Franchising Code of Conduct 2013 Review

Joint Submission

Submitted by:

Franchise Advisory Centre

Jason Gehrke
Director
Franchise Advisory Centre
PO Box 15304
Brisbane City East QLD 4002

Professor Lorelle Frazer
Director
Asia-Pacific Centre for Franchising Excellence
Griffith University, University Drive
Meadowbrook QLD 4131

February 22, 2013

Mr Alan Wein
Franchising Code Review Secretariat
Business Conditions Branch
Department of Industry, Innovation, Science, Research & Tertiary Education
GPO Box 9839
Canberra ACT 2601

Email: franchisingcodereview@innovation.gov.au

Dear Mr Wein,

Please accept the following as a joint submission by the Franchise Advisory Centre and Griffith University's Asia-Pacific Centre for Franchising Excellence.

The two centres have worked together on various projects in recent years, and feel it is appropriate to collaborate in response to the terms of reference for the current review of the Franchising Code of Conduct.

The Franchise Advisory Centre (FAC) is a private sector consultancy established in 2004, and specialises in non-award education and advisory services for franchise sector participants, and is operated by Jason Gehrke, who is also an adjunct lecturer at Griffith University.

The Asia-Pacific Centre for Franchising Excellence (APCFE) is a research and education centre established in 2008 and builds on the previous work of Griffith University's Business School. It offers Australia's only undergraduate and postgraduate franchise studies, as well as conducts the regular Franchising Australia survey, and various other sector reports. Centre director Lorelle Frazer was the first person in Australia to be awarded a PhD in franchising.

This joint submission responds directly to the 29 questions in the review Discussion Paper, and makes 18 recommendations which are highlighted in yellow for each response, and listed together at the end of the document.

Please fee to contact the authors if further clarification of any item is required.

Yours sincerely,

Jason Gehrke
Director
Franchise Advisory Centre

Professor Lorelle Frazer
Director
Asia-Pacific Centre for Franchising Excellence

Disclosure under the Franchising Code of Conduct

Q1: Has the additional disclosure requirement regarding the potential for franchisor failure effectively addressed concerns about franchisees entering into franchise agreements without considering the risk of franchisor failure?

No, however it is beyond the scope of the Code itself (not just the disclosure provisions) to address concerns about franchisees entering agreements without consideration to franchisor failure.

The Code limits itself to issues of disclosure, matters affecting the franchise agreement itself, and dispute resolution.

Aside from a generic "your business might fail if the franchisor's business collapses", there is little else that can be effectively disclosed without a specific and objective analysis of the risk attached to the franchise investment.

For example, the 2006 study *When the Franchisor Fails*[1] noted that the majority of franchisees of collapsed systems ultimately went out of business themselves, however hinted that this outcome was a function of the dependency of the franchisee on the franchisor.

The report included details of a travel franchise chain which collapsed, yet almost all of its franchisees were able to continue to trade independently following the demise of their franchisor.

This was because the franchisees were not dependent on their franchisor to provide them with critical supplies for the daily operation of the business (eg. Core goods or services), critical management systems (eg. IT platforms), and property rights (ie. Subleases or licenses to occupy business premises).

Disclosure relating to supply of goods and services (including IT platforms) by franchisors to franchisees is already required under Item 9 (Supply of goods or services to a franchisee) of Annexure 1 of the Code.

Similarly, property issues are also disclosed under Item 18 (Obligation to sign related agreements), which includes leases, subleases, etc.

From a purely Code perspective, the issue of addressing concerns about franchisees entering into franchise agreements without considering the risk of failure is less one of disclosure but franchisee **comprehension** of the information disclosed.

It follows that franchisee comprehension of the information disclosed in developing an overall assessment of the risks to their business in the event of franchisor failure is a function of the franchisee's *level of knowledge about franchising*, and their *willingness to seek appropriate advice from commercial advisors* prior to committing to the franchise agreement.

These issues can be addressed by firstly requiring franchisees to undertake an endorsed pre-entry education program, such as that which Griffith University's Asia-Pacific Centre for Franchising Excellence has offered since 1 July 2010 with the support and endorsement of the Australian Competition and Consumer Commission (ACCC).

The pre-entry program both discusses the consequences of franchisor failure, highlighting the need for potential franchisees to asses for this risk, as well as reaffirms the desirability and necessity for external advice from appropriately-qualified legal, accounting and business advisor professionals.

[1] Buchan, J. (2006) 'When the franchisor fails'. CPA Australia, Melbourne

However the Code is limited in the extent that it can prepare franchisees for the potential collapse of their franchisor.

Irrespective of the due diligence a potential franchisee undertakes before they join, unforeseen economic factors or poor financial management by the franchisor could result in the insolvency of the franchisor's business.

In this scenario, current insolvency laws provide less recognition to franchisees who have invested their life savings in a business than an employee or even a customer who has bought a low-value gift card.

The reason for this is that franchisees are rarely recognised as creditors, and therefore are entitled to little or no information from insolvency practitioners, despite their clear asset value to a franchisor's business.

The most significant recent example of this is the collapse of retail book chain Angus & Robertson in February 2011. The saga of this corporate collapse was well-documented in the media at the time, including the ultimately unsuccessful attempt by half of the franchisees in the network to disclaim their franchise agreement and trade as independent book retailers.

