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

BY EMAIL: franchisingcodereview@innovation.gov.au

SUBMISSION ON THE DISCUSSION PAPER "REVIEW OF THE FRANCHISING CODE OF CONDUCT"

Submission by:

Dr Elizabeth Spencer, Associate Professor of Law, Bond University; and

Simon Young LLM, Solicitor.

Contact details (to be kept confidential):

[redacted]

Date of Submission:

14 February 2013

Whether Submission is to be kept confidential or not and able to be released to the public:

Submission, but not contact details, may be released to the public.

Discussion Questions and Responses:

Part Two: Disclosure under the Franchising Code of Conduct

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 franchisor failure?**

Response:

This question relates to 2010 Amendment re Franchisor Failure para 1.1(e) Annexure 1: 'Disclosure document to explain that the franchise/franchisor could fail and this would have consequences for the franchisee.'

The Code mandates a warning that:
'*Entering into a franchise agreement is a serious undertaking. Franchising is a business and, like any business, the franchise (or franchisor) could fail during the franchise term. This could have consequences for the franchisee.*'

Discussion:

We do not believe that this additional warning/disclosure requirement has effectively addressed concerns about franchisees entering into franchise agreements without considering the risk of franchisor failure.

It is the vulnerability of franchisees to franchisor failure and their lack of capacity to protect against the risk of financial ruin, rather than the franchisee's knowledge of the risk, that needs to be at the heart of this discussion. We are of the view that such an amendment does not adequately address the problem because of the limitations inherent in this type of regulatory intervention. The use of a warning does little to improve franchisees' capacity to protect themselves against the risks.

It is worth noting that the Matthews Committee recommended not just a warning, but for franchisors to include a Risk Statement with the disclosure document. The Government's failure to adopt this recommendation undermines the practical and theoretical foundations of disclosure as the principal regulatory tool in this area.[1]

Warnings can be designed to include persuasive elements to correct beliefs and attitudes (such as over-optimism and confirmation bias), and they should motivate people to comply. Because warnings do not always lead to compliance, however, research suggests that the better approach wherever possible is to 'design out the hazard' using other means.[2]

Warnings are unlikely to change franchisor behaviour as long as contractual freedom remains the basis of franchising, as we expect it will and should be. The real issues, then, are the need for:

- franchisee education so that franchisees not only are aware of the risks, but *understand*
- them, and
- comprehensive pre-purchase due diligence appropriate to the circumstances.

The regulatory tool of warning is separate and distinct from that of education, but research shows that education complements disclosure, for example to help franchisees *understand* the risks. Warnings coupled with education might, for example, help a franchisee to understand what risks associated with a failure to renew should be addressed.

We believe that warnings such as this are most effective in conjunction with more comprehensive education programs and information, or else when addressed as part of independent advice.

Generally we consider the amendment to be a positive step, but one that represents only a minor part of the solution to a complex issue. Its effectiveness cannot be assessed in isolation.

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

Response:

Yes, although the concerns are wider than the issue under discussion. The distinction between awareness and capacity to protect one's interests is significant and has not been addressed, nor have other well documented issues relating to franchisor failure.

Some of the issues addressed by Mr. Young in practice include:

- Where the intellectual property of the system is owned by an entity other than the franchisor

1 See Secretariat, Office of Small Business, Commonwealth of Australia, Review of the disclosure provisions of the franchising code of conduct (2006) <http://www.innovation.gov.au/Section/SmallBusiness/Documents/Franchising_Code_Review_Report_2006_FINAL_0612072007020513425O.pdf> at 22 December 2009; Commonwealth of Australia Government, Australian Government Response to the Review of the Disclosure Provisions of the Franchising Code of Conduct (February 2007), <http://www.innovation.gov.au/Section/SmallBusiness/Documents/Response_to_Recommendations_(Final)06Feb072007020609101 9.pdf > at 22 December 2009.

2 Michael S. Wogalter and Kenneth R. Laughery, 'WARNING! Sign and Label Effectiveness' (1996) 5(2) Current Directions in Psychological Science, 33-37.

(which is usual) there is always a risk to franchisees.

- Franchisor failure not only creates potential for immediate 'downstream' loss of the use of trademarks, intellectual property (the franchise system) and access to suppliers, but does not relieve the franchisee of ongoing contractual obligations, and in fact new and additional obligations may result. For example, in one instance where the franchise trademarks were owned by an associate of the franchisor a further substantial payment was demanded from the franchisees by the trademark owner to continue to use the brand and system.

Requiring pre-purchase due diligence advice, together with better educational material, would improve the outcomes sought to be addressed by the amendment. The ability of franchisees to take such information into account is problematic, however, as disclosure is now so complex as to be beyond the grasp of the lay person and stretches the capacity of professional advisors who do not work regularly in the area.

Enhancing the capacity of professional advisers to identify and advise on factors relevant to franchisor failure would also be useful, as many 'generalist' solicitors and accountants are not aware of the need to comment upon, or the potential warning signs of, franchisor failure. There is a prospect of increased litigation for professional negligence where the relevant adviser has not considered the franchisor's risk of failure.

At the same time, the cost of a proper assessment regarding the risk of franchisor failure by an independent adviser (or more likely, advisers) - so as to identify and quantify the risk factors and then draw a conclusion without negligence - is prohibitive. Unfortunately the cost of pre-purchase due diligence is beyond the budget of many small/medium franchisees and the additional disclosure introduced by the 2008 and 2010 amendments has increased that cost further. We recommend working with the various Law Societies to generate an advice 'checklist' for solicitors (similar to those used in retail leasing) which, although not a replacement for considered legal opinion, will improve the quality of advice.

We also note that some of the worst outcomes suffered by franchisees in recent franchisor failures have been at the hands of external administrators who take control of the franchise system. In one example, the administrator forced franchisees to purchase 'dead stock' for the benefit of the creditors but refused to provide the services required of the franchisor. It was argued, probably correctly as a matter of law, that the administrator had obligations to creditors over and above that owed to franchisees.

In another case the franchise agreements of 'unprofitable' stores (as defined by the return to the external administrator) were disclaimed but the leases were retained so a new franchise store could be sold in that location.

Administrators are in a difficult position; reluctant to disclaim franchise agreements to preserve the system as a 'going concern' but usually being unable or unwilling to meet the franchisor's responsibilities.

Amending insolvency legislation must be involved if better protection is sought for franchisees. Consideration should be given to making franchisees priority creditors in circumstances where their franchise is not novated to another entity who will honour the franchise agreement (within a reasonable period of time) - if only to preserve the proportion of their initial franchise fee for the unused term. Franchisees might be allowed to register a limited interest in the names, brands, trademarks and intellectual property licensed to them as part of the franchise agreement, perhaps as part of the PPSR regime.

Amendments to State leasing legislation also should be sought (ideally via COAG) to give franchisees the option to novate any lease interest held by the franchisor in a failure event, rather

than the administrator disclaiming the lease (which leaves the franchisee to negotiate a new lease, often on less favourable terms) or assigning the lease to another entity which may not respect or recognise the franchisee's interests.

3. 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?

Response:

It is almost impossible to say without detailed, controlled research whether the amendments have improved transparency of financial information. Anecdotally, the amendments have been of marginal benefit to franchisees. Addressing each subheading in turn:

Payments to third parties

This subheading relates to 2010 Amendment *Payments to third parties*, Annexure 1, para 13.6A.1:

'*Franchisor must disclose payments within franchisor's knowledge/control, or reasonably foreseeable by the franchisor, that will be payable by the franchisee to a person other than the franchisor (or franchisor's associate).*'

Discussion:

The 2010 amendments require franchisors to effectively create categories for the franchisee's business plan/cash flow forecast and then insert a range of estimates for the relevant amounts even though much of this information should be sourced by, or is under the control of, the franchisee. Many of the third party payments should be assessed by the franchisee in any event when creating its own business plan rather than having this function delegated to the franchisor.

It is payments made to associates or related bodies corporate that are most relevant to disclose rather than genuine arm's length costs.

There is a significant burden here with relatively low benefit to franchisees. This information may be reasonably available in well-established franchise systems that collect the relevant data; it is not common in small to medium systems. There is no extra benefit to franchisees from this amendment because the disclosure information is generally presented as a range of estimates and is not specific to their franchise unit.

The requirement to provide this information is not useful unless such information is:

(a) Reasonably specific to the franchise unit; and
(b) Includes the franchisee in confirming the range of variables.

