



**Submission by the Franchise Council of  
Australia in relation to the Treasury Legislative  
Amendment (Small Business and Unfair  
Contract Terms) Exposure Draft 2015.**

**May 2015**

**Franchise Council of Australia**  
Level 1, 307 Wattletree Road,  
Malvern East, Victoria 3145  
1300 669 030

Contacts:

[Kym.debritt@franchise.org.au](mailto:Kym.debritt@franchise.org.au)

[Stephen.giles@franchise.org.au](mailto:Stephen.giles@franchise.org.au)

## 1. Executive Summary

The Franchise Council of Australia welcomes the opportunity to provide this submission to Government in relation to the Treasury Legislative Amendment (Small Business and Unfair Contract Terms) Exposure Draft 2015 (“the Exposure Draft”).

The FCA is the peak industry body for the Australian franchise sector. There are approximately 1180 business format franchise systems in Australia, with an estimated 73,000 outlets turning over \$131 billion, and employing more than 400,000 people<sup>1</sup>. Importantly, over 95% of franchisors, and almost all franchisees, would come within the definition of a small business. So the FCA represents over 73,000 small businesses.

This is important in the context of the current deliberations, as the FCA quite probably represents more small businesses than any other organization. Moreover there is strong evidence in Australia and globally to suggest that franchising remains almost the sole business mechanism that enables small business to compete effectively against larger businesses. Franchised businesses are market leaders in many industry sectors notwithstanding that they have to compete with large corporations. Automotive retail, bakeries, casual dining, fast food, coffee shops, convenience stores, real estate, tyre retail, bedding, furniture retail, postal services and home services are just a few examples.

We are very familiar with the issues that have motivated the Federal Government to commit to its current policy, and we support the broad policy intent. However we are very concerned that the Exposure Draft does not deliver on the policy objectives, and in fact will have the following negative consequences:-

1. The Exposure Draft will not provide sufficient mechanisms for business parties to contract with certainty. Without additional exemptions the party to a contract with a small business will always have a potential claim hanging over its head;
2. The Exposure Draft will make lenders less willing to deal with small business either directly, as loan documentation will be included, or indirectly when financing transactions;
3. The Exposure Draft does not take into consideration the fact that third parties frequently rely on, or are affected by, business contracts. Third parties can include financiers, landlords, suppliers, franchisees, contractors and employees.
4. The Exposure Draft will create additional disputation. Moreover, the Exposure Draft will steer parties towards the courts rather than towards mediation and other less costly alternative dispute resolution mechanisms;
5. The Exposure Draft will see small business excluded from business opportunities, including opportunities such as tenders and major projects which typically operate on a standard form contract basis.

To remedy the situation the FCA recommends that the following additional exemptions are included in the legislation:-

1. There should be a blanket exemption for all franchise agreements, as they do not sensibly sit within an unfair contracts regime and the sector is already comprehensively regulated;
2. Further or alternatively, there should be an exemption if the small business has obtained legal advice in relation to the contract. This not only provides complete certainty if the parties choose this option, but addresses one of the main reasons underlying the rationale for the law – the absence of legal advice. It is also consistent with the requirement in the Franchising Code of Conduct encouraging parties to obtain legal advice;
3. An exemption where the small business:-
  - a. is an existing franchisee; or
  - b. satisfies a sophisticated investor test.

The FCA further considers that the reverse onus provisions in sections 24(4) and 27(1) of the ACL should only apply to consumer contracts, and not to business contracts.

---

<sup>1</sup> Franchising Australia Survey

## 2. Business Contacts Generally

A copy of our submission in June 2014 is attached to this submission, as many of our general comments remain relevant. We see no point in repeating our comments in this submission, but commend the detail of our prior submission for your further consideration.

As almost all franchised businesses – both franchisors and franchisees – are small businesses we empathise with the Government's policy intent. Franchisors and franchisees are frequently presented with standard form contracts by landlords, financiers, suppliers and even sometimes customers. So we are very familiar with the issues that have motivated the Federal Government to commit to its current policy, and we support the broad policy intent.

However we are very concerned that the Exposure Draft does not deliver on the policy objectives, and in fact will have a number of serious negative consequences. Indeed in our view the Exposure Draft will lead to discrimination against small business, and exclusion from opportunities. Rather than assist small business it will harm them. Our reasoning is set out below.

### The importance of contractual certainty

There is no doubt that some small business transactions are like consumer transactions. The Exposure Draft will be useful in that context, protecting small business in the same manner as consumers are protected if a party seeks to enforce an unreasonably onerous term.

However many small business transactions are entirely different to consumer transactions. The unfair contracts legislation must be able of dealing with these contracts in an appropriate manner. That means, in our view, enabling parties to essentially avoid the legislation provided they satisfy criteria consistent with the rationale behind the legislation.