This move could at least partly be attributed to the lack of acknowledgement given to franchisees as key stakeholders in the business, and the failure of existing insolvency laws to recognise them as creditors (who are entitled to detailed reporting by insolvency practitioners).

This is contrasted with the treatment of franchisees in the collapse of jewellery retailer Kleins in 2008, and whitegoods retailer Kleenmaid in 2009 where franchisees were recognised as creditors because of rent payments made to the franchisor that were not passed on to landlords (Kleins), unfulfilled income guarantees made by the franchisor to the franchisee (Kleins), or commissions on sales made by franchisees (Kleenmaid) where these franchises were recognised as creditors.

If a franchisee does not have an existing two-way ongoing financial relationship with their franchisor (which few do) then recognising franchisees as creditors (and consequently giving them greater rights in the event of a franchisor insolvency) will not reduce their downside risk of franchisor insolvency.

A possible solution to provide a level playing field for a greater proportion of franchisees would be to amend current accounting practices to recognise the payment of upfront franchise fees by franchisees to franchisors prior to joining a system as a prepayment to be amortised by the franchisor over the term of the franchise.

For any system which charges an upfront fee (and most do), this would create a reducing debt owed to the franchisee over the term of the franchise, thus making a creditor of the franchisee throughout the term.

It is beyond the scope of this review and this response to consider the full implications classifying upfront franchise fees as prepayments, however may be worth further consideration at an appropriate point by a relevant body to address the issue of franchisee rights in the event of franchisor insolvency.

Q2: Does the sector have any concerns regarding the operation of this requirement?

The classification of franchisees as creditors in the event of a franchise insolvency is not so much an ongoing concern (ie. the sector is worried about it all the time), but rather a situational concern (ie. the sector worries about it when a system goes bust and the plight of affected franchisees is raised in the media).

Franchise insolvencies are like car accidents: They can be devastating for those involved, but otherwise provide a short-lived spectacle for everyone else.

No franchisor or franchisee wants to believe that insolvency will be an inevitable outcome for their system, and therefore it engenders little discussion in the sector until another system crashes (and the extent of the discussion will be determined largely by the size of the crashed system).

For example, very small franchise chains are unlikely to gain any real attention when they become insolvent (for example, the Sydney-based chain Hire A Box in 2010) compared to much larger and higher profile brands such as Angus & Robertson in 2011.

However, the impact of franchisor failure should not be dismissed. The *Franchising Australia*[2] research reports that some 90 franchisors failed in the period 2008 to 2012. With an average of 74 outlets per franchisor it is possible that approximately 6,600 franchisees were affected by the failure of their franchisors.

So while insolvency issues do not form the basis of everyday concerns in the sector (and it is noted above that current disclosure provisions appear to deal with them adequately), it does not mean that a new approach to recognising the interests of franchisees in the event of a franchisor insolvency should not be considered, even if it means looking for a solution outside of the regulatory framework provided by the Franchising Code of Conduct.

Q3: Have amendments to the Franchising Code improved the transparency of financial information for franchisees? If not, why not? If so, what benefit is this having for franchisees?

Q4. Does the sector have any concerns regarding the operation of these amendments?

In the main, the authors believe previous amendments have assisted the transparency of information available to franchisees, however there remain some gaps where this can be improved.

Payments to third parties

The disclosure of payments to third parties has been made more transparent by previous changes to the Code.

Unforeseen capital expenditure

By definition, unforeseen means simply that – unforeseen – and therefore ultimately incapable of being properly disclosed.

[2] Frazer, L., Weaven, S. & Bodey, K. 'Franchising Australia 2010' and 'Franchising Australia 2012', Asia-Pacific Centre for Franchising Excellence, Griffith University, Brisbane.

A better approach to this disclosure requirement is to relabel it as "possible future capital expenditure" which may help to distinguish the probable (ie. Refurbishment at the end of the lease term) from the improbable (ie. Rebuilding a store after being destroyed by a falling meteor), as "unforeseen" would need to otherwise encompass both of these examples, no matter how unlikely the latter.

Attribution of legal costs

The intent of the Code under Part IV 31(2), whereby the parties are equally liable for the costs of dispute resolution unless they agree otherwise may be undermined by requiring consent to an alternative arrangement from the franchisee on entering the franchise relationship through inclusion of a relevant clause in the franchise agreement.

Disclosure of rebates and other financial benefits

As far back as the Matthews Inquiry, it was suggested that the amount of rebate be disclosed.

As interesting as this information might be to franchisees keen to ensure their cost of goods is kept as low as possible, it is commercially impractical, as such information could easily find its way to the hands of competitors, who could reverse-engineer a franchisor's supply chain, and substantially harm or destroy their competitive advantage.

However, the provision in 9(k) about whether the benefit of the rebate is shared directly or indirectly with franchisees may need further guidance. Specifically, is the rebate refunded to the franchisees, is it attributed to a common purpose (eg. the marketing or conference fund), is it retained by the franchisor for their own purposes or is it applied it some other way?

Financial reports for marketing and cooperative funds

A decision by a 75% or greater majority of franchisees not to conduct an audit of a marketing fund currently lasts for three years.

Given the rapid growth experienced by systems (eg doubling or trebling their size in that timeframe), the normal turnover of franchisees as existing operators sell and are replaced by new franchisees, and the capacity for marketing requirements to change considerably in a three-year timeframe, it is recommended that the time be reduced from three-yearly to annually to allow greater engagement by all current franchisees, and improved transparency for and responsiveness through improved accountability.

