

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

25 February 2013

Dear Mr Wein,

RE: Review of the Franchising Code of Conduct

Thank you for giving me the opportunity to comment on the Discussion Paper: Review of the Franchising Code of Conduct.

As the NSW Small Business Commissioner, I have been appointed to advocate on behalf of small businesses in NSW and support small businesses by:

- Providing dispute resolution services
- Delivering quality business advice through Small Biz Connect
- Speaking up for small business within government

Since being appointed I have conducted two Listening Tours around the State to hear directly from businesses about the impediments they face that negatively impact on their business growth. In addition to this in my role as Registrar of the *Retail Leases Act 1994* I am incredibly familiar with the issues that both franchisees and franchisors face despite the existence of the Franchising Code of Conduct (Code).

The Franchising Code in practice

Through my experience as NSW Small Business Commissioner and Registrar I have come to understand that there is a difference between the theory behind the Franchising Code of Conduct and the practical reality of utilising the Code.

My view is that in practical terms if a franchisee takes action against their franchisor regarding a breach of the Code, the franchisee is in effect removing the likelihood that the franchisor will offer them a franchise arrangement in the future. This is exacerbated further by the fact that a breach of the Code currently does not incur penalties.

Pecuniary penalties

Would the introduction of penalties have a positive impact on compliance with the Code? Yes, the key to enforceable penalties is how they positively change behaviour. Where the industry perceives a penalty is unlikely to be imposed even where the behaviour contravenes the Code, a penalty is of little use. I therefore support the introduction of penalties but only if resources are allocated to ensure that penalties are imposed and issued and that breaches are investigated.

Franchisees regularly enter into franchise contracts under the understanding that the business will for example have an expected turnover of X, profit levels of Y and a retail space of Zm². However when one of these factors has been misrepresented, the imbalance of market power makes it nearly impossible for a fair negotiation to occur.

Claims for unconscionable, misleading or deceptive conduct should be taken to the Australian Competition and Consumer Commission (ACCC), however I understand that investigations of alleged breaches of the Code are not typically pursued by the ACCC to the extent expected by many small businesses. I am told that franchisees are advised by the ACCC that unless a business is able to afford to litigate their dispute they have no recourse to pursue a franchisor's breach of the Code. In addition to this, the test of unconscionable conduct and misleading and deceptive conduct is so high that most small businesses cannot succeed in a claim. I believe this is a similar concern for small businesses trying to claim breaches under *Australian Consumer Law (ACL)*.

Many franchisees tell my Office that they will not bring a complaint to the ACCC due to a fear of retribution. Therefore where the ACCC does not demonstrate their intent to take enforcement action, there is little motivation for a franchisee to take the risk of raising their issues.

Whilst no sanctions exist under the Code there is a perception that no consequences will apply for breaches of the Code.

The use of 'natural consequences'

For the Code of Conduct to operate more effectively there is the need for greater natural consequences to be incurred by the party that is proved to have breached the Code.

There is a particular need for franchisee's to be able to unravel false disclosure. An effective way of doing so would be to utilise a combination of implementing penalties and ensuring that natural consequences occur. A natural consequence would be where undisclosed or improperly disclosed costs could not be charged to the franchisee.

Disclosure

Disclosure of information in franchise agreements is so important given the information asymmetry that exists between franchisor and franchisee, particularly at the time that the franchise agreement is decided upon.

My office does not have enough visibility of the scope of franchise disputes to speak to the question of whether the 2008 and 2010 changes to the Franchising Code regarding disclosure has led to improved franchisee knowledge about franchisors and their conduct before they enter into franchise agreements. My Office has only been in existence since 2011 and as such all of the cases we have seen are post these amendments.

On the question of whether the effort by franchisors is justified by the benefit this disclosure is providing to franchisees is also unknown to me. However, I am certain

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that where small businesses are provided with a reasonable amount of information to base business decisions on, their likelihood of failure decreases.

