

Chapter 4

Pre-contractual arrangements

Definitional issues: coverage of the Franchising Code of Conduct

4.1 Clause 4 of the Franchising Code of Conduct (the Code) sets out the meaning of a franchise agreement. Key elements of the definition are that a franchise agreement is one in which:

(b) a person (**the franchisor**) grants to another person (**the franchisee**) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor...

and:

(c) the operation of the business will be substantially or materially associated with a trade mark, advertising or a commercial symbol:

(i) owned, used or licensed by the franchisor or an associate of the franchisor; or

(ii) specified by the franchisor or an associate of the franchisor; and

(d) under which, before starting business or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount...¹

4.2 Clause 4 also sets out a list of business relationships which do not constitute a franchise agreement in and of themselves.²

4.3 The committee received some evidence indicating that there is a lack of clarity in the current definition of franchising. Professor Warren Pengilley cautioned:

What we have to do is work out what we are trying to regulate because, if we do not get our definition right, we do not get the regulation right...I suggest to you that the appropriate definition has to have in it the concept of a long-term relationship or some more than passing relationship, dependence on a trademark for the overall business of the franchisee, and a power-dependence relationship...³

4.4 In his written submission to the committee, Professor Pengilley suggested:

1 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, pp. 9-10

2 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, pp. 10-11

3 Professor Warren Pengilley, *Proof Committee Hansard*, Sydney, 9 October 2008, pp 55-56

Many franchising arrangements are, in fact, normal commercial arrangements not necessitating specific regulatory control and the cost of complying with such control. It is only where there is "power imbalance" that specific regulatory control is required. "Power imbalance" may occur because of supply dependence, because of the power of the franchisor in controlling the franchisee's business by use of a trade mark or because of the public identification of the franchisor and the franchisee.⁴

4.5 Professor Andrew Terry agreed that the definition of franchising may be too broad:

The problem with the definition is that it...has the potential to catch arrangements that are not intended to be franchised—trademark licences and...distribution agreements.⁵

4.6 Conversely, the committee also received evidence suggesting that the definition of franchising may not currently be broad enough:

MTAA is concerned that the definition of 'franchise agreement' in the Code is not sufficient to ensure that all franchise arrangements fall within the scope of the Code...In particular, MTAA is concerned that it is relatively easy for franchisors to structure their agreements in a manner which enables them to avoid coverage under the Code even though those agreements are, for all intents and purposes, franchise agreements.⁶

4.7 This concern was also raised by Mr Hank Spier:

The...definition of a Franchise for the purposes of the Code...is very prescriptive and inflexible. Whilst prescription may appear to lead to certainty it is also often a road map for avoidance.⁷

4.8 Mr Spier's submission went on to cite the example of agency arrangements:

...where payment may be by way of commission and hence falls outside the definition.⁸

4.9 In his submission to the inquiry, Mr Dick Adams MP pointed out the similarities between franchises and the contractual arrangements of commissioned agents:

...the commissioned agents are also involved in a contractual arrangement between two independent parties with continuous obligations. And as with the franchising code, these relational contracts are prone to adaptation as time passes and circumstances change or have been misrepresented and

4 Professor Warren Pengilley, *Submission 27*, p. 7

5 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 67

6 Motor Trades Association of Australia (MTAA), *Submission 90*, p. 14

7 Mr Hank Spier, Spier Consulting, *Submission 151*, p. 2

8 Mr Hank Spier, Spier Consulting, *Submission 151*, p. 2

there is strong evidence that the Company exercises the control and takes a commission on every aspect of the business, whether they have an interest in it or not.⁹

4.10 Mr Adams' submission went on to outline the lack of recourse currently available to parties to such agreements if they are treated unfairly and to recommend:

That a review be undertaken by the Government of all these types of contracts with a view to bring standard guidelines and responsibilities across the nation.¹⁰

4.11 The committee received representations from some current participants in the sector who feel that the Code is not the most appropriate regulation for their industry. For example:

...the primary submission of the MTA is that the motor vehicle industry in Australia is so significant that it warrants separate legislation in much the same way that such legislation has been introduced for over five decades in America and in most of the European Union countries.¹¹

4.12 However, the Motor Traders Association of New South Wales (MTA) went on to acknowledge that such a change would be 'a quantum leap' in Australian legislation and, as such, is not an expected outcome of the current inquiry.

4.13 The Australian Marine Industries Federation Limited made a submission to the inquiry that trade in motor boats should not be covered by the Code:

In order to generate an acceptable turnover, almost all dealers/retailers sell a multitude of 'Motor Boat' brands and models all sold from the same premises and sourced from various suppliers. This makes the concept of franchising, where usually one major brand is promoted, impractical.¹²

4.14 7-Eleven advised the committee that the introduction of the Oilcode has caused some confusion for their operations:

Our business involves the franchising of convenience stores that are promoted and managed using our trade mark, "7-Eleven" and in accordance with our System. We franchise convenience stores (Stores) some of which sell fuel on our behalf. Of our 370 Stores, 187 do not sell fuel. Until the Oilcode was enacted our franchising business was...regulated by the Franchising Code only. Our business and the business of some of our Franchisees who own non-fuel stores are regulated by the Franchising Code, those with Fuel stores are regulated by the Oilcode and those with a

9 Mr Dick Adams MP, *Submission 154*, p. 1

10 Mr Dick Adams MP, *Submission 154*, p. 5

11 Mr Andrew Robinson, Motor Traders Association of New South Wales (MTA), *Proof Committee Hansard*, Sydney, 9 October 2008, p. 87

12 Australian Marine Industries Federation Limited, *Submission 158*, p. 1

mix of fuel and non-fuel Stores, are regulated by a combination of the Oilcode or the Franchising Code, dependent on the store.

