Parliamentary Joint Committee on Corporations and Financial Services

Opportunity not opportunism: improving conduct in Australian franchising

December 2008

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Duties of the Committee

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the Parliamentary Committee's duties as follows:

(a) to inquire into, and report to both Houses on:

(i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

Terms of Reference

On 25 June 2008 the Committee resolved to inquire into the Franchising Code of Conduct and related matters. The Committee will report by 1 December 2008. The terms of reference are:

The Committee is to inquire and report on the operation of the Franchising Code of Conduct, and to identify, where justified, improvements to the Code, with particular reference to:

(a) the nature of the franchising industry, including the rights of both franchisors and franchisees;

(b) whether an obligation for franchisors, franchisees and prospective franchisees to act in good faith should be explicitly incorporated into the Code (having regard to its presence as an element in paragraph 51AC(4)(k) of the Trade Practices Act 1974);

(c) interaction between the Code and Part IVA and Part V Division 1 of the Trade Practices Act 1974, particularly with regard to the obligations in section 51AC of the Act;

(d) the operation of the dispute resolution provisions under Part 4 of the Code; and

(e) any other related matters.

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Executive summary

The Parliamentary Joint Committee on Corporations and Financial Services inquired into the operation of Australia's Franchising Code of Conduct (the Code) with a view to identifying justifiable improvements to the Code. The committee has made eleven recommendations which are consistent with its overall aim of raising the standard of conduct in Australian franchising.

The nature of franchising

Franchising is an ongoing relationship between two separate commercial parties, a franchisor and a franchisee. The franchising relationship is based on a prescribed business model which is offered by the franchisor and carried out under their guidance and oversight by franchise owners (franchisees). The nature of franchising dictates that each party's obligations are ongoing and variable, forming an interdependent contract that is fundamentally based on an ongoing relationship.

Contracts of this nature underpinning the franchising relationship can impair the viability and success of individual franchise agreements for the following reasons:

- differing expectations about the obligations of each party to the agreement; and
- an asymmetric power dynamic within franchise agreements, with potential to lead to abuse of power.

Pre-contractual arrangements

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. Undertaking unbiased pre-agreement education is important, but even more critical is obtaining sound legal and business advice before entering into a franchise agreement.

The franchisor disclosure process mandated in the Code is intended to assist, not replace, due diligence by prospective franchisees. Better disclosure does not necessarily mean more disclosure; 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.

Recommendation 1 (paragraph 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.

This amendment would ensure that, before franchisees agree to enter into a franchise agreement, they are aware of their liabilities in the event of franchisor failure.

Recommendation 2 (paragraph 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*.

A system of this nature would generate an annual guarantee from franchisors that they are meeting their obligations under the Code. It would also mean that, for the first time, a central government agency would have useful data on how many franchises are operating in Australia.

Recommendation 3 (paragraph 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.

Some of the concerns about the disclosure process raised with the committee during its inquiry should be mitigated by the 1 March 2008 amendments if they function as intended. It is too soon for the committee to judge their efficacy at this stage.

Issues arising during franchise agreements

Although many franchise agreements result in successful and profitable ongoing business relationships, issues arising during the term of the agreement can cause tensions with the potential to escalate into disputes.

There are substantial practical difficulties in trying to regulate specific elements of conduct in a franchise agreement. A useful regulatory alternative would be the introduction into the Code of an overarching standard of conduct in franchising.

The end of a franchise agreement

Franchise agreements can end in early termination or through expiry and non-renewal of an agreement. Key concerns relating to end of term arrangements raised during the inquiry included:

- non-renewal of franchise agreements at the expiration of the first term, including whether there should be a right to automatic renewal or whether non-renewal by a franchisor should only be permitted where 'good cause' can be shown;
- the circumstances in which a franchisor should be able to terminate an agreement, including potential abuses of current termination provisions within the Code;

- whether a payment for the franchisee's contributed value to the business should be mandated if the agreement is terminated or not renewed for whatever reason;
- what happens when a franchisor fails;
- property rights; and
- transferability of equity in the value of the business as a going concern.

Recommendation 4 (paragraph 6.40)

The committee recommends that the government explore avenues to better balance the rights and liabilities of franchisees and franchisors in the event of franchisor failure.

Although the Code gives franchisors the ability to terminate franchisees, it does not provide reciprocal termination provisions for franchisees. In the event of franchisor failure, this can have serious consequences for franchisees who have no avenue to exit the business.

Recommendation 5 (paragraph 6.91)

The committee recommends that the Franchising Code of Conduct be amended to require franchisors to disclose to franchisees, before a franchising agreement is entered into, what process will apply in determining end of term arrangements. That process should give due regard to the potential transferability of equity in the value of the business as a going concern.

Franchisee expectations about renewal need to be better managed, and the financial implications of non-renewal better understood, before fixed term franchise agreements are initially signed. Franchise agreements should clearly stipulate what the end of term arrangements and processes are, and these arrangements should be fully and transparently disclosed to prospective franchisees.

Dispute resolution in franchising

Due to a lack of sound data, the true extent of disputation in the franchising sector is difficult to determine. When disputes do occur and cannot be resolved through internal processes, parties may choose to enter into formal mediation. If mediation fails, litigation is an alternative (but generally expensive) avenue for pursuing settlement.

Suggestions for improving dispute resolution outcomes included: an increased focus on pre-mediation strategies; the creation of a tribunal to make determinations; or the introduction of a franchising ombudsman. But inserting another layer into the resolution process between mediation and the courts would most likely add another layer of complexity and expense to the process without achieving materially improved outcomes. Instead, many of the issues which lead to franchising disputes, and hence the need for mediation or alternative dispute resolution mechanisms, may be mitigated

by the introduction of an explicit obligation into the Code for all parties to a franchise agreement to act in good faith.

Recommendation 6 (paragraph 7.22)

The committee recommends that the name of the Office of the Mediation Adviser be changed to the Office of the Franchising Mediation Adviser and that the Franchising Code of Conduct be amended to reflect this change.

This name change will aid understanding and recognition within the sector of the role this office plays in dispute resolution in franchising.

Recommendation 7 (paragraph 7.28)

The committee recommends that the government require the Australian Bureau of Statistics to develop mechanisms for collecting and publishing relevant statistics on the franchising sector.

Improved collection of statistics on franchising in Australia, with a focus on disputes and dispute-related unit franchise turnover, will help in developing a better understanding of how extensive disputation truly is.

Good faith in franchising

There remains concern in the sector at the continuing absence of an explicit overarching standard of conduct for parties entering a franchise agreement. The interdependent nature of the franchise contract leaves the parties to the agreement vulnerable to opportunistic conduct. The committee is of the opinion that the optimal way to provide a deterrent against opportunistic conduct in the franchising sector is to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith.

Recommendation 8 (paragraph 8.60)

The committee recommends that the following new clause be inserted into the Franchising Code of Conduct:

> **6 Standard of Conduct**
>
> **Franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement.**

Enforcement of the Code

Many franchisees made submissions to the inquiry outlining perceived inaction by, and ineffectiveness of, the Australian Competition & Consumer Commission (ACCC) in pursuing complaints against franchisors who are alleged to be in breach of the Code.

The ACCC is responsible for administration of the *Trade Practices Act 1974* (TPA), and its role extends to litigating in circumstances where it can substantiate evidence

that the TPA, including the Code, has been breached. The ACCC is not, however, responsible for prosecuting franchising disputes that relate to contractual disputes. Increased education efforts by the ACCC about its role would assist in bridging the expectation gap that seems to exist amongst franchisees. Notwithstanding the limitations of the ACCC's role, there also appears on the face of it to be room for improvement by the regulator in taking a more active role in the franchising sector.

Recommendation 9 (paragraph 9.35)

The committee recommends that the *Trade Practices Act 1974* be amended to include pecuniary penalties for breaches of the Franchising Code of Conduct.

The introduction of these penalties would assist the ACCC in its enforcement role by providing a greater deterrent for conduct that contravenes the Code.

Recommendation 10 (paragraph 9.37)

The committee recommends that consideration be given to amending the *Trade Practices Act 1974* to provide for pecuniary penalties in relation to breaches of section 51AC, section 52, and the other mandatory industry codes under section 51AD.

Similar penalties may be of assistance in improving conduct beyond franchising.

Recommendation 11 (paragraph 9.39)

The committee recommends that the ACCC be given the power to investigate when it receives credible information indicating that a party to a franchising agreement, or agreements, may be engaging in conduct contrary to their obligations under the Franchising Code of Conduct.[1]

This provision would assist the ACCC in taking investigative action in cases when franchisees fear retribution if they provide information directly to the regulator.

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1 The committee notes that the ACCC described this power as 'being able to undertake risk based audits' and went on to clarify that this would entail examination of disclosure documents and other material being circulated by a franchisor, as well as speaking with franchisees to discern any pattern of conduct. See Mr Brian Cassidy, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 99

Chapter 1

Introduction

Terms of reference

1.1 On 25 June 2008 the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into the operation of the Franchising Code of Conduct (the Code) and related matters. The terms of reference for the inquiry were:

> The Committee is to inquire and report on the operation of the Franchising Code of Conduct, and to identify, where justified, improvements to the Code, with particular reference to:
>
> 1. the nature of the franchising industry, including the rights of both franchisors and franchisees;
>
> 2. whether an obligation for franchisors, franchisees and prospective franchisees to act in good faith should be explicitly incorporated into the Code (having regard to its presence as an element in paragraph 51AC(4)(k) of the *Trade Practices Act 1974*);
>
> 3. interaction between the Code and Part IVA and Part V Division 1 of the *Trade Practices Act 1974*, particularly with regard to the obligations in section 51AC of the Act;
>
> 4. the operation of the dispute resolution provisions under Part 4 of the Code; and
>
> 5. any other related matters.

Relevant regulation and legislation

1.2 The Franchising Code of Conduct is a mandatory industry code established under section 51AE of the *Trade Practices Act 1974* and enforceable under section 51AD. The code and related information are at http://www.accc.gov.au/content/index.phtml/itemId/815503

1.3 The *Trade Practices Act 1974* can be accessed at http://www.comlaw.gov.au/ComLaw/Legislation/ActCompilation1.nsf/current/bytitle/FE54557126EA18EFCA257487000B9A3E?OpenDocument&mostrecent=1

Conduct of the inquiry

1.4 The inquiry was advertised in *The Australian* newspaper and through the internet. The committee invited submissions from a wide range of interested organisations, government departments and authorities, and individuals. The closing date for submissions was 12 September 2008, and the committee agreed to table its report on 1 December 2008.

1.5 The committee investigated deficiencies in the operation of the Franchising Code of Conduct and related legislation, and ways in which they might be improved. The focus of the committee's inquiry was on addressing broad structural, procedural and regulatory issues relating to franchise agreements in Australia, rather than on any particular franchising disputes. As such, the committee decided that it would not publish the details of individuals or corporations adversely commented on in submissions. Material deemed to have fallen within this category was deleted by the committee, and the amended version of submissions was made public on the inquiry webpage.[1]

1.6 The committee received 159 formal submissions and nine supplementary submissions, as well as associated correspondence and supporting material. A list of individuals and organisations that made public submissions to the inquiry is at Appendix 1.

1.7 The committee held four public hearings, in Sydney, Brisbane, Canberra and Melbourne. A list of witnesses who gave evidence at the public hearings is at Appendix 2.

Acknowledgement

1.8 The committee thanks those organisations and individuals that made written submissions and gave evidence at the public hearings.

Note on references

1.9 References to submissions in this report are to individual submissions as received by the committee and published on the Internet. References to the committee Hansard are to the proof Hansard, and page numbers may vary between the proof and the official Hansard transcripts.

Report structure

1.10 Chapter 2 describes the franchise business model, explaining the nature of the variable contracts that necessarily underpin a successful franchise agreement. The chapter highlights the potential benefits for both franchisee and franchisor from entering into such a business arrangement. It also acknowledges the potential for disputation to arise between the parties, either as a result of differing expectations or as a consequence of the power imbalance inherent in the relationship.

1.11 Chapter 3 opens with a statistical snapshot of franchising in Australia, followed by a description of the current regulatory framework that applies to the sector. A brief history of the development of the Franchising Code of Conduct and of previous inquiries into franchising in Australia reveals that many of the issues raised

1 http://www.aph.gov.au/senate/committee/corporations_ctte/franchising/submissions/sublist.htm

during the committee's current inquiry have also featured prominently in past deliberations.

1.12 Chapter 4 briefly discusses coverage of the Code and then focuses on pre-contractual arrangements that precede, or should precede, a decision by a franchisee and franchisor to enter into a franchise agreement. In particular, it emphasises the importance of engaging in pre-contractual education; obtaining appropriate legal, accounting and other business advice; and conducting due diligence. It also canvasses a range of factors that can influence the utility of the pre-contractual disclosure process mandated in the Code. In this chapter, the committee recommends that the Code be amended to include a statement in disclosure documents that sets out the specific consequences for a franchisee in the event of franchisor failure. The committee also recommends that the government investigates the benefits of establishing a simple online franchisor registration system, requiring a franchisor to guarantee on an annual basis that they are meeting their obligations under the Code. The committee further recommends that the government reviews the impacts of the March 2008 amendments to the disclosure provisions in the Code after they have been in effect for two years.

1.13 Chapter 5 highlights a selection of issues which were drawn to the committee's attention as having the potential to influence the smooth running of a franchise agreement, including unilateral variations to agreements; requirements to comply with operations manuals; opportunism; restraint of trade clauses; confidentiality clauses; and the use of advertising or other collective funds. The issues raised are indicative of tensions that may lead a franchisee and franchisor into dispute (Chapter 7), termination or non-renewal (Chapter 6), or litigation (discussed in Chapter 9). This chapter also foreshadows the need for an overarching standard of conduct in franchising, which is discussed in detail in Chapter 8.

1.14 Chapter 6 outlines the circumstances in which franchise agreements can end, be it through early termination or through expiry and non-renewal of an agreement. Many submissions and witnesses to the inquiry expressed concerns regarding lack of clarity and/or lack of fairness in relation to the ends of agreements, and this chapter summarises those concerns. In particular, it addresses whether existing arrangements for non-renewal are sufficient, explores the notion of goodwill in franchising, and canvasses whether franchisees should have any right to an exit entitlement that recognises the contribution they have made to building the reputation and success of the franchise. In this chapter, the committee recommends that the government explore avenues for better balancing the rights and liabilities of franchisees and franchisors in the event of franchisor failure. The committee also recommends that the Code be amended to require franchisors to disclose to franchisees, before a franchising agreement is entered into, what process will apply in determining end of term arrangements.

1.15 Chapter 7 recognises the need for a dispute resolution process in franchising and sets out the mediation provisions currently in the Code. Building on discussions in Chapter 3, the committee makes recommendations regarding a change to the name of

the Office of the Mediation Adviser and the need for better statistics collection in relation to franchising. The chapter presents views on the effectiveness of current mediation arrangements and some suggestions for improvements. It also points to the impact codification of good faith (discussed in Chapter 8) might have on franchising disputation.

1.16 Chapter 8 examines the need to introduce an overarching standard of conduct into the Code. It summarises arguments presented to the committee for and against the inclusion in the Code of an explicit obligation on all franchisors, franchisees and prospective franchisees to act in good faith. It also canvasses whether or not 'good faith' should be defined. In this chapter, the committee recommends that a new clause be put into the Code to specify that franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement.

1.17 Finally, Chapter 9 sets out the enforcement framework applicable to the Code and notes the investigative and enforcement role of the Australian Competition & Consumer Commission (ACCC). It identifies barriers to effective enforcement, including the level of ACCC activity, and presents some suggestions for improving enforcement tools. In this chapter, the committee recommends the introduction of pecuniary penalties for breaches of the Code and, potentially, other relevant parts of the *Trade Practices Act 1974*. The committee also recommends that the ACCC be given powers to investigate where it has reason to believe that a party to a franchise agreement is acting contrary to the Code.

Privilege issue

1.18 During the course of the inquiry, a matter of parliamentary privilege arose. A person who had made a submission to the inquiry drew the committee's attention to a letter in which they were threatened with a penalty as a direct result of making that submission.

1.19 The committee considered this to be a serious incident and took immediate action to address the matter, as detailed in Appendix 3.

Chapter 2

The franchise model

The franchise business model

2.1 Franchising is an ongoing relationship between two separate commercial parties, a franchisor and a franchisee. The franchising relationship is based on a prescribed business model offered by the franchisor and carried out under their guidance and oversight by franchise owners (franchisees). The Franchising Code of Conduct (the Code) stipulates that, under a franchise agreement, franchisees are granted the right to trade under the franchisor's brand and use their system or marketing plan. This occurs on the basis of certain conditions, which include:

- the franchisor retains control over the franchise system, including the use of the franchise brand, marketing and advertising, product/service quality and inputs;
- the franchisee's business is associated with the franchisor's trademark, advertising or commercial symbol;
- the franchisee pays a fee in exchange for the use of the franchisor's brand and systems. This can include initial one-off or continuing fees for either or all of the following: starting capital investment, payments for goods and services, royalties on profits and training.[1]

2.2 There has been some debate about the breadth of the definition of a franchise during the inquiry. This relates to the prospect of unintended regulatory encroachment—or, in some cases, potential lack of appropriate regulatory coverage—and is discussed further in Chapter 4, starting at paragraph 4.1.

Franchising appeal

2.3 For franchisees, the appeal of a franchise is the potential benefits of being able to conduct a business under an established brand name using tested operational systems. In turn, franchisors are able to grow their business by allowing others to use the model they have developed, within an agreement that allows them to retain substantial control over its use but without the financial risks of significant capital expenditure.

2.4 Franchising has proved a very popular business model in Australia. According to a Griffith University survey of franchising in Australia in 2008, there are now approximately 1100 business format franchisors in Australia, compared with 960 in

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

2006 and 850 in 2004.[2] There were an estimated 71,400 franchised units in 2008 turning over $61 billion (in 2007) and employing over 400,000 people.[3] Businesses that have adopted the franchising model range widely in type; examples include bakeries, mechanical services, travel agents, weight loss programs, fast food outlets, gardening services, coffee shops and dog washing services.[4] They vary in size from multinational franchise systems with thousands of franchisees, such as McDonald's, to emerging operations with just one or a handful of units operating under the franchise system. Further statistical information on franchising in Australia is contained in Chapter 3 starting at paragraph 3.5.

2.5 Despite the popularity of franchising in Australia, variable contracts underpinning the franchising relationship can impair the viability and success of individual franchise agreements for the following reasons:

- differing expectations about the obligations of each party to the agreement; and
- an asymmetric power dynamic within franchise agreements, with potential to lead to abuse of power.

Franchise contracts

2.6 As with other contractual relationships, franchise agreements may take the form of a written, oral and/or implied agreement.[5] The main difference from most other commercial relationships is that the nature of franchising dictates that each party's contractual obligations are ongoing and variable—forming a contract that is fundamentally based on an ongoing relationship. These are not discrete, one-off exchanges between parties on clearly defined terms that characterise ordinary contractual agreements.

2.7 The variable nature of the franchise agreement reflects the reality that successfully managing a franchising relationship over time requires flexibility of terms to adapt to constantly changing business conditions. Contracts between franchisees and franchisors therefore need continuing cooperation and agreement

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2 Frazer, L et al. *Franchising Australia 2008 Survey*, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 2. Business format franchises are the most common form of franchise in Australia, describing franchises operating at retail level under a common trademark and prescribed operating systems. See Franchise Council of Australia, 'What is franchising?', *FCA website*, accessed on 6 November 2008 at http://www.franchise.org.au/content/?id=183

3 Frazer, L et al. *Franchising Australia 2008 Survey*, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 10. When car dealerships and franchised fuel outlets are included, turnover increases to $130 billion.

4 Frazer, L et al. *Franchising Australia 2008 Survey*, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 19. The survey was sponsored by the Franchise Council of Australia.

5 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 9

between the parties to ensure the arrangement provides benefit to them both. Dr Elizabeth Spencer described the arrangement aptly:

> Relational contracts are defined by features of incompleteness and longevity. Relational contracts must be flexible, sometimes to the point of being vague. There is often a high level of discretion accorded to the parties, and such contracts therefore rely heavily on reciprocity and on trust that develops over time between the contracting parties.[6]

2.8 The real test of a franchise agreement comes after the contract has been signed and the working relationship between franchisee and franchisor begins. Although education, advice, disclosure and due diligence generate important information about the potential for success, the true nature of franchising cannot be appreciated until the relationship is under way.

Differing expectations

2.9 Franchise contracts establish a broad, loosely defined set of obligations for both parties. Franchisors are expected to offer an appropriate level of support, guidance and advice to franchisees on using their business model; maintain support through advertising and marketing; provide inputs and equipment of an agreed standard; and update the model when business conditions demand it. In return, franchisees are expected to pay agreed fees and royalties and execute the business model as prescribed by the franchisor, to a standard that maintains the reputation of the franchise network as a whole. The success of a franchise model depends on the provision of a consistent, quality product or service to consumers, who generally view the brand as a homogenous entity and exercise their spending preferences accordingly.

2.10 While contractual flexibility is necessary in the franchising context, an absence of clear and unambiguous responsibilities over the longer term provides a potential source of dispute or tension between franchisors and franchisees. Although the initial contract remains static, the terms of the contract are such that, in practice, changes in fees, conditions and business systems can be imposed on the franchisee by the franchisor through changes in the operations manual. Where expectations about performance and/or conduct do not match that of the other party, disagreements about how the franchise agreement is to be carried out can occur and the relationship can break down.

2.11 For instance, a franchisee might be disgruntled with the franchisor's prescribed model for offering a core product, based on direct customer feedback. The franchisee may be dissatisfied with a perceived lack of responsiveness to evolving consumer preferences and make minor changes independently to maximise store sales. In such a case, the franchisee expects the franchisor to update the business model to meet changing business conditions and may consider that these expectations have not been met. Conversely, the franchisor expects that the franchisee will strictly adhere to

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6 Dr Elizabeth Spencer, *Submission 39*, p. 7

the model in order to maintain brand integrity. In the hypothetical scenario presented above, their expectations have also not been met—which precipitates a dispute between the parties over who should be doing what and how. This example portrays a very basic version of the genesis of disputes that occur in practice, but demonstrates the potential for unmet expectations and consequential disputes within franchise agreements.

Power imbalance

2.12 Compounding the 'expectation gap' problem for franchisees is the asymmetrical distribution of power within the franchise agreement. The franchising model is necessarily predicated on strict franchisor control over the use of their brand, allowing them to impose strict terms and conditions on the way franchisees operate their franchise business. Because the franchisor's model needs to be implemented uniformly across the franchise network, franchise agreements are typically underpinned by standard form contracts drafted by the franchisor. These are presented to franchisees on a 'take it or leave it' basis: the franchisee can either agree to establish a franchising relationship on the franchisor's terms or not proceed at all.

2.13 In practice, franchisors are able to dictate business operations and procedures to franchisees, and are able to change these at will. Standard form contracts specify the beginning of a franchising relationship, but—as allowed for in the contracts—the operations manual and other communications or directions from the franchisor form the basis of daily operations. Franchisors can impose rigorous obligations on the way the franchisee operates, which are subject to change at the discretion of the franchisor. These obligations may be strictly enforced: failure by the franchisee to meet their obligations, as interpreted by the franchisor, can trigger termination of the contract.[7] This control allows franchisors to prevent franchisees from exploiting their intellectual property to the detriment of the overall franchise network but can also lead to the potential for abuse of power.

2.14 On the other hand, standard form contracts provide little or no scope for franchisees to impose stringent obligations on franchisors or apply their own discretion to open-ended terms of the agreement.[8] Despite their investment in the business and their dependence on the use of the franchise model to derive returns from this investment, franchisees can exert little or no leverage when seeking to impose their interpretation of the franchisor's obligations on the agreement.

2.15 Franchisors are therefore in a position to exercise far greater power than franchisees when enforcing the terms of open-ended, variable agreements. From the franchisee's position of relative weakness, they must hope that the franchisor will not exercise their discretion opportunistically. In good franchising relationships the

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7 Termination provisions in the event of franchisee breach are set out in Part 3 of the Code; see *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 22

8 See for example Dr Elizabeth Spencer, *Submission 39*, pp. 4-13

franchisor nurtures and assists franchisees to maximise profit royalties and achieve growth of their brand. Such is the cooperative and interdependent way the majority of franchising relationships are conducted. However, the imbalance of power within the relationship means that scope exists for rogue franchisors to use their control opportunistically for financial gain at the expense of franchisees.

2.16 Franchising regulations need to operate in a way that seeks to prevent these instances from occurring. This is the focus of the committee's inquiry.

Chapter 3

Franchising in Australia

The Australian franchising sector

3.1 Although the franchising model has become increasingly popular in Australia, the absence of an official register of franchisors makes it difficult to glean highly accurate statistical information on the franchising sector. The limited available data on the franchising sector is primarily derived from willing respondents to industry surveys, meaning that estimating trends and patterns across the entire sector can be problematic. Another factor that needs to be considered is that the results from these surveys are composed only from information provided by franchisors, which can potentially skew the results on contentious issues, such as disputes.

3.2 The Australian Competition & Consumer Commission (ACCC) commented that the shortage of statistical data on franchising 'contrasts with the level of information available about general business demography in Australia', noting that more comprehensive data would improve the effectiveness of its enforcement role and allow for a more informed debate about the sector. The ACCC recommended that:

> The committee consider the targeted collection and publication of information about the franchising sector to assist the ACCC, other government agencies, franchisees and prospective franchisees to better understand franchising.[1]

3.3 Presently, the Australian Bureau of Statistics (ABS) collects only limited data on franchising in Australia through its survey on business characteristics. The information collected is restricted to the proportion of businesses surveyed that identify as being involved in franchising as either a franchisor or franchisee.[2] The committee makes a recommendation relating to the ABS's collection of data on franchising at paragraph 7.28, in the context of franchising dispute levels and mediation.

3.4 With that qualification, a brief statistical snapshot of the franchising sector in Australia is presented below. The majority of the information has been extracted from a biennial survey undertaken by the Asia-Pacific Centre for Franchising Excellence within Griffith University. The survey is sponsored by the Franchise Council of Australia.

