication strategy. Communication strategies need to be considered on a case by case basis in the context of not just the change itself, but also the dynamics of the network. However as a general rule the better franchisees can understand and accept the reason for change, the less likely problems will occur. Although a franchisor may have the power to implement change, problems may still arise if franchisees feel their interests have not been considered or they have been treated with disrespect in communications.

5 Analysis prior to implementation

Before implementing any change, it is important to analyse the change and the effect that the change is likely to have on the network. This analysis often feeds into the development of the compelling business reason for the change, and is also relevant in the context of clause 30 of the Code.

How the change is analysed will depend on the type of change. However, some possible means of analysing a potential change include:

(1) Financial modelling and forecasting based on the change – it is often said that it is best to make all your mistakes on paper. So make sure to spend time modelling the impact the change may have – both at a network level and at a franchise level. This is a good chance to play with the variables and see what needs to be done to try and make the change successful. Sometimes it is prudent to have a supporting report from an independent expert setting out the rationale, outcomes and risks.

(2) Trial the change – the change could be piloted by a small number of franchisees or in corporate stores. This allows the franchisor to assess how easily the change can be implemented within the franchise network and to evaluate the financial impact of the change. It also potentially allows a franchisor to obtain specific customer feedback about the change.

Undertaking such a detailed analysis will not only provide the franchisor with guidance as to whether the change is viable, but may also assist the franchisor in combating any later claims that the franchisor failed to act in good faith or acted unconscionably.

6 Consultation and engagement

Often, but not always, it is useful to consult with or engage with a group of franchisees to get their opinions, thoughts and comments on proposed changes to the network, especially those changes that are likely to be considered significant within the franchise network.

While some franchisors can be reluctant to have these discussions (often because they are aware that there are agitators who will just reject the change, regardless of the potential benefits), such discussions can be invaluable. Such discussions not only give the franchisor the chance to sell the change to a small group (who can filter that through to the larger group), but can often give clear insight as to how the change is likely to be received by the whole network. By meeting with the initial group first the franchisor has the capacity to not only test the waters but also get feedback. Based on the feedback, the franchisor might decide to vary its proposed plans for change or, alternatively, see that it is in for a fight and start to prepare accordingly.

The composition of the initial group depends a lot on the network. In some networks, there are franchise advisory councils who are appointed representatives of all franchisees. In those circumstances, you would usually expect that the initial discussions would be held with the franchise advisory council. On the other hand, the franchisor could select a group of franchisees who are trusted and who it considers will provide an honest appraisal of the proposed changes. This strategy has some benefits but also has obvious drawbacks, as it could lead to a franchisee backlash against those “favourites” who have been chosen.

In any case though, it is important to consider how to engage and consult with the network. In particular, it is important to consider:

(1) timing (ie when engagement should take place); and

(2) what you, as franchisor, actually want from the engagement.

7 Rolling out the change

Once the franchisor has decided on the change it wants to implement, has satisfied itself that there is a good business argument for the change and, that it is permitted, legally, to introduce the change, the franchisor needs to consider, practically, how will the change be rolled out? Will it be a gradual roll out? Or will it be an overnight change? Such issues will clearly impact on the strategy for the roll out. However, having a strategy is unlikely to be enough on its own – you need to get the franchisees on board to implement the strategy.

7.1 Incentives for franchisees

While the franchisor might have the legal right, under the franchise agreement, to require a franchisee to implement a change that does not mean that all franchisees are going to jump at the opportunity. This is especially the case where the change will require the franchisee to spend a potentially considerable amount of money.

One method that is often used in such circumstances is to offer incentives to franchisees to implement the changes. The form, and duration, of the incentive may vary dramatically depending on the type of the change. However commonly used incentives include cash to assist with implementing the change; a waiver of fees for a given period; and/or an extension of tenure of the franchise agreement.

7.2 Negotiation

One of the key aspects of implementing change is likely to be negotiation.

Often, the negotiation is not a negotiation per se, but a period of reasoning to assist the franchisee to see why the change needs to be made and why the franchisor has decided to implement the change as it has. However in other circumstances there may be a straight negotiation. This is particularly likely where the franchise agreement does not give the franchisor a specific right to require change and the franchisor is seeking to work with the franchisees to implement the change, essentially outside the scope of the actual agreement. In such circumstances, where the franchisor's legal position to force change is not as strong, there will often be negotiation.