Unforseen capital expenditure

This subheading relates to 2010 Amendment *Significant capital expenditure*, Annexure 1, para 13A.1:

'*Franchisor must disclose whether the franchisee is to undertake unforeseen significant capital expenditure not disclosed before the franchisee entered the franchise agreement.*'

Discussion:

The intent of this change is confusing. Despite its nature as a pre-sales disclosure requirement, the wording suggests that the information is primarily intended for existing franchisees ("*...not disclosed*

before ...") but by this stage the franchisee will not be able to revise their entry into the franchise or modify the terms of their agreement.

Prospective franchisees might benefit from known areas of potential capital expenditure, but where the expenditure is genuinely unknown prior to entering into the franchise (which represents the usual position) they will not benefit from subsequent disclosure as existing franchisees.

Franchisors have experienced difficulty identifying the full range of potential unforseen capital expenditure and the outer limits of the required disclosure are not clear. Does the franchisor have to cover matters such as the destruction of premises through natural disaster? Or where the franchisee's business requires a further injection of capital to continue trading solvently?

Generic categories of future capital expense are usually included – such as the potential upgrade of IT systems or replacing equipment – but the timing and cost of such work cannot be disclosed in any meaningful way (unless the work is already planned in which case it is not 'unforseen' expenditure). Most franchisors cannot positively state that any such expenditure will be required.

When a franchisee is already trading including this information in a Disclosure document is a formality only and does not change any obligation to comply that is contained in the franchise agreement. As a result, the harm that was intended to be addressed by this change has not been reduced.

The consequence of a franchisor being unable to identify unforseen capital expenditure is unclear and will likely be a fertile ground for future litigation. For example, will failure to foresee a capital expenditure amount to a misrepresentation entitling the franchisee to terminate the agreement? If not, what penalty or remedy applies? This is particularly relevant if penalties are introduced for breaching the Code.

As the law currently exists, to invest the franchisee with any actionable rights the extent of the misrepresentation would need to be so serious that (on an objective basis) had the franchisee known the information they would not have entered into the franchise.

'Reasonable foreseeability' is always contentious and the amendment is unhelpful for parties trying to comply with, or to interpret, the Code. A breach of this disclosure may well result in no practical outcomes accruing to the franchisee, although the ACCC could potentially become involved at a regulatory level.

It may be possible to limit the scope of additional capital requirements to be paid by the franchisee during the term by regulation, however further investigation of the reasonable limitations would need to be undertaken. We note that the Expert Panel chose not to adopt this course.

No disclosure statement or franchise agreement reviewed by the authors commits the franchisor to taking into account a capital expenditure made by the franchisee at the end of the term (or at any other time). Disclosing that 'consideration will be given' to such payments is meaningless where the end of term arrangements are already contractually fixed or are otherwise at the discretion of the franchisor.

Notice must be taken of the continuing frequency of disputes involving the payment of further capital amounts, but this 2010 amendment should be removed entirely and should be subsumed (if it was not already covered) under Disclosure item 16.

Attribution of legal costs

This subheading relates to 2010 Amendment *Significant capital expenditure*, Annexure 1, para 13B.1:

'Disclosure document must state whether the franchisor will attribute the franchisor's costs (including

legal costs) incurred in dispute resolution to the franchisee.'

Discussion:

This amendment has resulted in a number of franchisors modifying their systems to require franchisees to pay such costs where previously the agreement was silent on the issue or the franchisor had been prepared to bear the cost.

This amendment has had an overall *negative* effect on franchisees and has increased the power imbalance between the parties in a dispute i.e. increased the financial disincentive for the franchisee to pursue a dispute.

The payment of legal or other dispute resolution costs should not be a matter for the franchise contract but reserved for a Court of competent jurisdiction. A presumption that each party should pay their own costs and contribute equally to third party costs (such as mediators) should be applied.

This Disclosure should be removed as an inadequate response to the harm being experienced by franchisees in this area, and the Code should be changed to prevent a franchisor from passing on costs in a dispute situation in the absence of a Court Order.

Disclosure of rebates

This subheading relates to 2008 Amendment *Disclosure of rebates and financial benefits*:
'*Franchisors are required to disclose in their disclosure documents from whom they receive rebates and financial benefits to increase the transparency of the relationship between the franchisor and franchisees.*'

Discussion:

The identification of the entities paying rebates to the franchisor has not materially benefited franchisees; there has been no increase in the relative bargaining power of franchisees with this disclosure and the 'tied supply' nature of franchising makes it extremely unlikely that the franchisee will receive a benefit that is not purely at the discretion of the franchisor. The broad disclosure that the franchisor may, or will, receive rebates that will not be shared with the franchisee coupled with education and independent advice about the ramifications of this practice should be sufficient for the purposes of deciding whether or not to invest in a system.

This disclosure should be removed or modified accordingly.

Financial reports for marketing funds

This subheading relates to 2008 Amendment *Marketing and other cooperative funds*:

'*Details of the expenses of marketing and other cooperative funds must be provided by franchisors to franchisees. If 75 per cent of franchisees agree that annual audits need not be undertaken, then this requirement does not need to be complied with, however, franchisees have to be renew this decision every three years.*'

Discussion:

This area remains a significant source of dispute and the disclosure amendments have not resolved the problems. Having better information about the marketing fund has not increased the ability of franchisees to contest, or benefit from, a fund controlled at the discretion of the franchisor. The amendment has not taken into account that the application and use of the marketing funds pursuant to the terms of the franchise agreement is part of the problem - not just a lack of information.

Franchisors consistently reject complaints about the use of the marketing fund on the basis that there is no obligation to apply any, or any particular, amount of the fund to the benefit of an individual franchise. Already this year Mr Young has been involved in a franchise dispute where the franchisor appears to have been using the marketing fund to subsidise its administration costs, but arguably in such a way as to comply with the franchise agreement. The franchisee cannot afford to take this matter further, and in any event there is no possible advantage or benefit to be obtained by them in pursuing the issue given the franchisor's undisputed discretion in allocating funds.

Disclosing the financial records, although relevant, has not resulted in any change of behaviour. Even when questionable payments are identified, franchisees lack the incentive or ability to take the matter further and the ACCC finds it difficult to become involved as the dispute is usually of a contractual, rather than regulatory, nature.

At the same time, franchisors are having increasing difficulty in avoiding the necessity of audits where insufficient numbers of franchisees respond to requests to accept unaudited information. The franchisees' deemed acceptance cannot be imposed (despite the attempts of some franchisors).

Most franchisees accept that the provision of information does not give them any input into the way the funds are spent (unless this already part of the franchise system) and this results in low response rates to franchisors to avoid the cost of a fund audit.

There remain unresolved interpretational issues in this provision; any franchise stores operated by the franchisor do not appear to result in any rights to vote as part of the 75% (although some funds are conducted this way) and strictly speaking multiple stores owned by a single franchisee does not permit multiple votes under s17(2) of the Code.

The rights that could accrue to franchisees for the franchisor's breach of this provision should be explored as there may be practical consequences that can be applied (such as a prohibition on taking any funds for administrative costs or for the costs of an audit) rather than just imposing a penalty.

Financial details of franchisor

This subheading relates to 2008 Amendment *Consolidated entities*:

'*Where the franchisor is part of a consolidated entity...required to produce audited financial reports under the Corporations Act 2001 (Cth) for that consolidated entity, those reports must be provided to franchisees on request. In the case of foreign franchisors, the use of their local accounting standards and auditors is accepted.*'

The Discussion Paper also refers to other Code provisions regarding disclosure of franchisor's financial information, e.g. a signed statement that the franchisor will be able to pay its debts and an independent audit or financial reports in support of that statement.

Discussion:

The specific amendments to be discussed here are difficult to identify; any problems in this general area extend well beyond the 2008 revision to require the reports of consolidated entities to be made available.

Expressing confidence in the financial position of the franchisor – especially for a legal or financial adviser engaging in pre-purchase due diligence for a prospective franchisee - is practically impossible. Only a detailed review of an audited statement can provide any assurance of the financial position of the franchisor. This immediately raises problems with accessing source documents and genuinely confidential commercial information. Generally, therefore, the solvency statement has to be accepted at face value, if for no other reason than the prohibitive cost of establishing that the statement is incorrect.