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1 ACCC, *Submission 60*, p. 18

2 This particular survey has only been undertaken since 2005-06. Australian Bureau of Statistics, *8167.0 - Selected Characteristics of Australian Business, 2006-07*, 'Business structure and arrangements', accessed on 17 November 2008 at: http://www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/8167.0Main%20Features22006-07?opendocument&tabname=Summary&prodno=8167.0&issue=2006-07&num=&view=

Franchise numbers and size

3.5 As indicated in the previous chapter (paragraph 2.4), the Franchising Australia 2008 Survey reported that there were approximately 1100 business format franchisors in Australia. This has been estimated as being one franchise for every 20,000 citizens, around five times the density of franchise systems as exists in the United States.[3] Sizes of franchise systems in Australia ranged from one to 2950 units. They vary in size from multinational franchise systems with thousands of franchisees, such as McDonald's, through to fledgling operations with just one or a handful of units operating under the franchise system. Survey responses indicated that the median number of franchise units per franchise was 20. According to the survey authors:

> This means that half the sample of franchisor respondents holds very small systems which will not be economically sustainable unless the systems continue to grow.[4]

3.6 The ABS business characteristics survey indicates that five per cent of businesses identified themselves as franchisees, and one per cent identified themselves as franchisors. Businesses employing between 20 and 199 people were most likely to be franchisees (10 per cent), and four per cent of businesses employing over 200 people identified as franchisors.[5]

Types of businesses

3.7 The Franchising Australia 2008 Survey indicates that 28 per cent of franchisors are involved in retail trade, followed by 16 per cent in accommodation and food services, and 15 per cent in administration and support services. From a franchise unit perspective, the survey indicates that there are more units per franchisor in the accommodation and food services industry than the other two categories. It should be noted, however, that the arbitrariness and breadth of business types within each industry classification diminishes the value of these figures. For instance, cleaning and gardening services are categorised with travel agents, while pet services and mechanics find themselves situated together in a separate category called 'other'.[6]

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3 Gehrke, J. 'An Overview of the Franchise Sector of Australia', Franchise Advisory Centre, 2008, p. 5, included as an attachment in Franchise Advisory Centre, *Submission 132*

4 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 24

5 Australian Bureau of Statistics, *8167.0 - Selected Characteristics of Australian Business, 2006-07*, 'Business structure and arrangements', accessed on 17 November 2008 at: http://www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/8167.0Main%20Features22006-07?opendocument&tabname=Summary&prodno=8167.0&issue=2006-07&num=&view=

6 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 20

Age of franchise systems

3.8 Offering more clarity are the survey's figures on the length of time franchise systems had been in existence. Approximately one third commenced franchising in the 1990s, one third from 2000-2005 and one fifth since 2006.

3.9 A conclusion that may be drawn from these statistics is that the vast majority of extant franchise systems in Australia have commenced operation during a period of economic prosperity. They have also commenced in a period during which franchising regulation has been in place.[7]

3.10 The survey further found that a substantial portion (nearly one third) of franchisors begin franchising very early in the life of their business. Some 14 per cent of survey respondents operated for just one year before launching their franchise system, and a further 17 per cent franchised either immediately or within their first year of operation.[8]

Franchise system exit data

3.11 A contentious aspect of statistical information on the sector is the extent to which franchisors exit franchising. Few statistics are available on this given that the Franchising Australia survey does not specifically outline the number of new entrants in the survey, from which the number that have exited since the previous survey could be determined. Ms Jenny Buchan has noted that:

> Griffith University conducts the biannual [sic] franchising Australia survey. The Griffith database records the former franchisors that are no longer contactable two years later but this is not a matter of public record.[9]

3.12 Mr Jason Gehrke of the Franchise Advisory Centre has commented that the rate of exits may be significant:

> When releasing the Franchising Australia 2006 survey findings at the Franchise Council national conference on October 21 that year, the authors specifically commented on the number of entrants and exits when compared with the previous survey. While the overall number of franchise systems in Australia had increased by approximately 100 from 2004 to 2006, this increase was made up of 200 new entrants and 100 franchisors that had ceased franchising since the 2004 survey. In other words, for every two new franchisors, one franchisor exited over a two-year period, accounting for a loss of almost 12% of the 850 franchisors identified in the 2004 survey.[10]

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7 The mandatory Franchising Code of Conduct was first introduced in 1998.

8 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, pp. 21-22

9 Ms Jenny Buchan, *Submission 89*, p. 9

10 Gehrke, J. 'An Overview of the Franchise Sector of Australia', Franchise Advisory Centre, 2008, p. 7, included as an attachment in Franchise Advisory Centre, *Submission 132*

3.13 A possible explanation for franchisor exit is that, particularly for those who may have entered franchising without significant experience of brand development, success proved more difficult to attain than they had initially expected.

3.14 Using a comparison between franchisors listed in a franchising publication from 1998 and the Franchise Advisory Centre's current database, Gehrke estimated that 30 per cent of the 1998 franchisors had ceased to franchise, and most appeared not to be operating in any capacity any more.[11]

Franchisee characteristics

3.15 Franchisees are mostly aged between 30 and 50, with just fewer than half being sole owners and a similar figure being husband and wife operators.[12] Only 43 per cent were reported to have independent business experience, half of these in the same industry. Prior to becoming franchisees, around 40 per cent had no salaried experience in the same industry or business experience of any kind.[13]

3.16 These findings are consistent with anecdotal evidence put to the committee. Typically, franchising attracts so-called mum and dad investors who want to get into business but, lacking relevant experience, feel a sense of security from having an established franchise brand and system behind them.

Franchisee turnover

3.17 The Franchising Australia survey reported that most initial terms of agreement are for fixed five (67 per cent) or ten (17 per cent) year terms.[14] These agreements carried a median initial fee for accessing the system of $30,000.[15] With respect to agreement renewal, the Franchising Australia survey reported that:

> Over half the franchisors (52 per cent) reported that 98 per cent of their franchisees had renewed their agreements upon expiration of the initial term. Only 5 per cent of franchisors indicated that none of their eligible

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11 Gehrke, J. 'An Overview of the Franchise Sector of Australia', Franchise Advisory Centre, 2008, p. 7, included as an attachment in Franchise Advisory Centre, *Submission 132*

12 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, pp 32-33

13 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 35

14 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 23. The figures refer to the proportion of fixed term agreements, which were used by 94 cent of total respondents.

15 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 29. Total median start-up costs were reported to be $100,000.

> franchisees had renewed. Overall, franchise agreement renewal was standard practice in the sector.[16]

3.18 The survey did not provide information on the 43 per cent of franchisors that fell somewhere in the middle of having almost all their eligible agreements renewed and those that had none.

3.19 The Franchising Australia 2008 Survey also reported that the median time franchisees remained in a system was seven years, which could indicate that a significant proportion of franchise agreements are not being renewed.[17] Interestingly, the committee heard from one witness that seven years also equates to the amount of time it takes to recoup a franchisee's initial investment: '… seven years is the standard payback period'.[18]

3.20 By way of comparison, the 1998 franchising survey stated that 55 per cent of fixed term agreements were for five years and 27 per cent for ten, suggesting that a shift in preference for five instead of ten year terms has occurred in the past decade. The proportion of franchisors using perpetual agreements was virtually unchanged at below ten per cent.[19] Data from earlier periods was unavailable. From an anecdotal perspective, Mr Robert Gardini told the committee that previously in the motor vehicle dealership sector franchise agreements were often evergreen; they had no fixed terms. He indicated a trend over time such that these agreements have now been replaced with fixed term agreements, some of which are as short as 12 months in duration.[20]

Dispute levels

3.21 A relatively high 17 per cent of franchisors reported having been in a dispute with at least one franchisee that was referred to an external adviser, though this was down from 35 per cent in 2006.[21] The survey stated:

> Major causes of substantial disputes were compliance with the system (66 per cent), profitability (37 per cent), territorial issues (21 per cent), communication problems (18 per cent) and fees (16 per cent).[22]

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16 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 22

17 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 37. It should be noted that non-renewal can be a decision by either the franchisor or franchisee.

18 Mr Greg Fisher, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 84

19 Franchising Australia 1998 Survey, p. 6; Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 22

20 Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008, pp 6-7

21 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 40

3.22 The strong possibility that non-respondents to this survey are more likely to be involved in disputes with franchisees must be considered. Further, 62 of 286 franchisor respondents to the survey did not answer the question about disputes, which would suggest an underestimation of the level of disputes within the sector.[23]

Regulatory and representative bodies in Australian franchising

3.23 Following is a list of the regulatory and representative bodies for the franchising sector in Australia who were involved in this inquiry.[24]

Australian Competition & Consumer Commission (ACCC)

3.24 The ACCC is an independent statutory authority responsible for enforcing the *Trade Practices Act 1974* as it applies to the franchising sector. Its role is to ensure compliance with the Franchising Code of Conduct (the Code) and the TPA through education, liaison and, where necessary, enforcement action. To this end, it develops educational and compliance materials such as guidelines, articles and fact sheets, and gives presentations in each state and territory.[25]

Office of the Mediation Adviser (OMA)

3.25 The OMA is a government funded body established in 1998, when the Code first came into effect. The role of the OMA is to appoint mediators to assist franchisors and franchisees in resolving their disputes without going to court.[26] However, franchising parties in dispute do not have to use an OMA mediator; they can use an alternative mediator if both parties agree.

Department of Innovation, Industry, Science and Research (DIISR)

3.26 DIISR provides policy advice to the Minister for Small Business, Independent Contractors and the Service Economy on franchising matters. As part of its role, DISSR monitors industry representations and statistics produced by the OMA, with the objective of identifying any systemic problems in the franchising sector that impede the operation of the Code.[27]

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22 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 40

23 Frazer, L et al. Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008, p. 41

24 The International Franchise Association based in Washington DC also made a submission to the inquiry; see *Submission 120*.

25 ACCC, *Submission 60*, pp 5, 7-8

26 OMA website, accessed 20 November 2008 at: http://www.mediationadviser.com.au/

27 DIISR, *Submission 137*, p. 2

Franchise Council of Australia (FCA)

3.27 According to its website, the FCA is the peak industry body representing franchisors, franchisees, service providers and suppliers involved in franchising. It is a nationally incorporated not-for-profit association which was established in 1983. Membership of the FCA is voluntary and is open to any organisation or individual involved in the franchise sector, including franchisees, franchisors, lawyers, accountants, banks, consultants, academics and publishers.[28]

Franchisees Association of Australia Inc (FAAI)

3.28 The FAAI is a voluntary organisation which exclusively represents franchisees. The majority of FAAI board members are either current or past franchisees or are representatives of organisations that have franchisees as members. The FAAI is a collective organisation, with a number of affiliated organisations.[29]

3.29 A number of industry-specific representative bodies also participated in the inquiry, including:

- Australian Retail Association (http://www.retail.org.au/)
- National Retailers Association (http://www.nra.net.au/)
- Retail Traders' Association of Western Australia (http://www.cciwa.com/default.aspx?MenuID=192)
- Shopping Centre Council of Australia (http://www.icsc.org/about/affiliates_australia.php)
- Motor Trades Association of Australia (http://www.mtaa.com.au/)
- Motor Traders Association of Queensland (http://www.mtaq.com.au/)
- Motor Traders' Association of NSW (http://www.mtansw.com.au/)
- Federal Chamber of Automotive Industries (http://www.fcai.com.au/)
- Lottery Agents Association of Victoria (http://www.laav.org.au/)
- Post Office Agents Association Limited (http://www.poaal.com.au/)

Franchising regulation in Australia

3.30 Franchising in Australia is regulated under the *Trade Practices Act 1974* (TPA) and the *Trade Practices (Industry Codes – Franchising) Regulations 1998*, which contains the Franchising Code of Conduct. Section 51AD of the TPA prohibits

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28 Franchise Council of Australia website, accessed 20 November 2008 at: http://www.franchise.org.au/content/?id=2,

29 Mr David Beddall, *Proof Committee Hansard,* Brisbane, 10 October 2008, pp. 22-23. See also FAAI website, accessed 20 November 2008 at: http://www.faai.com.au/

corporations from contravening an applicable industry code. Section 51AE of the TPA provides for the making of regulations to prescribe an industry code and to declare an industry code as mandatory or voluntary. The *Trade Practices (Industry Codes – Franchising) Regulations 1998* establishes the Franchising Code of Conduct as a mandatory industry code that binds parties to franchise agreements.

Franchising Code of Conduct

3.31 The Franchising Code of Conduct (the Code) came into effect as a mandatory code, enforceable under section 51AD of the TPA, on 1 July 1998. Its purpose 'is to regulate the conduct of participants in franchising towards other participants in franchising'.[30] The provisions of the Code are described briefly as follows.

Disclosure

3.32 Part 2 of the Code establishes the requirement for franchisors to provide certain information to prospective or renewing franchisees in a disclosure document, no less than 14 days before the agreement is entered into or renewed. This material must be read and understood by the franchisee. The franchisor must also provide to the franchisee a copy of the Code and a copy of the franchise agreement in the form in which it is to be executed. In turn, the franchisor must receive a written statement from franchisees that the disclosure document has been read and understood, and a written statement from prospective franchisees that they have sought independent expert advice (or have been told that such advice should be sought but have elected not to seek it).[31]

3.33 Information that must be disclosed in accordance with Part 2 of the Code includes:

- details of the franchisor's business experience;
- history of litigation relating to the franchisor's business dealings;
- existing franchisees operating within the franchise network;
- the details of franchises that have ceased to operate or changed hands in the past three years;
- intellectual property rights;
- exclusivity of territory;
- rights and obligations concerning the supply of goods or services;
- history of the franchise business in that location/area;
- details of compulsory marketing funds;

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30 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, pp. 15-16

31 This may be from a legal or business adviser, or accountant; *Trade Practices (Industry Codes – Franchising) Regulations 1998*, sections 6 to 11, pp. 13-15

- various payments the franchisee is required to make;
- financing arrangements;
- obligations of both parties; and
- financial details of the franchisor.[32]

Conditions of the agreement

3.34 Part 3 of the Code stipulates certain conditions relating to the franchise agreement. It establishes a cooling off period, ensures that franchisees are allowed to form associations with other franchisees, and sets out disclosure requirements concerning marketing funds and change of franchisor ownership. Part 3 also addresses the rights and obligations of the parties with respect to transferring the franchise and terminating the franchise agreement.[33]

Dispute resolution

3.35 Part 4 sets out the procedures for resolving franchising disputes. The Code states that mediation must take place where a dispute cannot be resolved between the parties themselves and either party refers the matter to a mediator. The mediation adviser, appointed by the Minister in accordance with section 25 of the Code, appoints a mediator of their choice where the parties cannot agree to a mediator on their own. The parties (or their representatives) must attend mediation to attempt to resolve the dispute, though no requirement to participate in good faith exists within the Code. If, after 30 days of unsuccessful mediation, either party asks the mediator to terminate the mediation, this must occur. The Code does not provide for the mediator to make a determination about the merits of each party's case in the event of failed mediation.[34]

Relevant Trade Practices Act provisions

3.36 The conduct of parties to franchise agreements is also regulated by relevant provisions of the TPA governing conduct in commercial activities. These are:

- section 51AC prohibiting unconscionable conduct;
- section 52 prohibiting misleading or deceptive conduct;
- section 53 prohibiting making false or misleading representations about the supply of goods or services; and
- section 59 making false or misleading representations about the profitability or risk or other material aspect of any business activity.

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32 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, Annexure 1, from p. 27

33 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, sections 13 to 23, pp. 16-23

34 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, sections 24 to 31, pp. 24-26

3.37 Where the court is satisfied that any of these provisions have been contravened, the TPA provides for courts to grant an injunction (section 80), allow an action to recover the amount of loss or damage (section 82), or make an order to vary the contract (section 87).

3.38 Section 51AC governing unconscionable conduct prohibits parties in trade and commerce from engaging in 'conduct that is in all the circumstances, unconscionable'. The provision does not seek to define what constitutes unconscionable conduct in statute, though it does list a number of matters courts may have regard to in determining unconscionability. These include the requirements of an applicable industry code, the extent of negotiation of a contract and the extent to which the parties acted in good faith.

3.39 The committee notes that, at the time of tabling this report, the Senate Standing Committee on Economics was conducting an inquiry into the need for a statutory definition of unconscionable conduct and the scope and content of any such definition.

3.40 The ACCC is responsible for 'compliance with the Act and the code by education, liaison and, where necessary, enforcement action'.[35] The ACCC investigates potential breaches of the TPA and may commence proceedings in the Federal Court if it deems there is sufficient evidence to support successful litigation.[36] Private actions seeking remedy for alleged breaches of the TPA may also be taken to the Federal Court.

Relevant case law

Ketchell v Master Education Services Pty Ltd

3.41 *Ketchell v Master Education Services Pty Ltd* (Ketchell) centred on whether or not a technical breach of clause 11 of the Franchising Code of Conduct rendered the agreement illegal and unenforceable. A requirement of clause 11 of the Code is that an agreement cannot be entered into until the franchisee has provided the franchisor with written acknowledgement that the disclosure document and the Code have been received, read and had an opportunity to be understood. In Ketchell, the franchisor failed to ensure the franchisee had provided this document before entering into their franchise agreement. The franchisee, Mrs Ketchell, argued that the franchisor was not entitled to receive disputed payments under the agreement because it had breached the Code.[37]

35 ACCC, *Submission 60*, p. 5

36 ACCC, *Submission 60*, p. 11

37 Watts, K and Gordon, T. 'Recent case law on the remedies available under the Franchising Code', *Australia and New Zealand Trade Practices Law Bulletin*, Vol 24, No. 3, July 2008, pp. 34-35

3.42 On appeal to the NSW Court of Appeal, the court adopted the strict common law rule that courts cannot enforce a contract prohibited by statute, concluding that the clause 11 breach rendered the whole agreement illegal and void, making the terms of the agreement unenforceable.[38] However, the High Court subsequently reversed this decision, finding that it is not the intention of the TPA to automatically make void any franchise agreement in which there has been a technical breach of the Code. The court held that:

> Section 51AD [of the TPA] does not in its terms prohibit the making of a franchise agreement where a franchisor has not complied with the Code. That section and the Code are concerned with the regulation of the conduct of participants in the franchising industry; in particular the conduct of franchisors. It is not to be inferred from a purpose which promotes or prescribes better and fairer business practices that contractual relations between parties will be affected.[39]

Hoy Mobile Pty Limited v Allphones Pty Ltd

3.43 The High Court's decision had followed similar reasoning in *Hoy Mobile Pty Limited v Allphones Pty Ltd* (Allphones). In this case, the franchisor argued that, on the basis of the NSW Court of Appeal's judgement in Ketchell, the agreement should be considered void because it (the franchisor) had itself breached the Code. The rationale behind the franchisor's argument was to sidestep its obligations under the agreement through its own breach of clause 11. The court rejected this, stating that the purpose of the Code is to protect franchisees, rather than to prevent them from being able to enforce the terms of their franchise agreement because of a technical breach of the Code.[40]

Implications for the franchising sector

3.44 The NSW Court of Appeal's strict approach in Ketchell seems to have been rejected, but uncertainty about the implication of technical breaches of the Code remains. While such breaches seemingly do not automatically render a franchise agreement illegal and void, it is still not clear as to the appropriate remedies, available through the TPA, to be applied for minor breaches of the Code.[41] Franchisors that do not observe the letter of the law when complying with the Code, or do not retain

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38 *Ketchell v Master of Education Services Pty Ltd* [2007] NSWCA 161

39 *Master Education Services Pty Limited v Ketchell [2008] HCA 38*

40 Watts, K and Gordon, T. 'Recent case law on the remedies available under the Franchising Code', *Australia and New Zealand Trade Practices Law Bulletin*, Vol 24, No. 3, July 2008, p. 35; *Hoy Mobile Pty Limited v Allphones Retail Pty Limited [2008] FCA 810*. Contributing to the different reasoning in Hoy was a 2001 amendment to the Code - the introduction of Clause 6A - that postdated the agreement in dispute in the Ketchell case.

41 The Franchising Code of Conduct does not prescribe penalties or remedies for breaches of its provisions.

appropriate evidence of same, are in a potentially vulnerable position in the event of a dispute with a franchisee.[42]

Other mandatory industry codes

3.45 Two other prescribed mandatory industry codes have been established under section 51AE of the *Trade Practices Act 1974* (TPA). They are the Oilcode and the Horticulture Code.

Oilcode

3.46 The *Trade Practices (Industry Codes – Oilcode) Regulations 2006* (the Oilcode) came into effect on 1 March 2007. It operates as a mandatory industry code under section 51AE of the TPA and replaced the repealed *Petroleum Retail Marketing Sites Act 1980* and *Petroleum Retail Marketing Franchise Act 1980*.[43]

3.47 The Oilcode regulates the conduct of suppliers, distributors and retailers in the downstream petroleum retail industry. It was implemented to establish the following:

- consistent and transparent approaches to terminal gate pricing and fuel re-selling agreements;
- standard contractual terms for supplier-retail re-selling agreements; and
- an independent dispute resolution scheme.[44]

3.48 As with the Franchising Code of Conduct, the ACCC is responsible for administering the legislation under which the Oilcode operates. The Oilcode's effectiveness is also monitored by the ACCC.[45]

3.49 The most relevant aspect of the Oilcode to this inquiry is the dispute resolution scheme. Under section 41 of the Oilcode, the Minister is required to appoint a Dispute Resolution Adviser (DRA). This person must arrange mediation or other assistance where the relevant parties cannot resolve the dispute themselves and is granted the authority to make a non-binding determination about the dispute.[46]

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42 Watts, K and Gordon, T. 'Recent case law on the remedies available under the Franchising Code', *Australia and New Zealand Trade Practices Law Bulletin*, Vol 24, No. 3, July 2008, pp. 35-36

43 ACCC, *The guide to the Oilcode for industry participants in the downstream petroleum industry*, p. iii, accessed on 7 November 2008 at: http://www.accc.gov.au/content/item.phtml?itemId=771848&nodeId=fd100c294232594ec7b32c7bbb9ef606&fn=Guide%20to%20the%20Oilcode.pdf

44 Department of Resources, Energy and Tourism, 'Downstream Petroleum Legislation', *DRET website*, accessed on 7 November 2008 at: http://www.ret.gov.au/resources/fuels/petroleum_refining_and_retail/downstream_petroleum_legislation/Pages/DownstreamPetroleumLegislation.aspx

45 *Trade Practices (Industry Codes - Oilcode) Regulations 2006*, section 3(1)

46 *Trade Practices (Industry Codes - Oilcode) Regulations 2006*, sections 44 and 45

Section 45(1) also stipulates that mediation and assistance provided in accordance with the Oilcode must be carried out in good faith.

3.50 These dispute resolution processes do not restrict parties to the dispute from making direct complaints to the ACCC or pursuing litigation.[47]

Horticulture Code

3.51 *The Trade Practices (Horticulture Code of Conduct) Regulations 2006* (the Horticulture Code) came into effect on 14 May 2007. It regulates participants in the horticulture industry and was implemented to achieve the following objectives:

- provide greater clarity and commercial transparency between growers and wholesale traders; and
- establish a dispute resolution scheme.[48]

3.52 The dispute resolution procedure provisions stipulate the circumstances in which a mediator may be appointed to resolve disputes. In contrast to the Oilcode, the Horticulture Code does not oblige the parties to mediate in good faith, and the appointed mediator may terminate the mediation if it is unlikely to resolve the dispute.[49]

State regulation

3.53 Although franchising is directly regulated by Commonwealth legislation and regulation, redress where unfair contracts have been entered into has also been available in New South Wales under state legislation. Mr Gardini told the committee that difficulties for motor dealers accessing remedies under section 51AC of the TPA could until recently be circumvented using NSW industrial relations legislation:

> Previously the issues of good faith and unconscionable conduct could be dealt with to some extent in the application of the unfair contracts provision in part 9 of the Industrial Relations Act 1996 of New South Wales. Remedies under section 106 of the IRA give the Industrial Relations Commission the power to vary or find void contracts which are deemed to be unfair. However, this avenue was significantly diminished when the High Court's decision in Fish v Solution 6 Holdings held that the jurisdiction of the commission only extended to contract disputes whereby a

47 ACCC, *The guide to the Oilcode for industry participants in the downstream petroleum industry*, pp. 20-22, accessed on 7 November 2008 at: http://www.accc.gov.au/content/item.phtml?itemId=771848&nodeId=fd100c294232594ec7b32c7bbb9ef606&fn=Guide%20to%20the%20Oilcode.pdf

48 ACCC, *The guide to the horticulture code for growers and wholesale traders in the horticulture industry*, p. iii, accessed on 7 November 2008 at: http://www.accc.gov.au/content/item.phtml?itemId=778037&nodeId=758ea14dc281f3340b110396c743a3c8&fn=Horticulture%20code%20guide.pdf

49 *Trade Practices (Horticulture Code of Conduct) Regulations 2006*, section 36

> person performs work in an industry. Since this decision in 2006 the trend has been to exclude the application of section 106 to commercial contracts. This has meant that the majority of motor vehicle dealers in New South Wales who may once have been able to seek remedy through the commission will now have to use alternative recourse unless they can satisfy the requisite jurisdictional elements of section 106.[50]

3.54 State-based retail tenancy laws are also relevant to franchising parties, outlining the rights and obligations of landlords and tenants entering into a tenancy agreement for designated retail premises. Provisions within these acts include disclosure requirements, end of term arrangements, minimum terms, the prohibition of certain conduct, rent negotiation, transfer arrangements and dispute resolution procedures.[51]

Committee view

3.55 Taking into consideration the fact that many franchise systems operate across multiple state jurisdictions, the committee believes that franchising is most appropriately and usefully regulated at the Commonwealth level.[52]

Background to the current regulatory system

3.56 The following section contains a brief description of the various reviews, recommendations, guidelines, regulations and amendments that have preceded the regulatory framework governing franchise agreements extant in 2008. It is notable for the fact that some of the contentious issues raised during this inquiry were identified by the parliament as long as 30 years ago, when franchising was in its infancy.