7.3 Disaggregation – divide and conquer?

In our experience it is very difficult to implement change if it is contrary to the wishes of the majority of franchisees. Assuming most agree with the change, there will also invariably be a small group that opposes the change. Any change management strategy needs to anticipate this circumstance.

A tactic that some franchisors use to secure full compliance is to seek to negotiate with each individual franchisee in order to try and strike deals individually, rather than dealing with the entire remaining franchisee group en masse. This can often work quite effectively, especially if the franchise group does not have one organised leader. However it is important to note that it can also cause considerable tension within the franchise community, so franchisors do need to be careful about how they go about such negotiations.

Often reluctance to change can be influenced by other factors, such a general dissatisfaction or financial difficulty. Some franchisees may see an opportunity to secure a buyout. Hence the need for a carefully planned change management strategy.

8 Termination

Termination is almost always a last resort in franchising and this remains the case in the context of introducing changes.

If a franchisor has a right, under the franchise agreement, to require its franchisee to implement a change, and the franchisee does not do it as required, the franchisor might (depending on the specifics of the clause) have cause to issue a notice of breach against the franchisee requiring them to action the change. If the change is not actioned as per the notice of beach, the franchisor may have grounds to terminate. However as with all terminations, franchisors need to tread carefully.

Franchisors also need to be mindful of other legal requirements – for instance:

(1) Could the clause on which the franchisor is relying to terminate the franchisee potentially be declared unfair and therefore deemed void?

(2) Would terminating based on the alleged breach be unconscionable?

(3) Has the franchisor acted in good faith in exercising its right to breach/terminate?

9 Litigation

Unfortunately, not all change goes to plan and it is possible that, despite the franchisor's best intentions, it will find itself facing a claim from one or more franchisees. Numerous matters have come before the courts in recent years that have arisen primarily due to a franchisor seeking to make changes to the system – be it changes to the franchise agreement (including fees), imposing new refurbishment requirements on franchisees or seeking to change the menu and product pricing. The most well-known such case, is likely to be the Pizza Hut case which is discussed in more detail below.

There is no way a franchisor can absolutely protect itself from litigation. However, there are ways a franchisor can increase its chances of success if it ever finds itself in litigation. In this regard, it is important for the franchisor to ensure that it has sought proper legal advice about not just the proposed change but also how the change will be rolled out.

10 Roadblocks

It is important to remember that even the best laid plans can sometimes be waylaid.

There are a number of potential road blocks that franchisors should be alive to from the outset. These include:

(1) The franchise agreement and the disclosure document. Does the franchise agreement allow you to do what you want to do? Have you disclosed any potential costs in the disclosure document? At all times?

(2) The Code. Does the Code in any way prohibit you from implementing the change that you want to make? For instance, clause 30?

(3) Good faith and unconscionable conduct. Will implementing the change give rise to a potentially valid claim that you have failed to act in good faith or have engaged in unconscionable conduct (noting that such claims are often made by franchisees)?

(4) Capex restrictions. Can the franchise businesses actually afford to implement the changes you want to implement?

(5) Misrepresentations. What has been represented to franchisees over the years in respect of the subject of the change? Do those representations conflict with the proposed change? If so, how are such prior representations going to be managed to minimise the likelihood of a claim? Similarly, have you ever been silent about the issue the subject of the change (ie could that silence be construed as a misrepresentation about the proposed plans?)

(6) The ACCC and competition laws. Is the subject of the proposed change likely to attract the attention of the ACCC? Does the proposed plan comply with Australia's competition laws – for instance, if the change relates to a merger between brands, will it be necessary to obtain merger clearance? Or if you are introducing new products, will there be exclusive dealing issues?

(7) Franchisee resistance. This is potentially the biggest road block, particularly if the franchisees are well funded (either themselves or through a litigation funder), are well organised and are willing to work together.

(8) Cost and risks of a protracted dispute including litigation. Can you afford to argue the matter if a franchisee refuses to enact the change or takes action against you? What is your position on litigation as both an offensive (ie to force the change) and defensive (ie if challenged by a franchisee) strategy?

(9) Adverse publicity (PR strategy) and consequent brand damage. If there is adverse publicity, how will you counter this? Do you have your branding and message sorted?