Although of some comfort, providing financial information does not materially reduce the risk of incoming franchisees and does not assist existing franchisees in any way (as although theoretically some response can be planned it has to be assumed that the franchisor's financial position has been fully and accurately disclosed, reflects the current position and is not likely to materially change for the worse in the future).

In any event, the consequences for a breach of this disclosure are unclear and if this provision is to remain then clarification of the rights that might accrue to a franchisee from a failure to provide accurate information should be included.

There is also an interpretational problem with the requirement for franchisors that have not been trading for the minimum 2 years as set out in clause 20 of the Disclosure document. There is no provision to permit the disclosure of financial information over a shorter period; an audited statement appears to be the only alternative to comply with the Code requirement. Clarification is needed (if this provision is to remain as is) whether an audited statement must be provided for systems of less than 2 years duration or if disclosure of the available financial records is sufficient.

Lease arrangements (and site information)

This subheading relates to at least three distinct 2008 Amendments:

'*The details and history of the territory or site to be franchised must be provided together with the disclosure document...*'

'*Conditions that deal with obligations for a franchisee regarding site and premises selection and acquisition as well as maintenance and appearance of site and premises, vehicles and equipment within the franchise agreement will have to be noted.*'

'*The last known particulars of name(s) and contact details of each ex- franchisee must be disclosed, unless the ex-franchisee requests that it be withheld. Franchisors are not required to update this contact information nor keep it for more than three years.*'

Discussion:

Lease arrangements are a continuing source of dispute, not least because of conflicts between State leasing legislation and the Franchising Code, especially in the areas of the payment of costs, but also arising from the differing contractual powers of franchisors and lessors. Consistency with State retail leasing legislation should be sought so to minimise conflicts between the fundamental aspects of the Code and commercial leases e.g. the timing of notifications for renewal.

Clarifying the rights and obligations that a franchisor can impose upon a franchisee through the use of a lease (*e.g.* the Federal Court action by the ACCC against Suffolke Park Pty Ltd in 2005) must be addressed.

Franchisors' site selection policies almost universally default to diverting all risk to the franchisee so as to avoid potential liability, even though the franchisor is often the party best placed to make an informed decision about the adequacy of a site. At best we have seen franchisors refuse to grant a franchise at a particular site, but this is itself problematic as many franchisors (especially in small and medium size systems) have been advised by their solicitors to avoid having site selection policies which can be subsequently challenged by a franchisee. Without a formal policy in place there is reduced scope for challenge; even by making a decision about a site can give raise to later allegations of a representation (whether direct or implied) that the site was suitable for the franchised business Alternatively where the franchisor already leases or owns the relevant site, disclosure of the site selection policy is superfluous.

The difficulties attending disclosure of previous franchisees in the site or territory have not been fully

resolved by the amendments as most franchisors will only provide a 'bare' disclosure, at best. It can be difficult to establish whether further inquiries are needed, and if they are, the information given may be inadequate to effectively pursue them.

Often the cost of professional advisers contacting previous franchisees, even if they are contactable and willing to discuss their experience (which is not often given that the franchisor's records for former franchisees are quickly out of date and do not have to be maintained) prevents enquiries being made; prospective franchisees generally do not know what specific information to ask. An associated issue is that of confidentiality agreements; almost all of the past franchisees contacted by Mr Young in his practice are reluctant to discuss their former franchise for fear of incurring legal liability for breaching a 'confidentiality arrangement' with the franchisor (or action for defamation).

Finally, the consequences of a breach of this disclosure are not clear; this year Mr Young has been involved in a matter where the franchised territory had been the subject of 3 different locations under previous franchisee; all were subsequently found to have been unviable. Most significantly the franchisor responded to the franchisee's dispute notice that the issue was not 'materially relevant' to the franchisee's original decision to purchase the franchise and therefore no right exists for the franchisee to disclaim the franchise agreement or to seek damages. Unless the franchisee can establish otherwise this is an accurate statement of the current law.

Compliance with this amendment has been problematic and disclosure of the fact of a previous franchisee or site does not itself provide sufficient information, increasing the cost and complexity of subsequent enquiries. Information relating to past franchisees may be vital in assessing a franchise opportunity, however, and the Disclosure document should include more accessible disclosure of the recent history of the site (bringing together, even if duplicating, such disclosures as previous franchisees and their contact details, reason for departure and number of locations) but possibly including further information, such as whether dispute notices were sent or received or dispute resolution undertaken.

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

Response:

These amendments should be further refined to provide more accessible information allowing better risk assessment.

These issues lend support to calls for the registration of disclosure documents (as in some overseas jurisdictions) allowing comparison with previous versions of the disclosure information.

In general, the 2008 amendments provided better practical outcomes than the 2010 amendments, which appeared to be largely trying to appease vested interests rather than resolving systemic concerns. The 2010 amendments should be significantly reduced as they create an unnecessary burden on franchisors and do not sufficiently enhance the decision making processes of franchisees.

We observe that much of this information could, and should, be the subject of professional advice rather than disclosure, as it is the context and consequences arising from the information, rather than information *simpliciter*, that is critical here.

5. **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?**

Response:

This question relates to various 2008 and 2010 amendments:

2010 *Unilateral variation* Annexure 1, para 17A and Annexure 2, para 9A:

'*Franchisors to disclose the circumstances in which they have unilaterally varied a franchise agreement in the last three years as well as the circumstances in which the franchise agreement may be varied unilaterally by the franchisor in the future*'.

2010 *Transfer or novation*:

'*Franchisor must disclose whether it will amend or require the amendment of the franchise agreement on or before the transfer or novation of the franchise*'.

Related amendments regarding the end of the relationship include disclosure of:

- *Details of the arrangements that will apply to unsold stock, marketing material, equipment and other assets purchased when the franchise agreement was entered into – including whether the franchisor will purchase these assets and, if so, how prices will be determined*;
- *Whether the franchisee will have the right to sell the business at the end of the franchise agreement and, if so, whether the franchisor will have first right of refusal, and how market value will be determined*; and
- *Whether the franchisor will consider any significant capital expenditure by the franchisee during the franchise agreement in determining the arrangements to apply at the end of the franchise agreement.*

Discussion:

These disclosures have made no difference to franchisor conduct and it is concerning to think that this may have been an intended outcome. Highlighting information that was already contained in the franchise documents provides no incentive to a franchisor to modify its system or documentation.

There are many valid reasons why a franchisor might make unilateral changes to the franchise system – noting that this is not equivalent to changing the franchise agreement – as was recognised by the Expert Panel.

The repeating of franchise information in a Disclosure document does not create any extra rights for a prospective franchisee and the benefits are marginal where the franchisee is not being independently advised. As with most raw information, it is the context and consequences that need to be explained, not just the facts alone.

Some of the changes are yet to have practical application and as such the effectiveness of reporting unilateral changes made in the preceding 3 years is unknown i.e. the review is premature.

The consequence of these changes includes a number of franchisors removing the Operations Manual from the franchise documentation (so it no longer forms part of the 'franchise agreement') thereby removing it from the definition. We expect this trend to continue.

Another practical consideration relates to the poor drafting and murky interpretation of these provisions; disputes have arisen regarding the differences between a 'novation' and a 'transfer' (and whether a franchisee can insist upon a novation when selling the franchised business) and how a 'unilateral variation' is defined as it applies to 'renewal' or 'transferred' agreements (where a party is entering into the 'then current' version of the agreement).

In any event these clauses, particularly as they relate to transfers and novations, do not reflect the realities of day to day practice and considerable revision of these amendments should be undertaken if for no other reason than to fix drafting inconsistencies.

As we will discuss below we have serious concerns about the ability of franchisors to impose terms that create an option to purchase the franchisee's business at less than market value at the end of the term. Disclosure has not prevented such terms from being included in franchise agreements.

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

Response:

Disclosure cannot take the place of more specific substantive measures and as such we feel these changes are ill-conceived.

Where the relevant information is otherwise contained in the franchise agreement it needs to be identified and the subject of professional advice (the potential consequences are too high to allow disclosure alone to be an adequate preventative mechanism) or else regulation needs to be included in the Code to specifically prevent the offending behaviour.

There is an ongoing lack of understanding among franchisees regarding the fact that the grant of franchise is for a fixed term and is not indefinite. Further, any option to extend the franchise is not, strictly speaking, a renewal (and the term is misleading) but rather a 'first option' to continue the franchised business under the then current terms of the franchisor's system.