4.15 7-Eleven indicated that their business has been adversely affected by the additional regulatory complexity and increased administrative burden that has followed the introduction of the Oilcode.

4.16 7-Eleven were not alone in noting the reach of the Oilcode with the inquiry. But where 7-Eleven felt that the Oilcode was not suitable for regulating some of their stores, Mr Ron Bowden of the Service Station Association Ltd told the committee that the Oilcode does not cover enough businesses:

The oil code is a fairly recent thing...Unfortunately, the code covers only a very small area of the oil company or the master-servant relationship in the oil industry. There are quite a few agreements in the marketplace now that are not covered by the code. In fact, they are not covered by anything other than just contract law.¹³

4.17 As acknowledged in the 7-Eleven submission, the Department of Resources, Energy and Tourism is currently carrying out a review of the operation of the Oilcode. The Oilcode only came into effect on 1 March 2007, so there has as yet been limited time to observe its impact in the marketplace.

Committee view

4.18 It is the committee's view that a broader review of the interaction between the industry codes, and the respective definitions of arrangements that fall within them, is beyond the role of the current inquiry. For the purposes of the current inquiry, the committee is comfortable that there is sufficient shared understanding of what constitutes a franchise agreement and is therefore covered by the Code. As expressed by Professor Terry:

Everything that you and I and everybody in the community would understand as a franchise is caught under the Franchising Code of Conduct.¹⁴

Pre-contractual education

4.19 For those business arrangements that are covered by the Code, the time during which a prospective franchisee is considering entering into a franchise agreement represents the best opportunity for both franchisee and franchisor to make an accurate and informed assessment about whether this is the right agreement for them.

13 Mr Ron Bowden, Service Station Association Ltd, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 26

14 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 67

4.20 From a franchisor's perspective, selection of appropriate franchisees is important to maintaining brand performance and profitability.

4.21 From the franchisee's perspective, it is critical that they develop an accurate understanding of what they are considering buying into. Often the investment required by a franchisee is substantial, with many putting their family home, their life savings and/or their superannuation investments at risk. Franchisees need to fully appreciate not only the contract and conditions they are being offered but the reality of the business they are taking on—including the style and type of work, the hours required, the likely turnover, the challenges of managing staff, and the need to conform with the franchise system and with the franchisor's directions as specified in the franchise agreement, relevant operations manuals and through other communications.

4.22 Franchisees also need to be alert to the real risk of business failure:

Entering into a commercial venture takes significant resources and requires significant sacrifice of time and other personal values.

...

No amount of legislation or Codes will protect a small business from failure. Indeed there is an entire sector that manages business failure. Franchisees investing in a franchise system cannot firewall themselves against failure. It is a false premise to think otherwise.¹⁵

4.23 There was widespread agreement amongst submitters that quality pre-franchise education is beneficial. As expressed by the Shopping Centre Council of Australia (SCCA):

It is generally agreed that the best way to redress imbalances in bargaining power is through education and accurate disclosure, since inadequate information, knowledge and understanding are often key contributors to the imbalance.

The SCCA certainly supports moves to provide and promote proper education to prospective franchisees, especially in assisting with pre-business feasibility planning and due diligence... Better educated and better organised franchisees invariably run better businesses with resulting fewer disputes with franchisors. Successful franchisees are generally good retailers and desirable tenants.¹⁶

4.24 The Franchise Council of Australia (FCA) noted:

Improved pre-franchise education is critical so prospective franchisees better understand what to expect, the risks involved, their rights and their due diligence and other obligations.¹⁷

15 Australian Retailers Association, *Submission 135*, p. 8

16 SCCA, *Submission 115*, p. 7

17 FCA, *Submission 103*, p. 4

4.25 Some franchisees recognise that their pre-entry knowledge is limited:

One has to remember that franchising is marketed to the 'mums and dads' of Australia, who generally...would not have had exposure to running a business themselves and therefore have little business acumen to rely upon.¹⁸

4.26 Dr Elizabeth Spencer told the committee: 'I think it is important to empower franchisees through education...';¹⁹ while Professor Andrew Terry took this a step further by suggesting that some form of pre-franchise training be compulsory:

We need better education of franchisees, with franchisees taking responsibility and exercising due diligence...Perhaps we should not let somebody become a franchisee until they have at least ticked some boxes that they have been to a course or they have been exposed to information.²⁰

4.27 Professor Lorelle Frazer emphasised that both franchisee and franchisor have a need in this regard, stating plainly: 'We need better pre-entry education for both franchisees and franchisors'.²¹ Post Office Agents Association Limited (POAAL) also drew attention to the need for franchisor education:

Just as many potential franchisees are not properly prepared for the nature of responsibilities of a franchise business so it is that franchisors are not necessarily prepared for the launch of their business as a franchise model. Many seem to be unaware of the discipline and processes that need to be in place for a franchise system to work effectively as a business.²²

4.28 The committee received evidence of a range of educational material available to prospective franchisees and franchisors. The Australian Competition & Consumer Commission (ACCC) provides free information on its website which is intended to promote compliance with the Code by both franchisees and franchisors.²³ The ACCC advised the committee:

To educate franchisors and franchisees about their rights and obligations under the code and the Act, the ACCC has published a number of educational materials to assist prospective franchisees, including:

- *Franchising Code of Conduct compliance manual for franchisors and master franchisees*, book with CD
- *The franchisee manual*
- *Franchisee start-up*, checklist

18 Ms Suzanne Brown, *Submission 84*, p. 3

19 Dr Elizabeth Spencer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 44

20 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, pp 67-68

21 Professor Lorelle Frazer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 5

22 POAAL, *Submission 101*, p. 6

23 <http://www.accc.gov.au/content/index.phtml/itemId/6118>

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- *Resolving franchising disputes*, fact sheet
 - *Disclosure under the Franchising Code of Conduct*, fact sheet
 - *Being smart about your new franchise: checklist before signing a lease agreement*
 - *Being smart about your new franchise and your retail lease*, fact sheet
 - *Overview of the Franchising Code of Conduct*, fact sheet.²⁴

4.29 The ACCC website also provides links to the Department of Innovation, Industry, Science and Research (DIISR), which has responsibility for assisting the federal government in developing franchising policy, and to the Office of the Mediation Adviser (OMA), which is responsible for facilitating mediation arrangements set out in the Code.

4.30 In addition, the ACCC told the committee that it is developing an improved communication strategy to advise franchisors and franchisees of their obligations and protections under the Code, and that it is increasingly engaging with advisers to ensure that legal, accounting and other business advice given to prospective franchisees and franchisors is sound.²⁵

4.31 The FCA sees an important role for industry bodies in providing education to the franchising sector, indicating to the committee:

We have some ideas about how we could work with the government to perhaps implement cost-effective educational campaigns, because at the end of the day people are entering into a business decision.²⁶

4.32 The FCA also noted that it is already taking action in this area:

We are working already on the education angle as hard as we can. Last Friday we had our first ever pre-entry seminar. We had a good turnout and got a very strong response. We did that in concert with the ACCC and with Small Business Victoria. That is something that we will take out probably to every state around the country.²⁷

4.33 Furthermore, the FCA has sponsored a Franchise Academy that provides training for franchisees and franchisors leading to nationally recognised qualifications. Courses offered include a Diploma of Business (Franchising).²⁸

24 ACCC, *Submission 60*, pp 7-8

25 ACCC, *Submission 60*, p. 8

26 Mr Stephen Giles, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 23

27 Mr Steven Wright, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 45

28 See information available at <http://www.franchiseacademy.org.au>

4.34 There is also training and research relating to franchising taking place in Australia's tertiary education sector. One example is the recently established Asia-Pacific Centre for Franchising Excellence at Griffith University, and there are a number of other academics practising in this field.

4.35 The ACCC sounded a cautionary note about how much training can hope to achieve and referred to the diversity of approaches needed to provide adequate coverage:

We work with a variety of organisations. They range from educational institutions, universities and even some TAFE-level courses. In the past we have worked with bodies such as the Institute of Company Directors, from very small micro firms, business enterprise centres and other business advisers. It is a never-ending task, because you have a large number of new firms always entering into the market, and you have also got a turnover of business owners and managers as well. The level of knowledge out there is very hard to maintain because it is not a fixed constant and you cannot improve it simply by adding more to the level. In terms of the range, it is fairly extensive—print media, educational, sometimes collaborative with other government agencies, small business advisory centres and professional advisers, as well as the general media. It is a fairly multipronged strategy.²⁹

4.36 The committee recognises that pre-entry education alone cannot be the panacea that prevents franchise failure. As expressed by Ms Jenny Buchan:

I have written and presented a paper recently on asymmetry of information. In writing that paper I looked at each state and the federal government's information available to franchisees from the public domain. For example, the federal government has a terrific online business information service. I have looked at the Franchise Council of Australia's education package and nowhere, anywhere, without exception, does it mention that a franchisor might fail. So the notion that a franchisor has got a pretty good system that is pretty robust is perpetuated throughout the information that is available to intending franchisees. Clearly that is incorrect so from that perspective I would have to say that the education could be better and it could be more comprehensive. However, even if you do educate people about some dire consequences, once you have entered a relational contract as a franchisee, regardless of the amount of information you have received you can sometimes find yourself in a situation that no education in the world could have prepared you for.³⁰

4.37 The Australian Retailers Association (ARA) also acknowledged that the picture painted in advance of franchise entry is sometimes too positive:

Perhaps franchisee education could further emphasis [sic] the risk of failure, as sometimes the publicity of the success of franchising, and even the

29 Dr Michael Schaper, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 98

30 Ms Jenny Buchan, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 77

increased security provided by the regulatory environment, makes prospective franchisees too optimistic...³¹

4.38 The FCA, while generally supportive of the need for franchisees to undertake pre-agreement education, cautioned that making such education mandatory could act as a barrier to entry at a time when it is already becoming difficult to secure good franchisees:

I love the idea of every potential franchisee having done a course, as was talked about earlier. In a real world, franchise inquiry rates are at a 15-year low at the moment. One of the biggest issues in this industry is attracting new franchisees, because we are in a full employment economy, and now we have got a double whammy where people cannot get access to finance. The problem with having prescriptive prior training for potential franchisees is that it will raise the bar to attracting new franchisees.³²

Committee view

4.39 The committee is of the view that, though unbiased pre-agreement education is extremely important (particularly for first-time franchisees), it remains the responsibility of individuals to ensure they seek out information and education before entering into a franchising relationship, not the responsibility of government. Such education should not be mandated. As the SSCC noted in its submission: 'Better education and better support services...are non-legislative options'.³³

4.40 However, there remains a clear and important role for the ACCC in making accurate, unbiased and up-to-date educational material available to those who choose to access it. Franchisee submissions to the inquiry revealed a degree of uncertainty about where to source such information, indicating that there is room for the ACCC to take a more proactive approach in its educative role.