(10) Franchisees, press and politicians. Franchising is a favourite topic among journalist and politicians. Have you considered how to respond if your brand becomes a media/political focus?

11 A case study – The Pizza Hut case

The decision in *Diab Pty Ltd v Yum! Restaurants Australia Pty Ltd* [2016] FCA 43 provides good guidance to franchisors seeking to manage significant network change, but it also demonstrates the challenges in achieving consensus across a network of independent business owners.

11.1 Background

In 2014 Yum! Restaurants Australia Pty Ltd (**Yum**) implemented a strategy known as the "value strategy" (**VS**) across the network of Pizza Hut stores. The VS was comprised of a number of elements. Crucially though, the VS provided for (1) the removal of 2 lines of pizzas; and (2) the reduction of the price of 2 lines of pizzas.

Prior to implementing the VS, Yum trialled the VS in the Australian Capital Territory (**the ACT Test**). Yum took steps to normalise the results and, based on these adjustments, predicted that the introduction of the VS should result in an increase in sales across the majority of Pizza Hut outlets.

Following the ACT Test, Yum met with franchisees in a number of States to discuss the ACT Test and the outcomes from the test. Yum also prepared a "model" (the **Yum Model**) to further assist in considering whether to implement the VS. The Yum Model was a tool that could be manipulated by inputting different information to see the impact on outputs. There were several reiterations of the Yum Model and evidence was given that at least one version of the model was shown to a number of franchisees prior to the introduction of the VS.

On 10 June 2014 the decision to implement the VS, with effect from 1 July 2014, was announced to Pizza Hut franchisees.

On 24 June 2014 the Federal Court heard and determined an interlocutory application made by A & A (Sydney) Pty Ltd and 80 applicant franchisees (including Diab Pty Ltd) (**DPL**) seeking to restrain Yum from implementing the VS. The application was not successful.

Meanwhile, Domino's had learnt of Pizza Hut's proposed plan. On 19 June 2014 Domino's notified its franchisees of its decision to pre-empt Yum and to launch an all-day every day $4.95 price point. Domino's implemented their reduced price strategy on 24 June 2014, before Pizza Hut implemented the VS, and therefore obtained any "first mover" advantage.

Yum implemented the VS on 1 July 2015.

11.2 Claims against Yum

DPL, acting both in its own capacity and as the representative applicant for approximately 190 Pizza Hut franchisees, commenced action against Yum following the implementation of the VS. DPL made a number of claims against Yum.

All Pizza Hut franchisees were party to an international franchise agreement (**IFA**) with Yum. The IFA, which was essentially a standard form document, included a number of relevant clauses. In particular, the IFA:

(1) Prohibited the franchisee from selling "Approved Products" above the maximum prices advised by Yum. (Clause C1)

(2) Required the Franchisee to participate in national and regional advertising and promotions that Yum required. This clause also provided that the franchisee would have no claim against Yum in connection with the level of success of such advertising or promotion.

DPL argued that pursuant to Clause C1, Yum was obliged to set profitable prices – being prices that allowed franchisees to maintain or increase their profits.

DPL also argued that Yum was subject to, and breached, a number of implied duties including:

(3) A duty to cooperate with franchisees to achieve the objectives of the IFA; and

(4) A duty to comply with standards of conduct that were reasonable having regard to the parties of the IFA.

In addition DPL argued that Yum:

(5) had a duty of care to each franchisee in relation to any conduct or decision by Yum in providing services as franchisor and in the exercise of its powers under the IFA; and

(6) had acted unconscionably, in breach of section 21 of the Australian Consumer Law.

11.3 The Federal Court's decision

The Federal Court generally accepted Yum's submissions and found that DPL had not established that Yum was in breach of its legal obligations in implementing the VS.

Implied duty of profitability?

The Federal Court considered that an obligation to ensure profits for each franchisee with respect to a given promotion was not only contrary to the express terms of the IFA, but was also commercially unrealistic. Given this, the Federal Court found that no such implied obligation should be imported into the IFA. To do so would be to essentially rewrite the bargain between Yum and the franchisees.

While accepting that Yum could set maximum prices, the Federal Court noted that Yum's discretion under the IFA was not unfettered and:

"…had to be exercised in good faith and reasonably with reasonable cause. Yum had an obligation to act honestly and with fidelity to the bargain but that does not mean that Yum was under a strict liability to make decisions that only resulted in success and more profits for the Franchisees. That does not mean that a decision made in good faith and on reasonable grounds that proved to be unsuccessful in realising profits…renders Yum liable for any Franchisee losses.…'

Breach of good faith?