There are fundamental misconceptions on the part of both franchisees and franchisors. Franchisees assume that their long term contribution to the franchise system creates rights to continue using the franchisor's intellectual property whereas franchisors tend to act as if they have acquired rights to the franchisee's business. (Although in fact they may have where the franchise agreement provides that all goodwill in the business is the property of the franchisor. The language of these agreements do not exclude site or personal goodwill.) It is the clash of these erroneous positions that has driven much of the disputation about end of term arrangements.

The amendments do not alter the contractual positions of the parties and the errors of perception are best addressed by pre-purchase advice and education rather than attempting to re-write contracts to suit the needs of one party over another *ex post*.

More concerning is the increasing trend for franchisors to include options to purchase the franchisee's business at the end of the term; quite often the franchisor writes in very favourable terms for the purchase – payment for goodwill is excluded and plant & equipment is paid at market value (or even at depreciated value).

When coupled with the right to take any lease (if the franchisor does not hold a head lease already) and franchisee's restraints of trade there is a growing problem that many franchisees could be required to sell their businesses to their franchisor for nothing more than the value of stock, plant & equipment.

Disclosure alone cannot change this type of conduct as the terms of the franchisor's contract are at its own discretion. Only jurisdictions with 'unfair contract' regimes will have a mechanism able to address the problem unless changes are made to the Code (and we note that any introduction of 'good faith' is unlikely to deal with the problem after the event). Though there are unfair contract terms provisions in the *Competition and Consumer Act* (Cth 2010), these provisions do not apply to and are not appropriate to the franchise agreement context.

Compounding this problem is where change is introduced at 'renewal' and the franchisee has already invested in the business and is faced with the prospect of losing the franchise now or accepting the sale terms introduced by the franchisor to gain an extension. This type of conduct may be caught by the introduction of a 'good faith' requirement; however its effect would be, at the very least, arguable. Stricter regulation – as opposed to disclosure - of end of term arrangements

should be considered to prevent these issues arising.

In general terms the ability of a franchisor to choose not to extend the franchise should be recognised but limitations imposed upon the franchisor's subsequent purchase of the franchisee's business for less than market value (or else eliminating restraints of trade at the completion of the agreement).

Ambiguities and other problems with the definition of the term 'Unilateral changes' and 'Franchise agreement'

There are two challenges here; the first relates to which documents unilateral changes are relevant (i.e. what is the "franchise agreement") and secondly when does a 'unilateral change' occur?

As mentioned previously, franchisors are removing those parts of their system subject to regular change (such as operations manuals) from the franchise contracts so as to avoid having to list every change to the system in the Disclosure document. The effectiveness of this approach is as yet untested. Where operations manuals are often not provided to franchisees in any event (other changes to the Code resulted in franchisees being able to keep such commercially sensitive documents, driving operations manuals out of disclosure) having to list changes to a document that cannot be reviewed is nonsensical. We therefore submit that the definition of a 'franchise agreement' in clause 4 of the Code is not suited to its use in this context and a better definition of the scope of documents to which this disclosure applies is required.

With respect to 'unilateral change' the common, although not unchallenged, view is that only changes made by the franchisor to an 'in-term' franchise agreement are relevant, rather than changes in which the franchisee has discretion. In practice this has led to confusion whether changes to the franchise agreement in the process of 'renewal' or 'transfer' are caught by the disclosure provision.

It is argued that the changes are not unilateral unless the agreement is being novated (in the strict, legal sense contemplated by the Code) rather than where the parties have the ability to negotiate terms or else refuse to accept the agreement. It should be noted that franchise agreements are hardly ever 'novated' in accordance with the Code definition as changes are often made between versions of the franchise agreement.

As any change takes the agreement out of 'novation' and into a 'transfer' the changes can be argued not to be unilateral as they are not being made to an *ongoing* franchise agreement; the changes were not unilaterally made by the franchisor as the new version is technically subject to negotiation or even refusal.

A better definition of unilateral change (or else some explanatory memoranda) is required.

Where practical – although it is not always – a marked up version of the new agreement showing the changes made to the previous version of agreement is preferable to a separate list in the Disclosure document. An amendment to allow this approach should be included.

Finally we are concerned that interpretational issues such as these, where there are genuine differences of interpretation, will result in poor outcomes for parties should penalties be introduced for breaches of the Code.

The ACCC has a less than enviable track record in dealing with commercial practicalities of the Code and introducing penalties may well result in parties having to adopt the ACCC's interpretations regardless of how impractical, uncommercial or unique the ACCC's position might be.

7. 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?

Response:

No. The changes to the Code responding to various concerns raised in previous inquiries again overstated the value of disclosure rather than adopting effective regulation (or else leaving the matter in the hands of franchisees to investigate prior to entering into the franchise contract). In most instances the complaints giving rise to these changes were the result of poor pre-purchase enquiries by the prospective franchisee or the failure to obtain independent legal advice.

Mr Young in particular has dealt with numerous franchise complaints where the issue about the franchisor's conduct is no more than a consequence of the franchisee not understanding their position at law – and having chosen not to obtain legal advice before signing the agreement.

These changes are ineffectual and simply highlight why the disclosure of facts alone cannot replace proper advice. The change relating to 'good faith' is particularly objectionable; it is out of place in a regulatory Code and adds nothing to the conduct of a franchise. This small provision has done more to the drive the push for State based franchising laws than any other single factor; it was perceived as nothing more than a token attempt to placate 'good faith' advocates and rightly or wrongly as confirmation that the Federal Government was not taking the issue seriously.

8. **Is the information being provided useful to franchisees?**

Response:

It is difficult to measure the usefulness of this information as it depends upon each unique situation. Generally, repeating what is already contained in the franchise document is unhelpful whereas extra information may be useful if the circumstances are relevant.

In isolation the changes do nothing more than complicate disclosure and make it difficult for a franchisee to assimilate all of the information being provided, much less discern what is important to their circumstances. This information may be useful to franchisee's advisers but generally not to franchisees themselves.

9. **What effect has the requirement to provide this additional information had on franchisors?**

Response:

We feel that the extent of disclosure in Australia has become so detailed as to have become more of a burden than a benefit, not only to franchisors, but also to franchisees.

A detailed review of the Disclosure documentation might now be opportune to reduce the extent of the information required in the Disclosure document and return some control of the due diligence process back into the hands of the franchisee. (For more on discretion, self-regulation and regulatory responsibility see Julia Black, (2001) Managing Discretion, ARLC Conference Papers Penalties: Policy, Principles and Practice in Government Regulation, London School of Economics Law Department and Centre for the Analysis of Risk and Regulation.)

The only change that has generated confusion is that of disclosing 'materially relevant facts'; the examples are quite specific and give a misleading impression about the 'limited' nature of disclosure required, whereas in fact the disclosure is wide and open ended.

The problem for franchisors has been one of subjectivity – some information will be universally

relevant to their franchise system but in many instances information has been withheld as it was not considered materially relevant to franchisees.

Franchisees often consider *any* information to be materially relevant, especially if they are in the early stages of business distress or are in dispute with the franchisor.

Once again the consequences for not complying with the disclosure are obscure and it would seem that the best answer is that the nature of the non-disclosure and its relevant importance to a franchisee (subjectively) will dictate whether any rights accrue.

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

Response:

The information is generally not onerous for franchisors to disclose however the benefit to franchisees is marginal at best. On balance these disclosures are not critical and should be reviewed with a view to streamlining their use. Clause 23A should be removed altogether.

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

Response:
This question relates to 2010 Amendment deleting the exemption from the Code formerly enjoyed by foreign franchisors.

Discussion:

The amendment might provide greater protection for master franchisees of foreign franchisors, but this group is, as a rule, better resourced, more commercially experienced and less vulnerable than most franchisees in the sector.

The incidence of foreign franchisors taking 'unfair advantage' of franchisees was never high and the problems appeared to be more related to the 'naturalisation' of the franchise concept to the Australian market (or misunderstanding the Australian market) rather than an unscrupulous targeting of unsophisticated business operators.

Detailed investigation of foreign concepts and proposals prior to investment will identify the level of risk sufficient for a franchisee to make an informed decision; onerous conditions on an entire class of franchisor should not be imposed because proper due diligence was not conducted by a few (or alternatively, where the risk was known and accepted however the concept did not work).

12. Has the removal of the exemption caused any issues?

Response:

The exemption should be re-considered and redefined to better meet the intended outcome.