Good faith – 2010 amendment (23A)

Developing the concept of good faith in section 23A of the Code through the provision of definitions and examples will provide an incentive for positive behaviour change and help parties resolve disputes at the earliest possible point. Having standards in the form of a regulation or in a format that allows them to change and be responsive to the franchising operating environment of the day will also assist the industry. It is my view that waiting for guidance from case law to develop the concept will not be adequate given that the findings often are not available for several years after the conduct occurs. For the Code to be most efficient, businesses need a set of standards now.

The test of good faith could address instances where the franchisor's profit margin on products is increased beyond the market price increases. Increasing the profit margin on products that a franchisee is required to purchase is a critical issue because a small business cannot forecast or build a business model when the franchisor can make material unilateral variances.

The test of good faith could also address issues that arise when a landlord advertises or discloses premises as a particular size yet they are later found to be significantly smaller (say 10 per cent or greater). This problem is not being adequately addressed by the misleading and deceptive conduct provisions; unconscionable conduct provisions; or pre-lease misrepresentation provisions of various regulatory instruments.

The test of good faith could similarly address instances where a franchisor is negotiating with a shopping centre owner in the franchise scheme's interest over that of individual franchisee's interest. In order for the franchisor to secure premises in multiple locations, I am told that some franchisors agree to an unsustainable rent in a particular centre in order to secure premises in other shopping centres. This rent however is agreed to at the detriment of the sitting or new franchisee.

The test of good faith could also address the multiple problems that the Code and the ACL deal with. Given that their enforcement is so difficult, some parties rely on the unlikelihood that any enforcement action will take place. Therefore the test of good faith will have the positive impact of creating uncertainty for those engaging in behaviour that unfairly disadvantages the other, whether or not it breaches the code.

End-of-term arrangements – 2010 amendment

The 2010 amendments do not seem to be well understood by businesses. A key issue is how to protect a franchisee from unanticipated costs when the franchise agreement is terminated.

Frequently the lease agreement (sublease where the franchisor holds the head lease) and the term of the franchise agreement are unaligned. In such a circumstance the small business is held hostage to financial obligations they cannot meet unless they are able to reach an agreement with the landlord or franchisor. To

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address this, franchisors should be required to align the franchise agreement with the leasing agreement expiration date.

Dispute resolution – Is it working under the Code?

Whilst the Office of the Franchising Mediation Advisor (OFMA) exists and assists many franchisors and franchisees resolve disputes, it appears to have a one-size-fits-all approach to mediation. OFMA is constrained by procedures in the Code, whereas the Office of the NSW Small Business Commissioner on the other hand is able to take a more tailored approach to dispute resolution. The extensive intake processes of the OSBC are in part responsible for my Office's high dispute resolution rate, with 89 per cent of all disputes being successfully resolved.

The Code allows the parties to appoint their own mediator and as a result some franchise disputes come through the OSBC. It would be helpful to make it clearer in the Code that a franchisor has complied with the mediation requirements of the Code if the parties agree to mediate through nominated services, including those provided by the various State-based Small Business Commissioners.

Education

Franchising is regularly advertised as the simpler, safer way to enter into business. One need only look at the ACCC's own information on franchising – "If you are thinking about starting a small business, franchising can offer many benefits. Franchising systems generally include a proven business model, an established brand or product and support from the franchisor through existing infrastructure and marketing schemes".¹ I see many examples where a franchisee has entered into a franchise agreement assuming the above statement to be the case, when in fact they need to conduct extensive due diligence. Operating a franchise business brings with it many complexities and many small businesses do not understand the need to conduct due diligence before proceeding with a franchise agreement. There is therefore a critical need for greater education for business operators that enter into a franchise agreement for the first time.

Significant benefit would be gained from introducing mandatory education measures, an example of which is the free online Griffith University 'Buying a Franchise' course. Education would enable businesses to gain a better understanding of what it means to enter into a franchise agreement and create an avenue for franchisees to have access to a wide range of franchise information and advice.

