

**Submission by the Franchise Council of Australia in response to Federal Government options paper on small business dispute resolution - July 6 2011.**

**1 Executive Summary**

The Franchise Council of Australia (FCA) is the peak body representing franchisors, franchisees and all other participants in the Australian franchising sector. Franchised businesses generate sales turnover of approximately \$128 billion per year and employ about 660,000 people nationwide. Franchising is the most dynamic of the small business operating models. Its growth has outstripped GDP growth and growth in the broader small business market every year for the past 15 years. A recent business survey indicated franchising activity may outstrip manufacturing as a contributor to GDP by 2022. The franchise sector is therefore a substantial contributor to the Australian economy.

The franchise sector is almost exclusively comprised of small businesses, with around 95% of franchisors and almost all franchisees coming within the traditional definition of a small business. This is relevant in the context of the design and operation of any regulatory framework, and the establishment of dispute resolution mechanisms. Small businesses can be significantly impacted by excessive regulation, bureaucracy and red tape, and are sensitive to the risks and costs of litigation.

Any consideration of dispute resolution options that have application to franchising needs to be put in context. Griffith University research consistently shows that the level of significant disputes in franchising, which are defined as being matters where a party instructs a lawyer, institutes legal proceedings or takes formal dispute resolution action, is under 2%. Of the disputes that escalate further most end up in mediation, which is achieving a success rate of around 80%. So the potential application of any new dispute resolution alternative is quite limited in the context of franchising.

The FCA is a strong supporter of the existing mediation based dispute resolution regime for franchising, and for small business more broadly. It believes it is an effective regime which is providing low-cost, readily accessible dispute resolution nationally. The 80% success rate of mediation in franchising is compelling evidence that the mediation based framework is universally accepted. Mediation typically occurs at a very early stage in a dispute, and provides a framework where the parties can meet together with the assistance of an independent third party with minimal preparation and cost. The Code based framework is supplemented in States such as Victoria by the Small Business Commissioner's dispute resolution process which provides mediators at heavily subsidized rates. It is hard to imagine any dispute resolution framework that could deliver such results at such minimal cost. It would disadvantage franchisors and franchisees and almost certainly add cost if any new initiative served to turn people away from mediation.

The FCA would be supportive of any arrangement which provided more accessible and effective dispute resolution. To this extent, the FCA is supportive of the Federal Government initiative to examine ways to compliment existing dispute resolution opportunities available to small businesses. However the FCA believes the need for a new Federal regime is unclear, and that pre-entry and general franchising awareness education may be a better channel for allocation of resources.

FCA believes any initiative by the Federal Government would need to:

- Be success focused, rather than remedy oriented;
- Ensure no actual or de facto change to the legal certainty that currently exists;

- Have a bias to better educating new business owners to avoid disputes ;
- Avoid duplication or overlap with existing programs, and not divert people away from the highly effective mediation process;
- Not cross any existing statutes, Codes or regulations; and
- Avoid an adversarial approach to dispute resolution, focusing instead on conciliatory or collaborative mechanisms

## 2 **FCA response to the options identified**

All options identified in the options paper carry risks, including the risk of reducing certainty and adding unnecessary cost.

Option 1 is the most appealing of the 4 options identified in the options paper, as it is consistent with the FCA's view that education and the prevention of disputes are the most important priorities.

Option 2 has some potential, on the proviso that it meets the criteria identified in the Executive Summary and does not duplicate or overlap existing services.

Option 3 is the most interventionist and likely to lead to the highest costs, without any clear indication that it would resolve any underlying causes of conflict or business failure. The FCA considers it is unlikely to add any material value given the fairly comprehensive nature of the existing regimes, and should be avoided.

Option 4 has some appeal, but should not operate in a way which pits big business against small or Government against business or fosters an adversarial environment. If implemented it would need to be structured in such a way as to avoid it becoming a commercial advocate or quasi-tribunal. The FCA would also be concerned at the possible impact on legal certainty.