Anecdotally a number of overseas franchisors have decided that Australian regulation was 'too hard' to meet for just one distributor and chose not to bring their business on shore; at least one of these businesses (involving carbon credit) was significant in dollar terms.

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

Response:

No, but the issue here is not a lack of information. In terms of recent amendments, we believe that there has been an unwarranted focus on disclosure in regulating franchising. More information does not necessarily equal better outcomes.

Adopting increasingly more specific disclosure requirements for expenditure and other payments to improve the outcomes for franchisees has been unsuccessful.

This is not surprising to experienced advisers who have observed that the trend toward disclosure away from franchisee due diligence has had the effect of reducing the investigations made by franchisees prior to purchase, rather than enhancing their bargaining power.

There is scope to reduce the level of raw information contained within the disclosure material and return many areas to franchisees and their professional advisers. A significant amount of the changes required by recent amendments are not strictly matters of disclosure and are more readily addressed in the context of professional advice.

It is time to reconsider the entire issue of disclosure (including franchisor liability in disclosure) at a fundamental level. Better outcomes would be achieved if the franchisor were able to engage with franchisees to provide relevant information without the prospect of liability for misrepresentation (aside from careless or negligent involvement).

The terms of the CCA are not geared towards 'relational' business models such as franchising where the interests both parties are intertwined (though often not aligned). The adversarial considerations of the current system mean that franchisors are necessarily, but unreasonably, restrained from assisting franchisees in whose success they otherwise have a vested interest.

It is our view that franchisors should be able to collaborate in the creation of franchisee business plans without being assumed to be making representations about the viability of the franchise unit.

A 'safe haven' environment should be created for franchisors that allows for relevant factual, consolidated or benchmarked information (that complies with a certain form or standard) to be provided to franchisees without the risk of subsequent liability.

'New' or 'unsophisticated' franchisees should be required to obtain independent legal and financial advice, rather than having the ability to opt out. Too many of the disputes we have seen (and these total hundreds) arise out of circumstances that could, and usually would, have been avoided had advice been obtained.

If a compulsory advice regime is implemented then similarly a standard advice protocol should be adopted by the relevant professions to ensure that consideration is being given to the areas most relevant to the circumstances of each franchisee.

Being provided with 'adequate information' is not as important as being able to understand the nature and effect of the information and this is the critical failure of many of the recent Code amendments.

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

Response:

This is debatable having regard to the intended outcomes; however the onus upon franchisors to provide adequate information is always justified.

We repeat our concerns that the 2010 amendments may actually have had the effect of reducing transparency rather than enhancing the franchisee's decision-making process.

Balancing adequate financial disclosure for the prospective franchisee (on the one hand) and the franchisor's liability for making representations has now become so unwieldy that the system is becoming unworkable in practice.

Franchisors increasingly view many items of disclosure as necessary to avoid liability, rather than to provide meaningful information to franchisees. Yet at the same time franchisees' decision making processes have not been significantly enhanced.

Dr Spencer discussed the over-emphasis on disclosure in Australian regulation in her 2009 submission, prior to the adoption of these amendments, and in our opinion disclosure has now been over-utilised in regulation of the franchise sector.

Twenty-one of 29 countries (and 43 of 53 jurisdictions) that have franchise-specific legislation rely heavily on disclosure as the principal regulatory tool. The number of items required to be disclosed varies widely. Some jurisdictions require no specified content but rather provide a general requirement of 'all material information' or 'all information a franchisee needs to make a decision.' Others set out a detailed list.

While some believe that Australia has lead the way globally in its emphasis on disclosure in franchising, Canada has required disclosure by franchisors to franchisees since 1972; the US, at the state level since 1972 and the federal level since 1979; France since 1989; Mexico since 1991; Brazil since 1994; and so on.

Australia has perhaps distinguishes itself in that its specific content requirement is arguably the most comprehensive and detailed in the world.

This does not mean, however, that all information that a franchisee needs is currently required to be disclosed, and it does suggest that increasing the content requirements for disclosure in Australia is probably not a solution to persistent problems.

Instead, as a general proposition, we recommend that there is a need to enhance and supplement the operation of disclosure, rather than to add more items of information to be disclosed.

At this point in the development of the Australian regulatory system emphasis needs to shift away from disclosure; changes to the disclosure regime are increasingly irrelevant to the endemic problems they seek to address. In particular the area of dispute resolution needs to be urgently addressed. One of the key recommendations of the 2006 Review of the Code of Conduct not agreed to by government was to urge a full report on mediation.[3]

Part Three: Good faith in franchising

15. 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?

Response:

[3] See Department of Industry, Tourism and Resources for links to report: http://www.innovation.gov.au/SmallBusiness/CodesOfConduct/Documents/FranchisingCodeReviewReport2006.pdf

In a very real way the amendments missed the target however this may be as a result of the amendments intending the 'least harm' instead of the 'most good'.

Put another way, the amendments were addressing symptoms, not diseases, and could never have resulted in changes of conduct where those changes are most required.

This is not to say that an overarching obligation to act in good faith would have delivered better outcomes; in our view both approaches fail to properly engage the causes of the problems and both approaches are ill-suited to the reforms needed in the sector.

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?**

Response:

Entirely ineffective and bordering on patronising. Perhaps its effectiveness can be best assessed in light of the immediate increase in the push for State based franchising laws after its introduction.

Our concern is not with a Code non-limitation of a common law obligation of good faith, but rather with the contractual consequences of such an obligation.

It is an obligation that offers little comfort to the less powerful party in most commercial contracts in Australia and we do not expect the development of this principle will materially benefit disaffected franchisees (in particular) in the near term.

We note in passing that the phrasing of this question in fact misrepresents the effect of s.23A.

There is no requirement in the Code to act in good faith; no common law limitation can apply to an obligation that does not exist. More correctly s23A provides that nothing in the Code prevents a requirement of good faith from applying to a franchise at common law – an important distinction.

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?**

Response:

This is entirely dependent upon the specific issue in question; many of the ongoing problems in the sector will not be remedied by good faith in isolation (any more than 'improving' disclosure solved the issues).

The better question is whether 'good faith' will improve the power imbalance between franchisors and franchisees at the time of entering into the contract and in the event of a dispute.

We think any advantage to franchisees by enshrining good faith in the Code is far from assured and that efforts should be focused on other, more specific, remedies.

It is not clear that the current standard of conduct - unconscionability - is deficient in a franchising context. What is clear is that there have been very few opportunities to bring allegations before the Courts for determination. This may be a failure of access to justice but is not necessarily a failure of the standard.

We are concerned that a lowering of the threshold of conduct to that of 'good faith' will not result in any real benefit to the franchise sector as a whole. In particular, the expectation that the introduction of good faith will make franchisors more accountable is heavily reliant upon the assumption that franchisees will be able to access a forum (i.e. Court) to have their grievances heard.

It is well recognised that such access is beyond the majority of franchisees (and not a few franchisors). How will changing the standard of conduct – which will extend the boundaries of dispute - result in an increased rate of dispute resolution?

Conversely there has been a growing realisation within franchisor (and franchisor advocate) ranks that a standard of good faith that applies to all parties equally will provide franchisors with an actionable response, in some instances for the first time, to franchisee conduct that directly or indirectly damages the franchise system and operations.

Some of the first salvos fired in a 'good faith' environment will be by franchisors seeking to reign in the excesses of disruptive franchisees (Mr Young has franchisor clients making initial preparations for such action in the expectation of good faith being introduced).

Unfortunately the effectiveness of 'good faith' at a practical level will be, as it is now with 'unconscionability', dependent upon the resources available to a party to pursue the matter.

Although we are not opposed to the introduction of a 'good faith' standard *per se* we consider that one of the most likely outcomes of a 'stand-alone' introduction of good faith is that, after the inevitable initial disruption, the *status quo* will remain entrenched.

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

Response:

Good faith has not been embraced by the courts or the legislatures of Australia. Whilst good faith is a part of broad contract and commercial codes in jurisdictions such as the United States and Germany, it is not part of the legal traditions of the UK or Australia.

The duty of good faith was not incorporated into the Trade Practices Act 1974, nor does it exist as a discrete requirement in its successor legislation, the Australian Competition and Consumer Act 2010.

In its place we have provisions proscribing unconscionable conduct, of which one relevant aspect is the extent to which parties conduct themselves in good faith.