It is vitally important that businesses have the capacity to make a business contract with certainty. If the Government remains determined to proceed with the Exposure Draft in essentially its current form there must be the capacity for the parties to still achieve contractual certainty. The Exposure Draft needs additional exemptions, as otherwise the party to a contract with a small business will always have a potential claim hanging over its head. As a consequence it will be less willing to transact with small business.

Without enhanced contractual certainty the Exposure Draft will make lenders less willing to deal with small business either directly, as loan documentation will be included, or indirectly when financing transactions.

### The interests of third parties

The Exposure Draft does not take into consideration the fact that third parties frequently rely on, or are affected by, business contracts. This is entirely different to consumer contracts. Third parties can include financiers, landlords, suppliers, franchisees, contractors and employees. Chain of title can even be affected.

The Exposure Draft provides no protection to third parties that have relied on a term in a contract, only to find that term is subsequently determined to be an unfair contract term, and void.

Every day banks lend on the assumption that business contracts will be honoured. Investors invest on the same assumption. The unfair contracts legislation will require new layers of due diligence from financiers and investors, and additional cost. These costs will either flow through to borrowers in higher costs, or deter financiers from dealing with small business, or both.

Take a typical loan by a bank to a franchisor. Often the main asset of the franchisor is the income stream derived from the franchise agreements in the network. At present banks do

not check all franchise agreements to ensure there are no unfair contract terms. They assume the contracts will be enforceable.

#### More disputes and more litigation

There is very little litigation involving unfair contract terms in consumer transactions. However there is likely to be a lot of disputes and litigation if the legislation is extended to business contracts. The unfair contract term provisions will be the first port of call for any business wanting to extricate itself from a contract. Not only will the Exposure Draft will create additional disputation, it will steer parties towards the courts rather than towards mediation and other less costly alternative dispute resolution mechanisms.

The mediation based disputes resolution framework has been one of the cornerstones of the success of the Franchising Code of Conduct. According to the Office of Franchise Mediation Adviser around 80% of disputes are successfully resolved via this process, and State Small Business Commissioners record similar success rates. Mediation occurs quickly, is essentially non-adversarial and is very low cost. Indeed the typical cost of a mediated outcome would be less than the cost of even issuing legal proceedings, let alone proceeding through the litigation process.

The Exposure Draft will drive people towards the courts, as it is only the courts that can declare a provision void. This is contrary to the Government's previously stated preference for low cost dispute resolution, as reflected in legislation such as the Small Business and Family Enterprises Ombudsman Bill and the Franchising Code of Conduct.

#### Exclusion from opportunities

The Exposure Draft will see small business excluded from business opportunities, including opportunities such as tenders and major projects which typically operate on a standard form contract basis. Somewhat ironically it is likely that Government itself may develop a bias against small business. There are many onerous provisions in Government contracts that may well not stand up to scrutiny under legislation prohibiting unfair contract terms.

The problem other businesses will face when dealing with small business is that there is a potential risk that applies when dealing with a small business that does not apply to other businesses. Pure economic logic will create a bias against small business, as the Exposure Draft will require not only that all contracts are reviewed for compliance with the Exposure Draft before they are signed, but that it will not be possible to categorically provide clearance. There is no meaningful body of law to provide guidance, and indeed there is plenty of law to the effect that unfairness alone is insufficient to justify a court overturning the intention of the parties.

### **3. Franchise Agreements**

The Exposure Draft clearly captures franchise agreements. The FCA considers that Franchise Agreements should be expressly excluded from the operation of any unfair contracts regime.

Franchise agreements are regulated by a mandatory industry code, the Franchising Code of Conduct. The Code provides a comprehensive framework that promotes fairness and enhances the contractual process between franchisor and franchisee by:-

- requiring extensive prior disclosure of information;
- inserting mandatory time frames to allow time for considered decisions, time to speak with existing and former franchisees (and via the required list of franchisee contact details a mechanism to do so) and importantly time to obtain advice;
- including a certification process aimed at strongly encouraging parties to obtain legal and business advice;
- including a specific cooling off right for franchisees;
- prohibiting the inclusion of certain provisions into franchise agreements;

- making it clear that there is a duty of good faith that applies to all franchise agreements, and expending that duty to negotiations and disputes;
- circumscribing the rights of a franchisor in areas such as transfer, termination and dispute resolution; and
- providing guidance and warnings to parties on the face of the documentation.

To the extent that any legitimate residual concerns in relation to the franchise sector have been identified by regulators and policy makers, these have been specifically addressed by changes to the Franchising Code of Conduct that will take effect from 1 January 2015, including changes in relation to good faith and non-compete provisions where franchise agreements are not extended.