In terms of additional alternatives, the FCA considers the Victorian Small Business Commissioner model has much to commend it, and provides in the context of dispute resolution in an effective and low cost process that supplements and does not counteract the existing OFMA process. Other proposals that assist parties to understand their rights and obligations, make informed decisions or obtain advice also merit consideration. In this respect the FCA has frequently remarked that the size and complexity of the Code disclosure requirements means that disclosure documentation is voluminous, and a cause for concern in terms of the cost of franchisee's obtaining legal and business advice. The FCA would support a more streamlined process that provided more focused information in a format that was easier for franchisees and their advisors to utilize.

The FCA does not support State based franchising legislation or the establishment of new State based bureaucracies such as those proposed in SA and WA, particularly as those proposals also include changes to the substantive law and will create additional uncertainty, duplication and cost.

The FCA's reasoning is set out in the following paragraphs of this submission.

### 3 Is there a need, and are there better alternatives?

#### 3.1 No overt need

The FCA's broad contention is that there is no overt need for the Federal Government to act to implement its own small business dispute resolution process, especially at a time when a number of States are taking an initiative to introduce Small Business Commissioners.

The courts provide a comprehensive dispute resolution framework that increasingly involves court ordered mediation at an early stage. Governments are also implementing a number of initiatives to encourage speedy and cost-effective resolution of disputes and reduce court delays. The ACCC is an active and effective regulator with a strong track record of instituting court proceedings where there has been a breach of the Competition and Consumer Act, which of course includes the Code. In addition the ACCC uses its power to require court enforceable undertakings very effectively. There are several cases where these powers have been used in a franchising context.<sup>1</sup>

The Code's mediation based dispute resolution process has been a resounding success. The FCA has commended the complementary roles of the Federal Office of Franchise Mediation Advisor and the Victorian Small Business Commissioner for the way these organisations function to the benefit of franchising businesses.

A new Federal program could provide another alternative to the existing Federal/State options. However, it is not clear to the FCA that there is a demonstrably different need in the small business community which is not being effectively addressed by the existing options.

Demand does not appear to be outstripping supply in terms of availability of mediation services. Neither OFMA nor the Small Business Commissioner of Victoria report a backlog of mediation cases. Both report strong success rates (around 80-85% for SBCV in the past few years), and advise that mediations are usually completed within a day. Prices are highly affordable (as little as a couple of hundred dollars in the case of SBCV) and legal representation is not necessary.

To the extent that any new initiative enhances availability of low cost, effective dispute resolution in small business, the FCA is supportive. However it may be that in contemplating the creation of a new Federal initiative the Government determines that scarce funding would in reality be channeled into an area which is already adequately served.

#### 3.2 Prevention versus resolution

It is almost trite to say that prevention is the best means of dispute resolution. Pre-entry education has been a focus of the FCA and more recently the ACCC and others as a consequence of recommendations from some of the recent inquiries into franchising. As franchising is a long term relationship there is considerable benefit in ensuring that the parties have a good understanding of the nature of the relationship and the way it is governed by the Franchising Code of Conduct, including the mandated commitment to dispute resolution as a means to facilitate business continuity.

---

<sup>1</sup> Indeed almost all cases where the ACCC has taken action in the franchise sector in recent years have been resolved using this process.

If the need for expanded dispute resolution service offerings is unclear, it may be that a better alternative is to direct funding to the prevention of disputes rather than their resolution.

It may be more beneficial to channel funds into education programs. Too many small businesses fail because of a lack of understanding of basic business principles such as planning, managing cash flow, use of measurement benchmarks and the importance of understanding obligations under legal documents such as supplier contracts and leases. FCA has long called for the involvement of Federal and State Governments in education programs which simultaneously drive business development and awareness of business principles. In submissions to the WA and SA inquiries into franchising and the subsequent Federal inquiry into franchising in 2008/09, the FCA highlighted education and enhanced dispute resolution as the key areas on which Government attention could most effectively be focused to achieve improvements in the fair and efficient operation of the franchising sector. The FCA repeated this contention most recently in its submission to the 2010/11 Western Australian Parliamentary inquiry into the WA Franchising Bill 2010, as proposed by backbench MP Peter Abetz.