Swanson and Blunt reviews

3.57 Major reviews of the TPA in 1976 (Swanson Committee) and 1979 (Blunt Committee) identified problems in the regulation of franchise agreements.[53] The Swanson Committee focused primarily on the issue of compensation to franchisees for goodwill on termination or non-renewal of their agreement by the franchisor, recommending a right to fair and equitable compensation.[54] The Blunt Committee

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50 Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 9

51 See for example *Retail and Commercial Leases Act 1995 (SA)*

52 This view was shared by the 2008 Western Australian government inquiry into franchising. See WA Small Business Development Corporation, *Inquiry into the Operation of Franchise Businesses in Western Australia*, April 2008, p.45

53 Trade Practices Act Review Committee, *Report to the Minister for Business and Consumer Affairs*, AGPS, Canberra, August 1976, chapter 5; Trade Practices Consultative Committee, *Small Business and the Trade Practices Act*, Vol 1, AGPS, Canberra, December 1979, chapter 11.

54 Trade Practices Act Review Committee, *Report to the Minister for Business and Consumer Affairs*, AGPS, Canberra, August 1976, pp. 36-38

addressed a wider array of issues, identifying pre-agreement disclosure, compensation for unjustified termination and transfer between franchisees as 'principal problems'. It recommended amendments to the TPA to mandate certain disclosure; stipulate the circumstances in which agreements could be terminated; provide rights to franchisees with respect to transferring the franchise to another person; and apportion goodwill upon termination or non-renewal of an agreement by the franchisor.[55]

Exposure drafts of a franchising bill

3.58 In 1986 two draft bills were prepared in an attempt to enact specific franchising legislation. The first draft contained a number of provisions that encapsulated and added to the recommendations contained in the Swanson and Blunt reviews. It sought to establish a comprehensive disclosure regime and cooling off period; prohibit unilateral contract variations; set out the right to transfer interests; and stipulate termination and non-renewal procedures (including minimum notice periods). It did not provide for automatic rights of renewal or entitlement to payments for goodwill at the end of an agreement, nor did it seek to prescribe the circumstances in which termination could occur.[56] The second draft bill pared back the provisions contained in the first, omitting the provisions on termination and non-renewal and curtailing the prohibition of unilateral variations of the agreement.[57] The bill was not enacted.

Beddall Committee report

3.59 In 1990, the House of Representatives Standing Committee on Industry, Science and Technology (Beddall Committee) conducted a broad inquiry into small business regulation.[58] The committee recommended that franchise-specific legislation be reconsidered to 'ensure fair dealing' between franchising parties, providing for pre-agreement disclosure, cooling off period, conditions applying to alterations of agreements and conditions for the termination/renewal or transfer of franchises.[59]

Voluntary franchising code of practice

3.60 A voluntary franchising code of conduct was introduced in 1993. Administered by the Franchising Code Administration Council Ltd (composed of representatives of franchisors, franchisees and the government), it reflected the Beddall Committee recommendations by including provisions on disclosure to

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55 Trade Practices Consultative Committee, *Small Business and the Trade Practices Act*, Vol 1, AGPS, Canberra, December 1979, pp. 102-110

56 Consultative Paper and Draft Franchise Agreements Bill, 1986, Part A, pp. 8-71

57 Second Exposure Drafts of the Franchise Agreements Bill 1986, Part A, p. 13 and Part B, p. 21

58 House of Representatives Standing Committee on Industry, Science and Technology, *Small Business in Australia: Challenges, problems and opportunities*, January 1990

59 House of Representatives Standing Committee on Industry, Science and Technology, *Small Business in Australia: Challenges, problems and opportunities*, January 1990, pp. 233-235

franchisees, a cooling off period, standards of conduct based on unconscionability, and dispute resolution procedures.[60]

Reid Committee report

3.61 In 1997, the House of Representatives Standing Committee on Industry, Science and Technology (Reid Committee) held an inquiry into 'business conduct issues arising out of commercial dealings between firms'.[61] The Reid Committee report recommended specific franchising legislation 'providing for compulsory registration of franchisors and compliance with codes of practice'.[62] The committee made their recommendation on the basis that 'self-regulation has not worked in part because it does not provide a viable regulatory strategy when there is such a disparity in the powers of the parties'.[63] The following year, a Franchising Code of Conduct was introduced as a mandatory industry code enforceable under the TPA.

3.62 Another important recommendation was for a new provision within the TPA to extend the unconscionability protection available to consumers to small business, which later became section 51AC of the Act.[64] However, the section 51AC provision does not reflect the committee's suggestion that 'unfair' conduct be prohibited, instead retaining the more narrowly applicable term 'unconscionable'.

Mandatory code of conduct

3.63 The provisions of the Franchising Code of Conduct are described above starting at paragraph 3.32. As far as the transition from a voluntary to mandatory code is concerned, the most notable difference was the discarding of the standard of conduct provisions contained in clause 12 of the voluntary code when it became a mandatory code enforceable under section 51AD of the TPA in 1998.[65] It should be noted, though, that parties to a franchise agreement are subject to the unconscionability provisions under section 51AC of the TPA, also enacted in 1998.

Matthews Review and subsequent amendments to the Code

3.64 In June 2006, the then Minister for Small Business and Tourism, the Hon. Fran Bailey MP, announced a review into the disclosure provisions contained in

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60 Franchising Code Administration Council Ltd, *Franchising Code of Practice*, 1 February 1993

61 House of Representatives Standing Committee on Industry, Science and Technology, *Finding a balance: Towards fair trading in Australia*, May 1997, p. 1

62 House of Representatives Standing Committee on Industry, Science and Technology, *Finding a balance: Towards fair trading in Australia*, May 1997, p. 120

63 House of Representatives Standing Committee on Industry, Science and Technology, *Finding a balance: Towards fair trading in Australia*, May 1997, p. 118

64 House of Representatives Standing Committee on Industry, Science and Technology, *Finding a balance: Towards fair trading in Australia*, May 1997, pp 157-182

65 Franchising Code Administration Council Ltd, *Franchising Code of Practice*, 1 February 1993

Part 2 of the Franchising Code of Conduct (Matthews Review). Completed in October 2006, the Matthews Review recommended a number of amendments to the Code. The government consequently amended the Code to require franchisors to:

- disclose materially relevant facts throughout the agreement within a shorter period (14 days instead of 60);
- provide a copy of the franchise agreement in the form it is to be executed;
- disclose the history of the franchise site;
- 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); and
- where the franchisor is a consolidated entity, provide audited financial reports for the last two years on request.[66]

3.65 These amendments came in to force on 1 March 2008.

3.66 The government also rejected a number of the recommendations in the Matthews Review. The most notable of these were the recommendations for inserting a good faith clause in the Code; requiring franchisors to provide a risk statement in the disclosure document; amending the code to prevent unilateral changes to the agreement; and prescribing the registration of disclosure documents.[67]

WA and SA inquiries

3.67 In April 2008 the Western Australian state government undertook an inquiry into the fairness of franchise agreements. The report included recommendations to improve franchisor disclosure and end of agreement arrangements, review mediation processes for resolving disputes, introduce specified penalties for breaches of the Code and establish a dedicated franchising enforcement branch within the ACCC.[68] In May 2008 the South Australian parliamentary Economics and Finance Committee also tabled a report on the efficacy of the laws regulating the franchisee/franchisor relationship. This adopted a stronger position on legislative reform than the WA government's report. The SA parliamentary committee concluded that a number of

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66 ACCC, 'Franchising Code of Conduct amendments', *ACCC website*, accessed on 13 November 2008 at: http://www.accc.gov.au/content/item.phtml?itemId=815467&nodeId=9c74905234475e10f491a278e2901a25&fn=Franchising%20Code%20of%20Conduct%20amendments.pdf

67 Australian government response to the review of the disclosure provisions of the Franchising Code of Conduct, February 2007, accessed on 13 November 2008 at: http://www.innovation.gov.au/Section/SmallBusiness/Documents/Response_to_Recommendations_(Final)06Feb0720070206091019.pdf

68 WA Small Business Development Corporation, *Inquiry into the Operation of Franchise Businesses in Western Australia*, April 2008, Executive Summary

improvements to the regulation of franchising were needed, including the following recommendations:

- establishing a federal registration scheme for franchise disclosure documents;
- including risk statements in disclosure material;
- introducing specific penalties for breaches of the disclosure provisions in the Code;
- amending section 51AC of the Trade Practices Act to include a statutory definition of unconscionable conduct;
- mandating more effective mediation and providing alternative dispute resolution avenues;
- amending the Franchising Code of Conduct to include a requirement to act in good faith; and
- putting a requirement in the Code for franchise agreements to 'include the basis on which termination payments or goodwill or other such exit payments will be paid at the end of the agreement'.[69]

Franchise-specific legislation

3.68 As referred to above, a specific act dealing with franchising has been proposed in the past to address the pressing regulatory issues affecting the franchising sector at the time (see paragraph 3.58). Rather than creating a new act, a mandatory industry code enforceable under the TPA was introduced to regulate franchising conduct. The committee does not propose to consider the potential for parliament to pass a new act to deal exclusively with franchising.

Committee view

3.69 The committee believes that, by making the improvements to the Code that are recommended in the remainder of this report and by allowing time for the 1 March 2008 amendments to the Code to have an impact, the existing regulatory framework is developing into the most appropriate mechanism for fostering franchising in Australia.

3.70 The committee further believes that the Code, and associated legislation (the TPA), will need to remain dynamic and subject to review as the franchising sector evolves.

69 SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008, pp. 96-99

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:

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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 of have been misrepresented and

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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

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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 Wale (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.

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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]

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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

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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

- *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]

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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

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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 is 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:

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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.

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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:

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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

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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

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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,

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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.

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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

Chapter 5

Issues arising during franchise agreements

Challenges to the working relationship

5.1 Many franchise agreements result in successful and profitable ongoing business relationships between franchisee and franchisor, with both parties benefiting substantially from the arrangement.

5.2 However, there is an inherent potential for tension during the relationship. While an individual franchisee's priority is the profitability of their unit franchise or franchises, the franchisor's aim is to grow and protect the overall network of franchises in order to maximise returns. Although most of the time both parties are likely to be working towards complementary goals, there will be occasions when what is best for the network as a whole, from a franchisor's perspective, is potentially detrimental to the business of an individual franchisee.

5.3 In particular, difficulties may arise when franchisees feel that operations or expectations during the life of the franchise agreement are contrary to what was disclosed to them before the agreement was signed and that these changes put them at a material disadvantage.

5.4 A range of issues raised with the committee about the realities of being in a franchise agreement are discussed in more detail below.

Unilateral variation of franchise agreements

5.5 The committee received submissions expressing concern that the Franchising Code of Conduct (the Code) does not prohibit unilateral variation of contracts. As explained by the Motor Trades Association of Australia (MTAA):

> The purpose of disclosure is to provide franchisees with sufficient information to decide whether or not to enter into the business agreement proposed by the franchisor. It is on the basis of that disclosure that the potential franchisee assesses the financial rewards and risks associated with the business. The ability of the franchisor to subsequently vary the terms of the agreement in a unilateral manner may, therefore, result in a circumstance whereby the revised terms of the agreement are materially different to those contained in the original agreements. In such circumstances, it is possible that the franchisee may not have entered into the agreement had the revised terms been included in the original agreement.[1]

1 MTAA, *Submission 90*, p. 16

5.6 Acknowledging that there may at times be sound commercial reasons for requiring changes to business practice and franchise operations, the MTAA suggested the following:

> While MTAA acknowledges that franchisors may need to amend certain elements of the agreement in response to marketing and trading conditions, the Association is firmly of the view that such changes should only be made after the franchisor has consulted with its franchisees and they have consented to the proposed changes. This approach, in MTAA's view, is necessary to ensure that franchisors do not materially alter the terms of the franchise agreement in a manner that may have a significant detrimental impact on the viability of a franchisee's business. It also ensures that the nature of the business arrangements do not vary materially from that disclosed by the franchisor in its disclosure document (upon which the franchisee made its decision to invest in the business).[2]

5.7 Other submitters emphasised that the power to vary contract terms lies almost exclusively with the franchisor and that, relative to the franchisee, the franchisor has a limited range of contractual obligations—many of which are to be carried out at the franchisor's discretion.[3]

Compliance with the operations manual

5.8 The committee heard similar concerns relating to the widespread practice of including a clause in franchise agreements stipulating that a franchisee will comply with an operations manual supplied by the franchisor, the contents of which are subject to change at any time.

5.9 From a franchisee's perspective, this can have the effect of changing the conditions that were in place at the time the franchise agreement was signed:

> There can be no better example of systemic problems in franchising if …
> (b) There exist Service or Operational Manuals which have the effect of materially altering the costs of compliance to the advantage of the franchisor but the disadvantage of the franchisee.[4]

5.10 Some submitters indicated that such variations should be prevented:

> The Franchising Code should prohibit the unilateral variation of Franchise Agreements and variations effected by changes to Operations Manuals…
>
> … A change to that manual, say in relation to the shopfit requirements can be in effect a major change to the franchise agreement and a major cost. Any directive that incurs costs changes the financial basis of the decision to enter that franchise and can have significant consequences. This would be

2 MTAA, *Submission 90*, p. 16

3 For example, see Dr Elizabeth Spencer, *Submission 39*, p. 42

4 Franchisees Association of Australia, *Submission 51*, p. 21

> avoided if unilateral contract variation was outlawed including variation to an operations manual which incurs franchisee costs.[5]

5.11 However, others submitted that the ability to make unilateral variations or change the operations manual is essential to ensuring that business practices and expectations evolve to fit a changing market. The Federal Chamber of Automotive Industries (FCAI) explained:

> As a relational contract, it is clear that various commercial elements of a franchise agreement will need to be modified from time to time in order to reflect the dynamic nature of a franchise business system. The concept of "unilateral variation" could be capable of extending to changes in programs, strategies, presentation, policies, models and brands and other elements essential to the efficient operation of a franchise system. Modifications of this kind are a necessary part of the business relationship between the franchisor and the franchisee.[6]

5.12 The FCAI also submitted that there are sufficient remedies in the *Trade Practices Act 1974* (TPA) to cover situations where a unilateral change introduced by a franchisor is seriously detrimental to a franchisee.[7]

5.13 IndCorp Franchisees' Association of Australasia put the issue in the following terms:

> IndCorp accepts and recognises the importance of a strong brand and the need for the franchisor to have the power to establish the strong guidelines and the criteria by which prospective and existing franchisees can operate a store. Where the issues arise for IndCorp's members are, to use a slight sporting pun, when the goalposts keep shifting. An operations manual sets out the standard by which franchisees must operate the franchises. Compliance with the operations manual is a mandatory term of the franchise agreement. There is a level of acceptance and knowledge and acknowledgement that the operations manual is an intrinsic part of a franchise agreement and the way franchises work. The issue is when a franchisor reserves the right to change it at any time and with very little negotiation or communication with the franchises.[8]

5.14 Rather than preventing franchisors from using a mutable operations manual, IndCorp suggested that one way to balance the interests of franchisees and franchisors in this matter would be to insert into the Code an obligation on all parties to the agreement to act in good faith:

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5 Lottery Agents Association of Victoria, *Submission 45*, p. 3

6 FCAI, *Submission 155*, p. 23

7 FCAI, *Submission 155*, p. 23

8 Ms Zali Steggall, on behalf of IndCorp Franchisees' Association of Australasia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 74

> Our submission is the good faith requirements would be needed to stop a franchisor from being able to completely alter the very nature of the initial agreement into which a franchisee has entered.[9]

5.15 It is IndCorp's submission that an 'underpinning legal right' to good faith will assist in mediating disputes arising out of changes to the operations manual which are, in a franchisee's opinion, unreasonable.[10]

5.16 The pros, cons and implications of including an explicit obligation in the Code for franchisors, franchisees and prospective franchisees to act in good faith are discussed in detail in Chapter 8.

Opportunism

5.17 The committee received submissions from franchisors indicating that, in some cases of opportunistic behaviour by franchisees, the balance of power in a franchising relationship actually lies with the franchisee. For instance, Fibrecare Australia submitted that:

> Much will be written and said about the "poor" franchisee and the "all powerful" franchisor…nothing could be further from the truth. Most franchisors are like me – small businesses, often family businesses, trying to compete in the marketplace.

They contended that:

> There are laws to protect franchisees from every conceivable wrong. The balance is firmly in the favour of franchisees. Indeed I believe the current system encourages franchisees to pursue spurious claims because it is so easy to make broad allegations that sound credible but don't stand up to scrutiny.[11]

5.18 However, the committee also received many submissions from current and former franchisees outlining situations in which franchisor opportunism had allegedly disadvantaged them and their business. In particular, submitters discussed churning—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.[12]

5.19 Since 1 March 2008, franchisors have been required to disclose more information about past franchisees (except where franchisees have requested in

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9 Ms Zali Steggall, on behalf of IndCorp Franchisees Association of Australasia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 80

10 Ms Zali Steggall, on behalf of IndCorp Franchisees Association of Australasia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 80

11 Mr Geoffrey Cope, Fibrecare Group, *Submission 144*, pp 1-2

12 See for example Mr Ray Borradale, *Submission 16*, p. 8

writing that their details not be passed on). The intent of this provision, in part, is to assist franchisees in discerning whether churning may have been taking place:

> …the level of movement in and out of the franchise system and the reason for that movement is also likely to be relevant to a prospective franchisee.[13]

5.20 It is too soon for the committee to judge the efficacy of this change to the Code in reducing churning. The potential to address opportunism in franchising more broadly by introducing a good faith obligation into the Code is examined in Chapter 8.

Restraint of trade clauses

5.21 Franchise agreements commonly include restraint of trade, or non-compete, clauses that oblige franchisees not to engage in business beyond the franchise agreement that operates in direct competition with the franchisor. As Yum! Restaurants Australia explained to the committee:

> In common with all industries, we have restraints of trade in our contracts that prevent our business partners from competing directly against us.
>
> …
>
> It is common. As you would be aware, restraints are common across all types of arrangements, and franchising is no different. So, employment contracts would contain an element of prohibition against competition as well. I think that is recognised. They are so prevalent because it is recognised as justified as a legitimate business interest…Bearing in mind that the law on restraint of trade is quite clear—that is, it is enforceable only to the extent that it is reasonable…[14]

5.22 For a franchisee, one practical consequence of such a restraint of trade clause is that, if it extends beyond the life of the franchise agreement, it may limit their ability to directly transfer the industry-specific skills, knowledge and assets they have developed through operating a franchise unit into an independent business of their own.

5.23 While franchisees arguably have the opportunity to negotiate with regard to the inclusion of such clauses before signing an initial contract or a renewal agreement, in practice the disparity in bargaining power between the parties makes this

13 *Review of the Disclosure Provisions of the Franchising Code of Conduct* (Matthews Review), Report to the Hon Fran Bailey MP, Minister for Small Business and Tourism, October 2006, p. 36

14 Mr Nick Bryden, Yum! Restaurants Australia, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 75

difficult. This may lead franchisees into signing 'take it or leave it' contracts that contain provisions they consider to be unfair.[15]

Committee view

5.24 While the committee recognises the commercial arguments underlying the application of restraint of trade clauses during the time in which a franchisee and franchisor have a working relationship, it is the view of the committee that it may not be appropriate in all circumstances for such restraints to apply once the franchise agreement has ended. The committee notes the severe restrictions that such restraints might impose on the ability of former franchisees to generate income as independent businesspeople.

Confidentiality clauses

5.25 Franchisors have a genuine need to maintain confidentiality around certain commercial information, in order to protect and advance the interests of the franchise as a whole. However, the committee heard that some franchise agreements contain confidentiality clauses preventing franchisees from discussing pertinent details of business arrangements or of mediation outcomes with their fellow franchisees.[16] The ACCC suggested that some such clauses do not serve a legitimate commercial purpose:

> To be quite frank, we have seen confidentiality clauses that do not seem to have any real commercial purpose…other than preventing franchisees from being able to discuss some fairly important details of their franchise arrangement with other franchisees.[17]

5.26 Again, while franchisees have a theoretical ability to negotiate with regard to such clauses if they consider them unfair, in practice franchisees are most likely to enter into standard form, 'take it or leave it' contracts as provided to them by the franchisor.

Advertising funds

5.27 The committee received submissions from franchisees and former franchisees expressing dissatisfaction with the management of advertising funds. In some cases, franchisees can see no apparent marketing in their area. For example:

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15 The committee also heard of franchisees feeling compelled to sign detrimental contracts at renewal, because their substantial sunk costs meant that walking away from the business was not a realistic option. For example, see evidence from Mr Robert Gardini, on behalf of the MTAA, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 25

16 For example, see Mr Scott Cooper, *Submission 15*, p.12 and Mr Ray Borradale, *Submission 16*, p. 29

17 Mr Brian Cassidy, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 92

> Only when we were part of the Franchise Group we were … made aware of the many problems within the group. There were many disgruntled franchisees because they felt there was no support given to the group in general. They believed they paid excessively high royalty and marketing fees with little support and minimal to nil national marketing to show for it. Sales had been in decline since mid 2005…It was apparent that no business plan existed, marketing plan or anything…that would improve the brand and bring clients through the door. Many…had asked for Audited marketing and Sales reports over the years but no one in the franchise community has ever received a copy…[18]

5.28 The committee notes that, depending on their background and experience in business, franchisors are not necessarily well equipped to conduct efficient or effective marketing campaigns. What franchisees perceive to be a lack of returns on their contributions to advertising funds may be a result of poorly conducted marketing, rather than a simple failure to advertise at all.

5.29 Another submission described a situation in which some franchisees were allowed to opt out of paying the advertising levy, presumably because their stores were underperforming. This had a detrimental effect on other franchisees in the system who continued to pay their advertising fees but did not receive adequate advertising outcomes in return.[19]

5.30 Following changes to the Code which took effect on 1 March 2008, franchisors are now required to provide relevant audited financial statements within four months of the end of the financial year to franchisees who make payments into marketing or other cooperative funds.[20] It is too soon for the committee to judge the efficacy of these amendments.

Committee view

5.31 When negotiated and resolved in a reasonable and timely matter, disagreements between franchisor and franchisee need not interfere with the long-term success of a business relationship. However, the issues raised in this chapter are clear examples of the sources of tension that may lead a franchisee and franchisor into dispute (discussed further in Chapter 7), termination or non-renewal (discussed in Chapter 6) or, in worst-case scenarios, litigation (discussed in Chapter 9).

5.32 The committee recognises that there are enormous practical difficulties with trying to regulate specific elements of conduct by parties to a franchise agreement, particularly the various manifestations of opportunistic conduct that franchising arrangements can foster. This is why the inclusion of an overarching standard of

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18 Kerrie Davies, *Submission 64*, p. 1

19 Name withheld, *Submission 63*, p. 6

20 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 18

conduct in the Code may be useful. This matter is discussed in the context of good faith in Chapter 8.

Chapter 6

The end of a franchise agreement

6.1 A franchise agreement may end in two ways: expiry of the term with non-renewal, or termination before the end of the agreement. In the case of non-renewal, an agreement ends at the conclusion of the period originally agreed, with no new offer being made for a further term. The processes that have to be followed in relation to terminating an agreement before the agreed term ends are covered by clauses 21 to 23 of the Franchising Code of Conduct (the Code).[1] These are discussed at paragraph 6.29.

6.2 The main concerns over end of agreement arrangements raised during this inquiry relate to the following:

- non-renewal of franchise agreements at the expiration of the first term, including whether there should be a right to automatic renewal or whether non-renewal by a franchisor should only be permitted where 'good cause' can be shown;
- the circumstances in which a franchisor should be able to terminate an agreement, including potential abuses of current termination provisions within the Code;
- whether a payment for the franchisee's contributed value to the business should be mandated if the agreement is terminated or not renewed for whatever reason;
- what happens when a franchisor fails;
- property rights; and
- transferability of equity in the value of the business as a going concern.

6.3 End of term arrangements are one of the largest areas of dispute in the franchising sector. The processes for dispute resolution are discussed in Chapter 7.

Non-renewal

Pre-contract disclosure

6.4 It has been suggested that concerns about end of term arrangements arise from an initial lack of understanding about the franchise contract and the potential financial implications of fixed term agreements. Professor Lorelle Frazer identified renewal as an area that prospective franchisees are often unclear about:

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1 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, from p. 22

> … because people I have spoken to who have gone into franchising do not often realise the implications of the five year term—that they are really renting the business for the five years. At the end of the five years it could all be over. …. Often when they are told that they have a five, plus five, plus five they have the idea that it is a 15-year agreement. Of course, it is saying that it can be renewed after five years and so on. That is an area where prospective franchisees really do not get it. It is not made clear to them.
>
> I gave a seminar to prospective franchisees in a new system once. When I mentioned the issue of renewal, it was clear that it had not crossed their minds at all. They did not realise that the franchise had a possible life of five years. If they are entering thinking it is forever and that perhaps they can sell when they want to, they are going to be very disillusioned, because it is not actually that way.[2]

6.5 The Australian Competition & Consumer Commission (ACCC) submitted that, if a franchise agreement does not contain a statement about the conclusion of an agreement, 'you either have to draw certain implications or it may well be that by omission it becomes misleading or deceptive'. Often the agreement will state what the arrangements will be, although it may be in 'fairly complex legal language, and the problem stems as a consequence of a failure on the part of the franchisee to take appropriate advice prior to entering the agreement'.[3]

6.6 However, Mr Tony Piccolo MP argued that the disclosure of end of term arrangements should be mandatory so that everyone 'knows what the product is that they are buying':

> If you go into a business for five or 10 years you know what you are going in for. We would argue that is reasonable. What we are saying, though, is that when you sign a contract for that five, 10 or 20 years you should know what you actually walk out with. You should know that when you sign up, not have to fight it out at the end. That is not provided for at the moment. The parties should adhere to that. We are not saying the code should say what it is. We are saying that when you sign a contract you will discuss these issues and make sure it is catered for in your contract. That should be mandatory, because you try to minimise disputes at the end of a contract, and you know what you walk out with. It would be wrong for us to say, 'Issue this form or that form.' That is inappropriate. But it is appropriate for the code to say, 'Your contract shall address this issue in some way.'[4]

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

3 Mr Graeme Samuel, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, pp. 92-93. A discussion of the efficacy of disclosure documents and other pre-contractual issues is at Chapter 4.