The FCA believes it is beyond rational argument that no further action is required in relation to unfair contract issues in the franchise sector. Further, all regulation of the sector should occur via the Code, rather than by some form of additional and non-specific regulation.

The other major concern in relation to franchising is that the vast majority of transactions are between two small businesses. The legislation will impose additional cost on small business franchisors. Further, the franchise agreement – the fundamental structural element of the franchise relationship – will be shrouded in uncertainty for its duration.

#### Franchise agreements do not fit the policy framework

We consider our detailed remarks in relation to franchising in our previous submission, which is included as an annexure to this submission, remain valid. Although we do not repeat our comments in this submission there are some comments in the material that accompanies the Exposure Draft with which we would like to take issue.

- 1.2 Small businesses, like consumers, are vulnerable to unfair terms in standard form contracts, as they are often offered contracts on a “take it or leave it” basis and lack the resources to understand and negotiate contract terms. There is potential for detriment where unfair contract terms are enforced in standard form contracts with small businesses.

Comment:- Franchise Agreements are rarely presented on a take it or leave it basis. Further, the cost of obtaining legal advice is not prohibitive, as it is typically less than \$1,500 - \$2,000. The FCA rejects the assertion that franchisee's lack the resources to 'understand' contracts. The Code also imposes a 14 day moratorium which allows a franchisee to go off and obtain advice, and a 7 day cooling off period.

- 1.3 Consultations indicated that unfair contract terms often allocate contract risks to the party that is less able to manage them (usually small businesses), as they are less likely to have robust risk management policies or be in a position to absorb the costs associated with a risk allocated to them eventuating.

Comment: This observation does not apply to franchise agreements. In addition franchisees are able to call upon other franchisees, with whom they have an ongoing commonality of interest and a capacity where appropriate to take group action.

- 1.4 Small businesses often lack in-house legal expertise and the cost of obtaining legal advice, particularly for low-value contracts, can be disproportionate to the potential benefits of entering into such contracts. Where small businesses decide to not enter into contracts due to their lack of confidence in understanding and negotiating terms or the cost of obtaining legal advice, they may miss out on market opportunities.

Comment: Franchise agreements are not 'low-value' contracts. To the contrary, together with a lease, a franchise agreement is usually one of the most significant

agreements a franchisee signs. If the legislation is aimed at 'low value' contracts then it makes sense from a policy point of view to regulate those contracts. However it should not capture the vast majority of contracts in the process.

- 1.7 Small businesses differ from consumers in that they also engage in high-value commercial transactions that are fundamental to their business and where it may be reasonable to expect that they undertake appropriate due diligence (such as seeking legal advice).

Comment: The FCA agrees. This is what the Code promotes and encourages.

- Limiting the extension of the unfair contract terms protection to low-value small business contracts that are standard form will support time-poor small businesses entering into contracts for day-to-day transactions, while maintaining the onus on small businesses to undertake due diligence when entering into high-value contracts.

Comment: The reference to 'low-value small business contracts' and "day to day transactions" is at odds with the fact that the Exposure Draft covers franchise agreements. A franchise agreement cannot fairly be considered to be a low value contract, or a day to day transaction. The Code and new risk statement expressly note the significance of entering into a franchise agreement because it is a 'big decision'. The Exposure Draft states that it is aimed at capturing those contracts that are in a sense thrust upon small business (mobile phone, car rental, software licenses etc), but the drafting goes far beyond those contracts.

Franchising is a million miles removed from being a low value standard form contract presented on a take it or leave it basis. A prospective franchisee receives a risk statement explain the risks of franchising, and containing recommendations as to due diligence and advice. The franchisee then receives prior to signing or committing any non-refundable money a disclosure document and franchise agreement, and at least 14 days must pass before the franchisee can be bound by the franchise agreement. A prospective franchisee is directed to get 3 forms of advice, or alternatively to certify that they have been told to do so but declined. Prospective franchisees can then negotiate terms, and are given the contact details of other existing and former franchisees so they are able to speak with them.

Even after signing there is a 7 day cooling off period, and at the end of this process, the prospective franchisee can still walk away without penalty. Therefore why should a franchise agreement be caught? The existing misleading/deceptive and unconscionable conduct provisions already protect the public (in this case franchisees) from any other inappropriate business behaviours.

The whole process is designed to give extensive information, and is arguably fool proof if a franchisee follows the recommended process. Perversely, if the Exposure Draft is introduced in its current form fewer franchisees are likely to seek advice and follow the appropriate process. They will draw false comfort from the fact that legislation exists that to a lay person offers protection against anything they consider to be unfair. This outcome is totally inconsistent with the policy behind the Exposure Draft.