The FCA conducts its own franchisee 'pre-entry' education initiatives, in collaboration with the ACCC and State small business development authorities. The key planks of this 'pre-entry' approach are face-to-face information seminars, held at Franchising Expos in the major capital cities, and follow-up seminars staged in the weeks following the seminars. However, these FCA programs are limited in their reach (capital city only) and frequency (seminars generally twice a year).

With minimal additional Government funding these initiatives could be significantly expanded. Research conducted by Griffith University identified a need for 'pre-entry' education, and in 2010, Griffith was awarded a grant from the ACCC to implement an online pre-entry education program for potential franchisees contemplating a franchise purchase.

### 3.3 Federal-State collaboration

In FCA's view, the Griffith-ACCC franchising 'pre-entry' education initiative is a strong contribution to enhanced awareness and better business preparedness for new entrants to the franchising sector.

The benefits could be extended if a similar program was initiated in collaboration between Federal and State Governments. Such a program could encompass face-to-face education (ala the FCA Expo information sessions and 'Eyes Wide Open' seminars) and online elements. FCA would be happy to create a more detailed proposal if the Government saw merit in such an idea.

In conjunction with the Office of the Small Business Commissioner, Small Business Victoria conducts a small business awareness program which reaches out through the suburbs of Melbourne and out into regional areas of the State, as well as the regional centres such as Bendigo, Ballarat, Shepparton, Sale and Warrnambool.

Such an initiative could provide a platform for promotion of a 'piggyback' online education opportunity which directly addressed business management skills and understanding of different business operating models (including franchising).

### 3.4 Promotion of franchising awareness in the general community

Franchising is growing at a faster rate than any other business model. The public enthusiasm for this way of getting into business would be better harnessed if it was accompanied by increased education about its function – both opportunities and the 'need to know' elements.

One of the challenges for pre-entry education is that many new franchisees have no prior business experience prior to taking on a franchise. It is therefore difficult to target them – one minute they are employed in an organization, the next they are a potential franchisee. The FCA therefore believes there is substantial merit in educating the general population about franchising.

The FCA is already exploring opportunities to introduce a discussion of franchising into the general business education framework, and there are various informal efforts undertaken with secondary schools, business colleges and tertiary institutions. However these initiatives could easily and at minimal cost be given additional structure and impetus.

With greater understanding of the concept and its workings in the general community, the incidence of disputes would likely fall. The same could no doubt be said about small business success generally.

### 3.5 Retarding growth through over-regulation

Franchising is already one of the most regulated business models in Australia.

The extent of regulatory compliance has arguably reached the point where it is becoming counter-productive. Disclosure obligations are so onerous as to render some documents borne of them so big and so detailed that they actually deter potential – and existing -- franchisees from reading them.

Understood or not, the perception of ‘too much red tape’ is a deterrent to business investment and to entrepreneurial endeavour. The Federal Government ought to be conscious of this as it contemplates the creation of what could amount to another layer of bureaucracy in dispute resolution.

Any initiative needs to have a focus on simple, quick and easy practical dispute resolution. Rules ought to be kept to a minimum.

### 3.6 An all business approach

The FCA notes that none of the options in the discussion paper recommends the ‘singling out’ of franchising; ie the options appear intended to apply to small business in general. FCA agrees with this approach. Measures should be accessible to franchise businesses, but the Government should be wary of ‘singling out’ franchising businesses for any obligations which do not apply to small business generally. See also our comments in paragraph 3 of the Executive Summary.

The one exception to this ‘general application’ approach is option 3, which appears to explicitly exclude application to businesses covered by existing regulatory Codes – which we understand to include the Franchising Code of Conduct. Again, the FCA agrees with this approach.

Creation of any new authority to sit in judgement of franchising matters would undermine the effectiveness of some of the key principles of the Franchising Code of Conduct, including that of mandatory dispute resolution. Any such move would be likely to reduce participation in dispute resolution between the parties and increase use of the tribunal, resulting in higher costs and slower resolution of disputes.