Pre-contractual advice

4.41 It is even more critical for prospective franchisees to obtain sound legal, accounting and other relevant business advice before entering into a franchise agreement. In particular, for those franchisees who are new to the small business sector, the committee considers it essential that they seek and take qualified advice.

4.42 On this matter, the committee agrees with the view of the ACCC, who emphasised the practical importance of obtaining such advice:

...we exhort and encourage franchisees to seek expert independent advice. That means expert legal advice, expert accounting advice and sometimes expert business management advice. So often what can happen is that a

31 ARA, *Submission 135*, p. 8

32 Mr John O'Brien, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 35

33 SSCA, *Submission 115*, p. 7

franchisee will enter into a franchise arrangement and will do so by investing a substantial sum of money with the thrill of getting a very substantial return, but without having proper business management advice as to the economic viability of the franchise, or indeed of the business expertise of the franchisee, and therefore the ability of the franchisee in business management terms to make the franchise work successfully.³⁴

4.43 The committee received evidence that many franchisees do not seek, or do not heed, such advice. An accredited mediator on the OMA panel indicated to the committee:

During mediations it frequently becomes apparent that the franchisee has declined to seek professional advice prior to entering into the Franchise Agreement. This is most evident when the franchisee is...lacking relevant business experience often of the most basic kind. In one example, the franchisee had not inquired into the nature and likelihood of payment of debts owing to the previous franchisee when taking over a franchise. In this case, the franchisee had relied on those debts but they were in fact worthless.³⁵

4.44 Participants in the franchising sector expressed some concerns about the limited expertise and lack of liability of some consultants giving advice to prospective franchisees. The ARA wrote in its submission: 'There is no protection for franchisees and indeed franchisors from poor advice'.³⁶ It followed this up in verbal evidence to the committee:

On the issue of consultants, both franchisor and franchisees require advice and help to enter the franchise system. With franchisors the consultant becomes a valuable support and their advice can mean the difference between success or otherwise, yet there are no ethical caveats upon those that can advise within the sector. Of course lawyers and some accountants have ethical considerations, but the vast majority of consultants advising the franchise sector are not so limited. Consultants write the franchise agreement and, indeed, the important operations manual. If there is no correlation between both documents then perhaps non-compliance will ultimately happen. The fact that there are many anecdotes of franchise agreements being cut and pasted, no matter the system, is a worry. In other words, advisers can be lazy and just use one written agreement for one system and the same agreement for another, when both systems are very different.

... ..

Another issue about these consultants includes those that are marketing firms that sell on behalf of various brands. These consultants ask for substantial deposits up front, and retain the moneys as a form of

34 Mr Graeme Samuel, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 83

35 David Lieberman & Associates, *Submission 31*, p. 1

36 ARA, *Submission 135*, p. 11

commission. These salespeople are not required to meet standards, nor indeed the code, and can virtually mislead at the expense of the franchisor, for it is the franchisor that retains responsibility.³⁷

4.45 Some submitters also pointed out that some legal and accounting professionals who are approached for advice may lack sufficient franchising-specific experience to give advice at the appropriate standard:

Your everyday solicitor/lawyer is not necessarily up to speed on the franchising laws, problems and pitfalls...³⁸

4.46 Some former franchisees who made submissions to the inquiry indicated that, in hindsight, the advice they obtained was not of a sufficiently high standard:

I believe that most of the franchisees that I have spoken to have gone and got advice. It was not necessarily the right advice because franchising is a complex issue. I do not think that a lot of advisers understand.³⁹

Committee view

4.47 The committee is of the view that it is the responsibility of individual franchisees, master franchisees and franchisors to seek and take competent legal, accounting and other relevant business advice prior to entering a franchise agreement. The committee considers that the stipulations already in the Code—which require new franchisees to sign a statement that they have either sought such advice or have chosen not to—are adequate, and that there is no role for government in ensuring the accreditation or performance of advisers.⁴⁰ However, industry moves to establish accreditation programs for franchising advisers may be of benefit to the sector overall. Those entering the sector for the first time should have particular regard to the franchising-specific experience and knowledge of those from whom they seek advice.

Due diligence and disclosure

4.48 It is central to good franchising regulation that prospective franchisees are provided with adequate information but franchisors are not unduly burdened by onerous disclosure requirements:

When placing disclosure obligations on franchisors, it is important that the Franchising Code strikes an appropriate balance between ensuring that prospective franchisees are adequately informed about their decision to enter a franchise agreement, while at the same time not placing an

37 Mr Richard Evans, ARA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 9

38 Mr Gavin Butler, *Submission 3*, p. 3

39 Ms Deanne de Leeuw, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 65

40 See Division 2.2, Clause 11(2) of the *Trade Practice (Industry Codes—Franchising) Regulations 1998*

unreasonable compliance burden on franchisors that will ultimately be to the detriment of both franchisor and franchisee.⁴¹

4.49 The current disclosure requirements imposed by Part 2 of the Code are described in Chapter 3 at paragraph 3.32. There are obligations on both parties to the agreement: franchisors must provide certain information in a timely fashion, and franchisees must acknowledge that they have received and understood it (including that they have either received independent advice or have chosen not to).