Financial details of franchisor

The provision of financial details of the franchisor via a solvency statement (as the end of the last financial year) and an audit statement or financial reports has been a cornerstone of the Code since the outset.

However, the financial circumstances and solvency of a business can change rapidly, resulting in franchisees receiving disclosure documents which assert the solvency of the franchisor, when the reality may well be different. Such was the case with Kleenmaid, where a franchisee joined the group in November 2008, only for the franchisor to be placed in administration just five months later in April 2009.

For the purposes of this review, consideration should be given to altering Item 20.1 of the Disclosure Document to require the franchisor's statement of solvency to be current as at the time the disclosure document is issued to a prospective franchisee.

Lease arrangements (History of Site or Territory to be franchised)

The site or territory history disclosure provisions of the Code (Item 11) appear to satisfy previous information gaps relating to franchises operated in a specific or general location.

However it does not apply to franchises operated in industries, where there may be no previous outlet in the general location to be franchised, but where a duty of disclosure would be reasonably expected to exist.

For example, the diverse range of service divisions which form the Jim's Group now includes a Jim's Locksmith's division, based in Adelaide. However, it is understood that Jim's previously operated a Locksmith's division, albeit in a different location.

In this example, the prior existence of a division offering the same service in the same market segment (or industry) would be materially relevant both to the master franchisee and any unit franchisees subsequently granted.

If the previous division ended more than three financial years ago (ie. the timeframe to disclose details of former franchisees and the circumstances by which they left under Item 6 of the Disclosure Document), then there is no current obligation under the Code to disclose its existence, or the circumstances of its discontinuance.

Irrespective of the physical location of the division's initial operations, the existence of a prior division in the same industry should be disclosed so that the new operator is prepared for market perceptions toward the division (both positive and negative) by centres of influence (eg. media), customer groups, and suppliers.

Therefore it is recommended that Annexure 1 Item 11 be amended to consider this issue of disclosing by industry, as well as site or territory.

Q5: Have the amendments regarding unilateral variation, transfer and novation been effective in addressing concerns about franchisors' ability to make changes to franchise agreements? Why or why not?

Q6. Does the sector have any concerns regarding the operation of these amendments?

Franchisee concerns about franchisors' abilities to make changes to franchise agreements are based on the extent to which changes are proposed or made.

Common sense suggests that in a dynamic business environment, a certain amount of change is inevitable if only to maintain relevance to an evolving market. Where this change has an obvious benefit to the network, is introduced incrementally, and does not require significant capital expenditure or an undue investment of the franchisee's time or consideration to implement, then it is reasonable and should cause no real issue.

However, where unilateral variations are poorly explained, have no demonstrable benefit to the franchisee (as opposed to the franchisor), involve significant cost and/or inconvenience, or are perceived as a veiled attempt to somehow damage the franchisee, then significant problems resulting in conflict may arise.

While it is often necessary for franchisors to introduce changes to a network via amendments to the franchise agreement, the franchise operations manual, or both, no amount of disclosure will overcome franchisee surprise, resistance or even anger if the changes are fundament to the franchisee's perspective of the brand, or involve undue effort or investment by the franchisee.

Of particular concern are changes that franchisees feel will threaten the continuation of their business, or their planned exit.

This could include new conditions in the then current franchise agreement to be signed by a franchisee's buyer which do not appear in the franchisee's original agreement which may have provided the basis for the buyer's original agreement to purchase, and therefore threaten the sale.

The extent of the changes in a new agreement to be signed by a buyer compared to the old agreement operated by the vendor franchisee may well have implications for the future viability of the business, and consequently the sale price realisable to the vendor.

Whether franchisors like it or not, vendor franchisees will hold them to blame if a buyer fails to complete or demands a lower price based on conditions of the new agreement that are not present in the vendor franchisee's agreement.

No amount of disclosure regarding changes to agreements will necessarily take into account the nature and substance of all possible changes themselves, and the Code can at best provide only limited guidance in this regard.

Q7 Have the changes to the Franchising Code led to improved franchisee knowledge about franchisors and their conduct before they enter into franchise agreements? Why or why not?

Q8 Is the information being provided useful to franchisees?

No. The level of knowledge of potential franchisees as a result of changes to the Code have had the same effect as smiling at someone in the dark. The person smiling feels good about themselves, but nobody else notices.

This is because the overall level of awareness of the Code among potential franchisees is and always has been generally very low until they are at an advanced stage of their search for a franchise, at which point they are presented with a copy of the Code along with the disclosure documentation provided by franchisors with whom they are in serious discussion.

This should not be taken as any failure by government departments to communicate about the Code. The ACCC in particular do an outstanding job making information available to potential franchisees, as well as the Franchise Council of Australia, and other groups, but this relies on identifying potential franchisees first, and therein lies the rub as it is notoriously difficult to identify and communicate with potential franchisees before they present themselves at a franchisor's door.

Potential franchisees can come from any walk of life, any educational, social, cultural or ethnic background, and be interested in a franchise at any level of investment, and any time in their working lives. They look the same as anyone else, and only their current interest in franchising defines them as potential franchisees.

Some will attend Franchise Expos but may be overwhelmed with marketing pitches and fail to notice the objective information about franchising that is available. Others will never attend an expo, read a franchise magazine or book, or otherwise engage with sources of information about franchising until they are on the verge of committing to a franchise agreement.