## 4 The fundamentals of effective dispute resolution

Any new dispute resolution mechanisms should be considered against the following fundamentals.

### 4.1 Legal certainty

The FCA has consistently opposed any new laws, such as the recent WA Franchising Bill 2010, which change the balance between the interests of the contracting parties or add uncertainty. Uncertainty creates additional disputes, and increases costs for all parties. Any new initiatives should not alter the existing regulatory regime or impact legal certainty, they should in this context be neutral. If new courts or tribunals are established, they should apply the law as it currently exists, rather than being given new powers to make decisions based on opinion or new legal concepts such as fairness or some new definition of good faith.

The FCA considers that the current framework for dispute resolution in Australia is vastly superior to many other models operating throughout the world.

There is significant structure around the franchising process, and the legal rights of the parties are quite clearly defined at law. The Code provides significant information and a pre-contractual process that is comprehensive and includes a certification and cooling off process. The Competition and Consumer Act (CCA) contains prohibitions on misleading or deceptive conduct and unconscionable conduct, and the implied duty of good faith and fair dealing will apply to most franchise agreements. The application of these laws to franchising is quite settled, so the parties to a franchise agreement have considerable certainty. This is important in the context of dispute resolution, and is probably a contributing factor to the high success rate of mediation – the parties know where they stand, and after some negotiation reach a mutually acceptable outcome without needing to resort to the courts.

The FCA considers the current regulatory framework to be world's best practice, striking a fair balance between the need for effective regulation and the principles of freedom of contract in business transactions. The Code and the CCA ensure responsible franchisor behavior and facilitate the provision of comprehensive information to franchisees in a framework that encourages franchisees to obtain advice and make an informed decision. Franchisees have the obligation to undertake proper due diligence and obtain advice.

### 4.2 A conciliatory rather than adversarial approach

A key to mediation is that the process is essentially conciliatory, rather than adversarial. In litigation and arbitration the parties adopt essentially an adversarial or competitive approach. This causes parties to have to assemble their case and prepare to attack the case of the other party. The initial stages of litigation are essentially procedural, involving cost associated with the process rather than the substance of the dispute.

The Code's mediation based dispute resolution is highly effective, and the courts are readily accessible to franchisors and franchisees. Litigation costs are significant, but the Australian legal system typically operates on a loser pays all costs basis. So an aggrieved franchisee or franchisor with a strong legal case has access to justice, albeit at a cost. The ACCC is a frequent initiator of litigation, and has new powers to take representative actions and distribute proceeds. The ACCC also has new additional remedies and enforcement powers such as the ability to issue substantiation

notices and conduct random audits. As a consequence a franchisor is very vulnerable should it breach the law.

The FCA would be supportive of any arrangement which provided more accessible and effective dispute resolution. To this extent, the FCA is supportive of the Federal Government initiative to examine ways to compliment existing dispute resolution opportunities available to small businesses. However we caution that many of the suggestions we have seen advanced propose an adversarial framework, which we doubt will deliver improved outcomes or lower cost dispute resolution.

#### 4.3 Recognition of the dynamics of franchising

Most franchisors, and virtually all franchisees, are small businesses. Furthermore, most assets of a franchisor or franchisee are intangible and are most valuable on a going concern basis. There is significant business interdependence between franchisor and franchisee, so that any adverse consequence for a franchisor is likely to impact its franchisees as well. And, at least in a reputational sense, the reverse often applies. Any dispute resolution mechanism needs to take these factors into consideration.

Franchising has been likened to a business marriage, and for good reason. The business interdependence and mutuality of interests is like a marriage. Like most marriages, the relationship has its tensions and conflicts, but generally operates best in continuum. Divorce is a costly and last resort process that typically leaves both parties worse off.