Unconscionability has been - just like good faith will be - incapable of precise definition and it is not desirable to attempt a comprehensive definition for risk of creating anomaly and 'exceptions to the rule'.

We do not believe that the standards of good faith or unconscionable conduct are relevant to most of the problems faced by franchisees in their contractual relationship with franchisors.

Neither standard provides, for example, a meaningful solution to the disputes over end of term arrangements as it only changes the context in which the conduct of the parties is viewed. It will still be acting in 'good faith' for a franchisor to decline to extend a franchise term indefinitely after its natural conclusion.

Should a good faith obligation be included in the Code it would be preferable not to define the term exhaustively; any attempt to do so will result in exceptions and unsatisfactory outcomes in unusual

situations.

Such concepts have been traditionally left to the Courts to define scope and context and there is no need to adopt any different approach to good faith.

On balance we do not recommend the inclusion of a general duty of good faith in the Franchising Code of Conduct however if introduced, it should not be defined in any limiting way.

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?**

Response:

If good faith is to be applied, it should apply to all parties to the franchise in every aspect of their dealing with each other.

Although we can see problems as this may relate to third parties such as suppliers or licensors of the franchise IP (as well as external administrators) it is not practical or desirable to create categories of people who are bound or not bound by the standard.

We already consider the benefit of good faith to be limited; we cannot see any advantage in limiting the parties conduct to a standard of good faith in only parts of their dealings. Surely such a proposal ignores the basic truth that franchising is, by its nature, a relational transaction? And if this is so, how can a party be released from acting in good faith in some parts of that relationship but not others?

What should also be borne in mind is that an obligation to act in 'good faith' is not the equivalent of putting another's business interests ahead of your own. 'Good faith' will not result in a franchising utopia where disputes cease and everyone works together to solve problems.

Even under a good faith standard it will be acceptable for a franchisor or franchisee to make decisions based upon their own needs and preferred outcomes, even at the expense of the other party, as long as they can be justified by reference to their circumstances; in other words whether a party acts in 'good faith' will be subjective as well as objective.

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?**

Response:

As the circumstances of each breach should be relevant to any consequence it is necessary that consequences are not mandated or inflexibly applied. The appropriate remedy should be specific to the injury or loss caused, which ultimately requires an independent determination.

For example a franchisor who is found to have not acted in 'good faith' by requiring the purchase of one specific product at an inflated price (out of a number of products sold as part of the system) should not risk having the franchisee terminate the agreement.

Similarly a franchisee should not have their franchise terminated (and potentially have to pay contractual damages) because they sold a non-approved product or criticised the franchisor.

It is interesting to note that many of the disputes cited as justification for introducing good faith

seek remedies that are not within the usual scope of orders made by Courts in commercial cases in any event.

Courts have consistently commented that their ability to resolve franchising disputes is limited by the nature of relief that is available; judgements tend to finalise commercial relationships rather than preserve, or even enhance, the outcomes for the parties.

It may be that to find the necessary balance for the remedies available under a good faith regime we need to look at other jurisdictions that have a focus on resolving relational disputes.

In Australia there are elements of the Family Court and State commercial tribunals that might provide the types of mechanisms and tools that will complement the introduction of good faith.

In a real way the method used to determine the consequence of any breach is just as important as the consequence itself.

However good faith will be of little practical benefit if parties cannot access a forum to seek redress.

A 'one size fits all' consequence – or even a range of fixed consequences - cannot work as good faith itself is a variable concept and flexibility will be required to find the correct balance between consequence and ongoing relationship.

We note that the current dispute resolution system does not cope well with these concepts as it is and we only expect these problems to be compounded if good faith is introduced without commensurate improvements to dispute resolution both under the Code and in the Courts.

21. 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?

Response:

As the Franchising Code is a mandatory industry Code there should be little difference if good faith is introduced; a change to the Code should not automatically require a change to the ACL (indeed, this is part of the rationale of having Codes in the first instance so to avoid changing the ACL with every change to industry specific needs).

A breach of the Code would therefore still give rise to rights under the ACL relating to a breach of an applicable industry Code. However, the weakness in the present system is the lack of certainty of the rights that accrue for a breach of the Code, particularly minor or 'regulatory' breaches (*e.g. Ketchell's* case) and the lack of ability to access the Court system to enforce these rights.

The remedies available under the ACL for a breach of a Code should be sufficient as they presently exist, provided that the aggrieved party can afford to go to Court. Rather than change the ACL, attention should be given to providing better access to the available remedies and then later determine whether the remedies meet the needs of a good faith regime.

We do not endorse further changes to the ACL at the present time however a further review of the rights and remedies under the ACL will be required within a reasonable time of any introduction of good faith into the Code.

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?**

Response:

Yes, although the full extent of consequential amendment will require careful consideration. For example, *Section 3: Definitions* of the Code alone will need consideration of the consequences of a good faith requirement in the following defined terms:

Associate;
Franchise;
Franchisor (especially (b));
Franchisee (especially (b)); and
Interest in a franchise.

It is not so much that these provisions *must* change however thought needs to be given, from a policy perspective, as to how good faith will impact the wide range of parties (and potential obligations) contemplated by the current definitions. For example, is it an intended policy outcome that an Associate of a franchisor (who might hold the intellectual property of the system or the lease of premises) must also act in good faith towards a franchisee, even if there is no direct contractual link between them?

Another question is whether a lessor will also be required to act in good faith where the premises are being leased to a franchised business - and would such obligation extend to the franchisor where the franchisee only holds the lease (and vice versa)?

Any provision of the Code that imposes a positive obligation upon a party should be reviewed as to the potential effect of a good faith requirement; this will be extensive and practical input should be sought from experienced franchisor and franchisee advisers so as to avoid the problems that arose from some of the 2010 amendments.

Some sections of the Code, such as the creation and maintenance of a Disclosure document, may not require amendment however certain *elements* of Disclosure will undoubtedly be the focus of good faith disputes, especially those disclosures that relate to financial matters or 'reasonable foreseeability'.

In addressing the threshold question of whether good faith should be introduced at all it is only relevant to note that substantial work will be required to 're-tune' the Code, rather than trying to work out exactly what amendments might be required before the exact nature and intent of the good faith term is known.

Part Four: End of term arrangements for franchise agreements

23. **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?**

Response:

This question relates to 2010 amendments to the effect that:

Franchisors be required to disclose details of the arrangements that will apply at the end of the

franchise agreement, including:

- Whether the franchisee will have any options to renew, extend or extend the scope of the franchise agreement and, if so, the process the franchisors will use to determine whether to renew, extend or extend the scope of the agreement or enter into a new agreement;

- Whether the franchisee will be entitled to an exit payment at the end of the franchise agreement and, if so, how the exit payment will be determined or earned;

- Details of the arrangements that will apply to unsold stock, marketing material, equipment and other assets purchased when the franchise agreement was entered into – including whether the franchisor will purchase these assets and, if so, how prices will be determined;

- Whether the franchisee will have the right to sell the business at the end of the franchise agreement and, if so, whether the franchisor will have first right of refusal, and how market value will be determined; and

- Whether the franchisor will consider any significant capital expenditure by the franchisee during the franchise agreement in determining the arrangements to apply at the end of the franchise agreement.

Discussion:

This range of problems cannot be solved through disclosure alone. Inappropriate conduct has not abated since these changes were introduced. Franchisor behaviour has not been affected because the amendments did not define the acceptable contractual behaviour as it relates to end of term arrangements.

Mandatory contract terms legislation will not provide the complete answer as it is too limiting on a sector that is noted and celebrated for its diversity. It is impossible to determine, on behalf of the parties, what a 'fair' arrangement will be in each unique set of circumstances however it is possible to identify types of conduct that are not acceptable.

At best all legislation should do is restrict the most egregious forms of conduct but otherwise simply protect the legal framework to ensure that both parties are fully informed of and have the capacity to protect their rights with respect to this issue.

Education and advice are vitally important in this area and more responsibility needs to be returned to franchisees to fully investigate and understand their end of term obligations before they enter into the franchise agreement.

Simply paraphrasing the franchise agreement terms is insufficient; firstly there are subtleties and context that are stripped away and secondly it gives unsophisticated operators the erroneous impression that they have a full understanding of the issue without needing independent advice.

We expect that the requirement to provide prior notification of a decision not to renew a franchise will create an entirely new area of dispute through challenging the franchisor's reasons for the decision.

