

Manager, Consumer Policy Framework Unit,
AustralianConsumerLaw@treasury.gov.au

Extending Unfair Contract Term Protections to Small Businesses
CONSULTATION PAPER
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Dear Sir/ Madam

I will confine my observations to the use of standard forms franchise agreements in business format franchising. On 2012 numbers there are approximately 73,000 franchisees operating in Australia, the sector accounts for an estimated 13% of GDP, and almost without exception the 73,000 franchisees operating 'small businesses' have had to sign a standard form contract. Franchise agreements would fall within the proposed changes. My broad proposition is that they should not fall within the legislation – the changes would serve to further entrench the franchisors' power and their ability to justify the ways they interpret their contract terms, without providing relief to franchisees from franchisor over-reaching. Franchise agreements should be a statutory carve-out.

Typical features of franchise agreements include:

- a) Non-negotiable
- b) Franchisees incur high sunk costs before fully understanding what they have bought. franchise contracts are not of low value and are not repeat purchases. A franchisee might have to invest several hundred thousand dollars to establish, for example, a café outlet. It will not know whether the concept is viable in the location until the whole investment is made.
- c) Unlike a usual consumer contract there is no consumer guarantee backing the sale of a franchise. A franchisee cannot get a refund if what the franchisor sells is defective.
- d) As K M Sharma writes: ... the liberal fiction that all the effects of a contract should be attributed to the will of those who made it still persists though contract law today even though the overwhelming majority of contracts are the product of the will of only one of the contracting parties'. (K M Sharma, 'From Sanctity to Fairness' (1999) 18 *New York Law School Journal of International and Comparative Law* 95, 115.) Naturally, parties to contracts act in their own interest. In franchising, the will of the franchisor dominates the franchise agreement.
- e) Franchisors draft franchise agreements to protect the franchisor's interests. For example the franchisor grants to itself the right to terminate the franchise and take back the franchisee's business if the franchisee commits an act of bankruptcy, but does not grant a franchisee a reciprocal exit right if the franchisor becomes insolvent.
- f) A franchisee is only able to initiate its own exit by selling the business (if it can find a buyer) or by the contract term ending.
- g) The one-sided contracts place only discretionary obligations on franchisors.
- h) Franchisees are encouraged to read the franchise agreement and ask questions, but any requests for changes are typically rejected by the franchisor. Standardisation of outcome is a more important result for a franchisor than letting a new franchisee enter the relationship in the mistaken belief that he or she has any bargaining power. The franchisee accepts the franchisor's

unwillingness to negotiate because standardisation reinforces the franchisor's mantra – we know how to do it, trust us and sign on with us and you will be successful before you know it.

- i) Nevertheless franchise agreements are: 'long-term contracts [that] involve continuing financial commitment in the course of which the consumer, being imperfectly informed and not fully aware about his needs – is largely reliant on the advice, guidance and skills of his counter-party'. (Andromachi Georgosouli, 'Investor Protection Regulation: Economically Rational?' (2006) Working Paper Series, University of London, Centre for Commercial Law Studies 10 <<http://ssrn.com/abstract=893451>> at 4 June 2010.)
- j) In addition to being a contract concerning the purchase and operation of a business the franchise agreement is a contract between a supplier and a business consumer. It places a franchisee in a position of dependence on the franchisor in relation to products and services provided by both the franchisor and by third parties.
- k) After the franchise agreement has been signed the franchisor can develop its business in any direction it wishes, including listing, selling, taking on risk without consulting its franchisees. This means that during the term of the franchise agreement the franchisee may become a party to a business that was unrecognizable from that they signed on to – obviously the result can be excellent or devastating.
- l) the problems caused by the standard form is that: '[c]onflicts of interest may, and do, create counter-incentives for [creating and] complying with contractual obligations. Especially in long term contracts and in conditions of asymmetric information, the possibility of opportunistic behaviour appears considerably increased not least because the value of the contract and the investment depends on the firm's performance after the point of purchase'. (Georgosouli, Andromachi Georgosouli, 'Investor Protection Regulation: Economically Rational?' (2006) Working Paper Series, University of London, Centre for Commercial Law Studies 10 <<http://ssrn.com/abstract=893451>> at 4 June 2010, 10-11, fn 40 citing I D C Ramsey, 'Rationales for Intervention in the Consumer Marketplace' (1984) Occasional Paper for the Office of Fair Trading 28.)
- m) The remedies provided by the ACL do not extend to a franchisee getting a refund for a faulty franchise; one that was never going to work or whose franchisor had failed to deliver on what it promised.
- n) In theory, franchisees whose franchisor fails to perform its contractual obligations could claim breach of the franchise agreement by the franchisor and make out a contract law based claim, or a quasi-contract claim. In practice, it is difficult for a franchisor to breach a franchise agreement as the agreement imposes so few, and such discretionary, obligations on the franchisor. In the absence of a breach of a term of the contract, a contract-based claim against a franchisor could be based on the doctrine of frustration or on unjust enrichment or anticipatory breach.
- o) Numerous terms of standard form franchise agreements 'would cause a significant imbalance in the parties' rights and obligations' but despite this a franchisor will always maintain that its provisions are reasonably necessary – and thus they will never see them as unfair.**

