



Dr Michael Schaper
Review of the Franchising Code of Conduct
The Treasury

By email: franchisingreview@treasury.gov.au

Dear Dr Schaper

Thank you for our meeting on 15 September and this further opportunity to provide feedback to the Review of the Franchising Code of Conduct (the Code).

The NSW Small Business Commissioner (the Commission) is an independent statutory office of the NSW Government. It provides advice, advocacy and affordable dispute resolution services to small businesses across NSW.

While the Commission does not have any specific function with respect to franchising, my office occasionally receives representations from small businesses relating to franchising issues as well as franchising-related disputes filed for mediation. Previous matters raised with my office have included:

- Concerns raised about the structure and/or transparency of franchising royalties
- Lease disputes, including matters involving franchisees or franchisors considered by my office in accordance with the *Retail Leases Act 1994* (NSW)
- General conduct or business practices within the franchising sector

In addition, my office observes challenges can emerge or be exacerbated by a lack of awareness of rights and obligations as either a franchisee or franchisor as well as misaligned expectations about the franchising business model.

Franchising royalties

Section 5 of the Code outlines the meaning of franchise agreement and states the franchisee must pay or agree to pay to the franchisor an amount including a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee.

The Commission has previously been contacted regarding the practice of calculating franchise royalties based on gross sales, rather than net sales, with the perception that this is an unfair practice due to it being charged on GST component of sales and may not always reflect the profit margins of franchisees (for example, if business costs increase). The Commission understands the Code does not restrict the practice of negotiating royalties based on gross sales.

While we understand it is ultimately up to franchisees and franchisors to determine whether a franchise agreement is within their commercial interests, the Commission encourages consideration of broader sector feedback to determine whether there is a need for further measures, including educational and guidance materials, to support potential franchisees to understand and navigate proposed fee and royalty structures.

Lease disputes

Lease arrangements can take multiple forms for franchises, for example some may involve a sub-lease arrangement where the tenant is the franchisor according to the lease.

Many lease disputes that come through mediation involve unpaid rent and outgoings, which can be complex depending on the lease arrangements. For example, if the tenant according to the lease agreement is the franchisor and the franchisee (as a third party to the lease) stops paying rent to the franchisor or the property owner directly (depending on the terms of the franchise agreement) the landlord may only want to deal with the tenant listed on the lease, due to the legal relationship. This can create significant difficulty for the franchisor as they attempt to recover the unpaid rent, while being liable for the amount owing.

Other disadvantages for the franchisor in these arrangements as the head lessee include absorbing the risk of the lease as the franchisor will be liable for a tenant's default under the lease, creating limited liability for the franchisee. There may also be a lack of clarity regarding terms of the lease such as which party is responsible for repairs and maintenance of the premises.

In turn, there are also disadvantages for the franchisee in these sub-lease arrangements. Franchisees often do not understand the legal relationships involved when the franchisor is the head lessee, as the franchisee may still be paying rent directly to the landlord. Disputes in these arrangements can be difficult to resolve as the landlord may not engage with the franchisee directly due to the lack of a legal relationship. Additionally, communication, rent relief and other incentives may not be passed on by the franchisor to the franchisee.

The Commission would welcome further consideration of whether the existing leasing provisions of the Code continue to meet objects and whether any enhancements could support best practice leasing and franchising practices.

Conduct within the franchising sector

Power imbalances can be present in some franchising arrangements. This can sometimes result from differences in economic weight (e.g. a small franchisee entering into an agreement with a very large franchise business with a much stronger negotiating position), or an imbalance in acumen related to the franchise model (e.g. because franchisees are less experienced at entering into franchise agreements compared to franchisors).

Such power imbalances, whether real or perceived, can tend to undermine trust in the franchising relationship. For example, the Commission has received representations from franchisees that allege bullying and harassment from franchisors attempting to force franchisees to exit the franchise arrangement and work as an employee instead. Many of the franchisees have also not been provided with a franchise agreement or have only been supplied with part of the agreement, leaving them unclear of their rights and obligations.

There have also been instances of franchisors removing franchisees from sales group and revoking their access to shared promotions in an attempt to make the continued running of the franchise for franchisees virtually impossible.

Lack of education and other issues

It appears that many franchisees are often not aware of what is involved when entering a franchise arrangement. The franchise model may appear simpler as the business is already established which is giving potential franchisees a false sense of security.