Currently it is good law to say that a franchisor has no obligation to extend the term of a franchise where no valid right to extend the agreement exists – the best example being at the natural conclusion of the franchise term (the Yum Brands/Competitive Foods Australia dispute over KFC outlets in Western Australia, *cause celebre* of the 2008 review and the reason for the

focus on good faith and end of term arrangements in that review).

However under the 2010 amendment is the franchisor's reason not to extend on the sole basis of expiry of the term of the agreement a sufficient discharge of the obligation? There is concern among franchising solicitors that unless the franchisor takes into account the circumstances of the franchisee there may be a basis to challenge the decision. It is easy to see why the introduction of good faith makes advisers even more uneasy on this issue.

There are consequential problems with the timing of the franchisor's notice when all of the relevant information may not be known. Leases often include strict notice requirements for renewal which do not correspond with the Code's timing.

There is no apparent provision for conditional approvals or refusals to be given by franchisors. This is relevant to the issues of leases and other external factors but can also apply to franchise agreements which make an extension conditional upon other factors such as continuing compliance with the system and – most relevantly – entering into the then current version of the franchise agreement (which may be in substantially different terms).

For a change in behaviour there needs to be regulation preventing opportunistic or predatory conduct. The types of outcomes that are undesirable should be proscribed (such as franchisors building in the ability to purchase the franchisee's business at less than market value). By the same token we do not support in any way a franchisee's insistence on a 'rolling' or indefinite renewal of the franchise where the franchisor did not intend to grant such a right.

The complaints that continue to accrue in this area demonstrate that leaving franchisees to negotiate end of term outcomes years before the event is not working. Stronger and more precise regulation of end of term arrangements is necessary to address the problem.

Part Five: Dispute resolution in franchising

24. 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?

Response:

This question relates to 2010 Amendment Subclause 29(8) *Behaviour in dispute resolution*: '*A party will be taken to be trying to resolve a dispute if they approach the resolution ofthe dispute in a reconciliatory manner. Behaviours that will be taken to indicate a reconciliatory manner are set out in the Franchising Code.*'

Discussion:

At best there has been a marginal improvement in the mediation process as a result of this amendment; however again we do not believe that the amendment addressed the problems underlying the numerous complaints regarding mediation.

Certainly some franchisors were considered to be serial offenders when dealing with individual disputes by not participating genuinely in mediation. There has been some observable change in their conduct in and before mediation however no change in outcome has resulted.

Participating at mediation in a 'reconciliatory manner' does not mean that a compromise or settlement is any more likely (despite the intention of the change) and we consider this is

because there has been no change in the inherent power imbalance between the parties.

We add that the issue is not confined to franchisors by any means; franchisees also engage in conduct that is intended to frustrate the resolution of a dispute.

Any genuine mediation does not require such a provision as the parties are already acting in accordance with the spirit of this change; parties who do not wish to engage in mediation are not going to be any more tractable just because there is a (slightly) clearer consequence for not participating in 'compulsory mediation'.

Rather than tinker with the rules of mediation there needs to be a re-examination of the role and expectation of mediation as the primary dispute resolution mechanism before litigation is commenced. The use of mediation requires proper processes be observed and fairness assured for all parties at each stage of the process:

1) **Preparation:** The Code process does not address preparation for mediation. Though mediators may charge three hours of preparation time, this does not ensure that franchisor or the franchisee themselves (or even the mediator in complex disputes) are adequately prepared for mediation.

2) **Advice and guidance in the process**:
It is not always clear to the parties involved in a dispute which of the organizations that are involved in franchising, such as the ACCC, the OFMA or the FCA, can help them, and, if so, how. This problem is most significant for franchisees because franchisees in Australia do not have the benefit any association or industry group to represent their interests.

3) **Monitoring of outcomes and transparency**: The Code does not make provision for monitoring mediation outcomes. The monitoring function is closely linked with the issue of transparency. Mediation does not offer precedent as litigation can, to send a message to or guide others who may be involved in similar conflicts. This is historically a concern with any private or confidential form of dispute resolution. Conflict is rarely without implications that extend beyond the parties. The privacy that may be valued by one or both of the parties to a dispute may come at a cost to other franchisors or franchisees, the industry and/or the community as a whole. This is a tension that has always faced dispute resolution procedures outside the court system. It is a tension worth exploring deliberately and carefully in terms of its implications for franchising in Australia. There are ways that de-identified information and reliable statistics about how disputes are resolved through mediation could be obtained without compromising unduly the confidentiality of the parties. This information would be extremely useful to the industry.

4) **Procedures where mediation fails**: While the option of litigation is left open under the Code process, procedures are not specifically outlined for cases where mediation fails.

We are concerned, as experienced franchising mediators, that too much is expected of mediation as a one size fits all solution and that the gap between consensual resolution and all out Court warfare is too large.

25. Does the sector have concerns regarding the operation of the amendments?

Response:

Of all of the recommendations and observations of the previous inquiries, the most glaring

omission in subsequent policy has been in the field of dispute resolution. It has been consistently recognised by the various inquiries, Courts and industry advocates that the present dispute resolution process does not deliver an effective outcome for many participants.

Many of the 2008 amendments, and most of the 2010 amendments (including those not considered in this Discussion Paper), **would not have been necessary** if improving the dispute resolution process had been addressed as a priority.

Improving the ability of (particularly but not only) franchisees to access a timely and affordable forum to have their disputes resolved is the single biggest improvement that can be made to the franchising sector.

Mediation should continue to be a cornerstone of dispute resolution in franchising. What we have learned however is that it is not sufficient by itself; it is only a tool, not the tool box. The inherent power imbalance between the parties in dispute (be it contractual or financial) militates against genuine compromise being reached through mediation alone.

It is perfectly proper for a party to maintain its position under a franchise contract and it is not reasonable to expect that a party in a position of strength will willingly compromise its advantage unless compelled to do so. However compelling 'genuine, reconciliatory participation' in mediation is a contradiction in terms; for mediation to be genuinely successful (and successful in the long term) participation must be genuine and consensual. But no law can enforce a state of mind.

The efforts of mediators (be they OFMA referrals or private sessions) should not be underestimated, yet the statistics confirm that the vast majority of franchising disputes remain unresolved – 23% of OFMA enquiries resulted in mediation of which 58% were settled (which is markedly lower than the 75% success rate published by the OFMA in previous statistics). This represents an overall resolution rate (assuming each OFMA enquiry represented a dispute) of under 18%.

It is the authors' direct experience that many (many, many) disputes do not result in an enquiry to OFMA, much less lead to even consideration of the appointment of a mediator. The role of the OFMA is stated by the office itself to be limited to assistance in the appointment of a mediator.

The reasons for disputes not progressing to mediation are numerous; however, lack of financial resources, uncertainty of outcome and fear of the franchisor's reprisal (the ramifications of continuing the dispute are often clearly expressed) are the most common reasons why franchisees fail in practice to proceed to mediation. Even when having a solid argument to present (and perhaps even more so) the imbalance of power in the relationship and in mediation means that franchisees are often cowed into not proceeding.

The use or not of mediation leaves open the possibility of litigation, but the advice of solicitors does not encourage disputes to be taken to litigation as it usually (and correctly):
(a) confirms the weakness in the franchisee's contractual position;
(b) anticipates that significant costs are possible, if not likely (including the prospect of adverse costs orders if unsuccessful); and
(c) cannot offer any guarantee of a favourable result.
Even if fully successful, a party faces the prospect of not recovering anything like the funds expended in pursuing the dispute through litigation.

A restriction upon awarding of costs is necessary to help prevent the threat of expensive litigation being used as leverage against a vulnerable participant; even better would be a forum where the parties were not required to use (but were not prevented from engaging) legal

representation in the first instance.

The parties to disputes in franchising need to be able to participate in dispute resolution processes other than mediation without lawyers representing their interests. This requires a reduction in the level of formality and relaxing the strict rules of evidence so that an unrepresented party can express their position without being constrained by formal rules of pleading or of evidence.

A presumption that each party would pay their own costs is consistent with other 'relational' Court models (although the discretion to award costs is valuable and should be retained so as to deter frivolous disputes).