Improving franchisee knowledge and comprehension about franchisors and their conduct before entering into franchise agreements relies to a certain extent on the cooperation of the franchisors themselves. Perhaps it was for this very reason that the Code mandated that a copy of it must be given to potential franchisees as part of the disclosure documentation in recognition of the general difficulty of otherwise communicating with potential franchisees.

Although there are franchise magazines, websites and so forth that communicate with potential franchisees, none of these can claim to communicate with every potential franchisee every time, as the provision of the Code itself can.

So if the provision of the Code itself is often the first, and always the last opportunity to communicate with potential franchisees about its provisions, then the answer to improving the knowledge of potential franchisees before they sign a franchise agreement lies in the Code itself.

The Code already advocates in the strongest possible terms the need for pre-purchase advice in Part II, Item 11(2). This is and should remain an essential element of the Code, but is challenged by a reluctance of potential franchisees to follow through and get advice for the following two reasons;

1. The advice is perceived as unnecessary as the potential franchisee has already made up their mind to proceed with the franchise; and
2. The potential franchisee does not wish to pay for professional advice, which is often seen as unnecessary (particularly if the franchisee has already decided to proceed).

With professional advice on a franchise agreement costing up to (or even more than) $5,000, franchisees who have made up their mind to proceed will be reluctant to spend that kind of money in order to "tick a box".

Of course at this stage prior to committing to the franchise, they don't know what they don't know, and this means they can't be confident that the professional advice will represent any kind of value for money.

The first step in this process should instead be a requirement in the Code for the potential franchisee to undertake an endorsed pre-entry education program in addition to obtaining advice from any of a lawyer, business advisor or accountant.

A pre-entry education program can help a potential franchisee gain the basic knowledge that they need to better assess the franchise offer, and to better understand the importance and need for professional advice before signing a franchise agreement.

Griffith University's Asia-Pacific Centre for Franchising Excellence has operated a free online pre-entry education program since 1 July 2010 which has been undertaken by more than 3,600 participants, most of whom are potential franchisees.

This online program was developed in conjunction with adjunct lecturer and Franchise Advisory Centre director Jason Gehrke, and compromises five modules as follows:

1. **An overview of Franchising;**
2. **Franchise Obligations & Costs;**
3. **Franchisor Support & Business Services;**
4. **The Evolving Business and Franchise Relationship;**
5. **Steps before buying Franchise.**

Each module consists of four learning topics, or units, and is delivered via a combination of video presentations, readings, and downloadable resources. At the end of each module, a multiple-choice questionnaire must be completed in order to progress to the next level. For participants who do not answer all questions correctly, the system also assists them to find the correct answer, so that they may progress. (See the full list of modules and units in **Appendix 1**).

The pre-entry education program was made possible by initial funding from the ACCC following Griffith University research into the causes of conflict in franchising. The research revealed that a major cause of conflict was due to the sometimes unrealistic expectations of prospective franchisees when insufficient due diligence was undertaken.

A recent research project[3] commissioned by the Department of Industry, Innovation, Science, Research and Tertiary Education (DIISRTE) and undertaken by Griffith University into the effectiveness of the pre-entry education program compared participants in the program against those who went into franchising without undertaking the pre-entry education.

Among other things, the research found that people who participated in the pre-entry education program took an average **five weeks** longer than non-participants to undertake their due diligence before committing to a business.

Most significantly however, was the finding that pre-entry education participants reported significantly higher levels of satisfaction with their business performance after commencement than non-participants.

(The research also found that the program was valued even by those people who participated, but did not go on to start a business. The implication is that the program helped these participants better evaluate their suitability for business, and as a result, they determined they were unsuited to self-employment. It is highly probable that as a result of discontinuing, these are future potential business failures that have been avoided).

The bottom line is that the pre-entry education program has created a benefit to franchisees, and should be made more accessible to more potential franchisees. As pointed-out before, the way to do this is to include a requirement under Part 2, Item 11 of the Code relating to advisor's certificates that potential franchisees should also undertake an endorsed pre-entry education program. (The reason for the term "endorsed" is that there may be other providers of education programs, but not all will be providing objective advice, such as business brokers who conduct seminars, etc).

Q9 What effect has the requirement to provide this additional information had on franchisors?

Q10 Does the sector have any concerns regarding the operation of the new provisions?

It is arguable that providing additional information regarding franchisor conduct initially increased the time and effort required to include this information in the disclosure document, but this would have affected the first update following the changes to the Code.

It is unlikely that subsequently maintaining this information, or complying with these disclosure requirements would be a burden for franchisors.

Q11 What impact has the removal of the foreign franchisor exemption had on the sector?

Q12 Has the removal of the exemption caused any issues?

The authors are not aware of any downsides in exempting foreign franchisors from the disclosure requirements of the Code.

If anything, it is likely to have resulted in better preparation by international franchisors prior to entering the Australian market, where anecdotally, the failure rate upon entry has previously been quite high (particularly among United States-based systems who mistakenly

[3] "*Preparation for Franchising: A study of prospective and current franchisees*", Asia-Pacific Centre for Franchising Excellence, 2012.

assume that the Australian and US markets are so similar as to not warrant local customisation of their goods, services or operations).

Q13 On the whole, do the 2008 and 2010 disclosure amendments ensure franchisees are provided with adequate information?

Q14 Is the extra onus on franchisors justified by the benefit this disclosure is providing to franchisees?