THE PROBLEM

1. How widespread is the use of standard form contracts for small business and what are their benefits and disadvantages?

- In franchising, very widespread, and unavoidable. It would be impractical for franchisors to have to negotiate a separate 'deal' with every franchisee. This would be as impractical as a retail shopping centre having a significantly different lease for each of its specialty tenants.

2. What considerations influence the design of terms and conditions in standard form contracts?

- In franchising,
 - the will of the franchisor
 - the susceptible nature of franchisees.
 - Information asymmetries that are not redressed by the disclosure document. This document is a point in time that focusses on 'the franchisor' and on the specific business the franchisee will be operating. Franchisors do not operate in isolation. They operate within large networks of entities which the franchisee is not made aware of until well after the agreement is signed.

3. To what extent are businesses reviewing standard form contracts or engaging legal services prior to signing them? Does this depend on the value or perceived exclusivity of the transaction?

- Franchisees are advised to receive financial and legal advice before they sign but as the agreement is non-negotiable many simply believe the marketing hype and do not seek specialised advice.
- Even if they did seek specialised advice there is often little an adviser can do to fully inform a franchisee because of information asymmetries.
- Law societies have Specialist accreditation programs but these do not extend to programs for specialist franchise advisers.
- A traditional contract the 'deal' as documented is not able to be subsequently amended without consent of both/ all parties. The law of guarantees, for example, recognises the vulnerability of guarantors by providing that if a deal is amended without the parties having secured the consent of guarantors to the new arrangements, the guarantors cease to be bound. A franchise agreement imposes few concrete obligations on a franchisor and numerous concrete obligations on a franchisee. The franchisor may shirk its discretionary 'obligations' and change the terms on which it will make supply to franchisees (eg change the range of products franchisees may sell as in *Meridian Retail*) but the law does not protect franchisees from adverse implications of such changes.

4. To what degree do small businesses try to negotiate standard form contracts?

- It may be possible to negotiate some deviation from the standard form franchise agreement if
 - Franchisor is desperate for cash and cannot get it from a traditional lender – some franchisors continue selling franchise opportunities even once they know they are insolvent.
 - Franchisee will be the first in a new territory that the franchisor wants to open up.