The FCA has developed a strong understanding of the causes of disputes in franchising. In our experience most of the disputes are resolved relatively quickly by the following means:-

- Direct discussions and resolution or compromise;
- Involvement of representative internal bodies such as Franchisee Advisory Councils;
- Internal dispute resolution mechanisms; or
- Intervention of the ACCC in a formal or informal manner.

Instances of serious franchisor misconduct are actionable in the courts by an aggrieved party or the ACCC, and 80% of other disputes are resolved by mediation.

There are instances where a party considers that mediation and traditional legal remedies have not produced an acceptable outcome. In our opinion these matters predominantly relate either to mismatched expectations or circumstances or events beyond the control of either the franchisor or the franchisee. In the context of mismatched expectations we frequently find the franchisee failed to obtain independent legal and business advice despite the Code process strongly encouraging the franchisee to do so.

A new dispute resolution mechanism is unlikely to have much impact in these areas. For this reason the FCA has been strongly supportive of increased pre-entry educational programs as a primary strategy to reduce disputation in franchising.

The FCA has developed a strong understanding of the causes of disputes in franchising. In our experience most of the disputes where a party considers that mediation and traditional legal remedies have not produced an acceptable outcome relate either to mismatched expectations or

circumstances or events beyond the control of either the franchisor or the franchisee. For this reason the FCA has been strongly supportive of increased pre-entry educational programs.

#### 4.4 Avoiding duplication and overlap

The FCA is strongly supportive of Federal Government initiatives including the COAG process aimed at harmonizing laws across Australia, and avoiding unnecessary duplication, inconsistency and overlap. Any new dispute resolution initiative needs to be consistent with these principles.

The recent proposals in SA and WA are good examples of the potential for overlap, inconsistency and duplication. In WA, the WA Parliament's Economics and Industry committee recommended against the introduction of the Franchising Bill 2010, noting that it did not regard the Bill as appropriate at this time. The committee questioned some of the claims made to it in submissions (written and verbal), adding that some of the claims of purported benefits of implementation of the Franchising Bill 2010 may have been overstated. Its report directly referenced comments by the self-proclaimed author of the Bill, Associate Professor Frank Zumbo (University of NSW) a number of times.

In fact, rather than deliver benefits to the franchising community, implementation of the Bill would lead to increased uncertainty and the likelihood of an increase in conflict. In this respect the committee recommended against adoption of a defined 'good faith' behavior obligation, citing the potential for difficulties of interpretation and potential overlap with the undefined 'good faith' obligation existing at common law. It also noted that the creation of such a right would lead to litigation in the courts, which was contrary to the aim of enhancing cost effective dispute resolution. The FCA agreed with the conclusions of the WA Parliamentary committee (see attached FCA media release). It is critical that the Federal Government avoid the possible consequences referenced by the WA Parliamentary committee when considering implementation of any national dispute resolution regime.

The FCA strongly supports the Franchising Code of Conduct, and the enforcement activities of the ACCC. The Code's mandatory dispute resolution elements are working (70-80% success rates in recent years, as reported by the Office of the Franchising Mediation Advisor). They are being effectively complemented by the mediation facilitating activities of the Small Business Commissioner in Victoria. The Office of the Small Business Commissioner of Victoria is facilitating low-cost, easily accessible dispute resolution. It is doing so with the backing of enabling legislation. However, this legislation does not overlap or seek to interact with any other statute, Code or set of regulations.

This is a model which is working in Victoria and which FCA has commended to State Governments. A number appear to be detecting the usefulness of this low-cost dispute resolution mechanism for small business, as they are going down the road of appointing their own Small Business Commissioners. To FCA's understanding, this is occurring in WA, SA, NSW and Queensland. In each case, with the possible exception of South Australia, the 'non-overlap' principle is being observed. In South Australia, the Government is weighing up its options. FCA believes the SA Government should be guided by the example set in Victoria and apparently being followed, to a large degree, by NSW and Queensland. The Federal Government ought to be similarly aligned to ensure any initiative is complementary to existing dispute resolution arrangements, State or Federal. It ought to be cautious to ensure any initiatives it adopts do not overlap or conflict with other existing programs.