4.50 It is essential for franchisees to understand that disclosure requirements under the Code are intended to assist, not replace, standard due diligence processes. The obligation remains on a franchisee, and their advisers, to adequately assess the business opportunity they are considering taking up. Equally, there is an obligation on franchisors to provide accurate and full information during disclosure.

4.51 Amendments to the Code that took effect on 1 March 2008 are intended to improve the future operation of the disclosure regime. In particular, new requirements that franchisors disclose the contact details of former franchisees for the last three financial years (except where a former franchisee has requested in writing that their details not be disclosed) are designed to assist prospective franchisees in identifying the reasons for previous franchise agreements ending. One practice that this is intended to guard against is franchise churning.⁴²

4.52 It would be premature for the committee to judge the efficacy of the March 2008 amendments to the Code in relation to disclosure. Nevertheless, submissions to the committee have highlighted a range of continuing concerns relating to the disclosure process. Some of these are discussed below.

Length of disclosure documentation

4.53 Many submitters have commented on the length of disclosure documents, noting that the costs of seeking appropriate legal advice and the time required to read them can be prohibitive:

Reduced, better focussed Disclosure Documents will also mean less onerous compliance burdens for franchisors – particularly if it can end the upward spiral in the size of disclosure documents. The FAA has the objective of halving most current disclosure documents. A bonus will be the greater likelihood that they are read and understood.⁴³

4.54 The FCA points to the size of disclosure documents as an impediment to franchisees obtaining appropriate pre-contractual advice:

41 Law Council of Australia, Trade Practices Committee, Business Law Section, *Submission 141*, p. 9

42 Churning is a practice in which a franchisor sells and re-sells a unit franchise, making a profit each time the business changes hands regardless of the profitability of the unit franchise.

43 Franchisees Association of Australia, *Submission 51*, p. 6

Franchisees are not getting advice in accordance with the Code requirements. Part of the problem relates to the cost of advice – with disclosure materials regularly in excess of 100 pages, and sometimes much more, it is difficult to keep costs down.⁴⁴

4.55 Some franchisees admitted that they do not read the disclosure documents they receive. For example:

The document is so thick and there is so much information there that I honestly do not read it. I give it to my lawyer and say: ‘Here you go. Just sign off on it.’ It has become crazy.⁴⁵

4.56 The SCCA commented:

...disclosure documents that become too long and too comprehensive can become intimidating for prospective franchisees and therefore be counterproductive.⁴⁶

4.57 7-Eleven agreed with this position:

7-Eleven is a strong advocate of clear and timely disclosure of all issues in the Franchising process. However we have a real concern that although the Franchising Code is well intentioned in relation to disclosure by Franchisors, in practical terms, the quantity of documentation for Franchisees to digest and receive advice on...goes beyond measures which assist the parties to the franchise relationship. The disclosure requirements are so large that Franchisees could not be expected to review all of the disclosed material despite them needing to certify that they have...

The costs to the Franchisee of obtaining advice which must involve a full review of the disclosure material, may act in practice as a restraint on Franchisees obtaining...independent legal, accounting and/or business advice...⁴⁷

Committee view

4.58 The committee agrees that better disclosure does not necessarily mean more disclosure. A franchisor acting in good faith should provide a prospective franchisee with the meaningful and truthful information they require to make a sound business decision about whether to proceed with entering the agreement. Disclosure documentation should be in line with Code requirements and should focus on the provision of information which is difficult and/or expensive for the franchisee to obtain through other means.

44 FCA, *Submission 103*, p. 3

45 Mr Tony Melhem, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 36

46 SCCA, *Submission 115*, p. 8

47 7-Eleven, *Submission 105*, p. 5

Accuracy and completeness of disclosure

4.59 Many submitters have also expressed concern about the accuracy of information contained in disclosure documents, indicating that the information they received during disclosure was incomplete, or was inconsistent with information they had access to after signing on as a franchisee. For instance, one submitter wrote:

Had I known what my foray into the franchising world would realise, I certainly would not have ventured into this so-called 'reputable and proven' franchise system...All the due diligence in the world does little in reality to prepare you for what you will be forced to endure once you are in the System.⁴⁸

4.60 Another claimed that his franchisor omitted mandatory disclosure information and dismissed the breach as a technical oversight by a third party.⁴⁹ Others referred to disclosure documents that were non-current or did not reflect the actual contents of the agreement, or to the provision of inaccurate or incomplete financial information.⁵⁰

4.61 The common complaint relating to inaccurate or incomplete disclosure was a perceived absence of legal accountability for franchisors that deliberately mislead prospective franchisees during pre-agreement discussions. The legal avenues available to franchisees and the ACCC in response to misleading disclosure are examined in Chapter 9, in the context of the enforcement of the Code and other relevant provisions of the *Trade Practices Act 1974* (TPA).