4 Mr Tony Piccolo MP, Economic and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 57

6.7 The Franchise Council of Australia (FCA) suggested that franchisees and prospective franchisees may not understand that the end of a franchise term can mean the end of their involvement in the franchise:

> We argued before and showed before that the current state of the law is crystal clear, but maybe not everybody understands that at the end of the franchise term if it is over then it is over. …the industry average franchise agreement term is five years, but franchisees are typically in for seven years. In other words, franchisees in 98 per cent of cases are actually getting that extra term. … The bottom line is whether there is an endemic industry issue in relation to non-renewal, and we would say, no.[5]

6.8 The FCA also supported disclosing details of end of term arrangements in disclosure documents: 'Put it in capital letters. Make it very clear to anyone who might have gone in with the wrong expectations.'[6]

6.9 The Motor Traders Association of Queensland submitted that it would be desirable if the Code required that arrangements for the renewal of the franchise be defined in the initial agreement, so that both parties are aware of them. Where the agreement was silent on the right to renewal, the renewal would have to be earned through performance. However, where there is a conditional right to renewal, the conditions should be clearly stipulated and agreed between the parties.[7]

6.10 The Small Business Development Corporation of WA also cited the importance of ensuring that prospective franchisees are made aware of their entitlements, if any, at the end of the agreement.[8] The ACCC also submitted that consideration be given to requiring franchisors to 'explicitly advise prospective franchisees about their rights to renew or extend their franchise agreement and about whether any goodwill may accrue to the franchisee upon exiting the system'.[9]

6.11 Some franchise agreements already contain terms relating to end of agreement arrangements. For example, Australia Post indicated that they made clear up front that the term of the agreement is for a specified period and that there will be an exit payment. While noting that none of their agreements had reached the end of their ten year terms, Australia Post franchisees know from the moment they sign up that they are entitled to an exit payment at the expiry of the agreement based on a predetermined formula.[10]

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5 Mr Stephen Giles, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 36

6 Mr Stephen Giles, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 41

7 Motor Traders Association of Queensland, *Submission 36*, pp. 7-8

8 Small Business Development Corporation of WA, *Submission 139*, p. 5

9 ACCC, *Submission 60*, p. 27

10 Mr Paul Ramm, Australia Post, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 100 Australia Post indicated that they purposefully refer to these payments as 'exit payments' rather than 'goodwill' payments.

6.12 The Cheesecake Shop's agreements were also explicit about end of term arrangements: 'the relationship will end at expiry of the term specified in the contract and … if termination occurs, goodwill remains with the franchisor'.[11]

6.13 Competitive Foods Australia Ltd (CFAL) contended that the disclosure of end of term arrangements is incidental to the real issue, which is the potential for a franchisor to exploit its contractual rights and obtain a windfall gain at the expense of the franchisee. Franchisors, contrary to industry practice and what has been sold to franchisees as the default position, can opt not to renew agreements to obtain this benefit:

> …it is not an answer, as some suggest, people should be more up front in their contracts about what happens at the end of the franchise term…. Franchisors, because they can write the contracts, can write in the most powerful statement, if you like, with no right of renewal, but that does not actually reflect the policy or the practice…. That might be useful to some extent, but it really does not deal with the problem at the end of the day where people enter into this industry believing what is said about it and putting their time, money and effort into it.[12]

6.14 The opportunistic conduct referred to by CFAL is discussed further at paragraph 6.72.

Conditions of non-renewal

6.15 The committee received considerable evidence on whether agreements should be subject to mandatory automatic renewal at the end of their term, or whether franchisors should be required to show good cause why they have not renewed an agreement.

6.16 CFAL's submission described the potentially serious consequences of non-renewal:

> If a franchise agreement is not renewed, the franchisee has no option to take its business elsewhere but must close the business. In addition, there will usually be restraints of trade provisions that prevent a franchisee from starting up any competing business … unlike retail tenants who can take their business and set up elsewhere when their leases expire.[13]

6.17 The Hon. David Beddall expressed the personal view that 'unless you breach you should virtually have a perpetual franchise'.[14] CFAL indicated that it was not

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11 Mr Warwick Konopacki, The Cheesecake Shop Pty Ltd, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 14

12 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 37

13 CFAL, *Submission 22*, p. 8

14 The Hon. David Beddall, Franchisees Association of Australia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 33

arguing in favour of perpetual franchises, but merely that 'the industry practice and the default position should be renewal'.[15] They told the committee:

> The franchisee enters into this industry, often many years before, believing that they are doing more than just buying a job. They are putting in the effort. They are putting in the extra dollars of cash flow … into building up that business because they believe they are building an asset for the future. They do it on an expectation of normal industry practice, which is renewals, and they do so on the basis of trust and relationship…[16]

6.18 Concerns were expressed about any attempt to codify the default practice of renewing agreements by legislating for an automatic right of renewal. The Shopping Centre Council of Australia (SCCA) argued that, while the statistics support the position that franchisees are renewed more often than not, this should not give prospective franchisees the expectation that renewal will be automatic:

> …in terms of what actually takes place as opposed to what expectations people are necessarily entitled to expect, what takes place is there is typically renewal….
>
> The expectation is that you then have to renegotiate and enter into a new arrangement if you wish to continue with that arrangement. [17]

6.19 The FCA submitted that the law is clear that, at the end of a franchise agreement, a franchisee has no legal right to an extension and no right to compensation. The FCA cited the High Court decision in *Ranoa Pty Ltd v BP Oil Distribution Ltd*, which stated:

> On expiry or termination of the agreement, the franchisee has no right to continue operating the business and no right to share in any goodwill that may have accrued to the system during the franchisee's tenure.[18]

6.20 Mr Piccolo MP also did not support the notion of an automatic right to renewal, stating that this would be a 'fundamental change to the law of contract'.[19]

6.21 McDonald's Australia Ltd conducts a board review at year 17 of its 20-year franchise agreements and, subject to certain criteria being met, would approach the review 'with an open mind' to re-entering another relationship with a franchisee. However, McDonald's expressed concern that any automatic right of renewal would impact on the ability of the franchisor to maintain the integrity of the brand:

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15 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 33

16 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 37

17 Mr Peter Speed, Shopping Centre Council of Australia, *Proof Committee Hansard*, Sydney, 9 October 2008, pp. 42-43

18 FCA, *Supplementary Submission 6*, p. 3, citing (1089) 91 ALR 251 at p. 257

19 Mr Tony Piccolo MP, Economic and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 57

> …if there is a specific right of renewal, a positive renewal, or a presumption in favour of somebody to renew an agreement at the end of its term—and in our case, for example, we have a 20-year term—the issue for us is that, part and parcel of our being able to deliver a business system model by which we provide our restaurants around the country, the standards we ask for and expect of our franchisees need to be upheld.[20]

6.22 In the absence of an automatic entitlement to renewal, the committee heard support for the notion that franchisors should be required to show 'good cause' why a franchisee's agreement was not being renewed. For instance, Dr Spencer told the committee that:

> Based on our experience in Australia and based on the nature of the relationship as it exists now, I think that a good cause requirement in renewal and in termination is something that ought to be considered.[21]

6.23 CFAL strongly advocated the inclusion of a good cause for non-renewal requirement in the Code. They stated that 'good cause is standard in terms of industry understanding' and considered that it was not a difficult concept but one that 'really reflects either a codification of existing practice, or an indication of what would be desirable practice'.[22] In support of their contention, CFAL submitted an amendment proposal stipulating that 'a franchisor shall not fail or refuse to renew a franchise agreement without good cause'. CFAL's proposed new section of the Code outlines circumstances that constitute good cause for non-renewal, including an intention to use the site for unrelated purposes, dispose of the site, terminate for a breach of the agreement, or purchase the site for market value.[23] This latter issue is discussed later in this chapter at paragraph 6.50 in the context of exit payments.

6.24 CFAL's proposal further outlines the procedures that must be followed in relation to renewal and non-renewal, including a requirement to provide notice of an intention not to renew or to renew with varied terms and conditions.[24]

6.25 These proposed 'good cause' amendments were opposed by the SCCA, who argued that renewal except for good cause was based on the false premise of an initial expectation of renewal:

> I do not quite understand why there is that expectation. The term of the franchise … is for a period of five years or whatever is stated. If the parties were negotiating for a longer term or they had that expectation, then you would anticipate that the longer term would be included into the

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20 Mr Philip Maloney, McDonald's Australia Ltd, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 39

21 Dr Elizabeth Spencer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 43

22 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 34

23 CFAL, *Submission 22*, Attachment 1

24 CFAL, *Submission 22*, Attachment 1.

> arrangement or there would be some option or other term that would allow there to be a rollover. Therefore, the premise that there is an expectation that there will be renewal is not necessarily well founded and it is not well founded from the franchisor's point of view. If you are talking about the franchisee, they may in their own mind have that expectation, but that is not necessarily something that has been agreed by the other party.[25]

6.26 The Cheesecake Shop concurred with this view, warning of the possible implications for the sector:

> Why is franchising different from any contract for service? If you start to say you cannot not renew other than for a good reason you will always have an argument as to whether or not it is a good reason, so to avoid the argument you pay some money. I think you will find if you do that franchising will cease to be used in those circumstances where there may be an obligation to renew because it is just too risky.[26]

6.27 Yum! Restaurants Australia (YRA) expressed concern about the uncertainty that such amendments might create, emphasising the importance of parties to a contract being able to rely on the agreed length of its term:

> If it was made clear by the committee in its recommendations that whatever happens the parties have the right ultimately to rely upon the length of contract, if there was some notice period before that and some discussion, we would not have a problem. But the proposition is more than that.[27]

Termination

6.28 The Code specifies three ways in which a franchise agreement may be terminated. These are described below.

Termination – breach by franchisees

6.29 Section 21 of the Code stipulates the process for terminating an agreement for a breach of its terms by a franchisee.[28] Before a franchisor can terminate an agreement in accordance with this section of the Code, the franchisee must be given notice of an intention to terminate and afforded a reasonable opportunity to remedy the breach.

6.30 Concerns have been expressed that the Code provides insufficient protection for arbitrary or unreasonable termination for breaches. This refers to instances where

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25 Mr Peter Speed, Shopping Centre Council of Australia, *Proof Committee Hansard*, Sydney, 9 October 2008, pp. 41-42

26 Mr David Meagher, The Cheesecake Shop Pty Ltd, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 20

27 Mr Nick Bryden, YRA, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 89

28 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 22

franchisees have their agreement terminated for inconsequential, trivial or otherwise minor breaches of the agreement; an excuse for terminating rather than a reasonable and legitimate justification. One option to protect franchisees from this conduct is by introducing a good faith requirement into the Code. This proposal is examined in Chapter 8.

6.31 Another possibility raised with the committee would be to disallow termination where franchisees had exercised 'due diligence' in attempting to remedy breaches, or where the breach is not a 'fundamental breach'. Peregrine submitted that:

> Franchisees need confidence that their franchise agreement will not be unreasonably terminated or that they won't be "held to ransom" or "threatened" with unnecessary demands of the franchisor.[29]

6.32 Peregrine proposed three alternative approaches to dealing with arbitrary termination

- Defence of due diligence
  - Whereby a franchisor cannot terminate for a breach where the franchisee has displayed all due diligence in remedying the breach
- Good faith obligation
  - Introduce an obligation to act in good faith
  - Specify acts which are 'prima facie' not good faith
  - Specify that terminating a franchisee who has displayed all due diligence to remedy a breach is not acting in good faith
- Fundamental breach only
  - Only allow termination for a fundamental breach
  - Describe in the Code what a 'fundamental breach' is.[30]

6.33 In contrast, 7-Eleven argued that the Code should be amended to allow franchisors to terminate an agreement without complying with section 21 where a franchisee 'breaches the franchise agreement, otherwise than by conduct set out in subclauses 23(a) to (f), at least three times'.[31] This is the 'three-strikes-and-you're-out' approach, regardless of any subsequent remedy of the breach to avoid termination in accordance with section 21.

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29 Peregrine Group of Companies, *Submission 116*, p. 4

30 Peregrine Group of Companies, *Submission 116*, p. 4. See SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008, p. 70 (SA Report), which also considered that a statutory duty of good faith would operate to discourage arbitrary termination. The need for a statutory duty of good faith is discussed in Chapter 8.

31 7-Eleven, *Submission 105*, p. 2

Termination – special circumstances

6.34 Section 23 of the Code provides that a franchisor is not required to comply with sections 21 or 22 and may terminate a franchisee under specified circumstances, including where the franchisee: no longer holds a licence required to carry on the business; voluntarily abandons the business; is convicted of a serious offence; or agrees to the termination of the agreement.[32]

6.35 Concern was expressed that, though section 23 of the Code gives the franchisor the right to terminate a franchisee if they become bankrupt or insolvent, there is no right for a franchisee to exit the contract in the event of franchisor failure.[33] Mr Howard Bellin highlighted the examples of Quiznos and Kleins, where franchisees received little or no compensation following the failure of these franchisors.[34]

6.36 It was also noted that, though section 18(2)(g) of the Code requires the franchisor to give written notice to a franchisee or prospective franchisee when the franchisor becomes an externally administered body corporate, the appointment of an administrator for a franchise system does not of itself terminate or constitute repudiation of the agreement. When companies fail, secured creditors are given priority over remaining assets, followed by unsecured creditors, shareholders and then other parties. When a franchisor fails, a franchisee may be terminated with little prospect of compensation or ability to continue trading, yet may still be required to pay franchise fees, including royalty payments, to the liquidator until the franchisor is wound up—despite no longer receiving support or services from the franchisor.[35]

6.37 In response, the ACCC recommended that consideration be given to providing some form of protection to franchisees in the event of franchisor failure, such as granting the franchisee the right to exit the franchise agreement.[36]

Committee view

6.38 The committee shares the concerns raised regarding the plight of franchisees when franchisors fail. The committee's earlier recommendation that disclosure documentation include an explicit statement of the consequences of franchisor failure (see Recommendation 1 at paragraph 4.80) is a step towards improving this situation.

6.39 In light of recent failures of this type in the Australian sector, the committee further recommends that the government explore avenues to better balance the rights and liabilities of involved parties in the event of franchisor failure.[37]

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32 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 23

33 Section 23(b); See for example, Ms Heather Shearer, *Submission 79*, p. 3; ACCC, *Submission* 60, p. 27

34 Mr Howard Bellin, *Proof Committee Hansard*, Melbourne, 5 November 2008, pp.72-73

35 ACCC, *Submission 60*, p. 28

36 ACCC, *Submission 60*, p. 28

Recommendation 4

6.40 The committee recommends that the government explore avenues to better balance the rights and liabilities of franchisees and franchisors in the event of franchisor failure.

Termination – no breach by franchisee

6.41 Section 22 of the Code provides for termination where there has been no breach by a franchisee. Before franchisors are permitted to terminate the agreement in these circumstances, it must 'give reasonable written notice of the proposed termination, and reasons for it, to the franchisee'.[38]

6.42 For a franchisee to have their agreement unilaterally terminated would generally represent a significant financial upheaval, necessitating a fair period of time for them to organise their affairs before the agreement ended. But mandating a uniform minimum period was considered potentially difficult to apply, given the variable terms of franchise agreements.[39]

6.43 Concerns about franchisors exploiting the termination provisions to 'churn' franchisees were raised in a number of submissions.[40] This refers to the 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. The termination provisions in the Code, particularly section 22, potentially enable this to occur. They also give franchisors the opportunity to capitalise on successful franchise units once the hard work has been done to establish their continuing profitability. These practices may be described broadly as opportunistic termination—that is, franchisors using the powers contained in the Code to obtain a 'windfall gain' at the expense of franchisees.

6.44 While it has been argued that it is not in the franchisor's interest to capriciously fail to renew or terminate an agreement that has been operating successfully, the economic temptation for doing so has also been highlighted. According to CFAL, the benefits from this conduct can obtained in three ways:

- buying a franchise back at less than market value and then selling it on for its full value to another franchisee;
- once the viability of an individual franchise unit has been established, taking it over to run as a company store to be able to recoup 100 per cent of the profits rather than a percentage through royalties;

37 Notably Kleins and Quiznos

38 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, Section 22(3), p. 23

39 See for example, YRA, *Submission 118*, p. 14

40 See for example Ms Sam Gow, *Submission 61*; Ms Sue Brown, *Submission 84*; Ms Dianne Grey, *Submission 96*; and *Ms Cheryl* Borradale, *Submission 125*

- churning successive franchisees who pay up-front franchising fees and royalties which may be higher because the store is an established going-concern rather than a start-up site.[41]

6.45 However, the costs associated with training a new franchisee and other associated costs are a sound economic reason to retain successful franchisees. Accordingly, the extent to which churning is a significant problem in franchising has been questioned, despite the concerns raised by many contributors to the inquiry. The Franchising Australia 2008 Survey found that approximately nine per cent of franchise units experienced a change in ownership in the 2007 financial year, consistent with the 2006 survey results. Professor Frazer stated that, were the practice of churning of units to be widespread, she would have expected this figure to be higher:

> I am not saying that I have evidence on churning or not. I am just saying that I would have expected it to be higher. I know that there are allegations about churning. The ACCC has even said that churning exists. So I am sure it does in some cases. But, that would be a rogue operator. It does not make business sense to churn. It would be much easier to keep a good franchisee in the system. Normal practice would be to do that. There would be instances of it, but it would not be good practice to do it, nor would it make sense.[42]

6.46 Furthermore, Mr Conaghan of DLA Phillips Fox argued that since the introduction of the Code the incidence of churning has been significantly lessened because of the disclosure requirements:

> In the early 1990s before the code and disclosure obligations came in, churning was perceived as a problem in the industry. In our experience, since the disclosure obligations have came in, and even more so since the 1 March changes came in, in our experience there was a significant lessening of the churning element because of the disclosure aspects and particularly because of the contacts of former franchisees.[43]

6.47 Professor Lorelle Frazer described the contrast between opportunistic 'churning' and the difficulties associated with non-renewal:

> I would see churning as when you put a franchisee into a store that you know will fail—it is in a bad location or whatever—and it does fail and then you are move them out and get another person in. You keep doing that because you are obtaining the initial fee. It is a different matter if the franchisee has come to the end of the agreement and they knew they had that agreement. It may not be fair, but I think legally that is the situation. If the franchisor takes over that unit, probably because it has been a good

41 CFAL, *Submission 22*, p. 8

42 Professor Lorelle Frazer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 11

43 Mr Anthony Conaghan, DLA Phillips Fox, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 51

> operation, then you need to look at whether that is fair and whether anything can be done to stop it happening.[44]

6.48 Other submissions took the view that enforced equitable financial settlements could address abuse of the termination provisions of the Code. For instance, Spier Consulting argued that a franchisor's right to unilaterally terminate an agreement should be modified or removed, but, if retained, compensation or a guaranteed buy-back should be provided for and included in the disclosure document.[45]

6.49 The equitable financial treatment of franchisees who have had their agreements terminated, or not renewed, is discussed in the following section, starting at paragraph 6.52.

6.50 As with non-renewal, there was some discussion about the possibility of franchisors being required to show 'good cause' before terminating an agreement. There was little disagreement that a franchisor should retain the right to terminate in the interests of the integrity of the franchise system, but it was argued that termination in the absence of a breach should only take place where there is good cause to do so. For instance, the MTAA stated that, while franchisors should retain the right to terminate an agreement for a clear and material breach by the franchisee, they should not be able to terminate without due cause.[46]

6.51 However, the FCA argued that the Code has detailed processes such that 'you cannot terminate a franchise agreement for an improper purpose' and in any case such behaviour would eventually have market repercussions:

> … let us say the franchisor does get up on a bad hair day and does something that is inappropriate but perhaps not outside the law. Eventually enough franchisees will get jacked off with the system that they will sell out of the system. You will find it difficult to attract good-quality franchisees because when they do their due diligence in ringing up those past franchisees they will not necessarily be talking well about the system. Over time you will get fewer franchisees applying, you will get fewer conversions, poorer quality franchisees and eventually you will kill your own system.[47]

Exit arrangements

6.52 The committee received extensive submissions and evidence addressing the question of whether franchisees whose agreements were not renewed should receive

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44 Professor Lorelle Frazer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 12

45 Spier Consulting, *Submission 151*, p.3

46 MTAA, *Submission 90*, p. 13. See also Mr Andrew Robinson, Motor Traders Association of New South Wales, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 94; Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008.

47 Mr John O'Brien, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, pp 32-33

an exit entitlement in return for their contribution to the business. This was a particularly complex and contentious aspect of the committee's inquiry.

Goodwill

6.53 There are three recognised types of goodwill: product/brand goodwill; site goodwill; and operator/personal goodwill.[48] Being able to differentiate between the relative values of each at the end of an agreement is a vexed question. In particular, what degree of goodwill could or should be attributed to the franchisee?

6.54 DLA Phillips Fox contended:

> When a franchisee sells the franchise business, inevitably in the business purchase contract will be a description of goodwill. It has a particular meaning for revenue and tax consequences in that business purchase agreement. In relation to a franchisor and the goodwill that it has, that term goodwill is used in a different context. There is a lot of confusion about goodwill and what it means in a particular circumstance.[49]

6.55 Ms Deanne de Leeuw argued that goodwill should be attributable to the input of franchisees:

> When a franchisee is terminated or their franchise agreement is not renewed, the franchisor takes ownership of the goodwill generated by the franchisee through their investment and hard work. If they can sell that franchise on, the profit generated from the sale remains the property of the franchisor. It should not be legal for a franchisor to take over a franchise without fairly compensating the franchisee.[50]

6.56 However, the Franchise Alliance queried whether a franchisee has created any goodwill whilst in the system, or whether the business goodwill is all associated with the brand; the system of business; the ongoing support, training and strategising of the franchisor; group marketing; and local area marketing devised by the franchisor. As such, it would belong to a franchise group and not a sole trader. The Franchise Alliance cautioned that any change to the law in Australia relating to goodwill would have far-reaching consequences for franchising, including that it would be likely to change the design and structure of franchise systems and make them more akin to partnerships. [51]

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48 Ms Jenny Buchan, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 84

49 Mr Anthony Conaghan, DLA Phillips Fox, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 55. NB refers to SCCA's submission, clause 7.2.

50 Ms Deanne de Leeuw, *Submission 114*, p. 30

51 Franchise Alliance, *Submission 48*, p. 3

6.57 The SCCA considered that 'personal goodwill' lies with the individual and cannot be traded. Therefore, 'at termination that "personal goodwill" remains with the individual and he or she should not be entitled to any compensation in relation to it'.[52]

6.58 The Cheesecake Shop highlighted an additional complication of whether goodwill should be payable to a master franchisee:

> Throughout the term of the master franchise agreement, the master franchisee receives a substantial amount of money for each franchisee that joined the system. Asking for a goodwill payment at the end of the term when the master franchisee has already received a lump sum for every franchisee that joined and an ongoing royalty for providing ongoing support would, put simply, be double dipping. The master franchisee should not be paid twice for the same thing.[53]

6.59 CFAL argued that the issue of goodwill would not arise if franchisors continued to renew agreements, as this would enable the franchisee to sell the business and recoup their goodwill:

> Goodwill only becomes an issue if the franchisor wants to step across the line and, if you like, corporatise, privatise, remove inefficiencies, or whatever term is used, and cease being the franchisor of that business.
>
> ….
>
> If it wants to change that relationship and wants to, in effect, take the business off the franchisee, why should it not pay the fair value for that business like anybody else in the market?[54]

6.60 CFAL further submitted that the goodwill in a franchise is held jointly by the franchisor and the franchisee, but the franchisee's financial interest in the joint goodwill was subject to the franchisor's decision to renew:

> It is a goodwill because the franchisor has provided the systems, recipes, trademarks and advertising, but it is also your goodwill because you have put in the time and effort, you built the store, you hired the staff, you organised the supply chain, your people manage the store and you look after your people well so that you have good motivated employees. It is a jointly owned goodwill, but it is a goodwill that the franchisor can destroy at the stroke of a pen, and that is the real issue.[55]

6.61 Eagle Boys Dial-A-Pizza also acknowledged the joint nature of the goodwill in a franchise:

> We have many franchisees that sell their business after a number of years for well in excess of what they paid to get into it because they built up what

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52 SCCA, *Submission 115*, p. 18

53 The Cheesecake Shop, *Submission* 136, pp 2-3

54 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, pp 29-30

55 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 29

> the previous speaker spoke about as the personal good will component. Obviously we are retaining the good will component associated with the brand and what they have helped us build. What they have built their business into over that period of time helps us as well, so there is shared good will there.[56]

6.62 A factor that was considered to contribute to the extent to which goodwill could be attributed to the franchisee was the nature of the franchise system:

> It depends on what you are talking about really. Looking at franchise relations, say, you are talking about a McDonald's store. In terms of McDonald's, if you walk into one store as compared with another store, it makes no difference what the franchisee particularly is doing. The branding is such and the regulation is so strict that essentially you get the same product at any store. The goodwill of that store is referrable entirely to the franchisor from that perspective. If you are looking at other arrangements where you might have, say, a pool store, a franchisee may have a much greater role in terms of the product that is being offered and the service that is being provided. In that circumstance you can actually see that the franchisee has made a contribution, you might say, to the franchisor's business or reputation. In that instance the question becomes not who made the contribution but who in fact owns that goodwill. If you have an employment arrangement and someone develops a product, then invariably, if that was part of the employment contract, it belongs to the employer even though the employee was largely responsible. In a context of this nature, if the contract was drafted on the basis that the franchisor was the party to get the goodwill, that is the arrangement that pervaded the contract and the franchisor should be the party that has the goodwill.[57]

6.63 DLA Phillips Fox dismissed the contention that a justification for a goodwill payment at the end of an agreement is the 'franchisee having enlarged the franchisor's goodwill or, more precisely, the value of the franchisor's intellectual property':

> Whilst it cannot be denied that the franchisee needs to apply a certain level of business acumen and skill, it does not have an obligation…to develop the market using its own initiative, systems or marketing plan. Accordingly it is difficult to appreciate on what basis, if any, a franchisee has contributed to or added to the franchisor's customer base…Clearly this would be the only basis on which a franchisee may arguably be entitled to some goodwill compensation because for the balance the franchisee relies upon and uses the franchisor's intellectual property. By operating a franchise under an agreement….cannot entitle a franchisee to a proprietary interest in franchisor intellectual property convertible to a dollar value. [58]

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56 Mr Murray Stewart, Eagle Boys Dial-A-Pizza, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 69