The need for education however needs to parallel the knowledge by industry that breaches of the Code will be prosecuted in some manner.

Response to specific discussion paper questions

1) *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 franchise failure?*

The disclosure statement that "a franchise is a business and like others could fail" does not seem particularly helpful given that it does not allow the prospective

¹ <http://www.accc.gov.au/content/index.php?id/785095>

franchisee to assess the viability of the businesses where franchisors provide incomplete or inaccurate disclosure. It would be more helpful to provide protections for individual franchisees when franchisors become insolvent.

2) *Does the sector have any concerns regarding the operation of this requirement?*

Yes, there can be instances where franchisees are paying rent to the head tenant (franchisor) that is not being passed on to the landlord. This then can result in the franchisee being locked out of their premises, with little or no recourse with the landlord.

3) *Have amendments to the Franchising Code improved the transparency of financial information for franchisees? If not, why not?*

It is unclear to me whether a franchisor is able to take back a store, run it as a company store for a time and then disclose to prospective franchisees that the site was a company store and mask failed franchisees. Such a scenario can lead to “franchise churn” of these businesses without there being greater disclosure. Franchise churn is a common claim that may warrant further investigation by the Review.

In addition to this, I strongly believe that franchisors should bear their own cost of dispute resolution with franchisees. If they are not responsible for this cost they do not have the same motivation to resolve matters at the earliest possible point.

16) *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.*

This is not particularly helpful in light of the prohibitive costs of litigation.

17) *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?*

Uncertainty about the implications of not acting in good faith would encourage both franchisors and franchisees to maintain good and defensible behaviour.

18) *If an explicit obligation of good faith is introduced, should ‘good faith’ be defined? If so, how should it be defined?*

Examples of bad faith and guidance that does not limit what can be considered bad faith would be helpful. Case law can also further develop the principle. Complaints that are taken to the ACCC and OFMA could also be used as guidance for parties to better understand the boundaries of conduct.

19) *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?*

The obligation to act in good faith should be extended to the entire franchise relationship.

20) *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?*

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The consequence should be to provide a remedy to the damage that flows from the breach of the Code or principle of good faith.

22) 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?

The provisions of the Franchising Code of Conduct may need to be established as an Act rather than a Code in order to remain aligned with the Government policy that codes are intended to be prescriptive rather than set out aims and ideals.

Additional points

The ability for franchisors to unilaterally vary the franchise agreement should be limited to non-material variations that do not affect the fidelity of the bargain.

Where a franchisor has the power to require a franchisee to make a capital expenditure during the term of the franchise agreement, they must give a corresponding term of the agreement that allows the franchisee to depreciate the expense. Allowing a franchisor to require a capital expenditure without the ability to write it off gives a significant advantage to the franchisor in the end-of-term negotiations. For example I am aware of situations where a franchisee has been required to spend \$1 million on capital expenditure whilst only being given a one year term.

Unconscionable conduct is not an effective remedy for small businesses due to the prohibitive cost of litigation. This is a result of the fact that the franchisor is able to pass on the cost of the legal fees for dispute resolution to the franchisee as part of the franchise fee. This therefore results in the franchisee bearing the brunt of the cost of the franchisor's poor conduct. Franchisors should be forced to bear the risk of their own conduct.

The Review and the need for market balance

Compared to other nations Australia has far more extreme examples of market power in place. This economic environment therefore means it is critical that this Review finds a balance in the franchising industry between freedom of contract and government regulation and legislation in order to address this market imbalance.

Thank you for giving me the opportunity to comment on the Review of the Franchising Code of Conduct. Should you wish to discuss any of the issues raised in this submission further please contact Jane Want, Assistant Advisor, Advocacy on (02) 8222 4818.

Yours sincerely



Yasmin King
NSW Small Business Commissioner
25 February 2013