Yes, the 2008 and 2010 disclosure amendments provide franchisees with adequate information, subject to the following conditions: accuracy, currency, and referral to pre-entry education.

Accuracy

The 2010 changes to the Code were followed by increased powers available to the ACCC from January 1, 2011 to conduct random audits and to issue substantiation notices. It is unknown to what extent audits have been conducted on disclosure documents so far, however random audits to assess the veracity of information in disclosure documents would help ensure the information is accurate.

Currency

The circumstances of a business, including a franchisor's business, can change rapidly. There is an argument that annually-updated disclosure is effectively out of date by the time it is given to a recipient (ie. four months from the end of the financial year in which it relates at the earliest, and potentially 16 months at the latest immediately prior to the next update deadline).

Details such as the list of current franchisees can change rapidly, as well as the financial situation of the franchisor. These details are highly relevant to a potential franchisee, and could be addressed by amending the Code to require the solvency statement disclosure in Item 20.1 to be current as at the time of issuing the disclosure document, rather than as at the end of the last financial year (see our previous recommendation on this issue), and for the list of existing franchisees to also be current as at the time of issuing the disclosure document.

Neither of these provisions should cause compliance difficulties. Franchisors generally issue disclosure documents on an "as needed" basis" rather than printing quantities in advance, so including the latest list of franchisees should be straightforward. Providing a current solvency statement signed by a director of the franchisor should also be straightforward for the overwhelming majority of franchise systems.

Pre-entry education

As noted above, the authors believe that Part 2, 11.2 of the Code be amended to include a requirement for potential franchisees to undertake an endorsed pre-entry education program, or to indicate that they have been advised to undertake such a program, but have declined to do so.

Good faith in franchising

Q15 How effective were the targeted amendments in 2010 to the Franchising Code in addressing specific issues, instead of inserting an overarching obligation to act in good faith?

The authors believe that changes to the Code in 2008 and 2010 which improved disclosure have helped address specific issues of concern at the time, but acknowledge there is no empirical evidence to support or reject this conclusion.

Q16 How effective is section 23A of the Franchising Code, which provides that nothing in the common law limits the obligation to act in good faith?

Since the Code was specifically amended in 2010 to acknowledge good faith, there has been no noticeable difference in franchise sector behaviour that the authors have identified.

Q17 What specific issues would be remedied by inserting an obligation to act in good faith into the Franchising Code which would not otherwise be addressed under the unwritten law or by the ACL?

Inserting a specific obligation to act in good faith into the Code may achieve nothing more than to elevate the potential for conflict in franchise relationships, where one party can accuse the other of a failure to act in good faith.

Good faith already exists in common law and has in many ways already been included in the Code via explicit obligations required by franchisors toward franchisees (eg. disclosure, cooling-off periods, notice for breach, etc).

It could even be argued that the Code itself determines good faith behaviours that should be displayed between franchisors and franchisees.

It should also be noted that not all obligations under the Code which represent examples of behaving in good faith are reciprocal. For example, there is no requirement for potential or existing franchisees to disclose certain information to franchisors in the same manner that franchisors are required to disclose prescribed information to franchisees.

However amendments to the dispute resolution provisions of the Code in 2010 requiring the parties to attend mediation and try to resolve the dispute (29.6) apply equally to both parties and indicate a codification of good faith behaviour.

Therefore it is not recommended to include a specific definition of good faith in the Code.

The authors are not aware of other issues that would be remedied by inserting a specific obligation to act in good faith in the Code.

Q18 If an explicit obligation of good faith is introduced, should 'good faith' be defined? If so, how should it be defined?

No. A specific definition of good faith in an industry code may well be inconsistent with the common law interpretation, or the application of good faith in enabling laws, such as the Australian Competition Law.

Q19 If an explicit obligation to act in good faith is introduced, what should its scope be? That is, should it extend to: the negotiation of a franchise agreement, and/or the execution of a franchise agreement, and/or the ending of a franchise agreement, and/or dispute resolution in franchising?

As mentioned in the response to Q17 above, the requirement to provide disclosure by franchisors and other provisions of the Code have a substantial good faith application in the negotiation and execution stage of a franchise agreement, without any reciprocal obligation on a franchisee.

The inclusion in the Code of an obligation for the parties to act in good faith toward one another will not prevent inaccurate or out of date disclosure by franchisors, or the withholding or misrepresentation of information by franchisees in portraying themselves as suitable candidates to join a franchise system (for example, by overstating work experience, skills, qualifications, financial capacity and other attributes deemed necessary by the franchisor to maximise the franchisee's chances of success in the business).

The ending of a franchise agreement by termination already has good faith behaviours incumbent on franchisors in the Code (eg. notice of breach, special circumstances for termination etc), but again these are not reciprocated by any corresponding good faith obligation by a franchisee (eg. adhering to restraints, maintaining confidentiality, etc).

The dispute resolution phase already has codified good faith behaviours, including attending mediation and attempting to resolve disputes.

A further blanket obligation to act in good faith in addition to those good faith behaviours already included in the Code and not otherwise covered by the common law obligation to act in good faith may be disingenuous and potentially contradict code requirements that already exist, or create an elevated platform for subjective interpretation by the parties, which may well create an environment for greater conflict.

Q20 If a specific obligation to act in good faith was introduced into the Franchising Code, what would be an appropriate consequence for breaching such an obligation?

If a specific obligation to act in good faith was introduced into the Code, the consequence for breaching the obligation would need to be determined on a case by case basis.