The Commission has also seen disputes relating to selling a franchise business, primarily due to a lack of education of franchisees. Franchisors want to be able to decide who they have as a franchisee when a business is sold and additionally having control over the retail tenancy. Many franchisors may prefer to

buy back the franchise so they can control the next franchisee, rather than support the sale of the business. Franchisees have to seek the consent of the franchisor to sell the franchise business and while franchisors cannot unreasonably withhold their consent, the franchisee may not understand that there are acceptable reasons that a franchisor can rely upon to refuse a transfer such as the relevant selection criteria and breaches of the current franchise agreement.

The Commission notes many of the issues stem from a lack of education primarily with franchisees and advocates for the exploration of educational and guidance materials to provide franchisees with a clear understanding of what is involved and how to successfully enter a franchise agreement.

Review of the Retail Leases Act

As noted in our meeting on 15 September, the Commission recently undertook a review of the *Retail Leases Act 1994* (NSW) (the Act) with the final report published on the Commission's website in August 2023.

During the review, some stakeholders raised broader issues with the intersection between the Act and the Code. Feedback advised there is currently confusion between franchisors and landlords in relation to:

- The disclosure obligations for the franchisor (as the sublessor)
- The wording used for franchising consent clauses
- The ability for the franchisee (as the sublessee) to be the guarantor in the head lease and provide insurance and bank guarantees directly.

More generally there are other parallels that can be observed between retail leasing legislation as a mechanism to promote best practice leasing arrangements, and the Code as a mechanism to promote good franchising practices. There may be overlap in some of the issues considered by the Commission in the course of its review.

The review can be found at:

https://www.smallbusiness.nsw.gov.au/sites/default/files/2023-08/Review%20of%20the%20NSW%20Retail%20Leases%20Act%20July%202023_accessible_0.pdf

Value of cost effective mediation services in resolving disputes

In considering mechanisms to address the above and related issues relating to franchisee and franchisor disputes the Commission recommends consideration be given to the effectiveness of mediation services currently provided by the NSW Small Business Commission and other state Small Business Commissions which are highly cost effective as a means of expanding accessibility and affordability. Mediation services offered by the NSW Small Business Commission have over many years proven to be a highly effective mechanism for resolving disputes and are offered at \$330 per party inclusive of GST for a five-hour session.

Mediation is strongly recommended over other arbitative mechanisms as a first step in resolving disputes. Consideration should be given to an expressly stated obligation in the Code in respect to a requirement to participate in mediation prior to commencing litigation or arbitration.

Arbitative mechanisms are available to franchisees and franchisors however, the expense and often litigious nature of these processes often discourages parties to address disputes as they maintain concerns around the expense of the process and the uncertainty in respect to potential outcomes and future relationships.

The majority of disputes referred to the NSW Small Business Commission are resolved at or before a formal mediation is scheduled which further highlights the effectiveness of mediation in resolving disputes and its potential to improve outcomes for both franchisees and franchisors.

NSW Small Business Commission Momentum Survey results

During September 2023, the Commission ran its monthly NSW Small Business Commission Momentum Survey which included questions relating to the effectiveness of the Franchising Code of Conduct. The survey obtain qualitative feedback to identify key themes and issues that small businesses have experienced. An extract of this data is provided to the review secretariat on a confidential basis.

Franchisees advised the causes of disputes with franchisors that they experience, including:

- A lack of autonomy for franchisees and continuous interruptions from franchisors when running their businesses.
- Franchisors charging set up costs that exceed the previously agreed upon amount.
- Franchisors not passing on rebates received from suppliers.

The Commission also asked respondents whether they had any feedback relating to the effectiveness or suitability of the Franchising Code of Conduct. Key feedback provided in the survey results included:

- The Code serves its purpose well; however, its effectiveness is diminished significantly by the lack of enforceability by the regulator.
- The Code is in favour of the franchisor and needs to provide more protections for franchisees (it is noted that franchisees accounted for the majority of respondents)
- Confusion for franchisees where franchisors are altering franchise agreements to become agency agreements.

The overarching theme of the feedback expressed there is a power imbalance between franchisees and franchisors for small business. This is often the case when small businesses attempt to make a claim under the Code or resolve disputes using the Code as it can be a time consuming and burdensome exercise while also attempting to run a business. Large franchisors are often well-resourced in comparison to small business franchisees, resulting in franchisees feeling intimidated and under protected by the Code.

Thank you for the opportunity to make a submission. If you require further information, please contact Megan Bennett, at either megan.bennett@smallbusiness.nsw.gov.au or (02) 9372 8767.

Yours sincerely

Chris Lamont
Commissioner
NSW Small Business Commission

Date: 28/09/23

Encl. [**Confidential**: NSW Small Business Commission Momentum Survey – Qualitative Data]