Ideally such a jurisdiction would respond to complaints, provide managed and enhanced dispute resolution services but also hold the authority to resolve disputes in a binding way if the parties cannot reach an agreement. To address the actual deficiencies in the current system that relies principally on mediation and litigation, both fraught with risks for franchisees, a further level of enhanced dispute resolution needs to be introduced which retains an emphasis on mediation in the first instance (and where appropriate) but adds opportunity to have the dispute independently managed which assists the parties to resolve the dispute before Court action is undertaken. This is similar in concept to the case management systems increasingly adopted by Courts in commercial disputes but also has similarities to the functions of tribunals where alternative dispute resolution is exhausted before a determination is rendered. The ability to compel attendance and participation in such alternative methods of dispute management is necessary to overcome the resistance still shown by some parties in fully engaging in dispute resolution processes.

The tribunal model is a worthwhile starting point for this type of forum as it is less complex than Courts (not being bound by the strict rules of evidence), allows the parties to express their position in the own words, is generally 'lawyer free' and presumes that each party will pay their own costs. Tribunals also emphasise the preference for the parties to reach their own solutions and offer 'managed' or 'enhanced' dispute resolution services often involving the final decision maker, who then has a comprehensive knowledge of the parties' respective position and concerns. Most States now have a tribunal system that could be adapted to include franchise disputes of low to moderate complexity. There will always be the need for Courts to deal with more serious issues; however, many of the disputes that were identified in previous inquiries would have been resolved using a system along the lines set out above.

Alternatively a modification to rules of the Federal Magistrates Court could be considered to create a 'franchise division' with similar considerations to those expressed herein however we are conscious that the current workload of the FMC, as well as the nature of many 'day to day' franchise disputes, suggests that a different forum would be preferable.

This present review is an opportunity to confront the urgent needs of the sector and to recommend solutions for the well documented shortcomings of the dispute resolution system.

Part Six: Enforcement of the Franchising Code

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

Response:

There are two main factors to consider in the current enforcement framework; the first is the

ongoing misunderstanding of the role of the ACCC (particularly when dealing with complaints) and second is the lack of resources available to the ACCC.

We observe that the ACCC is often used as a 'complaints ombudsman' where (usually) a franchisee has no other options to pursue apart from expensive and uncertain litigation. This is not the ACCC's role, however, as the industry watchdog it is expected to deal with all dissatisfaction experienced by franchise participants where no other remedy has availed.

An overhaul of the dispute resolution system will significantly reduce the amount of regulatory 'noise' currently suffered by the ACCC. As an aside, we respond to the submissions previously made to State and Federal inquiries that the ACCC 'lacked teeth' by noting that much of the conduct complained of was not, strictly speaking, regulatory but contractual. We again refer to the need for better dispute resolution processes which will largely obviate the need for ACCC involvement in contractual disputes.

To say that the ACCC is underfunded in franchising is trite, but should not be forgotten. Further reductions in the ACCC's franchise division in 2012 (as a result of Federal budget tightening) have not improved confidence in the ACCC's ability to investigate and respond to issues. Extra funding for education would be welcome; the ACCC has provided good information in the past but much is now dated or does not reflect current industry need. The exponential advances in technology in recent years allow for exciting possibilities in a broader education delivery program more representative of the wide range of interests and viewpoints of various stakeholders in the sector, and we recommend that education delivery not be unduly informed or pre-empted by one interest group of the sector with its own particular viewpoints.

The recommendation to introduce penalties for Code breaches, while worthy of consideration, carries with it a significant burden of evaluating the potential impact upon the sector. The required conduct for the ACCC to use such power should also be closely examined. Some conduct no doubt warrants a civil, or even criminal, penalty. Our concern is that many minor infringements might attract penalty when this is not a proportionate or appropriate response to the conduct. We are also conscious that in areas of 'grey' interpretation – novation and transfer at the top of the list – then there is an unacceptable risk that a perfectly normal commercial transaction will technically be in breach of the Code, leading to the risk of penalty or even jeopardising the transaction.

It is not good public policy to allow the ACCC, in enforcing penalties, to 'pick and choose' what conduct is worthy of sanction and what can be dealt with by other means (such as undertakings). The ACCC's lack of commercial experience in interpreting of some of the recent changes gives us concern that should the ACCC come to dominate the interpretation of the Code (so parties avoid penalty) then some very unsuitable outcomes would result. The lack of success of the ACCC's interpretations in Court generally demonstrates the potential difficulty in allowing it to be judge and executioner.

The ACCC is already under-resourced to conduct its present functions. Adding a further level of bureaucracy, formality and the inevitable administrative reviews of penalty decisions will only tie up resources that are needed elsewhere.

The reasons for not including penalties in previous amendments to the Code are still valid; we do not believe that any changes have occurred in the sector that are sufficient to displace the current regime.

27. How can compliance with the Franchising Code be improved?

Response:

We take the position, which is supported by the published results of ACCC random audits, that compliance with the Code has not been demonstrated to be a significant problem. Rather it is our view that shortcomings in the Code have created the issues that remain unresolved.

However, in general terms, awareness of Code obligations (and why these obligations are imposed) can be improved through increased education together with a greater emphasis on the need for independent advice prior to the entry into the sector of unsophisticated or inexperienced participants.

Granting parties a better dispute resolution forum – narrowing the power imbalance in disputes - allows greater accountability between the parties thereby increasing Code compliance without regulatory intervention.

Finally, allowing the ACCC to issue private rulings in relation to uncertain interpretations of the Code (similar to private rulings from the ATO) will assist parties until such time as Court or legislative intervention resolves the matter, and will also be useful to highlight those areas requiring attention in the future.

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

Response:

None. Enforcement should be secondary to the ability of the parties to resolve their own disputes.

What is required is greater clarity of the circumstances and use of the enforcement options already available to parties, particularly in relation to relatively minor breaches of the Code. Business needs simple and clear regulations and this has not been delivered by many of the recent Code amendments:

'Unfortunately, regulations appear to be becoming ever more complex. An important challenge for policy makers ... is to regulate more sparingly, transparently, simply, and appropriately, generating desired social benefits while minimizing the burden on the businesses that generate the income and tax revenue on which governments depend.' [4] This sounds simple, but the simple, elegant solutions are often the hardest to put into practice. In this case, the difficulty arises because the simple solution requires a change in the fundamental approach to the regulatory process, i.e., to identify the stakeholders, seek out information, identify the harms and strengths of various proposals, and include *all* of the important stakeholders throughout the regulatory process.[5]

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

Response:

[4] Simon C. Parker, Comparative Labor Law and Policy Journal, Vol. 28:695

[5] See Malcolm Sparrow (2000), *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance*, Washington, D.C.; Brookings Institution Press.

While avoiding the problem in the first instance is obviously the best solution, achieved through better education and information at the pre-contract stage, not all Code breaches can be avoided. Unfortunately, it is a common perception that breaches of the Code, as well as other adverse conduct, generally goes unpunished in franchising matters. This is largely true to the extent that an aggrieved party does not have access to a fair, cost effective and viable dispute management process or legal forum in which to have their grievances heard and determined.

Presently the options are summarised here:

(a) Communicate with the offending party and attempt to negotiate;
(b) Complain to the ACCC;
(c) Issue a dispute notice;
(d) Mediate;
(e) Initiate Court proceedings.

These limited options available to franchise businesses currently are insufficient as can clearly be seen by the ongoing push for State laws and increasingly detailed amendments to the Code. (As an aside to this discussion, we note that the damage has been done at least by the time of mediation and usually before the point of a dispute notice being issued, which underscores the importance of measures such as education and independent advice to ensure that the parties' relationship is as sound as possible from the outset so that it can weather the inevitable challenges that arise.)

A dispute resolution process that deals with the conduct in the context of an ongoing relationship is preferable to mediation with its inherent disadvantages to franchisees. Such a process would also be preferable to the 'mutually assured destruction' of formal litigation. This sort of alternative process is missing from the present procedures, which allow the offending party to run the gauntlet (often successfully) for the damage caused without being held to account.

A significant number of Code breaches are minor and do not directly cause loss or damage, yet there is no consequence currently available to the aggrieved party outside of Court action. Some breaches are in fact a subjective interpretation of the Code and may not be breaches at all; many 'end of term' disputes fall within this category. Again no remedy outside of Court action is generally available - and these types of 'breaches' are almost never prosecuted through the civil Courts due to the expense and genuine uncertainty of the outcome.

If the Government wishes to improve perceptions in the sector with respect to breaches of the Code or adverse conduct, then the issues identified and raised by every previous formal inquiry with respect to dispute resolution must be urgently addressed – empowering the parties directly is far preferable to additional layers of regulation.

END OF SUBMISSION