Unlike prescribed penalties for a breach of the Code (see later questions dealing with penalties) where a financial penalty is incurred due to say, a failure by a franchisor to provide a potential franchisee with a disclosure document, a breach of a duty to act in good faith may not be so self-apparent, and would need to take into account the relevant circumstances of the parties at the time.

Any potential system of fines or penalties for breaches of the Code will be unable to encompass all possible scenarios in which a breach of good faith may occur (aside from those good faith behaviours which are already specified in the Code).

Consequently, disputes that are based on a breach of good faith argument are still likely to require formal dispute resolution processes possibly resulting in a determination by the courts.

Through the mediation processes that have existed in the Code since its inception, there is a clear recognition that it is highly desirable for franchise disputes to be resolved by this rapid and low cost method.

If a specific definition of good faith is embedded in the Code and is relied upon in franchise disputes, it will have the result of driving more disputes to the courts, where extended processes and costs add to the burden of the dispute for all parties involved.

If any serious consideration is to be given to including a definition of good faith in the Code, there must be equal or greater consideration given to how to resolve disputes based on good faith arguments more quickly and affordably for all parties (both franchisee and franchisor) than is currently available under the existing court system. Franchisee advocates in particular criticize this approach as being beyond the reach of franchisees whose financial resources may be severely limited.

Creating such a method of resolving disputes based on good faith may well be beyond the parameters of the current Code review.

Q21 If a specific obligation to act in good faith was introduced into the Franchising Code, how would such an obligation interact with the provisions of the ACL?

The authors believe that a specific requirement to act in good faith introduced into the Franchising Code of Conduct risks potential inconsistency with the ACL, and/or conflict with the implied duty of good faith that exists in common law.

Q22 If the Franchising Code was amended to contain an explicit obligation to act in good faith, would there need to be other consequential amendments to the Franchising Code?

This may depend on whatever penalty system may be applied. As discussed previously, the Code already specifies certain good faith behaviours (eg. disclosure, mediation, etc), so the Code may need to be amended to either specifically include or exclude these behaviours from an assessment of good faith between the parties.

End of term arrangements for franchise agreements

Q23 Have the amendments regarding end of term arrangements and renewal notices been effective in addressing concerns about inappropriate conduct at the end of the term of franchise agreements? Why or why not?

A decline in complaints to the ACCC over franchise terminations for the period 1 July 2010 to 31 December 2012 indicates that there may be some empirical evidence to support the 2010 amendments as a means of addressing concerns about inappropriate conduct at the end of a franchise term.

ACCC complaints relating to franchise terminations are shown below:

2010 1 July – 31 Dec	2011 1 Jan – 30 June	2011 1 July- 31 Dec	2012 1 Jan – 30 June	2012 1 July – 31 Dec
38	30	56	12	26

ACCC Franchise Termination Complaints (2010-2012)[4]

The decline in complaints about termination issues in 2012 to a total of 38 (compared to total of 86 in 2011) may indicate that the requirement to provide six months notice of a franchisor's intention to renew or not renew a franchise has begun to gain traction.

It is unlikely that many franchisees who joined a system after 1 July 2010 (and who would therefore have been given disclosure about end of term arrangements at the time of joining) have yet reached the end of their initial franchise term and option period, so the full consequences of this requirement to provide upfront disclosure of end of term arrangements may not be fully evident for many years to come.

However there is no evidence to suggest that these amendments to the Code have not been effective.

Nonetheless, critics who believe that a financial settlement must be made by franchisors to franchisees at the end of their term if their franchise is not to be renewed fail to recognise that the very nature of a franchise is a conditional grant limited by time.

The risk that a franchise may not be renewed or may be terminated must be assessed by the potential franchisee when undertaking their due diligence prior to joining a network. This risk is borne by the franchisee throughout their tenure in the network, and therefore it is incumbent upon the franchisee to plan well ahead for a staged and orderly exit that maximises the capital value of the business as a going concern.

Equally, it cannot be expected that an agreement for a period of time will be prorogued indefinitely. Both parties initially enter a franchise agreement for a limited period of time and are not entitled to expect that something which is effectively a temporary arrangement will continue indefinitely.

Managing this expectation is a key element of franchise disclosure, as noted by the 2010 amendments. There must also be a recognition of external risks to the continuance of the business beyond either the franchisee's or franchisor's control, which may include economic factors, competitive forces, and site issues, including ongoing occupancy of the premises from which the business operates.

[4] Compiled from ACCC *Small Business, Franchising and Industry Codes Bi-Annual Reports*, accessed at www.accc.gov.au/content/item/phtml/itemId/1054613

Dispute resolution in franchising

Q24 Has conduct and behaviour during mediation changed since the introduction of the 2010 amendments to the Franchising Code, including requiring parties to approach mediation in a reconciliatory manner? If so, in what ways?

Q25 Does the sector have concerns regarding the operation of the amendments?

The authors are unable to adequately respond to the question of conduct and behaviour during mediation since the 2010 Code changes as neither have firsthand experience in mediation during that timeframe.

For a more meaningful response to the question about conduct and behaviour, it may be worth surveying those mediators appointed by the Office of the Franchising Mediation Advisor (OFMA) to mediate disputes since 1 July 2010, particularly those who also mediated disputes in the corresponding period prior to the introduction of the Code changes.