For the reasons outlined above the FCA considers that a general exemption should be granted to a franchise agreement covered by the Franchising Code of Conduct. Franchising already has a comprehensive regulatory framework. This is to be contrasted with every other

form of business contract. Only retail leases have a disclosure framework, and it is much less prescriptive than the Code.

As noted above, the Code process is designed to give extensive information, and is arguably fool proof if a franchisee follows the recommended process. Arguably the only deficiency with the Code is the fact that franchisees are encouraged, but not obliged, to seek legal advice. The vast majority of complaints by aggrieved franchisees feature one common element – the failure to obtain advice in accordance with the Code recommendations.

If the Exposure Draft is introduced in its current form it is likely that even fewer franchisees will actually seek advice and follow the appropriate Code process. They will draw false comfort from the fact that legislation exists that to a lay person offers protection against anything they consider to be unfair. Although the actual legislation is likely to have a more narrow ambit, the description of the legislation as relating to “unfair contract terms” will clearly be taken by many to apply to anything they would regard as “unfair”. This was the experience when the unconscionable conduct legislation was introduced, and indeed led to numerous complaints that the legislation was not operating as some felt was intended.

#### Additional specific franchising exemptions

If the Government is not inclined to grant such an exemption at this point the FCA seeks some additional specific exemptions.

Some recognition of the need for franchisees to take responsibility for business decisions is reflected in the \$100,000 / \$250,000 limit. This distinction is welcomed by some franchise systems.

However smaller franchise systems with lower investment levels feel they have been discriminated against, and make the point that there should also be a lower level. The FCA considers that in fairness there should also be a low level of investment in a franchise – say under \$25,000 – which is also exempt, on the basis that with the comprehensive disclosure framework, the regulatory supervision of the ACCC and a level of investment that is not likely to be a franchisee’s life savings there are adequate safeguards in place.

#### **4. Additional General Exemptions**

There should be an exemption if the small business has obtained legal advice in relation to the contract.

This not only provides complete certainty if the parties choose this option, but addresses one of the main reasons underlying the rationale for the law – the absence of legal advice. It is impossible to argue that a small business that has obtained legal advice, but still chooses to sign a business contract, deserves the protection of the law.

This recommendation is also consistent with the requirement in the Franchising Code of Conduct encouraging parties to obtain legal advice, and in the franchise sector will have additional flow on benefits. It will ensure that far more franchisees actually obtain legal advice, as more franchise systems will insist upon it to ensure that the franchise system has the certainty the exemption from the Exposure Draft will provide.

Paraphrased, clause 10 of the Code provides that a franchisor must not enter into a franchise agreement unless it has received a written statement that the prospective franchisee has either been given independent legal advice, or has been told that legal advice should be obtained but has decided not to seek it. Notwithstanding this clear direction the majority of franchisees do not seek legal advice. This has direct consequences in terms of franchisee dissatisfaction. Almost all franchisee complaints received by the Franchise Council of Australia over the past 2 years come from franchisees that have failed to obtain legal advice prior to signing the franchise agreement.

If more small businesses seek legal advice there will also be more negotiation of terms, achieving another objection of the legislation. With the internet and other means giving small business owners convenient access to lawyers experienced in providing advice on these types of contracts the cost of advice to small business is likely to decrease. This is the experience with consumer credit contracts, personal guarantees and other areas of law where legal advice became either mandatory or a specific requirement of the other contracting party.

The FCA considers that there should also be an exemption that allows the other contracting party to have contractual certainty where the small business:-

- a. is already party to an existing agreement that is substantially similar; or
- b. satisfies a sophisticated investor test.

If a small business is already party to a contract, and chooses to execute another similar contract, the Exposure Draft should not apply. Similarly a sophisticated investor experienced in business and able to afford legal advice should not be entitled to rely on legislation designed to protect those unfamiliar with business. This exemption would also allow a sophisticated investor to transact more efficiently, and without having to be treated in some concessional manner. Such exemptions already apply in relation to the issues of shares and securities, so should apply in relation to business contracts.

## **5. Onus of proof**

It is a generally accepted legal principle that the onus of proof should be upon the person making any claim. In recent times there are examples where Government has chosen to reverse the onus of proof. However this is only in exceptional circumstances.

The Australian Consumer Law considers that in consumer transactions, where consumers have far less capacity to establish a position, there should be a reverse onus of proof. (See sections 24(4) and 27(1)). However the reverse onus should not apply to business contracts. It should be the responsibility of the business making an allegation of unfairness in relation to a contract term to make the case and meet the normal onus of proof. It is unfair and unreasonable to reverse the onus of proof in business contracts.

Even people such as Associate Professor Elizabeth Spencer, who have zealously advocated the extension of unfair contract terms to business contracts, agree that there should not be a reverse onus of proof.