57 Mr Peter Speed, SCCA, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 44

58 DLA Phillips Fox, *Submission 81*, p. 9

6.64 The ability of a franchisee to sell their business before the expiry of their term did not, in Professor Andrew Terry's view, necessarily entitle them to a goodwill payment:

> The fact that a franchisee has a right to sell a franchise acknowledges, in itself, that they can benefit from the sale of the business as well as from their trading.
>
> …If you are putting the question directly 'should franchisees have any right to goodwill on termination of that agreement or expiry of that agreement? I would not be putting that case.[59]

6.65 The reverse implication of the argument for an entitlement to goodwill was also highlighted:

> …if franchisees have a right to claim payment for good will in defined circumstances, it follows than an underperforming franchise may be deemed to have undermined the franchise brand and negatively impacted the performance of other franchisees, thus rendering the failed franchisee liable to pay compensation arising from the negative good will generated. [60]

6.66 A number of submissions argued that the introduction of a form of goodwill payment at the end of an agreement would invite dispute and increase franchising costs and, in addition, may adversely impact on the feasibility of franchising as a business model.[61] The National Retail Association (NRA) expressed concern that:

> Any change to the law dealing with the concept of good will may inevitably result in increased costs for both franchisors and franchisees. That is, if franchisees have a right to claim goodwill upon the termination of the franchise agreement, then the anticipated cost of these claims will be factored into franchise negotiations and inevitably lead to higher costs of entry and/or operation for franchisees.[62]

6.67 Mr Meagher of The Cheesecake Shop indicated that, if they were expected to make a goodwill payment at the expiry of the franchise agreement, it would affect the way they draft their contracts.[63]

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59 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 71

60 National Retail Association, *Submission 109*, p. 6. See also McDonald's, *Submission 142* , p. 6

61 See for example FCA, *Submission* 103, pp 11-12 and Supplementary Submission 2; Mr Andrew Foote, *Submission 106*, p. 10, The Cheesecake Shop, Submission 136, p. 2, YRA, Submission 118, p. 2. For retrospectivity and implications beyond the franchising sector, see for example, FCA, *Supplementary Submission No 2*, p. 5; Mr Nick Bryden, YRA, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 89; Mr Milton Cockburn, SCCA, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 47; Small Business Development Corporation of WA, *Submission 139* p. 6

62 NRA, *Submission 109*, p. 5. See also McDonald's, *Submission 142*, p. 6

63 Mr David Meagher, The Cheesecake Shop, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 17

6.68 While the contribution of the franchisee to the goodwill of the business is recognised in some agreements, devising a fair method of calculating exit or goodwill payments could present difficulties if sought to be applied universally.[64] The Australian Retailers Association (ARA) agreed that there should be some recognition of the franchisee's contribution to the goodwill of a particular location, but the percentage would need to be negotiated and agreed at the start of the agreement.[65]

6.69 The Franchisees Association of Australia Inc (FAA) suggested that there could be a formula in the Code 'based on the amount of capital invested at the start to ensure that you return that capital over a period and there is such an opportunity'. However the FAA acknowledged that it would be difficult to include such a measure in the Code.[66]

6.70 The NRA noted the complexity of assigning goodwill in a franchise context but concurred with the view that the issue should be dealt with up front in the franchise agreement:

> As we generally understand it, that is the way it should be happening now. This issue should be dealt with and both parties should be aware of their rights or obligations when they entering into the agreement. The proposition that we are most keen to articulate is that the concept of goodwill is not as easily translated as we generally understand it to be in the franchise sector. The franchise sector survives on what I regard as very high and stringent forms of replication…. These are operations that survive on their replication, their sameness. It is not easy, if you want to make a judgement about goodwill, to determine what goodwill is attributable to the contribution of the franchisor, the system or the brand and what portion is attributable to the franchisee…. It is a very complicated subject. Our view is that if it is to be dealt with at all in terms of the code, it should be dealt with only to the extent of saying that it is something that ought to be specifically provided for in the agreement up front.[67]

6.71 Mr Piccolo MP proposed that a formula for an exit payment could be negotiated:

> When you exit, for example, the parties might say, 'We will agree up front that the formula will be that when we cease as an exit payment you will get 10 per cent of six months returns' or whatever formula they agree to. That is still theirs. That is up to the parties to freely contract to, but it has to be

64 See for example, Mr Gary Black, NRA, *Proof Committee Hansard*, Brisbane, 10 October 2008, pp 17-18

65 Mr Richard Evans, ARA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 18

66 The Hon. David Beddall, FAA, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 33.

67 Mr Gary Black, NRA, *Proof Committee Hansard*, Brisbane, 10 October 2008, pp. 16-17.

> addressed. Most of the ones which go bad do not address that. That is why you spend a lot of time in courts in disputes, et cetera, because it is silent.[68]

Market value

6.72 As a proposal to ensure fair financial outcomes for both parties at the end of an agreement, the suggestion was put forward to provide restitution to franchisees on the basis of what they would have received for the business had they sold it to another franchisee prior to the agreement ending.

6.73 CFAL acknowledged that the debate over quantifying the division of goodwill between franchisors and franchisees had generated confusion:

> I talked about the goodwill being jointly owned. I think there was a bit too much focus on the word 'ownership'. The goodwill is jointly created by the franchisor and franchisee. In a sense, nobody owns it. It is jointly created, but nobody owns it, although in practice what happens is that when you sell the business the franchisee is able to recoup the benefit of that goodwill.[69]

6.74 To resolve the complexities around seeking to quantify who has contributed what to the business, CFAL argued that a franchisor should be required to pay market value for a franchise they decide not to renew:

> All that is sought is some protection from the ability of a franchisor to appropriate the value that a franchisee has created in the business based on existing market practice.[70]
>
> It goes to the nub of our arguments about renewal provisions and good cause. What should really happen in this industry is that industry practice should be enforced in the code, and that way you solve the problems. The problems arise when franchisors do not want to be franchisors any longer and actually want to run the business as well. If they do that, they should pay for the business as if they were any other person coming to acquire the franchise business on the market.[71]

6.75 The Australian Retailers Association (ARA) considered the position of a franchisee in the event of non-renewal:

> Should they [franchisors] have the power to reduce the value to zero? If the outlet or the franchise is saleable on the market, the answer is, no. The franchisee should in fact share some of that sale cost. I am not sure as to the percentage.[72]

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68 Mr Tony Piccolo MP, Economics and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 58.

69 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 36

70 CFAL, *Supplementary Submission 6*, p. 36

71 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 30

72 Mr Richard Evans, ARA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 20

6.76 Ms Deanne de Leeuw also highlighted the inequitable financial position a franchisee finds themselves in should the franchisor choose not to renew:

> The franchisor will not pay for the franchisees goodwill either; the franchisee will only be offered the 'market value' for their equipment, as determined by the franchisor. One day a franchisee could 'own' a franchise valued at a million dollars, the next day all they have is a cheque 'buying' their equipment at a greatly depreciated value; with no legal recourse. [73]

6.77 CFAL argued that, while some had contended that an explicit duty to act in good faith would assist in addressing end of agreement concerns, this would not prevent opportunistic conduct where a franchisor is able to make a 'windfall gain' at the expense of the franchisee.[74] They submitted that '[m]ore specific provisions in the Code dealing with renewal of franchise agreements are necessary in order to recognise the contribution of franchisees'.[75]

State inquiries

6.78 Both the Western Australian (WA) and South Australian (SA) inquiries made recommendations in relation to renewal and termination.

6.79 In its Final Report on Franchises, the SA Economics and Finance Committee concluded that making 'renewal an assumption in the franchise contract would constitute an undue interference in the specifics of a business relationship and compromise the ability of a franchisor to protect the value and reputation of their brand'. But a statutory duty of good faith would 'provide improved certainty to both parties as to their rights and obligations upon entering into renewal negotiations'.[76]

6.80 The SA Committee recommended that:

- the Code be amended to insert a provision imposing a duty to conduct renewal negotiations in accordance with good faith and fair dealing by each party (rec 7.2.14);
- the Code be amended to include a provision mandating that franchise agreements must include the basis on which termination payments or goodwill or other such exit payments will be paid at the end of the agreement. (rec 7.2.15); and
- the exclusion or inadequate determination of goodwill or other such exit payments by a franchisor during negotiations with a franchisee regarding

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73 Ms Deanne de Leeuw, *Submission 114*, p. 29

74 See for example Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 3; MTAA *Submission 90*, p. 6. But see McDonald's Australia Limited, *Submission 142*, p. 6 for concern about good faith applying to renewal negotiations.

75 CFAL, *Supplementary Submission 6*, p. 44

76 SA Report, p.69

a franchise agreement should constitute 'unconscionable conduct' and should be included in any discussions regarding an amendment to section 51AC of the Trade Practices Act. (rec 7.2.16)

6.81 In relation to goodwill, the SA Committee concluded:

> …inherent in recognising that the success of a franchise depends on both parties is the need to recognise and, where necessary, quantify the value of franchisee efforts over the term of a contract. While an individual franchise may not succeed without the brand power and resources provided by the overarching system, the efforts of the franchisee operating that outlet at that location need to be acknowledged when the relationship reaches critical points such as renewal or expiration.[77]

6.82 The Inquiry into the Operation of Franchise Businesses in Western Australia recognised the gap in protection for franchisees at the expiry of an agreement. This 'gap' exists because:

- Pursuant to contract law, when the term of an agreement expires, there is no obligation to renew. While theoretically it is possible for the common law and equity to intervene, this rarely occurs.
- There is no legislation specifically addressing renewal issues at a Commonwealth, state or territory level.
- The Code addresses termination but not renewal of franchise agreements.
- The restrained interpretation of the unfair business conduct provisions of the TPA, particularly s51AC, makes it unlikely that a franchisor's refusal to renew a franchise would contravene the legislation.[78]

6.83 The WA Report found, in contrast to the later SA inquiry, that the use of a 'good faith', unconscionability or similar standard to regulate franchise renewal was 'unlikely to be effective where the franchisor's conduct simply involves the exercise of a legal right'. Instead, the WA Report considered there was merit in further examination of the right to compensation upon renewal.[79]

6.84 The WA Report recommended the Code be amended to require franchisors to:

- explicitly specify, in the disclosure document, what end of agreement arrangements are in place under the franchise agreement (rec 3.1)

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77 SA Report, p. 75

78 WA Small Business and Development Corporation, *Inquiry into the Operation of Franchise Businesses in Western Australia*, April 2008, pp 21-22 (WA Report)

79 WA Report, p. 24

- explicitly specify, in the disclosure document, what the position is in relation to the franchisee's entitlement or lack of entitlement to goodwill or other compensation if the agreement is not renewed. (rec 3.2)
- conduct a pre-expiry review with the franchisee at least one year prior to the expiry of the franchise agreement. The purpose of the review is to inform the franchisee of any variations between the existing and new agreement and any conditions that need to be met in order for agreement renewal. (rec 3.3)
- specify, in the disclosure document, a reasonable period of notification in which to inform the franchisee of their intention not to renew the agreement. (rec 3.4)[80]

Committee view

6.85 The committee is of the view that franchisors should be entitled to decline to renew franchise agreements on expiration if that is their choice. The committee therefore does not support an automatic right to renewal or the requirement for good cause to be shown for not renewing a franchise agreement. It is not the role of the law to force unwilling parties to enter into any commercial arrangement, including new franchise agreements. However, the committee notes that a franchisee should receive reasonable notice from a franchisor of any decision not to renew. Furthermore, a decision by a franchisor not to renew should not be designed to extract extra payments from a franchisee, nor to generate a windfall gain for the franchisor.

6.86 The committee considers that franchisee expectations about renewal need to be better managed, and the financial implications of non-renewal better understood, before fixed term franchise agreements are initially signed. Franchise agreements should clearly stipulate what the end of term arrangements and processes are, and these arrangements should be fully and transparently disclosed to prospective franchisees. In particular, the committee is of the view that pre-agreement disclosure documentation should explicitly discuss the transfer process that will apply to equity in the value of the business as a going concern at the time the agreement ends.

6.87 The present situation where a franchisee's contribution to their business has a market value prior to the end of the agreement which can be arbitrarily reduced to an amount determined by the franchisor afterwards is inequitable. At the end of an agreement, a franchisee has already committed considerably to the franchise system, financially and through their hard work, and is financially tied to the business. Franchisees stand to lose the prospect of returns on their capital investment, which in many cases is substantial.

6.88 The committee contends that a starting point for making an exit arrangement could be the market value of the business as a going concern.

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80 WA Report p. iv. See also ARA, *Submission 135*, pp. 15-16

6.89 The committee puts forward the following scenario as an example of an appropriate arrangement. If at the end of the term of a franchise agreement the franchisor exercises their right not to renew, they should give reasonable notice of this decision to the franchisee. The franchisee should then be given the right to sell the business at market value. First right of refusal could be held by the franchisor. Such an arrangement would take place in the context of both parties acting in good faith (as further discussed in Chapter 8).

6.90 The committee believes that franchisors who, as a matter of general practice, choose to end agreements with their franchisees at the end of the term should make clear at the disclosure stage not only their intention to do so but also the exit process that will apply.

Recommendation 5

6.91 The committee recommends that the Franchising Code of Conduct be amended to require franchisors to disclose to franchisees, before a franchising agreement is entered into, what process will apply in determining end of term arrangements. That process should give due regard to the potential transferability of equity in the value of the business as a going concern.

6.92 Concerns raised during the inquiry about opportunistic termination and 'churning' of franchisees by exploiting the termination provisions of the Code are legitimate. Although most franchisors succeed on the basis of mutually beneficial relationships with their franchisees, evidence from the inquiry suggests a small element of franchisors seek financial gain through opportunistic termination. However, the committee does not propose to address this problem directly by recommending changes to the circumstances in which franchisors are presently able to terminate agreements under the Code. Franchisors need to retain the ability to protect the value of their brand across the network by being able to terminate agreements that are not deriving benefit for the network. Furthermore, the committee is of the opinion that it would be sensible to allow recent changes to the disclosure provisions of the Code, which enable prospective franchisees to access information about the history of the franchise site (including contact details of former franchisees) and were designed to help alert franchisees to the possibility that churning is taking place, to have an effect before recommending any further changes designed specifically to address this problem. Instead, the committee seeks to reduce opportunistic behaviour through the introduction of broad good faith requirements, as discussed in Chapter 8.

Chapter 7

Dispute resolution in franchising

The need for a dispute resolution process

7.1 Previous chapters have described a range of behaviours and circumstances that can strain the working relationship between franchisee and franchisor, potentially leading them into dispute and, if not resolved, towards franchise failure.

7.2 Professor Lorelle Frazer, who is currently engaged in collaborative research with the ACCC into causes of conflict in franchising, told the committee:

> The most common cause appears to be because franchisees' expectations about franchising are mismatched for two main reasons. Sometimes it is the franchisee's own naivety and sometimes it is the result of franchisors making misleading statements in an attempt to recruit the franchisees. There is certainly a gap between what franchisees expect to find and the reality. That leads initially to disappointment, then to blame and often to a breakdown in the relationship. It can result in a dispute or even failure of the business. It affects their health and personal relationships. So it has quite an impact.[1]

7.3 Post Office Agents Association Limited (POAAL), in reflecting on disputes in franchising in overseas jurisdictions including the United States, noted:

> …the franchisor /franchisee relationship can easily cause conflict if either side is incompetent (or not acting in good faith). For example, an incompetent franchisee can easily damage the public's goodwill towards the franchisor's brand by providing inferior goods and services, and an incompetent franchisor can destroy its franchisees by failing to promote the brand properly or by squeezing them too aggressively for profits.[2]

7.4 Franchise failure can have devastating consequences for franchisees:

> …when franchisees fail they will accumulate substantial debt or loss of personal assets including family homes, forcing individuals or family to go bankrupt and into poverty adding a financial and medical burden on the government and taxpayer…employees are also made jobless and creditors including other small to medium business are financially affected.[3]

7.5 Former franchisees who have been through such failure frequently liken the experience to a breakdown in a personal relationship, using the analogy of divorce or even death.

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1 Professor Lorelle Frazer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 3

2 POAAL, *Submission 101*, p. 9

3 Mr Leicester Ramsey, *Submission 56*, p. 4

7.6 Franchisors also stand to suffer when a relationship with a franchisee breaks down, with interruptions to royalty flows when a unit franchise stops trading and the potentially negative effect on the overall brand.

7.7 Other franchisees in a network can also suffer as a consequence of the publicity associated with disputes:

> …there is potential brand damage that will be done and that brand damage can have its own backwash effect on other franchisees, which in the global context of a particular franchise could do more damage than may have occurred as a result of the particular misconduct that has affected the franchisee concerned.[4]

7.8 Clearly, it is in the best interests of all parties if disputes can be resolved before a franchise fails and without the need for recourse to expensive litigation.

Existing mediation provisions

7.9 As previously outlined in paragraph 3.34, Part 4 of the Franchising Code of Conduct (the Code) sets out mediation procedures to be followed in resolving franchising disputes. Parties are initially obliged to try to agree about how to resolve a dispute but, in the event that they cannot, may refer the matter for mediation. When either party seeks to put a mediation process in place, section 29(6) states: 'The parties must attend the mediation and try to resolve the dispute'.[5]

7.10 Parties may agree to appoint a particular mediator. Where they cannot agree, either party may approach the Office of the Mediation Adviser (OMA), which will then appoint a suitably qualified and experienced mediator.[6]

7.11 The Department of Innovation, Industry, Science and Research (DIISR), which has responsibility for providing policy advice on franchising to the Minister for Small Business, Independent Contractors and the Service Economy, submitted the following information to the committee regarding the current operation of the OMA:

> OMA statistics indicate that around 75 per cent of mediations conducted through the OMA result in a binding settlement.[7] Under the terms of the Government contract with the OMA, the maximum fee for the mediator is $275…per hour. The cost of the mediation is shared between the parties involved (unless otherwise agreed). On average, mediations cost each party

4 Mr Graeme Samuel, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 84

5 See Part 4 of the Franchising Code of Conduct

6 Franchising Code of Conduct, section 29(3)(b)

7 Note that the Franchising Code of Conduct does not formally provide for binding settlements. A mediation process may or may not lead to a mutually agreed outcome, and the Code does not include a process for enforcing agreements reached at mediation.

> approximately $1,500 and average completion time after the appointment of the mediator is five weeks.[8]

7.12 The Department clarified in verbal evidence to the committee that the costs cited are only for the time directly spent in mediation and do not take account of any preparation or advice costs on the part of franchisor or franchisee, nor any financial loss suffered if either party has to close their business in order to attend and participate in the mediation.[9]

7.13 The Department also provided information on the level of activity of the OMA:

> The latest report from the OMA indicates that the OMA has received around 3,064 dispute enquiries since 1 October 1998. Over the same period, 919 appointments were scheduled with mediators. The number of dispute enquiries received by the OMA each year is generally stable, averaging around 365 enquiries each year since 2002. This is despite the growth of the franchising sector over the same period. The largest number of dispute enquiries relate to the retail trade industry, including motor vehicle, fuel and food retailing.[10]

7.14 It identified 'Terms of Termination/Exit Arrangement' as the most frequently mediated issue and further noted that: 'The majority of the referrals to the OMA are from the ACCC, solicitors and industry representatives (such as the Franchise Council of Australia)'.[11]

7.15 The lower number of referrals from franchisees is inconsistent with claims in franchisee submissions to the committee that there is significant disputation in the sector. This is likely to reflect a combination of lack of confidence by franchisees in mediation processes (discussed further below); use of mediators other than those appointed by the OMA; and the establishment of internal dispute resolution mechanisms in some franchise systems.

7.16 Mr Scott Cooper hypothesised:

> Contrary to reports suggesting that levels of dispute remain low in franchising, one could suggest that the inability to afford the cost of even engaging a lawyer sees franchisees surrendering to the pressure of the franchisor and soldiering on. Alternatively, the franchisee accepts total defeat and walks away as opposed to raising a dispute and fruitlessly throwing good money after bad.[12]

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8 Department of Innovation, Industry, Science and Research*, Submission 137*, p. 3

9 Ms Sue Weston, Department of Innovation, Industry, Science and Research, *Proof Committee Hansard*, Canberra, 17 October 2008, pp. 13-14

10 Department of Innovation, Industry, Science and Research, *Submission 137*, p. 3

11 Department of Innovation, Industry, Science and Research, *Submission 137*, p. 4

12 Mr Scott Cooper, *Submission 15*, p. 15

7.17 POAAL put forward a number of reasons why franchisees might choose not to engage in mediation through the OMA, including fear of retribution; potentially high costs; a sense that franchisors are unlikely to engage in meaningful negotiation; and the possibility that franchisors will draw out the process in order to pressure the franchisee into giving in to franchisor demands.[13]

7.18 The committee heard evidence of some disputes being resolved by parties other than mediators appointed through the OMA (as provided for in the Code). For instance, the Lottery Agents Association of Victoria (LAAV) advised that numerous 'soft' mediation outcomes have been achieved before the Victorian Small Business Commissioner. LAAV also indicated, however, that in more difficult cases this mediation is less successful:

> The Small Business Commissioner's processes do not succeed to the same extent…when an issue is aggressively pursued by one of the parties. The fact is that the mediation process only requires both parties to attend. It does not require either party to do anything but be there. To be successful, mediation requires there to be goodwill from both parties. When that is not the case then mediation fails...[14]

7.19 A related issue raised is a potential lack of understanding of the OMA's responsibilities with respect to franchising. To assist with public recognition of the OMA's franchising mediation role, the ACCC suggested that consideration be given to changing its title to more clearly identify the office's relevance to the franchising sector.[15]

Committee view

7.20 The committee recognises that franchising dispute referrals to the OMA are not completely indicative of the level of disputation within the sector. This is part of the broader problem of a deficiency of statistical information collected in Australia about franchising, as noted by the committee in Chapter 3. This is discussed further below, starting at paragraph 7.23.

7.21 The committee also agrees with the ACCC that greater awareness and understanding amongst franchisees and franchisors of the OMA's role would be promoted by a more suitable name. Therefore, the committee recommends that the name of the Office of the Mediation Adviser be changed to the Office of the Franchising Mediation Adviser, in order to make the office's role in the franchising sector more readily apparent to franchisees and franchisors seeking assistance in dispute resolution.

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13 POAAL, *Submission 101*, p. 9

14 LAAV, *Submission 45*, p. 3

15 ACCC, *Submission 60*, p. 22

Recommendation 6

7.22 The committee recommends that the name of the Office of the Mediation Adviser be changed to the Office of the Franchising Mediation Adviser and that the Franchising Code of Conduct be amended to reflect this change.

Statistical measures of disputation in franchising

7.23 The committee notes the useful franchising survey results collated by the Asia-Pacific Centre for Franchising Excellence, Griffith University, in its biennial Franchising Australia surveys. However, though these surveys do collect information on dispute levels, it is sourced only from existing franchisors, meaning that dispute levels as a proportion of franchisees are not measured. A franchisor with 100 franchisees could be in dispute with one or all of them, but this is not reflected in the results. This deficiency is in addition to the high proportion of franchisor respondents who choose not to respond to the question on disputes (see paragraph 3.22).

7.24 In the absence of comprehensive data, the true extent and nature of disputation in the sector is unclear. Ms Jenny Buchan pointed out to the committee:

> …there are currently no useful statistics available about the true nature of disputes, serial offenders (if any), the speed and cost of the process, etc. I submit that the OMA could release sanitized statistics that are far richer than the bland numbers currently available without compromising the mediation process.[16]

7.25 As referred to earlier in this chapter, the OMA is only one avenue for dispute resolution. Statistics relating to disputes resolved through internal processes, before an agreed mediator or through an alternative path (including recourse to state or territory based processes) are not centrally captured, meaning that it is not possible to form an accurate picture of the number of disputes being taken to mediation in the sector.

7.26 Data on the extent of disputes where no mediation action is taken is also not available.

Committee view

7.27 It is difficult to assess the efficacy of current mediation provisions in the Code in the absence of a reliable understanding of the true extent of disputation in the sector. The committee therefore recommends that the government require the Australian Bureau of Statistics (ABS) to develop mechanisms for collecting and publishing statistics relating to the franchising sector, with a focus on franchise disputation and dispute-related franchisee turnover, using information collected from both franchisees and franchisors. This may be appropriately undertaken as part of existing business surveys, or as a new survey directed at the sector only.

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16 Ms Jenny Buchan, *Submission 89,* p.7

Recommendation 7

7.28 The committee recommends that the government require the Australian Bureau of Statistics to develop mechanisms for collecting and publishing relevant statistics on the franchising sector.

Effectiveness of mediation

7.29 Views put to the committee on the utility of the current mediation arrangements under the Code were polarised. For instance, the Franchise Council of Australia (FCA) stated:

> The mediation based dispute resolution process is highly effective and considered world's best practice. It is quick, low cost and effective in over 81% of cases, which is a phenomenal result.[17]

7.30 In stark contrast to this statement, many submissions to the committee revealed substantial dissatisfaction amongst franchisees, and also some franchisors, regarding the current operation of the mediation provisions.