5. Is it the terms or the process by which some contracts are negotiated that is the main concern for small businesses?

- Both terms and process, and thirdly the fact that there is no ready escape for a franchisee who realises their franchisor cannot deliver on the marketing hype
6. How do small businesses differ from consumers in relation to their interaction with standard form contracts?
- Consumers have statutory warranties they can fall back on, including product recall rights where goods are faulty. Franchisees discovering they have bought into a non-viable franchise system have no such statutory protection. They are told their loss is their fault because they are no good, or they have only themselves to blame for not doing adequate due diligence.
7. What terms are businesses encountering that might be considered 'unfair'?
- Franchisors impose discretionary obligations that on themselves but mandatory obligations on franchisees. A more balanced contract would involve the franchisor's obligations being mandatory and more extensive.
 - *Ipsa facto* clauses favouring franchisors
 - Right to amend the Operations Manuals at will
 - Franchisor's right to sell its business without owing any duty to franchisees to sell to a competent buyer.
8. What detriment have businesses suffered from unfair contract terms?
- Loss of investment
 - Loss of self esteem
 - Loss of life of franchisee owners
9. What protections do businesses currently have when they encounter unfair contract terms and are they sufficient?
- Hypothetically franchisees can litigate for misleading and deceptive conduct/ unconscionable conduct. Very expensive, very slow, asymmetry of information – it is hard for franchisees to discover how the franchisor has treated others, yet the franchisor knows how it has addressed all situations related to all of its franchisees
 - If the matter is widespread enough the ACCC might take the franchisor on (eg Allphones after a franchisee had successfully prosecuted and funded a test case *Hoy v Allphones*)
 - Mediation under the Franchising Code of Conduct ('Code') if the matter falls under the Code
10. What regulatory responses are already in place that aim to protect small business from unfair contract terms and how effective are these mechanisms?
- Franchising Code of Conduct is not concerned with breaches of franchise agreements so much as with pre-contract disclosure and the creating of a mediation service.

THE POLICY RESPONSE

11. What responses (including by government or industry) could be implemented to help businesses with ensuring contract terms respect the legitimate business objectives and interests of both big and small contracting parties?
12. Would information disclosure requirements impact on the decision to review standard form contracts and/or consider the terms included in them?
- Disclosure does not work as it is intended to in franchising. The disclosure policy for franchising is not guided by the franchisor having to material that would be costly or impossible to find out otherwise.
 - Disclosure is also flawed in franchising as disclosure is retrospective and to an extent 'today'. It does not look into the future and a franchise agreement starts today and binds a franchisee for many years in the future.
13. Given the Commonwealth Government's commitment to extend existing unfair contract term provisions to small businesses, what should be the scope of the protections?
- Franchising should be excluded unless franchisees can be provided with the type of product warranty that consumers have.
14. Should the Australian Consumer Law UCT provisions be extended to cover small businesses defined using contracting party characteristics or transaction size? Should small business to small business contracts be included?
- Characteristics, not transaction size.
 - Transaction size becomes outdated very fast and if franchising does end up being caught it is proper for all franchisees to be 'protected'. The ones who have made the biggest financial investments may be more vulnerable than those who have invested in, say, a van or some other capital purchase that can reasonably readily be repurposed if the franchise turns out to be a faulty investment. It is much more difficult to repurpose, say, a motor vehicle salesroom or a heavily branded restaurant/ café.

CONCLUSION

200. Option 1 describes no new government action, where small businesses would continue to rely on existing laws and market forces to provide protection from UCTs and associated conduct by businesses. This is inconsistent with the Commonwealth Government's policy commitment.

My response: new government action – but a carve-out for franchise relationships.

202. Option 2 outlines that light touch or non regulatory options could be taken such as industry led initiatives to curtail the use of UCTs, improve small business awareness and information campaigns, information disclosure requirements and the development of guidance material for businesses.

My response: industry led responses are less than optimal in the franchise sphere. They may work where the stakes are not so high and where warranties exist.

204. Option 3 (the preferred option) outlines that the existing UCT provisions in the ACL could be extended to protect small business from UCTs. This is the Commonwealth Government's policy commitment. Attachment A also discusses the possible scope of such a legislative extension.

My response: This is too simplistic in the context of franchising. It gives franchisees no greater protection than they currently have, and places them at even greater risk of abusive terms.

207. Option 4 proposes legislation requiring that business be willing to negotiate terms in all contracts. Given the substantial costs associated with this option, it is not considered further.

My response: This is unrealistic and would require considerable expenditure on compliance auditing and enforcement.

Yours sincerely,

Dr Jenny Buchan, <http://www.asb.unsw.edu.au/schools/Pages/JennyBuchan.aspx>

UNSW: Business School

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