Frequency of disclosure

4.62 The Code requires franchisors to maintain a current disclosure document, ready to provide to prospective franchisees, or to existing franchisees who are considering whether to renew or extend the term of a franchise agreement. A franchisor must also honour a written request from a franchisee to provide a current disclosure document, though such a request may only be made once in 12 months.⁵¹

4.63 Some franchisees indicated that more frequent or even continuous disclosure would assist them in conducting their business and in being appropriately aware of the true state of their franchisor's business:

48 Ms Suzanne Brown, *Submission 84*, p. 4. For further examples, see *Submission 32* and *Submission 114*.

49 Mr Scott Cooper, *Submission 15*, pp 10-11

50 See for example Mr Damien Hansen, *Submission 1*, pp. 1-3; Ms Samantha Gow, *Submission 61*, p. 5

51 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 21

It is recommended that franchisors must commit to a continuous process of disclosure similar to the disciplines imposed on companies listed with the Australian Stock Exchange.⁵²

4.64 In particular, franchisees felt that a requirement for ongoing disclosure would assist in alerting them to imminent franchisor failure:

A most significant omission is the lack of a requirement for a company to change its disclosure document if it encounters difficulties such as the appointment of an administrator or receiver during a current financial year. The quality of reporting during the financial year is far less stringent than that for public companies. Yet, franchisees, typically, have far more invested in their businesses than average shareholders in their shares.⁵³

4.65 Following the Code amendments that took effect on 1 March 2008, franchisors are now required to disclose 'any materially relevant facts' to franchisees in writing within 14 days of becoming aware of such facts. The Code lists matters deemed to be materially relevant, and these include any change in majority ownership or control of the franchisor.⁵⁴

Disclosure of leasing arrangements

4.66 The committee heard from franchisees and former franchisees who were unaware of the head lease arrangements applying to their unit franchise when they took up their agreement. Some suggested an additional disclosure requirement for franchisors, obliging them to disclose to prospective franchisees and franchisees the details of any head lease arrangements. This was also a recommendation of the South Australian parliamentary inquiry.⁵⁵

4.67 The Law Council of Australia disagreed with this position, in part on the basis that franchisees can in many cases already obtain copies of registered head leases through relevant Titles Offices in the states; franchisees are not a party to the head lease; and it is a matter for the landlord to determine whether they want to enter a direct tenancy relationship with a franchisee in the event of franchisor default.⁵⁶

Disclosure of rebates and similar financial arrangements

4.68 An issue of concern has been the disclosure to franchisees of rebates or similar financial arrangements that franchisors have in place with other parties, including suppliers or in relation to head leases. The committee notes that the recent

52 POAAL, *Submission 101*, p. 6

53 Mr Howard Bellin, *Submission 30*, p. 1

54 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 19

55 SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008, p. 83

56 Law Council of Australia, Trade Practices Committee, Business Law Section, *Submission 141*, pp 9-10

changes to the Code now require franchisors to disclose whether the franchisor 'will receive a rebate or other financial benefit from the supply of goods or services to franchisees, including the name of the business providing the rebate or financial benefit'.⁵⁷

4.69 However, franchisors are not required to disclose the dollar amount involved. The Law Council of Australia opposed any additional mandatory requirement along these lines:

...a requirement to disclose the dollar amount of rebates may prove practically difficult for a franchisor to comply with. The key material information, being the price of the goods or services supplied, is already required to be disclosed.⁵⁸

Disclosure of franchisor relationships with financial institutions

4.70 The committee also received numerous complaints from franchisees and former franchisees about what they perceive to be close, and perhaps inappropriate, relationships between franchisors and banks. For example, one submission described a situation in which, having been refused a loan for a franchise by their own bank due to having insufficient equity in their home, prospective franchisees were referred to a second bank by the franchisor—a bank with whom the franchisor had a 'special relationship':

This relationship needs to be examined and the bankers should be charged for falsely approving loans that are not viable and will cause destruction to their clients.⁵⁹

4.71 Ms Sam Gow described the circumstances in which she obtained a loan as follows:

My application was declined as I did not have the security nor did I have any capital to start a business. I went back to the master Franchisee and said "thanks but no thanks" as I can't get the finance. He said here contact this person from a major bank, he will be able to help you and needless to say the rest is history. Surprise Surprise I got the loan & they even got my mum to go guarantor.⁶⁰

4.72 Another franchisee put it this way:

Many franchisors have begun touting "relationships" with banks that are designed to secure funds to purchase the franchise. However in many cases

57 Franchising Code of Conduct, Annexure 1, 'Disclosure document for franchisee or prospective franchisee', section 9.1(j)

58 Law Council of Australia, Trade Practices Committee, Business Law Section, *Submission 141*, p. 10

59 George and Ruth Nimbalker, *Submission 67*, p. 8

60 Ms Sam Gow, *Submission 61*, p. 4

the banks and their "franchise relationship" department care little about the use of the money – they are just throwing the money at the franchisee using their homes as collateral – not the franchise! When the franchise fails, the banks just grab up the home if they can't get paid out. This kind of lending short-circuits the usual fiduciary responsibility a bank should have.⁶¹

Calls for the inclusion of risk statements

4.73 Some submissions to the committee suggested that a risk statement should form a compulsory part of disclosure or agreement documentation. In particular, franchisees felt that it would be useful if the possibility and consequences of franchisor failure were spelled out clearly in advance of them taking up a franchise agreement:

I appreciate that any business venture presents risks including the potential for total loss. However, franchising is very much presented as a way of reducing this risk...

Potential franchisees should be made aware that the Franchisor could fail, and what happens in the event of a Franchisor failure needs to be defined in the Franchise Agreement...Failure of the Franchisor should not automatically doom all the franchisees businesses to failure as well.⁶²

4.74 Ms Jenny Buchan suggested:

The Code should include a requirement that franchisors disclose the specific consequential contractual risk to the individual franchisee of the franchisor being placed into administration or becoming insolvent (failing). (See Matthews Report Recommendations 3 and 21). This should not be left to the ACCC to do generically...

...