Franchisee views

7.31 Mr Gavin Butler submitted:

> A franchisor can approach mediation…with no intention of achieving resolution because they know their franchisees generally cannot afford to take them on through the court processes.
>
> … … …
>
> …my assessment of mediation is all about the franchisor using their deep pockets and bargaining power to exit the franchisee with as little as possible and to ensure they silenced the franchisee from ever saying anything negative about the franchisor.[18]

7.32 Another franchisee indicated:

> The mediation process was a joke, because as soon as I tried to discuss the attached report, the franchisors representative threatened to leave …[19]

7.33 Ms Nicole Hoy wrote:

> …until there is a method put in place that can provide affordable and immediate relief, it is near impossible for the average franchisee to enforce their rights under their agreement or under the code.
>
> … … …

17 FCA, *Submission 103*, p. 6

18 Mr Gavin Butler, *Submission 3*, pp. 1-2

19 Name withheld, *Submission 7*, p. 1

> Mediation only works when both parties are reasonable and compromise can be reached. If the other party refuses to mediate there is no other recourse but litigation…[20]

7.34 Mr Ray Borradale described a situation in which:

> Mediation was openly used to force a franchisee into additional cost where the franchisor would not entertain any issue in dispute after proclaiming beforehand that any agreement reached in the presence of a mediator would be discarded after mediation.[21]

7.35 Discussing mediation processes more broadly, Mr Borradale further contended:

> Mediation continues to allow a rogue franchisor the ability to use the process to further drain the finances of a franchisee and where the opportunist franchisor can flaunt that there is no requirement to abide by any agreements made in mediation.[22]

7.36 George and Ruth Nimbalker wrote:

> The dispute resolution process as it stands now does not work; the office of the OMA is not effective and has no powers to stop the franchisors with the big pockets and sleek lawyers.[23]

7.37 Some submitters argued that the power imbalance between franchisor and franchisee that permeates pre-contractual arrangements and the life of the franchising agreement also renders current mediation processes unsuccessful. As expressed by Mr Peter Moon:

> There will always be disagreements but with the current system when the "David and Goliath" disputes occur, it is invariably the case that the Goliath Franchisor "outguns" the franchisee in every material aspect which all too often renders truth and fairness a very impotent tool in seeking recourse. The pendulum is weighted too far in favour of the franchisor. It is certainly time to bring a better balance back to the world of franchising.[24]

7.38 There was support for this contention from the Law Institute of Victoria:

> We are aware of the existing remedies available to franchisors, however are concerned that franchisees can often be significantly disadvantaged in a franchise commercial relationship…under this dispute resolution process, franchising disputes can escalate quickly, often resulting in expensive

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20 Ms Nicole Hoy, *Submission 8*, pp. 1-2

21 Mr Ray Borradale, *Submission 16*, p. 7

22 Mr Ray Borradale, *Submission 16*, p. 20

23 George and Ruth Nimbalker, *Submission 67*, p. 4

24 Mr Peter Moon, *Submission 93*, p. 1

> litigation. As a result, this dispute resolution process is often not viable for franchisees with limited resources, facing closure of their business.[25]

Franchisor views

7.39 However, some franchisors strongly contested this negative perspective. They instead indicated to the committee that there is potential in the current dispute resolution system for franchisees to act capriciously, raising spurious claims that franchisors are then obliged to disclose to their other franchisees and which can damage the brand. Mr Geoffrey Cope, Managing Director of the Fibrecare Group, wrote:

> I feel there is a view amongst franchisees that if they aren't happy they can get out of their agreements if they cause a bit of a stir. This is because the law is in their favour and they only have to make allegations of being misled or mistreated to cause problems for the franchisor. Like most franchisors we can't afford expensive litigation, so we will usually try to settle even if we are 100% in the right.[26]

7.40 7-Eleven also suggested that some franchisees take advantage of current Code requirements:

> The current mediation and disclosure requirements in the Franchising Code have in certain instances invited franchisees to use litigation proceedings, or the threat of them, as a form of commercial blackmail in recognition that the Franchisor is at an immediate disadvantage in relation to such proceedings because it has to include the details of it in its Disclosure Document which both Franchisees and Franchisors know affects the Franchisor's brand and probably its market position, and can affect the goodwill of other associated franchisees. Unscrupulous Franchisees can use those concerns as leverage to extract settlements or concessions from Franchisors.
>
> … … …
>
> …I genuinely believe that many franchisors rush to settle mediation of even spurious claims to project their brands, as the balance of protection seems to now be in imbalance between Franchisor and Franchisee.[27]

Limitations of mediation

7.41 The dispute resolution process currently in the code has been described as 'imperfect':

> There are difficulties in getting the parties to mediation in a timely fashion, mediation at times becomes like a court case and mediation outcomes are uncertain and often cannot be enforced.[28]

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25 Law Institute of Victoria, *Submission 159*, p. 2

26 Fibrecare Group, *Submission 144*, p. 9

27 7-Eleven, *Submission 105*, pp. 4-5

7.42 Some submitters and witnesses commented that representatives at a mediation may not have full authority to negotiate an outcome (despite this being a requirement under the Code):

> Parties can come along to mediations and…really just go through the motions…Perhaps they do not have authority to actually negotiate fully at the mediation. Perhaps the requisite senior people are not present at the mediation. That is often an indication that they are going through the motions. Those mediations just do not get anywhere, principally for the reason that if in the event in this industry parties have access to legal advice if the advice is the distributor believes that there is no legal action that can be brought, there is very little incentive to actually offer some settlement. The franchisee for its part realises on its legal advice that perhaps it is very difficult and very expensive to take any action, particularly if 51AC does not provide an adequate remedy.[29]

7.43 Furthermore, the main aim of the franchisor may be in negotiating an exit arrangement, rather than a resolution that would enable a franchisee to continue trading:

> At the mediation maybe all that is on the table for discussion is that the dealership is coming to an end…Maybe all that is the subject of negotiations is how you are going to end the relationship…[30]

7.44 Others emphasised that, although mediation is intended to be a low-cost option, it is sometimes still beyond the resources of franchisees facing business failure and, potentially, loss of substantial investments. According to Mr Leicester Ramsey,

> While mediation is significantly cheaper than litigation, the cost of participating in the process may represent a significant expense for many franchisees.[31]

7.45 Mr Damien Hansen confirmed that costs were a prohibitive factor in trying to resolve a dispute with his franchisor:

> …the mediation and legal system was out of my reach.[32]

7.46 The Franchisees' Association of Australia pointed out that in these circumstances franchisees often feel they have no choice but to accept whatever mediation terms they are offered:

> The truth is that many franchisees settle, but only in despair, having no alternative, especially given the imbalance in bargaining power.[33]

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28 Mr Hank Spier, Spier Consulting, *Submission 151*, p. 3

29 Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 9

30 Mr Robert Gardini *Proof Committee Hansard*, Sydney, 9 October 2008, p. 9

31 Mr Leicester Ramsey, *Submission 56*, p. 4

32 Mr Damien Hansen, *Submission 1*, p. 4

7.47 The ACCC also acknowledged the quandary faced by franchisees in dispute:

> The nature of franchising means many are small- or medium-sized businesses where owners have a large share of their wealth at stake…Consequently, franchisees involved in disputes with their franchisors sometimes stand to lose (or have already lost) a significant share of their personal assets and may not be able to afford litigation.
>
> Serious franchising disputes can escalate quickly and a franchisee may feel forced to accept whatever settlement the franchisor proposes because they have limited financial resources and do not see any alternative.[34]

7.48 In light of these comments, the relatively high settlement rate cited for the OMA mediations is potentially misleading. The blunt settlement figure provides no indication either about the relative satisfaction of the parties with the mediation outcome, or whether the mediation outcome subsequently occurs. According to Mr Robert Gardini:

> …the high settlement rate of motor vehicle dealer disputes under mediation is not representative of a high rate of dealers receiving equitable resolutions to their disputes. Although mediation is being sought more frequently by dealers, this is merely indicative of their inability to seek adequate redress in the court system, and not a testament to the effectiveness of the settlement process. It should not be forgotten that 'settlement' can encompass…any one scenario on a continuum of outcomes, including (at best) the circumstance of a satisfactory outcome for both parties, to the more realistic results whereby a dealer is reluctant but can live with the terms of the settlement, and finally (arguably the most common outcome) where a dealer has little choice but to accept any offer in the absence of either adequate legal redress or the ability to fund costly legal proceedings.[35]

Suggested improvements to the mediation process

Good faith in mediation

7.49 The committee received a range of evidence suggesting that, if parties were required to mediate in good faith, more meaningful results might be achieved. Mr John Levingston, an OMA mediator, characterised the current absence of a good faith provision as 'surprising':

> Good faith has become an element of domestic commercial activities though well known and of long standing in international commerce and equity. One of the problems for good faith in franchising activity arises from the common law approach to good faith where it is regarded as a mere implied term which can be expressly excluded by contract. More recently,

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33 Franchisees' Association of Australia*, Submission 51*, p. 18

34 ACCC, *Submission 60*, p. 20

35 Mr Robert Gardini, *Submission 92*, p. 3

> good faith has become a subject of statute where it is recognised as an element of unconscionable conduct, but, surprisingly, good faith is not identified as an express requirement under the Franchise Code.[36]

7.50 Mr Levingston has also pointed out that an obligation for parties to act in good faith during mediation is already a part of the court rules in operation in New South Wales.[37]

7.51 Mr Robert Gardini suggested:

> …settlements and the dispute resolution would be significantly enhanced where the parties had a positive obligation to mediate in good faith. If the code were amended to include such a provision there would be a greater chance of equitable settlements as both parties would have to make genuine attempts to reach resolution.[38]

7.52 In relation to the dispute with her franchisor, Ms Deanne de Leeuw considered that:

> If good faith provisions had been in there, I potentially could have used that to say, 'We need to be dealing with each other honestly and reasonably and this is my problem. Can we sort it out?'[39]

7.53 Competitive Foods Australia Pty Ltd told the committee:

> …the real problem is that, if you do not have standards of conduct that can hold franchisors accountable, you will not have a successful mediation. On the other hand, if you put in standards of conduct, particularly for good faith, you may in fact nip a lot of big problems in the bud because people could then go to mediation quickly and easily on small problems. Franchisors could be held accountable because of their good faith obligations, and they could resolve their difficulties before it becomes a big problem.[40]

7.54 The insertion of a good faith provision into the Code was a key recommendation of the 2008 inquiry into franchising by the Economic and Finance

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36 John Levingston, 'Franchise mediations: Experience, problems and solutions (reflections of a franchise mediator), (2008) 19 ADRJ 83, p. 91

37 John Levingston, 'Franchise mediations: Experience, problems and solutions (reflections of a franchise mediator), (2008) 19 ADRJ 83, pp. 91-92

38 Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008, pp. 3-4

39 Ms Deanne de Leeuw, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 69

40 Mr Tim Castle, Competitive Foods Australia Pty Ltd, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 36

Committee of the South Australian Parliament.[41] Mr Tony Piccolo MP, representing the Economic and Finance Committee, told the committee:

> The current code requires you to attend mediation. It does not require you to attend mediation in good conscience or in good faith. Unfortunately, in reality that is how it is treated in practice. It requires you to participate in a process. If you drag the process out as a franchisor your position to bargain with the franchisee is strengthened. You weaken their position even further than it is already. There has to be some discussion about good faith dealing…[42]

7.55 The committee was cautioned that the notion of good faith mediation could introduce complications for mediators. Mr David Lieberman, a former ACCC commissioner and currently a nationally accredited mediator and member of the OMA panel, raised the question of the mediator's position with regard to assessing whether the good faith obligation has been met:

> While adding a provision that the parties must mediate in "good faith" may be helpful…it raises the same issues as to impartiality and potential for a party to seek review should the mediator take the view that a party was not acting in good faith. In such a case, if "good faith" was a requirement of the mediation provisions of the Code, the mediator would be expressing a view that a party was not in compliance with the Code.[43]

7.56 However, the committee contends that there are clear indicators of whether mediation is taking place in good faith, including whether a party attends at all; whether they attend in a timely matter; whether they attend in person; and whether they demonstrate an intent to work towards a mutually agreeable settlement.

Alternative dispute resolution mechanisms

7.57 Having regard to both the limitations of mediation as it currently exists and the high, often prohibitive, costs of litigation, many submitters and witnesses asked the committee to consider the introduction of alternative dispute resolution mechanisms in franchising. Suggestions put forward included an increased focus on pre-mediation strategies; the creation of a tribunal to make determinations; or the introduction of a franchising ombudsman.

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41 In recommendation 7.2.18, 'The Committee recommends amending the Franchising Code of Conduct by inserting a provision imposing a duty to act in accordance with good faith and fair dealing by each party of the franchise relationship.' SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008, p. 98

42 Mr Tony Piccolo MP, Economic and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 60

43 David Lieberman & Associates, *Submission 31*, p. 2.

Pre-mediation processes

7.58 Mr David Lieberman submitted that, for there to be a realistic prospect of resolving disputes satisfactorily, such that the working partnership between franchisee and franchisor can continue, there is a need for pre-mediation processes:

> Often by the time a dispute is referred to the OMA, the relationships have soured to an almost irreconcilable point. Ideally parties should have a way to communicate issues early…One approach with which I am familiar…is for the Franchisor to have a voluntary system which provides for review of an issue by an internal panel and then, if still unsatisfied, by an external independent panel…[44]

7.59 This notion was supported by POAAL, who cited the example of how they have negotiated an internal mediation process with their franchisor on behalf of their members:

> A better model is a dispute resolution process involving a stepped process with early discussion and resolution at lowest management level. This includes provision for higher referral if the dispute is not resolved quickly and to the satisfaction of both parties. Such a system was established through negotiation…by POAAL.[45]

Tribunal

7.60 The committee received some suggestions that a low-cost tribunal be introduced to sit above the current mediation process, to make determinations on disputes without the need for recourse to litigation. According to Professor Andrew Terry:

> I am not sure that there is a very high success rate for mediation in terms of settlements that arise out of it. Because of confidentiality you do not know how many of those franchisees are entirely happy with the settlement or felt like they had no option but to make a settlement with the franchisor…I would have thought there would…be an argument for a specialist tribunal.[46]

7.61 When asked what powers he envisaged such a tribunal having, Professor Terry responded:

> A tribunal like a consumer claims tribunal that sits out of the court structure with limited appeal rights on law back into the court structure. A mediator is not empowered to give a decision, of course, and nor would an ombudsman be, but a tribunal would have the power to make a decision in cases under a certain threshold.[47]

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44 David Lieberman and Associates, *Submission 31*, p. 2

45 POAAL, *Submission 101*, p. 9

46 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 74

47 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 74

7.62 Ms Jenny Buchan, speaking in relation to current circumstances in New South Wales, cautioned that adding a new layer to franchising dispute resolution through the creation of an additional tribunal might dilute franchising expertise:

> I understand the reason that having a low-cost tribunal is attractive. I have hesitation, though, about dissipating the expertise too broadly. Currently, the understanding of what is a functioning franchise essentially sits in three places. It sits amongst the mediators. It sits in the Federal Court; some Federal Court judges are gaining a pretty good idea of what is a functioning franchise. And it sits in the Industrial Relations Court in New South Wales. So, I think when you are thinking about a tribunal or another potential avenue of dispute resolution you do need to consider how broadly you want to dissipate the understanding of what is a franchise.[48]

7.63 It is necessary to note that there are constitutional limitations on the powers and role of a tribunal. As Mr Brendan Bailey pointed out in his submission to the committee:

> The powers of a tribunal at the Commonwealth level are limited by wording in the Australian Constitution. A Commonwealth tribunal may make an assessment of the rights between parties but it is unable to enforce its own order because enforcement is a judicial function – a matter for the courts…[49]

7.64 The powers of any Commonwealth tribunal are substantially less broad than those of state tribunals, due to the separation of powers doctrine set out in the Australian Constitution. Under state legislation, state tribunals are able to hear consumer, trading, tenancy and other disputes and make determinations, but Commonwealth tribunals are limited to review of administrative decisions. As explained by the Hon. Justice Garry Downes AM:

> The judicial power of the Commonwealth cannot be exercised by the executive. It can only be exercised by the judiciary.
>
> In Australia, reviewing administrative decisions on the merits is not an exercise of judicial power, any more than the making of original administrative decisions is an exercise of judicial power. Both are exercises of executive or administrative power. The review of Commonwealth administrative decisions on their merits is appropriately carried out by tribunals not courts. The validity of Commonwealth administrative review tribunals is not in doubt.
>
> However, determining disputes between landlord and tenant or resolving a consumer's claim for compensation does involve the exercise of judicial power. The separation of powers doctrine governing the Commonwealth

48 Ms Jenny Buchan, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 82

49 Mr Brendan Bailey, *Submission 152*, p. 3

> Government precludes Commonwealth tribunals from exercising this or any judicial power.[50]

7.65 This suggests that the introduction of a franchising tribunal at the federal level would not materially assist in overcoming current frustrations regarding the lack of enforceability of mediation outcomes, because the tribunal would not be empowered to enforce judgements. Mr Bailey commented that the existing codified mediation process recognises this constitutional limitation:

> Mediation is a valuable mechanism to assist in dispute resolution, particularly when it is assumed that the parties look to continue a working relationship…Mediation is not an exercise in making a binding determination that can be enforced by the mediator – it never is. That does not mean that mediation is not valuable. Litigation is expensive but the Franchising Code of Conduct should not be found lacking simply because it pays due regard to the limitations imposed under the Commonwealth Constitution and offers a relatively low cost dispute resolution mechanism…that will not be undone by a finding of constitutional invalidity.[51]

A franchising ombudsman

7.66 The committee received suggestions that the introduction of a franchising ombudsman may assist in dispute resolution:

> I would have thought there is a role for an industry ombudsman. There needs to be someone who by their experience and the authority of the position can attempt to have some influence.[52]

7.67 The Economic and Finance Committee of the South Australian Parliament also recommended that the introduction of an ombudsman be considered.[53]

7.68 A potential model for such an ombudsman is the Banking and Financial Services Ombudsman, who is empowered to consider disputes involving services provided by a bank or affiliated financial institution to individuals or small businesses, where the amount being claimed is less than a set amount (currently $280,000).[54] The

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50 The Hon. Justice Garry Downes AM, 'Overview of Tribunals Scene Australia', Speech delivered to the International Tribunal Workshop, Canberra, 5 April 2006. http://www.aat.gov.au/SpeechesPapersAndResearch/speeches/downes/OverviewTribunalsSceneApril2006.htm , viewed on 17 November 2008

51 Mr Brendan Bailey, *Submission 152*, p. 3

52 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 74

53 SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008, p. 98

54 See Terms of Reference for the Banking and Financial Services Industry Ombudsman at http://www.abio.org.au/abioweb/ABIOWebSite.nsf/0/B385C2D0F3E87335CA256C0E0045047A/$file/BFSO+Terms+Of+Reference+1-1-07.pdf , viewed on 17 November 2008

committee notes that the ability of a franchising ombudsman to be effective might be constrained by limits on the financial magnitude of disputes that could be heard.

Arguments for maintaining the status quo

7.69 The committee also received submissions indicating that it is not necessary to change existing franchising dispute resolution procedures. In particular, the FCA contended:

> …that any new tribunal or any arbitration or ombudsman process is unlikely to offer any material benefits to franchisees, and is likely to be more costly.[55]

7.70 The Law Council of Australia endorsed this position:

> …the dispute resolution processes contained in the Franchising Code are adequate in their current form and the inclusion of a new binding alternative dispute process (based around expert determination by an Ombudsman or expert) is not warranted.
>
> Franchising is a contractual business arrangement pursuant to which a franchisee is granted a right to operate a franchise business. It is appropriate that disputes regarding franchise agreements, which cannot be resolved through the mediation processes contemplated by the Code, are resolved in the manner contractually agreed by the parties to the franchise agreement. If the parties determine that disputes will ultimately be resolved by Courts, this is entirely appropriate.[56]

7.71 Mr Robert Gardini, despite outlining substantial concerns regarding the efficacy of current mediation processes, acknowledged that changing aspects of the dispute resolution model might not fix existing problems. He suggested addressing overall conduct in franchising and improving remedy as a useful alternative:

> I do see some expansion of dispute resolution procedures, but moving to a tribunal or a franchise ombudsman may be just creating another level of unnecessary red tape and an institution that perhaps does not achieve anything better than is currently achieved. In a regulatory sense, let us get to the fundamentals: if we are striving for a minimum affect of regulation let us look at the adequacy of the code and whether we need a good faith provision in the code, which I support, and whether we look at an effective remedy at law that deals with the small number of serious complaints that exist in this industry. I…have a hesitation about creating new entities that in fact may not deliver. Let's keep it simple. Let's provide an effective remedy, because if you do that then I think the result will follow that there will be

55 FCA, *Submission 103*, p. 6

56 Law Council of Australia, Trade Practices Committee, Business Law Section, *Submission 141*, p. 11

realistic settlements or improved satisfaction through the mediation process.[57]

Committee view

7.72 The committee supports any efforts by franchisors and franchisees to engage in constructive and fair internal complaint handling and dispute resolution procedures, avoiding the need for formal mediation to be triggered. Such procedures are already allowed for in the Code, which states that parties should 'try to agree about how to resolve the dispute' before resorting to mediation.[58]

7.73 Inevitably, some disputes cannot be resolved this easily, and the committee recognises that there is substantial dissatisfaction in the sector about the outcomes of existing mediation processes. In the absence of both parties engaging meaningfully in the process, resolving franchising disputes through mediation can be a flawed process. However, the Code's current mediation provisions do at least provide franchisees and franchisors wanting to constructively resolve their dispute with a less costly resolution option than litigation.

7.74 The committee does not support the introduction of alternative dispute resolution mechanisms to overcome the problem of parties approaching mediation uncooperatively. A Commonwealth tribunal sitting between mediation and the courts would most likely add another layer of complexity and expense to the process without achieving improved outcomes, given the need to ensure appeals to the courts and the constitutional uncertainty over how binding its decisions would be.

7.75 It is the committee's view that many of the issues which lead to franchising disputes, and hence the need for mediation or alternative dispute resolution mechanisms, may be mitigated by the introduction of an explicit obligation into the Code for all parties to a franchise agreement to act in good faith. This would apply more broadly than a simple requirement to approach mediation in good faith. The pros, cons and implications of including such an obligation in the Franchising Code of Conduct are discussed in detail in Chapter 8.

7.76 Enforcement options are discussed in Chapter 9.

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57 Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 11

58 See 29(2) and 29(3) of Part 4 of the *Trade Practice (Industry Codes—Franchising) Regulations 1998*.

Chapter 8

Good faith in franchising

8.1 While the pre-contractual disclosure obligations of the Franchising Code of Conduct (the Code) have been, for the most part, adequately addressed by past inquiries, there remains concern at the continuing absence of an explicit overarching standard of conduct for parties entering a franchising agreement.[1]

8.2 As described in Chapter 2, the interdependent nature of the franchise relationship leaves the parties to the agreement vulnerable to opportunistic conduct by either franchisors or franchisees. Franchisee opportunism may take the form of free riding, unauthorised use of franchisors' intellectual property rights, underperformance, or failure to accurately disclose income. However, the franchisor's control over the provisions in the contract enables franchisors to address opportunistic behaviour of this kind by enforcing the terms of the franchise agreement.[2]

8.3 Franchisor opportunism has been described as 'predatory conduct and strong arm tactics by franchisors' involving the exploitation of a pre-existing power relationship between the franchising parties, which makes the franchisee 'vulnerable or economically captive to the demands of the franchisor'.[3] There is an inherent and necessary imbalance of power in franchise agreements in favour of the franchisor, but abuse of this power can lead to opportunistic practices including encroachment, kickbacks, churning[4], non-renewal, transfer, termination at will, and unreasonable unilateral variations to the agreement.[5]

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1 Competitive Foods Australia Pty Ltd (CFAL), *Submission 22*, p. 6. See also Mr Michael Delaney, Motor Trades Association of Australia (MTAA), *Proof Committee Hansard*, Canberra, 17 October 2008, p. 19

2 Dr Elizabeth Spencer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 38 and *Submission 39*, p. 5

3 CFAL, *Submission 22*, p. 7

4 A number of submissions raised the issue of churning (see for example Mr Gavin Butler, *Submission 3*, Mr Michael Sheridan, *Submission 20*, Ms Deanne de Leeuw, *Submission 114*). Following the 2006 Matthews Review, a number of amendments were made to the disclosure provisions of the Code. The amendments were introduced in March this year and were, in part, aimed at reducing churning. See the government response to the Matthews Report, February 2007.

5 Dr Elizabeth Spencer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 39 and *Submission 39*, pp. 4-5. See also for example CFAL, *Submission 22*, pp. 7-8. In response to the Matthews Report, the government agreed to address the issue of unilateral variation through reform of section 51AC of the Trade Practices Act where such clauses (either in relation to terms or termination of the agreement) would be a factor that may indicate that a corporation has engaged in unconscionable conduct.

8.4 Aside from the personal hardship that opportunistic conduct can cause, such behaviour may also have negative ramifications for individual franchise systems and the franchising sector as a whole. The imbalance of power in franchise agreements is not something that should be changed, but what does need to be checked is any abuse of this power.

8.5 The problem of opportunism in the franchising sector may be addressed through constraining the behaviour of franchisors, and empowering franchisees.[6] The introduction of a statutory obligation of good faith within the Code has been suggested as one possible mechanism for regulating the conduct of franchising parties and, in particular, for preventing franchisor opportunism.[7]

8.6 The concept of good faith is not new and there is existing statutory precedent for recognising or imposing obligations of good faith, including in the 2006 Oil Code regulations, section 51AC of the *Trade Practices Act 1974* (TPA), the Victorian *Fair Trading Act 1999* and Native Title legislation.[8]

8.7 Although there is no clear definition of 'good faith', it would be generally understood to mean acting fairly, reasonably and honestly, encapsulating the concept of 'a fair go'.[9] The South Australian Economic and Finance Committee concluded that '[w]hile an abstract formulation of a generalised concept of good faith may be indistinct, the courts have demonstrated that they are able to know it when they see it, or more properly, they know a breach of it when they see it.'[10]

8.8 However, the lack of a universally accepted specific definition of good faith has led to differing views on the implications of inserting an express good faith clause into the Code.

Implied or explicit good faith

8.9 Professor Andrew Terry argued that 'the experience at common law with the implication of a good faith covenant is far from certain' and cautioned against the inclusion of a good faith obligation in the Code as the 'holy grail of franchise

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6 Dr Elizabeth Spencer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 37

7 Dr Elizabeth Spencer, *Submission* 39, p. 29

8 Dr Elizabeth Spencer, *Submission* 39, p. 37. Dr Spencer's submission also outlines a range of overseas jurisdictions, both civil and common law, where good faith is incorporated, including the US Uniform Commercial Code, Restatement (Second) of Contracts, UNDROIT Principles of International Commercial Contracts, and the UN Convention on Contracts for the International Sale of Goods (CISG).

9 See for example, Mr Kim Rosenwald, *Submission 44*, p. 3, Mr Scott Cooper, *Submission 15*, p. 16, and Mr Howard Bellin, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 80.