The Asia Pacific Centre for Franchising Excellence would be willing to assist in the design and delivery of such a survey for this inquiry in a timeframe consistent with the inquiry's reporting obligations.

The authors are unaware of concerns regarding the operation of these amendments.

Enforcement of the Franchising Code

Q26 Is the current enforcement framework adequate to deal with the conduct in the franchising industry?

The authors are not aware of any compelling evidence to indicate that the current framework (ie. mandatory industry code under the Competition & Consumer Act (CCA) is not adequate to deal with franchise sector conduct.

Australia is a world-leader in the regulation of franchising, and its regulatory model has been the inspiration for similar models in other nations.

Improvements suggested in this document are made in regards to the specific detail of the Franchising Code of Conduct itself, rather than its regulatory framework per se.

Q27 How can compliance with the Franchising Code be improved?

Compliance with the Code may be improved through the following:

- Greater resourcing of the ACCC for enforcement activity, particularly in the areas of random audits and substantiation notices;
- The introduction of financial penalties for certain breaches of the Code;
- Improved education of participants in the franchise sector, including franchisees, franchisors and service providers, particularly those advising aspiring and early stage franchisors;
- Proper identification of franchisor participants in the sector via a registration process which need not necessarily seek to vet new systems, but to make the identity of all systems a matter of public record, and to provide a definitive population in which education programs or enforcement activities (eg. random audits by the ACCC) may occur;

Q28 What additional enforcement options, if any, should be considered in response to breaches of the Franchising Code?

In addition to increasing the number of random audits and substantiation notices issued by the ACCC, the introduction of financial penalties for breaches of the Code may assist to deter franchisors from non-compliant behaviour.

For the benefit of this submission, a financial penalty will be read as having the same meaning as that of an infringement notice, as defined in the Discussion Paper for this review.[5]

However, any application of financial penalties must only be considered for those elements of the Code that are clear and unarguable. These could include the following requirements:

[5] Page 31, Discussion Paper: Review of the Franchising Code of Conduct, January 2013.

- *Failure to provide a disclosure document, the Code and the franchise agreement;*
- *Failure to provide the franchise agreement in the form in which it is to be executed;*
- *Specific omissions within a disclosure document;*
- *Failure to refund funds after a franchisee exercises their cooling-off option;*
- *Failure to audit a marketing fund;*
- *And so on.*

This is not proposed to be an exhaustive list, and the ACCC should be consulted on the types of behaviour it has observed that will be most effectively modified to improve Code compliance by the introduction of a financial penalty scheme.

However, it must be highlighted from the outset that financial penalties should not be applied for trivial or inconsequential breaches, and that consideration may need to be given to an appeals process for those individuals or organisations who have reason to believe that a fine has been unjustly applied to them.

Finally, the purpose of any penalties must always be to enforce compliance, and not be established in any manner that is likely to threaten the viability or smooth operation of the sector and its participants.

Q29 What options are available to businesses to address breaches of the Franchising Code, or any other adverse conduct in the franchising industry?

The existing dispute resolution provisions of the Code allow either party to put the other on notice of a dispute, and to proceed with mediation, or alternatively commence legal proceedings.

It should be noted that the OFMA has reported an increasing number of mediations initiated by franchisors, rather than franchisees, indicating that this method of dispute resolution is favoured by both groups.

Additionally, franchisees can complain to the ACCC if they have grounds to believe that a breach of the Code or the CCA has occurred.

Since 2008, current and former franchisees, as well as other franchise sector participants have had significant opportunities to provide comment on any perceived shortcomings of the Code or its enforcement through the various franchise inquiries that have been held at state and federal level.

Lobbying by franchisee action groups has also led to attempts to introduce specific franchise legislation in Western Australia, South Australia and New South Wales. While it is acknowledged that interest groups have the right to lobby elected representatives, the authors view any attempt to legislate franchising outside the existing industry code and CCA regulatory framework will add complexity, cost and confusion to future franchise relationships.

Additional recommendations to improve the Code

Delete Annexure 2 Disclosure

The authors are not aware of any franchisor at any investment level, or indeed any lawyer acting for any franchisor, who uses or recommends Annexure 2 disclosure.

This "short form" disclosure is an anachronism that may have had some relevance as a transitional arrangement for low-investment service systems to ease the original introduction of the Code in July 1998, but in practice today is redundant.

The authors are not aware of any franchisor who currently uses Annexure 2 disclosure, or any who have ever used it.

Its continued existence in the Code is irrelevant as any franchisee who receives Annexure 2 disclosure is entitle to receive Annexure 1 disclosure on request, thereby leading franchisors to comply with Annexure 1 as the safest method of disclosure. This would also reduce the Franchising Code of Conduct by 15 pages.

It is recommended that Annexure 2 disclosure be removed from the Code to eliminate a redundant element, and to reduce the Code's overall volume.

Aside from the benefit of relieving franchisees and their advisors of the unnecessary and duplicated task of reading Annexure 2 when supplied with a copy of the Code by franchisors, it would also save a significant amount of paper currently being wasted. (It remains common practice for disclosure documentation to be provided in hard copy, or if provided electronically, the sheer number of total pages will still require a reader to print it out rather than attempt to read it on a computer screen.

For every 5,000 new franchise grants, renewals or resales, this would amount to at least 40,000 sheets of paper (ie.8 sheets saved per document, printed both sides) and weighing more than 200kg[6] saved, not including the resources and energy consumer in producing, printing, handling and reading the paper.