It's time for the sector to be realistic about franchisor failure. Because the power in the drafting and the negotiation sits with the franchisor, it is almost impossible for an otherwise keen franchisee to insulate themselves from the consequences of franchisor failure ex ante.⁶³

4.75 However, the Law Council of Australia stated:

It would be unduly onerous and probably impossible for a franchisor to accurately outline the risks of a franchisee. The franchisee is best placed to assess their own risks having regard to their own facts and circumstances,

61 Name withheld, *Submission 63*, p. 7

62 Mr Terry Cowan, *Submission 11*, p. 2

63 Ms Jenny Buchan, *Submission 89*, p. 8

and the information they receive...under the existing regime for disclosure.⁶⁴

4.76 The FCA acknowledged mismatched expectations between franchisees and franchisors:

...it would appear some franchisees see franchising as a guarantee of success and do not understand normal business risk. Some franchisors may (in breach of current law, notably s52 TPA) oversell the business opportunity. The ACCC needs to act here.⁶⁵

4.77 However, the FCA rejected the call for franchisors to have to produce a risk statement:

Franchisors should not have to produce a risk statement of all risks relating to their individual franchise, as this would create major new cost. This issue is much more efficiently addressed through education, including through the publication by the ACCC of a booklet on franchise risk.⁶⁶

Committee view

4.78 The committee is of the view that requiring a general and broad risk statement as part of disclosure/pre-agreement materials is unnecessary. It is the franchisee's responsibility to obtain and have regard to competent legal and accounting advice that identifies relevant risks.

4.79 However, the committee is concerned about the specific implications that franchisor failure can have for franchisees—for example, the potential in some cases for franchisees to continue to be liable for paying a royalty stream to administrators and/or to continue accepting stock already ordered from suppliers under arrangements made by the former franchisor, even in circumstances where the franchisee is effectively unable to continue trading. Therefore, the committee believes the disclosure requirements in the Code should be amended to require a franchisor to include a specific statement of the liabilities and consequences for a franchisee in their network should the franchisor fail.

Recommendation 1

4.80 The committee recommends that the Franchising Code of Conduct be amended to require that disclosure documents include a clear statement by franchisors of the liabilities and consequences applying to franchisees in the event of franchisor failure.

64 Law Council of Australia, Trade Practices Committee, Business Law Section, *Submission 141*, p. 10

65 FCA, *Submission 103*, p. 3

66 FCA, *Submission 103*, p. 4

Calls for registration or vetting of disclosure documents and standard form contracts

4.81 The committee received evidence suggesting that centrally registering disclosure documents and/or standard form contracts may improve compliance with the Code and would also provide a useful research tool for those considering entering a franchise agreement and for those monitoring the sector.

4.82 The ARA submitted:

A central body that registers disclosure documents will add credibility to a franchisor. Thus the market can gain confidence in knowing that a checking and validation system exists.⁶⁷

4.83 The establishment of a mandatory federal registration system for franchise disclosure documents was an explicit recommendation of the South Australian parliamentary inquiry into franchising. The ACCC was suggested as the appropriate body to maintain such a register and ensure that all documents lodged are in compliance with the Code.⁶⁸

4.84 An alternative suggestion received by the committee is that a franchise section could be established within ASIC, giving it responsibility for:

...oversight of the franchising market in the same way it oversees the equity and financial services markets.

...

Vetting by ASIC would, at a single stroke, cut back on thousands of individual franchisees duplicating each other in consulting lawyers as to whether or not a given franchise system meets the requirements of the Franchising Code, the Trade Practices Act and that market buyers are fairly informed.⁶⁹

4.85 However, there were some concerns from franchisors about the implications such a scheme would have for commercial-in-confidence information:

I believe there could well be some commercial material in the agreements which we and other franchisors would not want publicly presented. I thought I heard the proposition earlier today actually extending to disclosure documents as well. I would have slightly heightened concern about some commercial information in those documents...

...

Perhaps the information could be put up in a non-attributed way. In other words, to say that X number of franchisors have the following termination

67 ARA, *Submission 135*, p. 15

68 SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008, p. 34

69 Franchisees Association of Australia, *Submission 51*, p. 7

provisions and the others do not, or information of that nature without actually saying which are which. At least people would then arguably have the ability to say that the majority of them deal with the issue in this way, why does mine not?⁷⁰

4.86 Some submitters also expressed concern that registration of disclosure documents, be it with the ACCC or another body, might somehow imply endorsement of the system and discourage franchisees from seeking appropriate additional advice.⁷¹

4.87 The International Franchise Association stated that it has seen little benefit in registration systems operating in the United States:

...decades of practical experience with state franchise registration and review requirements has shown that these regulations are burdensome for franchise companies and state governments while conveying little or no protection for franchisees. In fact, we are aware of no data in the United States that shows that franchise investors in states with registration requirements are more adequately protected from sales fraud than investors in states without registration.⁷²

Committee view

4.88 The committee considers that it is the proper role of legal advisers to determine whether disclosure documents and agreements are in compliance with the Code and other relevant regulation and legislation. Government resources are better directed to educational and enforcement responsibilities.

4.89 However, the committee does see merit in a simple annual online registration system for franchisors, requiring them to identify the nature and size of their franchising system and, through the act of registering, to provide a guarantee that they are operating their system in compliance with the Franchising Code of Conduct. The ACCC could administer this system.

4.90 The features and benefits of such a system would include:

- For the first time, a central government body would have useful data on how many franchise systems are operating in Australia each year.
- Franchisors would be required to confirm each year that they are continuing to operate in compliance with the Code.
- Because it does not involve the actual lodgement of disclosure documents or standard form contracts, businesses need not provide

70 Mr Scott Staunton, Australia Post, *Proof Committee Hansard*, Canberra, 17 October 2008, pp. 99-100

71 For example, FCA, *Submission 103*, p. 4

72 International Franchise Association, *Submission 120*, p. 1

commercial-in-confidence information as part of the registration process.