10 SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008 (SA Report), p. 55

relationship reform'.[11] He considered that a more appropriate response to specific and substantiated problems in the sector would be a targeted response.[12]

8.10 The Australian Competition & Consumer Commission (ACCC) noted that there was a 'degree of uncertainty' about a statutory obligation to act in good faith, and it would be difficult to independently define or reduce to a 'rigid rule':

> … if an obligation to act in good faith were included in the code, the meaning of good faith would have to be considered separately in each case depending on its particular facts. This may introduce ambiguity and confusion about the rights and responsibilities of franchisors and franchisees, and potentially increase disputes and conflict among franchising participants.[13]

8.11 The National Retail Association (NRA) opposed the explicit inclusion of a good faith clause in the Code:

> An implied duty of good faith may already exist in the common law and the concept continues to evolve as courts decide relevant matters. The Auto Masters case found, for example, that the precise nature of any good faith obligation depends on the circumstances of the case and the context of the contract as a whole. NRA doubts whether much benefit will accrue from the introduction of a statutory concept of "good faith" and suggests that the more sensible course would be to allow the current legal processes to continue to resolve argument around the concept.[14]

8.12 DLA Phillips Fox concurred:

> …the current state of our common and statutory law provide adequate protection and any attempt to introduce an explicit good faith obligation into the Code may not only be unnecessary but an unfortunate legislative indication that 'good faith' has a different meaning as currently understood, applied and continually further developed by our Courts.[15]

8.13 In addition to potentially creating legal uncertainty, there were concerns that an explicit good faith clause in the Code may add to the expectation gap in franchise relationships:

> I think it would significantly increase the expectation gap. I am not sure whether that is a wise thing to do. The expectation gap is significant at the moment….
>
> …On top of the prescriptive requirements of the Franchising Code of Conduct and of the relatively low threshold of misleading and deceptive

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11 Professor Andrew Terry, *Submission 91*, p. 4

12 Professor Andrew Terry, *Submission 91*, p. 5

13 ACCC, *Submission 60*, p. 19

14 NRA, *Submission 109*, p. 10

15 DLA Phillips Fox, *Submission 81*, p. 4

> conduct, that is, have you been honest or have you been dishonest, layer on top of that this somewhat hazy, woolly concept of good faith, and all I can say to you is that we will end up having is an increased expectation gap where people will say, 'But I believe that the franchisor did not act in good faith, and the ACCC wouldn't deal with it.'[16]

8.14 The Law Society of Western Australia stated that, as a franchise agreement contains an implied duty of cooperation and good faith is generally implied in contract law, 'each party will normally be expected to act in good faith towards the other'.[17]

8.15 Ms Deanne de Leeuw, who detailed her experiences as a franchisee, argued that 'the lack of Good Faith and Goodwill provisions within the Code enable franchisors to act unethically, protected by the franchise contract'. She observed that many franchisees believe that franchisors will act in good faith towards them when they enter franchise agreements, but the 'implied' duty 'means little if a franchisor acts in an abusive or opportunistic manner towards them'.[18]

8.16 The Motor Trades Association of Australia (MTAA) expressed concern at the apparent ability of franchisors to effectively 'write out' an implied duty to act in good faith through an express clause in the contract. While it has been argued that franchisees do not have to sign up to an agreement containing such a clause,[19] the MTAA submitted that 'due to the bargaining power imbalance, the franchisee, as the more vulnerable party to the agreement, will continue to voluntarily enter into agreements despite the existence of unfavourable terms and clauses.'[20] For this reason, the MTAA argued, 'legislation should intervene to set the minimum standard of conduct to protect the parties to the franchise agreement.'[21]

8.17 IndCorp Franchisees' Association of Australasia argued that currently, the concept of good faith is arbitrary and determined by whoever is in charge at the time:

> The problem that I think we have with the good faith, especially with a company that is an American-based company, is that good faith is determined by whoever seems to be captaining the ship at the time…so good faith is determined at the time by whatever that person determines is good faith, not by any set guidelines as to what good faith should entail.[22]

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16 Mr Graeme Samuel, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, pp. 95-96.

17 Law Society of Western Australia, *Submission 58*, p. 2

18 Ms Deanne de Leeuw, *Submission 114*, p. 5

19 See for example ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 83

20 MTAA, *Submission 90*, p. 6

21 MTAA, *Submission 90*, p. 6

22 Mr Greg Fisher, IndCorp Franchisees Association of Australasia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 85

8.18 This view was supported by Mr Tony Piccolo MP, Member of the South Australian Economics and Finance Committee:

> The reason we say it should be 'explicit' is that it is implied in law already. Given that it is implied in law, the difference between it being an implied provision and an explicit provision is that an implied provision can actually be written out. It is still there but it has to be fought for in the courts. An explicit provision states up front the standard of behaviour we require.[23]

8.19 In contrast, Professor Terry argued that an 'open-ended obligation of good faith' would invite disputation, as there is 'no scope for good faith in the face of express contractual provisions':

> Good faith basically hangs off contractual provisions to make sure that those contractual powers are not exercised in a capricious manner. Good faith is not going to solve the problem.[24]

8.20 The Shopping Centre Council of Australia (SCCA) concurred with Professor Terry's position, arguing that:

> Good faith, as developed by the courts, needs to be understood in that context, because it is only limited, it is only case specific and it is only in that context and it is not contrary to the express words. You need a surrounding contract and you need a common purpose to in fact imply such a term.[25]

8.21 In not objecting to an express provision of 'good faith' being included in the Franchising Code, without first seeing how it is defined and then implemented, Australia Post could not see how it would materially advance the interests of franchisees.[26] This position was supported by the Federal Chamber of Automotive Industries who argued that 'to introduce a statutory concept of "good faith and fair dealing" into the Code is unnecessary and would not add any certainty or clarity to the rights of franchisors or franchisees.'[27]

8.22 The Law Council of Australia Trade Practices Committee, Business Law Section, drew upon the current case law to support their claim that:

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23 Mr Tony Piccolo MP, Economic and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 58

24 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 76

25 Mr Peter Speed, SCCA, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 49

26 Mr Scott Staunton, Australia Post, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 99

27 Federal Chamber of Automotive Industries, *Submission 155*, p. 12

> Australian Courts have recognised that a franchise agreement includes an implied term requiring parties to act in good faith and reasonably, and not to act capriciously or for some extraneous purpose.[28]

8.23 However, they also noted that the courts had made clear that the implied duty did not require franchising parties to act against their legitimate business interests consistent with the terms of the agreement, but were uncertain whether an express obligation to act in good faith would be interpreted in the same way.[29]

8.24 The MTAA argued that the interdependent nature of the franchising relationship, in which the 'long-term success of one party is reliant on the cooperation and performance of the other', requires a 'greater degree of consideration with respect to the "good faith" in dealings between parties.'

> …the usual commercial conduct of 'acting at arms length' and the 'pursuit of individual interests' can not be expected or tolerated by the parties to a franchise agreement. Rather, the franchise relationship should be co-operative, enduring and guided by the principle of good faith.[30]

8.25 The Franchise Council of Australia (FCA) rejected the claim that an express clause would merely reflect the implied duty to act in good faith that currently exists:

> There has been no rational argument advanced to justify the introduction of a new statutory obligation to act in good faith, and no effort made to define such a term. Rather the proposal has been misrepresented as a codification of the existing law, or a simple change that will have minimal effect. This is not the case.[31]

8.26 However, the FCA subsequently conceded:

> … we are concerned that the definition is appropriate. If, for example, there were simply a reiteration of the current implied position so that it were said that in the conduct of the franchise relationship the parties will act in good faith, or something like that, then that is just a repeat of the current state of the law. If you are asking, 'Would the FCA object to repeating the current state of the law and the statutory framework?', I think the answer to that would be, no. Our concern is extending it.[32]

8.27 According to Associate Professor Frank Zumbo, an explicit good faith provision would set the standard of conduct expected of franchising parties:

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28 Law Council of Australia Trade Practices Committee, Business Law Section, *Submission 141*, p. 2

29 Law Council of Australia Trade Practices Committee, Business Law Section, *Submission 141*, p. 2

30 MTAA, *Submission 90*, p. 5

31 FCA, *Submission 103*, p. 17

32 Mr Stephen Giles, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 27

> …the concept of good faith has not only received strong judicial support, but now has reached the point in Australia where its nature and scope is being defined with an increasing degree of precision. Consequently, there is a ready body of law on which a statutory duty of good faith could quite readily and usefully draw upon in seeking to promote ethical business conduct.[33]
>
> A statutory duty of good faith would represent a positive statement of what is considered ethical conduct within a franchising context and provides an appropriate and well accepted benchmark of appropriate standards of ethical behaviour. This is particularly relevant in a franchising relationship given the inter-dependency of the franchisor and franchisee. The ongoing success of the relationship requires that they act in a mutually respectful and cooperative manner throughout the course of the relationship. A statutory duty of good faith would set out the boundaries of acceptable conduct in a positive manner for the benefit of both franchisors and franchisees.[34]

8.28 This view was supported by Mr Piccolo MP, who claimed that in addition to making the current law easier to enforce, requiring the parties to a franchise agreement to act in good faith would also promote 'business integrity and ethics'.[35]

8.29 An express good faith obligation would also be consistent with the policy objectives for which the Code was established.[36]

Good faith in section 51AC of the Trade Practices Act

8.30 The extent to which a party has acted in good faith is already a factor to be taken into account by courts in determining whether conduct is considered to be unconscionable under section 51AC of the Trade Practices Act (TPA).

8.31 The FCA stated that 'at a conceptual level the Code supports the basic principles of freedom of contract, but provides additional specific protection beyond the already powerful remedies of misleading or deceptive conduct and unconscionable conduct contained in the Trade Practices Act'.[37] DLA Phillips Fox also submitted that the interrelation between the Code and the relevant parts of the TPA as they apply to franchising are 'robust and broad enough in scope and application to provide adequate protection to franchisees'.[38]

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33 Associate Professor Zumbo, *Submission 140*, p. 39

34 Associate Professor Zumbo, *Submission 140*, p. 39

35 Mr Tony Piccolo MP, Economics and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 58

36 MTAA, *Submission 90*, p. 7

37 FCA, *Submission 103*, p. 20

38 DLA Phillips Fox, *Submission 81*, p. 6

8.32 Competitive Foods Australia Pty Ltd (CFAL) maintained that the Code and section 51AC of the TPA were inadequate in preventing unethical or 'rogue' franchisors, who did not act consistently with accepted industry norms and practices, from 'abusing their stronger bargaining and contractual powers to the disadvantage of franchisees'.[39] The MTAA also rejected the argument that the existence of good faith in section 51AC of the Trade Practices Act provided sufficient protection to franchising parties:

> …the reference to good faith is not sufficient for the requirements under the Code, as the unconscionability provision of the TPA is a difficult benchmark to meet. Often the conduct of franchisors, whilst significantly detrimental to a franchisee, may fall short of the scope of 51AC.[40]

8.33 Mr Robert Gardini concurred with this view, noting legal advice he had received that a motor dealer agreement that allowed termination at will with 12 months notice fell outside the scope of section 51AC because 'the conduct of the distributor was within the confines of its original contractual rights under the agreement and not in breach of the Code.'[41] He submitted:

> …section 51AC has an extremely high benchmark and distributors operating within their contractual rights will prima facie fall short of breaching the unconscionability provisions.[42]

8.34 The Motor Traders Association of NSW also submitted that the current regulatory framework was inadequate, noting that the TPA's unconscionability provisions have 'eluded objective interpretation'. Concepts of 'good faith' and 'fair dealing' other than 'peripheral mention in section 51AC of the TPA, had also 'eluded general application to franchise legislation in Australia' despite being introduced in international jurisdictions.[43]

8.35 The Franchisees Association of Australia (FAA) was critical of the limitations of considering good faith when interpreting section 51AC:

> The current 51AC has characteristics which are listed as (a) through (k) to help identify contributing elements to unconscionable conduct, but the courts seem to take the view of guidance from the phrase "in all the circumstances" as meaning all elements, not just some, or the majority, must be present.
>
> Clearly there is a gross failure of the intent of 'unconscionable conduct' under current Trade Practice Laws. The FAA requests that Section 51AC

39 CFAL, *Submission 22*, p. 3

40 Motor Trades Association of Australia, *Submission 90*, p. 7

41 Mr Robert Gardini, *Submission 92*, p. 2

42 Mr Robert Gardini, *Submission 92*, p. 2

43 Motor Traders Association of NSW, *Submission 99*, pp. 11-12

> should be redrafted and then re-tested by the ACCC so that a fairer balance is obtained.[44]

8.36 The Australian Competition & Consumer Commission (ACCC) advised that there is a difference between unfair and unconscionable conduct and that, while not designed to prohibit merely unfair conduct, section 51AC:

> …recognises there may be an inequality of bargaining position in arrangements between small business and larger, more powerful organisations (such as large franchisors), and aims to afford small businesses protection from exploitation from a stronger party. This exploitation, however, must go beyond normal hard commercial dealings to be unconscionable conduct.[45]

8.37 Yum! Restaurants Australia (YRA) also commented on whether unconscionable conduct provisions should be extended to 'unfair' conduct. It noted that franchisors make decisions not only in their own interest but also in the interest of the franchise system as a whole. YRA observed:

> In a business setting, things can and do happen which may seem "unfair" from one person's perspective but which clearly are not fraudulent, abhorrent or beyond all good conscience. Any attempt to prevent businesses from exercising their business judgment within these bounds would be inappropriate and could seriously impact the development of the industry in question.[46]

8.38 While noting the intention of the unconscionable provisions in the TPA was to provide a level playing field for commercial parties of different sizes and bargaining strengths, Ms de Leeuw observed that 'the lack of clarity surrounding its definition has meant that it is rarely used and is therefore ineffective.'[47]

8.39 Post Office Agents Association Ltd (POAAL) suggested that the inclusion of an explicit good faith clause in the Code would give the franchisee 'something to point to' and, while not necessarily stronger than the current requirements, 'would be more immediate and certainly be cheaper'.[48]

8.40 Ms Jenny Buchan noted that although the absence or presence of good faith is a factor courts may consider when determining whether conduct has been unconscionable, this was 'not the same as imposing a mandatory requirement that

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44 FAA, *Submission 51*, p. 14

45 ACCC, *Submission 60*, p. 16. See also Shopping Centre Council of Australia, *Submission* 115, p. 11

46 Yum! Restaurants Australia, *Submission 118*, pp. 14-15

47 Ms Deanne de Leeuw, *Submission 114*, p. 17

48 Mrs Marie McGrath-Kerr, POOAL, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 46

business relationships that fall under 51AC must be entered into, conducted or prematurely terminated with good faith by all parties.'[49]

Defined versus general good faith

8.41 While there was general support among franchisees for the inclusion in the Code of a broad requirement to act in good faith, some considered that good faith should be defined.

8.42 Professor Warren Pengilley supported a general obligation on franchising parties to 'disclose material facts and act in good faith'.[50] This could be accomplished by either a short statement to the effect that 'parties shall deal in utmost good faith' or a more expansive statement such as the one found in a Texas Bill, namely:

> The franchisor and franchisee shall prior and subsequent to the execution of a binding franchise or other agreement have the mutual obligation to deal fairly, openly, honestly and in good faith and to exercise reasonable care and diligence in complying with all provisions of the franchise and other agreements between them.[51]

8.43 Professor Pengilley argued that:

> …a requirement that parties act in good faith…would cover any omissions in legal remedies which may exist. It would fulfil much the same role as s.52 of the Trade Practices Act (i.e. as an overarching provision to cater for conduct not within other black letter law prohibitions).[52]

8.44 The FCA expressed concerns about the potential scope of an undefined good faith clause. Early in their appearance before the committee they said that without a 'precise description' a good faith clause would have the effect of inviting legal argument about its meaning and application, especially with respect to the end of the term of a franchising agreement.[53] The committee notes, however, that the FCA later indicated that they would not object to a good faith clause that simply reiterated any existing implied common law requirement to act in good faith (see paragraph 8.26).

8.45 The Motor Traders Association of NSW concluded that, while the requirement to act fairly and in good faith would be hoped to cure current deficiencies, in reality 'terms such as these will import a subjective element to conduct assessment which will be a breeding ground for disputes'. It suggested that it was

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49 Ms Jenny Buchan, *Submission 89*, p. 6

50 Professor Warren Pengilley, *Submission 27*, p. 21

51 Professor Warren Pengilley, *Submission 27*, p. 21, citing Texas Senate Bill s.18.06 (1971)

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

53 FCA, *Submission 103*, p. 11

necessary, therefore, to underpin these concepts with an 'objective proscription of categories of conduct which are regarded as inappropriate.'[54]

8.46 Professor Andrew Terry also supported the need to provide a clear definition of good faith:

> If there is to be an obligation of good faith enshrined in the Franchising Code of Conduct, I strongly impress on the committee the importance of trying to spell out what good faith means rather than just throwing the general motherhood, feel good sort of statement up there and probably giving false hope to a lot of franchisees that now they are protected by an obligation of good faith and can pay less attention to education, due diligence or talking to other franchisees.[55]

8.47 7-Eleven Stores argued that as there is no 'concluded definition of "good faith" in the Trade Practices Act or the law, a requirement for franchisors and franchisees to act generally in good faith would not assist the franchise relationship'. They suggested instead that if a duty of good faith is included in the Code it should be on the following basis:

> (a) it is imposed in a way that does not derogate from otherwise lawful terms of franchise agreements but only to assist the parties exercise them;
>
> (b) the duty applies equally to Franchisees and Franchisors;
>
> (c) the duty is defined in some way. For example, "good faith means the Franchisee and Franchisor cooperating to achieve the objects of the franchise agreement honestly and in compliance with reasonable standards of conduct" (adopted from Sir Anthony Mason "Contract, good faith and equitable standards in fair dealing" (2000) 116 LQR66 (2000)); and
>
> (d) the duty applies to discreet aspects of the Franchisee/Franchisor relationship and not generally. For example, "the prospective Franchisee and the Franchisor will negotiate in good faith in relation to the renewal of the franchise agreement".[56]

8.48 CFAL sought to define the concept of good faith as a proposed new section of the Code.[57] The draft provisions, modelled on the standards of conduct outlined in clause 12 of the 1993 voluntary code of conduct, would provide in part that:

> **23A Obligation to act in good faith**
>
> (1) A franchisor and a franchisee shall act towards each other in good faith in the exercise of any rights or powers arising under, or in relation to, a franchise or the renewal of a franchise.

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54 Motor Traders Association of NSW, *Submission 99*, p. 68

55 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 69

56 7-Eleven Stores, *Submission 105*, p. 4

57 CFAL, *Submission 22*, Attachment 1

(2) For the purposes of sub-clause (1), good faith in relation to conduct by a franchisor or a franchisee means that the party has acted:

(a) honestly and reasonably; and

(b) with regard to the interests of the other parties to the franchise,

in all the circumstances, including without limitation:

(c) the commercial and business objects of the franchise;

(d) the legitimate business interests of each of the parties, and what is reasonably necessary for the protection of those interests;

(e) the respective financial and non-financial contributions made by each of the parties to the establishment and conduct of the franchised business;

(f) the risks taken by each of the parties in the establishment and conduct of the franchised business;

(g) the alternative courses of action available to the parties in respect of the matter under consideration; and

(h) the usual practices in the industry to which the franchise relates.[58]

8.49 Yum! Restaurants Australia Group (YRA) did not, in principle, oppose a statutory definition of good faith. However, in recognising that good faith generally means 'acting honestly and reasonably during the course of the relationship', YRA made the following observation:

> The principal criteria YRA would place upon a legislative concept of good faith is that it must be sufficiently certain and it must not unduly interfere with the contractual rights of the parties. These are not inconsiderable hurdles to overcome…it is not an easy concept to define without risky imposition upon the ordinary operation of business in a market-based economy.[59]

8.50 YRA addressed the relative merits of a general versus a defined obligation to act in good faith, noting that a general statutory duty to act in good faith would confirm that good faith is imported into franchise agreements but it would not remove uncertainty surrounding its meaning. It would, however, enable the concept to 'develop organically and incrementally, based on actual, rather than hypothetical scenarios'. [60] Alternatively, achieving greater certainty via a specified set of factors

58 CFAL, *Submission* 22, Attachment 1. The proposed new Part 3A *Franchising in good faith* also includes 23B and 23C which deal with renewal and non-renewal of franchise agreement. These issues are discussed in Chapter 6.

59 YRA, *Submission 118*, p. 7

60 YRA, *Submission 118*, p. 7

would depend on the factors chosen and on whether they were proscriptive or allowed for discretionary decision making.[61]

Implications for current agreements and other sectors

8.51 Several submissions raised concerns about the possible effect that the inclusion in the Franchising Code of Conduct of an express obligation to act in good faith would have on existing agreements and other commercial arrangements.

8.52 The FCA cautioned that the lack of an authoritative High Court decision, combined with a duty to act in good faith that did not 'clearly and precisely' address its content, would be 'highly undesirable' and would have wider implications beyond the franchise sector:

> … the imposition of a statutory good faith obligation would discriminate unfairly against franchising when compared to distribution, licensing, agency, joint venture and other commercial arrangements. The current law strikes a sensible balance, and provides greater certainty.[62]

8.53 For similar reasons, Ms Buchan suggested consideration should be given to inserting a good faith requirement into Part V Division 2 of the TPA to make it a requirement for all consumer contracts:

> If a requirement of good faith is inserted into the Code the risk is that, by deduction, good faith is not required in other consumer contracts as it is franchise contracts that have been singled out for imposing the obligation.[63]

She noted that:

> For me there are risks in inserting good faith in the code and I suppose the risk is that, in that twisted way that we lawyers operate, it might be interpreted that it is not so important in non-franchise agreements.[64]

8.54 The MTAA considered that the inclusion of the explicit provision would 'have very serious moral and educative benefits for any agreements on foot'.[65] The MTAA did not consider that the inclusion of a good faith provision into the Code would have a retrospective impact in terms of existing contracts, except where the implied term had been excluded from the contract:

> If you said that it was a simple description of good faith, the impact on existing agreements would be to say that the courts already imply a term of good faith into those agreements. So it would be just providing statutory backing to the implied term that already exists….However, it might apply

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61 YRA, *Submission 118*, p. 7

62 FCA, *Submission 103*, pp. 18-19

63 Ms Jenny Buchan, *Submission 89*, p. 6

64 Ms Jenny Buchan, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 83

65 Mr Robert Gardini, MTAA, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 21

> to some agreements where that implied term had been excluded from the agreement.[66]

8.55 In relation to the implications for existing contracts, CFAL sought advice on whether the inclusion into the Code of provisions relating to good faith and fair dealing would involve any retrospective alteration to existing franchise agreements.[67] Mr Robertson SC advised:

> In my opinion such an amendment would be unlikely to be regarded by the courts as involving a retrospective alteration of existing franchise agreements….
>
> There is a distinction to be drawn between conduct, on the one hand, and contract on the other. To regulate future conduct does not involve the retrospective alteration of the contract pursuant to which that conduct will be or might otherwise would be engaged in.
>
> In my opinion therefore any such amendment would do no more than regulate future conduct of existing franchisees and franchisors.[68]

Committee view

8.56 The committee is of the opinion that the optimal way to provide a deterrent against opportunistic conduct in the franchising sector is to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith.

8.57 The committee notes that a number of submissions recommended specific changes to the Code to address a range of opportunistic conduct. While some of these recommendations may warrant further investigation, the diverse nature of the franchising sector presents the potential problem that a specific change, while beneficial for one system, may have unintended consequences for another.

8.58 The committee envisages that the role the insertion of 'good faith' in the Code will have on termination and renewal is to ensure that what has already been stated in the courts will be uppermost in franchisors' minds when contemplating non-renewal or termination without breach—that is, that any decision to do so should not be made capriciously and without consideration for the reasonable rights of the other party to the agreement.

8.59 The express obligation to act in good faith is not designed to alter the current rights of franchisors to maintain control over the integrity of their brand. It will, instead, provide a clear, overarching statement of expectation as to the standard of

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66 Mr Robert Gardini, MTAA, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 22

67 See recommendations 7.2.13 and 7.2.14 on good faith and fair dealing of the report of the SA Report

68 CFAL, *Submission 22*, Attachment 4

conduct that should be adopted by franchisors, franchisees and prospective franchisees.

Recommendation 8

8.60 The committee recommends that the following new clause be inserted into the Franchising Code of Conduct:

> **6 Standard of Conduct**
>
> **Franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement.**

Chapter 9

Enforcement of the Franchising Code of Conduct

Enforcement framework

9.1 As outlined in Chapter 3, the Franchising Code of Conduct (the Code) is a mandatory industry code enforceable under section 51AD of the *Trade Practices Act 1974* (TPA). In addition to the Code, franchisees and franchisors are also protected by other relevant provisions in the TPA, including the unconscionable conduct provisions relating to small business transactions in section 51AC and the misleading and deceptive conduct provisions in section 52.

9.2 The TPA sets out a range of remedies for breaches of these sections. These include injunctions, compensation orders, damages, setting aside or varying contracts, and corrective advertising orders.[1] Access to these remedies is via legal action and judicial enforcement.

9.3 The ACCC is responsible for administration of the TPA, and this role extends to litigating in circumstances where it can substantiate evidence that the TPA, including the Code, has been breached.[2] The ACCC is not, however, responsible for prosecuting franchising disputes that relate to contractual disputes, though this distinction is not always clear to complainants (as described below at paragraph 9.15). Franchisees and franchisors also have the option to take independent legal action in relation to alleged breaches of the Code or other sections of the TPA.

ACCC investigation and enforcement activities

9.4 In its appearance before the committee, the ACCC indicated that franchising-related complaints within its Code compliance and enforcement role fall broadly into three categories:

- a relevant complaint is lodged but the complainant does not want to be involved in taking the complaint further;
- a relevant complaint is lodged and the complainant assists the ACCC investigation, but insufficient evidence is uncovered to substantiate the complaint; or
- a relevant complaint is lodged, the complainant is able to provide evidence that substantiates the complaint, and the matter is suitable for taking forward.[3]

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1 These remedies are found in section 80, section 82 and section 87 of the TPA.