This initiative has no downside to franchisors, franchisees or other participants in the franchise sector.

[6] Calculated by the authors on the basis of a ream of 500 sheets of paper weighing 2.55kg.

Summary of recommendations:

Disclosure under the Franchising Code of Conduct

Regarding improved franchisee comprehension of disclosure information (Q1):

1. ...requiring franchisees to undertake an endorsed pre-entry education program, such as that which Griffith University's Asia-Pacific Centre for Franchising Excellence has offered since 1 July 2010 with the support and endorsement of the Australian Competition and Consumer Commission (ACCC). (p3)

Regarding the rights of franchises in the event of a franchisor insolvency (Q1):

2. ...amend current accounting practices to recognise the payment of upfront franchise fees by franchisees to franchisors prior to joining a system as a prepayment to be amortised by the franchisor over the term of the franchise. (p4)

3. ...a new approach to recognising the interests of franchisees in the event of a franchisor insolvency should be considered, even if it means looking for a solution outside of the regulatory framework provided by the Franchising Code of Conduct. (p5)

Regarding a narrower definition of unforeseen capital expenditure (Q3 &4):

4. ...relabel it as "possible future capital expenditure" which may help to distinguish the probable from the improbable. (p5)

Regarding disclosure of rebates (Q3 &4):

5. ...whether the benefit of the rebate is shared directly or indirectly with franchisees may need further guidance. (p6)

Regarding financial reports for marketing and cooperative funds (Q3 & 4):

6. ...it is recommended that the time be reduced from three-yearly to annually to allow greater engagement by all current franchisees, and improved transparency for and responsiveness through improved accountability. (p6)

Regarding financial details of the franchisor (Q3 & 4):

7. ...consideration should be given to altering Item 20.1 of the Disclosure Document to require the franchisor's statement of solvency to be current as at the time the disclosure document is issued to a prospective franchisee. (p6)

Regarding lease arrangements (History of Site or Territory to be franchised) (Q3 & 4):

8. ...it is recommended that Annexure 1 Item 11 be amended to consider this issue of disclosing by industry, as well as site or territory. (p7)

Regarding improving franchisee knowledge about franchisors and their conduct before entering a franchise agreement (Q7 & 8):

9. ...include a requirement under Part 2, Item 11 of the Code relating to advisor's certificates that potential franchisees should also undertake an endorsed pre-entry education program. (p10)

Regarding further disclosure requirements for franchisors (Q13 & 14):

10. ...to require the solvency statement disclosure in Item 20.1 to be current as at the time of issuing the disclosure document, rather than as at the end of the last financial year (see our previous recommendation on this issue), and for the list of existing franchisees to also be current as at the time of issuing the disclosure document. (p11)

11. ...Part 2, 11.2 of the Code be amended to include a requirement for potential franchisees to undertake an endorsed pre-entry education program, or to indicate that they have been advised to undertake such a program, but have declined to do so. (p11)

Good faith in franchising

Regarding inserting a definition of good faith into the Code (Q17):

12. ...it is not recommended to include a specific definition of good faith in the Code. (p12)

Dispute resolution in franchising

Regarding conduct and behaviour during mediation since the 2010 Code amendments (Q24 & 25):

13. For a more meaningful response to the question about conduct and behaviour, it may be worth surveying those mediators appointed by the Office of the Franchising Mediation Advisor (OFMA) to mediate disputes since 1 July 2010, particularly those who also mediated disputes in the corresponding period prior to the introduction of the Code changes.

Enforcement of the Franchising Code

Regarding improved compliance with the Code (Q27):

14. Greater resourcing of the ACCC for enforcement activity, particularly in the areas of random audits and substantiation notices;

15. The introduction of financial penalties for certain breaches of the Code;

16. Improved education of participants in the franchise sector, including franchisees, franchisors and service providers, particularly those advising aspiring and early stage franchisors;

17. Proper identification of franchisor participants in the sector via a registration process which need not necessarily seek to vet new systems, but to make the identity of all systems a matter of public record, and to provide a definitive population in which education programs or enforcement activities (eg. random audits by the ACCC) may occur; (p17)

Additional recommendations:

18. It is recommended that Annexure 2 disclosure be removed from the Code to eliminate a redundant element, and to reduce the Code's overall volume.

Appendix 1:

Asia-Pacific Centre for Franchising Excellence
Free online pre-entry education for potential franchisees

List of Modules and Units:

Module 1: An overview of Franchising

1. What is Franchising
2. Advantages & Disadvantages of Franchising
3. The Franchising Code of Conduct
4. The Role of the ACCC and Other Regulatory Bodies

Module 2: Franchisee Obligations & Costs

5. Understanding Franchise Disclosure
6. The Franchise Agreement
7. Franchise Fees and Royalties
8. Finance: Financing, Cashflow and On-going Franchise Costs

Module 3: Franchisor Support & Business Services

9. Franchise Support Services
10. Site & Territory Selection
11. Retail Leasing
12. Franchise Marketing Funds

Module 4: The Evolving business and Franchise relationship

13. Franchising Intellectual Property
14. The Franchise Operations Manual
15. Franchisor / Franchisee Relationship
16. Dispute Resolution

Module 5: Steps before buying a Franchise

17. Questions to ask Franchisors, Existing Franchisees and Ex-franchisees
18. Additional Due Diligence
19. Useful Business Skills
20. Assessing Your Suitability as a Franchisee