DPL argued that Yum had implied duties to cooperate with franchisees to achieve the objectives of the IFA and to comply with standards of conduct that were reasonable having regard to the parties of the IFA.

In considering, and ultimately rejecting, DPL's argument, the Federal Court noted that:

(1) Yum had carefully considered ("agonised over") the appropriate maximum price to include as part of the VS, taking into account that it was part of an overall strategy.

(2) Yum had met with numerous franchisees before finalising the Yum Model and there was no evidence to suggest that any of those franchisees had complained about the parameters used in the Yum Model (including the labour hours).

(3) Yum was of the view that the VS was capable of:

    (a) delivering the same profits to the franchisees, as the Yum Model indicated a 34.5% uplift in transactions; and

    (b) reversing a perceived downward trend in market share that Pizza Hut was experiencing.

The Federal Court's position supported the findings of the earlier interlocutory application. During that interlocutory application, the Federal Court noted, in considering the interlocutory application, that Yum had "*shown great care in developing the VS and that it was not a strategy that was developed capriciously or arbitrarily…even if the modelling was wrong, it did not necessarily mean that Yum had breached any implied term or engaged in unconscionable conduct*."

Negligence

DPL argued that Yum owed a duty of care to franchisees in respect of any conduct or decision by Yum in providing services as franchisor and in the exercise of its powers under the IFA.

Based on the existence of a duty of care, DPL alleged that Yum had acted negligently in relation to modelling, the likely Domino's response and the design and implementation of the VS.

Yum denied a duty of care.

The Federal Court ultimately accepted Yum's submissions as to its obligations under the IFA and the exercise of those powers. The Federal Court held that DPL had failed to establish that Yum owed the franchisees a duty of care in relation to the provision of services provided by Yum as franchisor. The Federal Court also held that Yum was not

under a duty to ensure profitability of each franchise, nor under a duty to ensure that profits were maintained or increased.

Unconscionability

DPL also sought to argue that Yum had acted unconscionably, in breach of section 21 of the Australian Consumer Law. Specifically, DPL argued that:

(1) the implementation of the VS would see a movement of wealth from franchisees to Yum and that the decision to implement the VS was made by Yum's management, without consideration for the franchisees "ruthlessly and for the purposes of their US superiors".

(2) The decision to implement the VS was so unreasonable that no reasonable person would have made it.

Yum countered DPL's arguments noting that the franchisees had entered into the IFA without any promise of profitability.

While finding that Yum may have been naïve or demonstrated poor business judgement, the Federal Court found that this did not equate to unconscionable behaviour. The Federal Court found that Yum had made what it considered to be the best decision from the point of view of Yum and the future profitability of the franchisees. Whether the reasons for such belief were right or wrong, they were made reasonably. On this basis, Yum did not act unconscionably.

11.4 Learnings

Yum was ultimately successful in this case, even if the implementation of the VS did not have the positive impact on Pizza Hut businesses that Yum had hoped for.

The evidence indicated that Yum expended considerable time and effort considering, developing and testing the VS. Yum looked to other jurisdictions to see what had worked there, developed its own plan then sought to test and improve the strategy before implementing it. Yum also consulted with franchisees about the VS prior to it being implemented. The considerable care shown by Yum in developing the VS was highlighted by the Federal Court in both the interlocutory application and in the judgement following the trial.

This case clearly offers support for franchisors seeking to make substantive changes to their operations. However, it also confirms that there is a relatively high bar that franchisors

must meet in implementing changes - not surprisingly, franchisors cannot simply do as they please.

11.5 Appeal

It is worth noting that this case been appealed by a number of the Yum franchisees (see *Virk Pty Ltd (in Liquidation) ACN 132 822 514 v Yum! Restaurants Australia Pty Ltd ACN 000 674 993* NSD1671/2016). However, judgement has been reserved and we don't yet know the outcome of the appeal.

12 Summary

Change management is probably the most complex challenge faced by franchise networks, particularly where changes are fundamental and involve some commercial risk or uncertainty. Franchisors are expected to show leadership, but they must objectively consider all of the above factors and consult in a manner that is genuine and respectful of the interests of all franchisees.