- It does not require a central agency to either store or vet disclosure documents or standard form contracts.

Recommendation 2

4.91 The committee recommends that the government investigate the benefits of developing a simple online registration system for Australian franchisors, requiring them on an annual basis to lodge a statement confirming the nature and extent of their franchising network and providing a guarantee that they are meeting their obligations under the Franchising Code of Conduct and the *Trade Practices Act 1974*.

Disclosure exemption for foreign franchisors

4.92 The March 2008 changes to the Code removed a disclosure exemption that formerly applied to foreign franchisors. Previously, if an operation based outside Australia had only a single master franchisee in Australia, it was sufficient for the master franchisee to disclose information to prospective franchisees relating to their business dealings. Now the overseas-based franchisor is also required to complete the disclosure requirements.

4.93 The committee received a submission from the International Franchise Association pointing out that the removal of the foreign franchisor exemption has created a substantial compliance burden on US franchisors operating in Australia through a master franchisee:

In particular, this obligation is highly burdensome for franchise systems that are not engaged in current sales activity in Australia. In effect, the removal of the exemption requires many foreign franchise systems to prepare annual disclosure documents for which there is simply no relevant audience, and we strongly encourage you to consider restoring the exemption.⁷³

4.94 Mr Robert Gardini told the committee that the removal of the foreign franchisor disclosure exemption has created some uncertainty in the motor trades industry:

Now this exemption has been removed there is growing uncertainty around the obligation for foreign franchisors to provide disclosure documents to potential dealers in addition to or jointly with the Australia master dealer... It would therefore be my recommendation that the ambiguity in the code should be addressed so that dealers, master franchisors in Australia and

73 International Franchise Association, *Submission 120*, p. 4

overseas distributors can all be aware of the disclosure obligations relating to foreign motor vehicle dealer distributors.⁷⁴

Committee view

4.95 Much has been written and heard about the power imbalance in the relationship between franchisor and franchisee. Once a franchise agreement has been signed, the franchisee is bound to operate in accordance with the franchisor's system, including changes to that system and any other requirements that are made from time to time. However, at the pre-contractual stage, the power rests with the franchisee. As put by Mr Graeme Samuel of the ACCC:

...we would want to stress to franchisees that their strongest bargaining position exists up until they sign the franchise contract. Although a lot is said about the disparate bargaining positions of a franchisor and a franchisee, up until the franchising contract is signed they have a very strong bargaining position. They have the money in their pocket. They have the pen in their pocket, and they do not have to sign up to the franchising contract. The moment the contract is signed by the franchisee, the bargaining position shifts dramatically.⁷⁵

4.96 The committee's view is that the pre-contractual period provides the key opportunity for franchisees to protect themselves by ensuring that they are appropriately educated—that is, that they fully understand the nature and conditions of the business they are buying into—and to take heed of suitable professional advice before signing an agreement. As noted by Professor Andrew Terry:

While it is appropriate that the special risks in franchising due to the information and power imbalance be addressed (as indeed they have been to a greater extent than anywhere else in the world under the FCC regime supplemented by TPA misleading/unconscionable conduct provisions of general application) ordinary commercial risks must remain with the parties.⁷⁶

4.97 Nonetheless, it is incumbent upon franchisors to provide truthful and meaningful information during the disclosure process, such that franchisees are best placed to make an accurate risk assessment of the proposed business arrangement:

Clearly potential franchisees have responsibilities and must accept certain levels of risk when investing in a franchise. However we don't deserve to be scammed by unscrupulous operators; we deserve to have a level playing field...The current system has been successful for those on both sides that have good intentions and play by the rules. The system has however been

74 Mr Robert Gardini, *Proof Committee Hansard*, Melbourne, 9 October 2008, p. 4

75 Mr Graeme Samuel, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 83

76 Professor Andrew Terry, *Submission 91*, p. 2

exploited and manipulated by a growing minority with only their own agendas and profits at heart.⁷⁷

4.98 The committee is particularly concerned that franchisors disclose appropriately the liabilities and consequences for franchisees in the event of franchise failure. It is this concern that underpins Recommendation 1 at paragraph 4.80

4.99 Although the committee does not support the creation of a registration system for disclosure documents or standard contracts, it does see value in creating a central register of all franchisors operating in Australia. Furthermore, it sees an opportunity for the act of registering to constitute a guarantee from the franchisor that they are operating their franchise system in compliance with the Franchising Code of Conduct and the TPA. This is the rationale behind Recommendation 2 at paragraph 4.91.

4.100 It is the committee's view that some of the other concerns raised in submissions relating to the pre-contractual period will be addressed by the changes made to the disclosure provisions of the Code as of 1 March 2008. The committee recommends that the government monitor the disclosure issues canvassed in this chapter and review the efficacy of the recent amendments in mitigating these issues, with a view to making further amendments in the future as necessary.

Recommendation 3

4.101 The committee recommends that the government review the efficacy of the 1 March 2008 amendments to the disclosure provisions of the Franchising Code of Conduct within two years of them taking effect.

4.102 The committee makes an additional recommendation relating to the disclosure of end of term arrangements in Chapter 6 at paragraph 6.91.

4.103 The committee addresses concerns about the enforcement of Code requirements and relevant provisions of the TPA in Chapter 9.

77 Name withheld, *Submission 63*, p. 8