2 ACCC, *Submission 60*, p. 5

3 Mr Graeme Samuel, *Proof Committee Hansard*, Melbourne, 5 November 2008, pp 81-82

9.5 While stressing that complaints in all three categories may involve 'great hardship', Mr Samuel explained that only cases in the third category can be taken forward by the ACCC.[4] Mr Samuel emphasised that the majority of relevant franchising-related complaints they received actually fall into the first and second categories.[5]

9.6 For complaints that fall into the third category, the ACCC has three general avenues of investigation and action available to it:

- demonstrating misleading and deceptive conduct under part V of the Trade Practices Act;
- demonstrating a breach of the Code; and
- pursuing a case of unconscionable conduct.[6]

9.7 The ACCC indicated a preference for pursuing matters under the misleading and deceptive conduct provisions or as breaches of the Code, rather than for unconscionable conduct, in order to achieve timely outcomes.[7]

9.8 The ACCC also highlighted to the committee:

> …as the law currently stands, whether it is a breach of part IVA, which is unconscionable conduct, or part IVB, a breach of the Franchising Code, or part V, a breach of the misleading and deceptive conduct provisions, except in a case where we proceed with a criminal prosecution under part VC—which is quite unusual—it is not possible for us to get any pecuniary penalties.[8]

9.9 In its written submission to the committee, the ACCC detailed the 15 franchising-related matters it has taken to court since the Code came into force, and a further five matters in which it has obtained court-enforceable undertakings.[9] Of the matters taken to court, five were contested and 10 were settled by consent.[10]

Barriers to effective enforcement

Level of ACCC activity

9.10 The committee received many submissions that were highly critical of the ACCC's responsiveness and effectiveness as the regulator for Code compliance. The

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4 Mr Graeme Samuel, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 82

5 Mr Graeme Samuel, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 85

6 Mr Graeme Samuel, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 82

7 Mr Graeme Samuel, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 82

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

9 ACCC, *Submission 60*, pp 29-32

10 ACCC, *Submission 60*, p. 13

regulator was variously described by submitters and witnesses as 'toothless', a 'lame duck' and 'useless'. Representative examples of their claims are outlined below.[11]

9.11 Mr Ray Borradale detailed a range of cases in which a lack of ACCC action, or failure of ACCC litigation, seemed to be inconsistent with a body of evidence pointing to franchise churning or other poor franchisor behaviour. He suggested that, on the basis of this history of limited success:

> Frustrated franchisees, for the most part, have lost faith in ACCC investigations and their unwillingness to pursue the most blatant breaches of the TPA and the Code.[12]

9.12 Mr Garry Clarke referred what he described as 'a blatant breach of the law' to the ACCC and was disappointed to receive advice that the ACCC would not be pursuing the matter. He noted that this was contrary to other legal advice he had received and suggested:

> …**the root cause of the issues** being created for franchisees and other small business's [sic] is not a result of significant deficiency in the Franchise Code of Conduct or the provisions in the TPA **but rather it is a direct result of the absolute and abhorrent refusal** by the Australian Competition & Consumer Commission…to take appropriate action against a larger business that has demonstrated a complete disregard for the TPA in relation to their dealings with a smaller business.[13]

9.13 Ms Heather Shearer outlined to the committee the steps she took in providing the ACCC with a detailed allegation of poor franchisor conduct, noting that the complaint she put forward was endorsed by a number of franchisees. Again, Ms Shearer was disappointed when advised that the ACCC would not be pursuing the matter. In particular, she questioned the ACCC's advice that, having raised the complaints directly with the franchisor, its concerns had been allayed:

> Obviously, a company is not going to **admit** to the regulator that they engaged in misleading conduct, or misused franchisee marketing funds.
>
> Due to such issues, and a general lack of action against rogue franchisors…by the ACCC, many franchisees have increasingly come to believe that the legislation (Trade Practices Act 1974) and the…body (the ACCC) aimed to protect small business owners such as themselves … has failed them.[14]

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11 Ms Sam Gow, *Submission 61*, p. 12; Mr Garry Clarke, *Submission 119,* p. 2; Ms Deanne de Leeuw, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 69

12 Mr Ray Borradale, *Submission 16*, p. 17

13 Mr Garry Clarke, *Submission 119,* p. 2

14 Ms Heather Shearer, *Submission 79*, p. 2

9.14 Ms Samantha Gow, who wrote to the committee of her experiences of incomplete disclosure and third line forcing while she was a franchisee, summed up the feelings of many:

> The ACCC is another body that I have largely realised is a toothless tiger. They have failed the Franchisee's [sic] in this industry time after time, incident after incident. There is not a franchisee in this country who hasn't written to this organisation for help. In the vast majority of cases disappointment and neglect is unfortunately the forthcoming response to those so desperately in need.[15]

9.15 Some submitters and witnesses expressed frustration at the limitations of the ACCC's role and the fact that they were left with nowhere to turn if the regulator found their dispute to be a contractual matter, rather than a breach of the Code per se. Ms Deanne de Leeuw told the committee:

> Every argument on which they [the ACCC] would come back to us was about the contract rather than the conduct. Yes, we all knew that we had signed a contract, but the contract that we signed did not cover the conduct we all experienced once we were franchisees. There are no protections … once you have signed.[16]

9.16 Ms de Leeuw further explained:

> The biggest problem was that we felt there was nowhere to go and that the ACCC was useless.[17]

9.17 Franchisees also articulated concern about the slow pace of ACCC investigations, describing situations where they were led to believe that action was likely to be taken, only to eventually be told that there was insufficient evidence against the franchisor to mount a legal case.[18]

9.18 Mr Scott Cooper acknowledged that, given the expense and time required to mount successful litigation, it may not be possible for the ACCC to act against all franchisee complaints. However, he pointed out that this leaves many franchisees unsupported and suggested it would be useful to have a better understanding of the types of cases the ACCC is likely to take forward:

> Franchisees would greatly benefit from further clarification of how severe a situation has to be in relation to breaches of the Franchising Code or the Trade Practices Act by a franchisor, before the assistance of the ACCC can be relied upon with any degree of certainty.[19]

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15 Ms Sam Gow, *Submission 61*, p. 12

16 Ms Deanne de Leeuw, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 62

17 Ms Deanne de Leeuw, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 69

18 See, for example, Ms Suzanne Brown, *Submission 84* and Ms Deanne de Leeuw, *Submission 114*.

19 Mr Scott Cooper, *Submission 15*, p. 17

9.19 Some of the criticism of ACCC inaction may stem from a lack of understanding about the extent of its enforcement role. Ms Nicole Hoy acknowledged that she was initially unclear about what part the ACCC could properly play in taking her dispute forward:

> At the time I thought the ACCC were not doing their job and my solicitor was incapable of protecting my rights. It has taken some time for me to accept that the people dispensing this information were not trying to be difficult and unsupportive but they have to work within a system that does not provide for immediate relief that is affordable.[20]

9.20 The ACCC itself expressed concern about the 'expectation gap' in what franchisees believed the ACCC should be able to do to assist them:

> We have been very concerned about the expectation gap, and the fact that there are suggestions that the ACCC is not investigating thoroughly, or is not proceeding to an enforcement…
>
> We put significant details of our investigation process and of the findings of those investigations on to our website, so that those who had complained, those who had been observing and others could observe the nature of the investigations that we undertook. It included what we found, what we did not find, why it was that enforcement action was not taken. It was all designed to try to bring a reality check to what is occurring in relation to these investigations.[21]

9.21 The ACCC suggested to the committee that the provision of misinformation by certain advisers active in the sector was a contributing factor to the 'expectation gap':

> I will not name them, but there are certain people operating in the franchise sector as supposed advisors who I must say are more in the nature of carpetbaggers than genuine advisors. They show up, tell a franchisee who is out of pocket for whatever reason, 'Yes. This is a clear breach of the law. You have a right of action.'[22]

9.22 Mr Samuel commented:

> They are out there making extravagant and exaggerated comments. In my view, very often those comments are frankly dishonest. They are dishonest to the extent that they are misleading franchisees into believing that there are solutions to their problems, which are problems of extraordinary hardship, whereas in fact no law—and I would suggest—no judgement on the part of this committee would assess that what they have been subjected

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20 Ms Nicole Hoy, *Submission 8*, p. 4

21 Mr Graeme Samuel, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 85

22 Mr Brian Cassidy, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 97

> to is either unconscionable conduct or dishonest conduct, but what has happened is that there has been misfortune in the conduct of the franchise.[23]

9.23 The ACCC further indicated that such misleading behaviour could in itself constitute a breach of part V of the TPA.[24]

Prohibitive costs of independent litigation

9.24 A recurring theme in submissions to the committee was that the expense of litigation, including time, severely limits the ability of many franchisees to take independent legal action even when they are confident of demonstrating clear breaches of the Code. Some submitters also put forward their belief that franchisors, or their legal representatives, deliberately draw out legal proceedings in order to exhaust any funds the franchisee may have available to finance the action. For example:

> Given that many franchisees are in a parlous financial situation, they have virtually no recourse to private action against a large company. And in many cases, when a franchisee has commenced suit…the large franchisor practises delaying tactics until the franchisee can no longer afford the legal fees, and in some unfortunate cases, has had to sell their property and even declare bankruptcy.[25]

9.25 Mr Scott Cooper wrote:

> The gaping void…is the undeniable fact that the legal system is out of reach for the vast majority of franchisees. Most franchisees are not adequately resourced personally, emotionally or financially to confront a well financed and well practiced franchisor by engaging the legal system…All too common with the law, it is not the person with the strongest case that succeeds in litigation, but the person with the deepest pockets.[26]

9.26 These sentiments were echoed by Ms Nicole Hoy:

> I believe based on my experience with the Office of Mediation Advisors [sic], the ACCC and the legal system, that until there is a method put in place that can provide affordable and immediate relief, it is near impossible for the average franchisee to enforce their rights under their agreement or under the code. The average franchise agreement is usually 5 years. The average franchisee is a small business operator with limited resources. Justice is simply out of reach.[27]

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23 Mr Graeme Samuel, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 97

24 Mr Graeme Samuel, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 98

25 Ms Heather Shearer, *Submission 79*, p. 2

26 Mr Scott Cooper, *Submission 15*, p. 5

27 Ms Nicole Hoy, *Submission 8*, p. 1

Improving enforcement tools

Pecuniary penalties

9.27 Although the ACCC indicated to the committee that the current laws regulating conduct in franchising are largely sufficient and that it is exercising its powers appropriately, it suggested that the introduction of pecuniary penalties for breaches of the Code (as well as for breaches of section 51AC and section 52) would provide a useful deterrent to those who might otherwise fail to observe the conduct requirements imposed by the Code.[28] The ACCC further noted that the proposed introduction of such penalties is consistent with a recent Productivity Commission recommendation for the introduction of civil pecuniary penalties under Part V of the Act.[29]

9.28 This suggestion is also consistent with the recommendation of the South Australian parliamentary inquiry:

> …that the Franchising Code of Conduct be amended to introduce specific penalties for breaches of the disclosure requirements under the Code.[30]

9.29 Similarly, the recent Western Australian inquiry recommended that:

> The Commonwealth Government amend the *Trade Practices Act 1974* to prescribe penalties for breaches of the Franchising Code of Conduct.[31]

9.30 The implementation of such penalties would also in part address concerns that the Code and/or the regulator lack teeth.[32]

Investigative power

9.31 The ACCC further suggested that its ability to protect franchisee interests would be enhanced if it were given the power to conduct proactive checks of franchisors' records and activities.[33] Mr Cassidy described the potential benefits of such a power as follows:

> We have talked about being able to undertake risk based audits, where we do get some indication that perhaps a franchisor is operating close to the wind, and not a hard allegation that gives us a basis for using our existing

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28 Mr Graeme Samuel, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 103; ACCC, *Submission 60*, pp 23-24

29 ACCC, *Submission 60*, p. 23. This is reference to Recommendation 10.1 of the Productivity Commission's recent report, *Review of Australia's Consumer Policy Framework,* vol. 2, p. 251

30 SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008, p. 42

31 WA Small Business Development Corporation, *Inquiry into the Operation of Franchise Businesses in Western Australia*, April 2008, p. 49

32 For examples, see *Submission 49, Submission 61, Submission 114* and *Submission 119.*

33 ACCC, S*ubmission 60*, p. 24

> formal investigative powers. You do get a bit of a sniff that maybe a particular franchisor is pushing the envelope, if you like. This goes to the ability to undertake what we call a risk based audit. In other words, look at the disclosure documents that are being used, see what other material is being put out by a particular franchisor, perhaps speak to other franchisees of that franchisor to see whether we can get a pattern of conduct occurring.[34]

Committee view

9.32 The committee understands the deep and widespread frustration amongst franchisees over perceived inaction by, and ineffectiveness of, the ACCC in pursuing complaints against franchisors who are alleged to be in breach of the Code. Notwithstanding the limitations of the ACCC's role, there appears on the face of it to be room for improvement by the regulator in taking a more active role in dealing with franchising-related complaints. The committee encourages the ACCC to prioritise and actively pursue franchising-related complaints where breaches of the Code or other relevant parts of the TPA can be substantiated.

9.33 The committee also strongly encourages the ACCC to develop and distribute educational material to the sector that clearly explains the role and limitations of the ACCC in enforcing compliance with the Code. In order to address the existing 'expectation gap', there is a particular need for ongoing clarification that the ACCC's role does not extend to settling contractual disputes.

9.34 The committee agrees that the lack of pecuniary penalties for breaches of the Code means there is insufficient deterrence for conduct that contravenes the Code. Accordingly, the committee recommends that the TPA be amended to include pecuniary penalties for breaches of the Code.

Recommendation 9

9.35 The committee recommends that the *Trade Practices Act 1974* be amended to include pecuniary penalties for breaches of the Franchising Code of Conduct.

9.36 The committee recognises that such an amendment may also be desirable for the other mandatory industry codes operating under the TPA. It also notes the ACCC's suggestion that similar pecuniary penalties be enacted in relation to section 51AC breaches (unconscionable conduct) and section 52 breaches (misleading and deceptive conduct). These changes would have ramifications and applications beyond the franchising sector and, as such, are beyond the remit of the current inquiry. Although the committee stops short of directly recommending their enactment, the committee recommends that consideration also be given to further amending the *Trade Practices*

34 Mr Brian Cassidy, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 99

Act 1974 to provide for pecuniary penalties in relation to breaches of these additional sections.

Recommendation 10

9.37 The committee recommends that consideration be given to amending the *Trade Practices Act 1974* to provide for pecuniary penalties in relation to breaches of section 51AC, section 52, and the other mandatory industry codes under section 51AD.

9.38 The committee sees value in increasing the ACCC's powers to conduct proactive investigations, particularly in cases where franchisees fear retribution if they provide information directly to the regulator. Accordingly, the committee recommends that the ACCC be empowered to conduct investigations when it has credible information indicating a potential contravention of the Franchising Code of Conduct.

Recommendation 11

9.39 The committee recommends that the ACCC be given the power to investigate when it receives credible information indicating that a party to a franchising agreement, or agreements, may be engaging in conduct contrary to their obligations under the Franchising Code of Conduct.[35]

9.40 The committee acknowledges the difficulties franchisees face in seeking remedy under the TPA due to the potentially high costs of taking legal action. Through recommendations made elsewhere in this report—in particular, Recommendation 8 to introduce an overarching obligation for all parties to a franchising agreement to act in good faith—it is the committee's intention to bring about an overall improvement in conduct in Australia's franchising sector, thereby reducing the need for legal action.

Mr Bernie Ripoll MP
Chairman

35 The committee notes that the ACCC described this power as 'being able to undertake risk based audits' and went on to clarify that this would entail examination of disclosure documents and other material being circulated by a franchisor, as well as speaking with franchisees to discern any pattern of conduct. See Mr Brian Cassidy, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 99

Appendix 1

Material received by the committee

Submissions

1 Mr Damien Hansen
2 Mr Geoffrey Trewin
3 Mr Gavin Butler
4 Mr Christopher May
5 Ms Margaret Quirk MLA
6 John and Dianne Purtell
7 NAME WITHHELD
8 Ms Nicole Hoy
9 Mr Malcolm Wilson
10 Ms Rachel Neilson
11 Mr Terry Cowan
12 Mr Christopher May
13 Mr Colin Varacalli
14 Retail Traders' Association of Western Australia
15 Mr Scott Cooper
16 Mr Ray Borradale
17 Mr John Rutherford
18 Mr Darren Huth
19 Mr Gerry Hugh
20 Mr Michael Sheridan
21 Mr Graeme L Ross
22 Competitive Foods Australia Pty Ltd
23 CONFIDENTIAL
24 Mr David Wilkinson
25 CONFIDENTIAL
26 Mr John A Shirlaw
27 Professor Warren Pengilley
28 Mr Damien Hansen
29 CONFIDENTIAL
30 Mr Howard Bellin
31 David Lieberman & Associates
32 Jon Cornish
33 Sands Fridge Lines

34 Ms Narelle Walter
35 Ms Shanell Gooch
36 Motor Traders Association of Queensland
37 The Government of South Australia
38 Ms Pauline Williams
39 Dr Elizabeth Crawford Spencer
40 Mr Nigel Millward
41 Tony Morriss & Jacques Birckel
42 Mr Todd Gooch
43 Mr Jack Otto
44 Kim Rosenwald
45 Lottery Agents Association of Victoria
46 David Ford
47 Narelle Betts
48 Franchise Alliance
49 Graeme & Anne Brown
50 Ledgers Bookkeeping
51 Franchisees Association of Australia
52 Mr Rodney Hackett
53 Robert Ferraro
54 Russell Rees
55 Rachel Nielson
56 Leicester Ramsey
57 David Johannsen
58 Law Society of WA
59 CONFIDENTIAL
60 ACCC
61 Samantha Gow
62 Ray Borradale
63 NAME WITHHELD
64 Kerrie Davies
65 Darren Scott
66 CONFIDENTIAL
67 George & Ruth Nimbalker
68 Mr Michael Renwick
69 Professor Lorelle Frazer
70 Elvio DiZane
71 CONFIDENTIAL
72 CONFIDENTIAL

73 Mr Rick Kenyon
74 CONFIDENTIAL
75 KFC Whitfords
76 CONFIDENTIAL
77 Grey Army Australia
78 Penny Campbell
79 Heather Shearer
80 Norman Topp
81 DLA Philips Fox
82 David Eagle
83 CONFIDENTIAL
84 Suzanne Brown
85 CONFIDENTIAL
86 Mr Brian Cini
87 Rick & Sue Rampling
88 CONFIDENTIAL
89 Jenny Buchan
90 Motor Trades Association of Australia
91 Professor Andrew Terry
92 Robert Gardini
93 Peter Moon
94 CONFIDENTIAL
95 CONFIDENTIAL
96 Dianne Grey
97 CONFIDENTIAL
98 CONFIDENTIAL
99 MTA
100 Stuart Beechen
101 POAAL
102 Eagle Boys Dial-a-Pizza
103 Franchise Council of Australia
104 Julie Anfield
105 7-Eleven Stores
106 Andrew Foote
107 Kevin Moore
108 CONFIDENTIAL
109 National Retail Association
110 Ross Freeman
111 Mr Tadele Feleke

112 Warren Ballantyne
113 Park Legal Solutions
114 Ms Deanne de Leeuw
115 Shopping Centre Council of Australia
116 Peregrine Group of Companies
117 Don Hamence
118 Yum Restaurants Australia
119 Garry Clarke
120 International Franchise Association
121 Peter Buckingham
122 Daniel Ganon
123 Mr Mahmood Hussein
124 CONFIDENTIAL
125 Cheryl Borradale
126 Dr Evan Jones
127 Mr Nigel Butler
128 CONFIDENTIAL
129 Keith Blanchard
130 Alan Payne
131 Rhonda Cox
132 Franchise Advisory Centre
133 Malcolm MacKellar
134 CONFIDENTIAL
135 Australian Retailers' Association
136 The Cheesecake Shop Pty Ltd
137 Department of Innovation, Industry, Science and Research
138 Mr Steve Hansen
139 Small Business Development Corporation of WA
140 Associate Professor Frank Zumbo
141 Law Council of Australia Trade Practices Committee, Business Law Section
142 McDonald's Australia
143 Ms Edilia Ford
144 Fibrecare Australia
145 Mr Shane Calegari
146 Jenny Brearley
147 Mr Steve Wanmer
148 Mr Stephen Spitz
149 KFC Beechboro
150 Mr Trevor Nelson

151 Spier Consulting
152 Brendan Bailey
153 Mr John Levingston
154 Mr Dick Adams MP
155 Federal Chamber of Automotive Industries
156 Mrs Gracie Clift
157 Mrs Kay Staples
158 Australian Marine Industries Federation Limited
159 Law Institute of Victoria

Supplementary submissions

1 Mr Robert Gardini
2 Franchise Council of Australia
3 CONFIDENTIAL
4 CONFIDENTIAL
5 Mr Robert Gardini
6 Competitive Foods Australia Pty Ltd
7 Alto Group
8 MTAA
9 Graeme & Anne Brown

Tabled documents

Sydney, 9 October 2008

Professor Warren Pengilley—Copy of a speech to be given to a Franchising Colloquium held at Bond University on 20-22 November 2008 (under embargo until 23 November)

Melbourne, 5 November 2008

Mr Tony Piccolo MP—Summary table showing key recommendations, and justifications for them, arising out of SA Economic and Finance Committee parliamentary inquiry into franchising.

Additional material received by the committee

Franchising Australia 2008 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2008

Buchan, J (by email): example information from a free repository of franchise documentation that operates in the United States

Weston, S: Letter to the committee containing information on the following:

- General business vs. franchised business – exist and failure statistics
- Information on franchise mortgages
- Reference to ACCC Franchisee Manual on the business.gov.au website

Appendix 2

Witnesses who gave evidence at public hearings

Sydney, 9 October 2008

GARDINI, Mr Robert Charles, Private capacity

The Cheesecake Shop Pty Ltd
KONOPACKI, Mr Warwick, Joint Managing Director
MEAGHER, Mr David, Independent Director

Competitive Foods Australia Pty Ltd
CASTLE, Mr Timothy David, General Manager, Business Development, and General Counsel
COWIN, Mr John James, Chairman
PARKER, Mr Ian, Group General Manager

Shopping Centre Council of Australia
COCKBURN, Mr Milton, Executive Director
SPEED, Mr Peter Stuart, Solicitor, Speed and Stracey Lawyers, acting on behalf of Shopping Centre Council of Australia

PENGILLEY, Professor Warren James, Private capacity

TERRY, Professor Andrew, Private capacity

BUCHAN, Ms Jennifer Mary (Jenny), Private capacity

Motor Traders Association of New South Wales
McCALL, Mr James, Chief Executive Officer
ROBINSON, Mr Andrew, Consultant
SMITH, Mr David, Senior Manager, Divisional Services
WAY, Mr Nicholas, Consultant

Brisbane, 10 October 2008

FRAZER, Professor Lorelle, Private capacity

National Retail Association Ltd
BLACK, Mr Gary David, Executive Director

Franchisees Association of Australia Inc.
BEDDALL, the Hon. David, President

SPENCER, Dr Elizabeth, Private capacity

DLA Phillips Fox
CONAGHAN, Mr Anthony James, Partner, Co-chair Franchise Group

Eagle Boys Dial-A-Pizza Australia Pty Ltd
STEWART, Mr Murray John, General Manager Corporate
VINE, Ms Shirley Hane, In-house lawyer

IndCorp Franchisees Association of Australasia
FISHER, Mr Greg, Secretary
STEGGALL, Ms Zali, Barrister

Canberra, 17 October 2008

Department of Innovation, Industry, Science and Research
FREEMAN, Ms Julia, Manager, Competition Team, Industry and Small Business Policy Division
GREENWELL, Mr Tony, General Manager, Business Conditions Branch, Industry and Small Business Policy Division
WESTON, Ms Susan, Head, Industry and Small Business Policy Division, Department of Innovation, Industry, Science and Research

Motor Trades Association of Australia
DELANEY, Mr Michael, Executive Director
GARDINI, Mr Robert, Solicitor
SCANLAN, Ms Sue, Deputy Executive Director
Service Station Association Ltd
BOWDEN, Mr Ron, Chief Executive Officer

McDonald's Australia Ltd
MALONEY, Mr Philip, General Counsel
MULLEN, Ms Kristene, Vice-President, and Director, Corporate Communications

DE LEEUW, Ms Deanne, Private capacity

Yum Restaurants Australia
BALADI, Mr Albert, Managing Director
BRYDEN, Mr Nick, Chief Legal Officer

Australia Post
RAMM, Mr Paul Damien, Manager, Retail Channel
STAUNTON, Mr Scott James, Deputy General Counsel, Legal Services Group

Melbourne, 5 November 2008

Australian Retailers Association
EVANS, Mr Richard, Executive Director

Franchise Council of Australia
O'BRIEN, Mr John, Chairman
GILES, Mr Stephen, Legal Committee Chair
MELHEM, Mr Tony, Franchisees Forum Chair
WRIGHT, Mr Steve, Executive Director

Post Office Agents Association Ltd (POAAL)
KERR, Mr Ian, Chief Executive Officer
MCGRATH-KERR, Mrs Marie, Chairman

South Australian Parliamentary Committee on Economics and Finance
PICCOLO, Mr Tony MP

HACKETT, Mr Rodney, Private capacity

BELLIN, Mr Howard, Chairman, IF International Pty Ltd; and Private capacity

ACCC
SAMUEL, Mr Graeme, Chairman
CASSIDY, Mr Brian, Chief Executive Officer
SCHAPER, Dr Michael, Deputy Chairman
RIDGWAY, Mr Nigel, General Manager, Compliance Strategies Branch

Transcripts of the public hearings were published on the inquiry webpage at:
http://www.aph.gov.au/senate/committee/corporations_ctte/franchising/hearings/index.htm

Appendix 3

Report on a matter of parliamentary privilege

1.1 As noted in the first chapter of this report, a matter of parliamentary privilege arose during this inquiry.

1.2 Senate Parliamentary Privilege resolution 1(18) provides that:

> Where a committee has any reason to believe that any person has been improperly influenced in respect of evidence which may be given before the committee, or has been subjected to or threatened with any penalty or injury in respect of any evidence given, the committee shall take all reasonable steps to ascertain the facts of the matter. Where the committee considers that the facts disclose that a person may have been improperly influenced or subjected to or threatened with penalty or injury in respect of evidence which may be or has been given before the committee, the committee shall report the facts and its conclusions to the Senate.

1.3 A person who had made a submission to the inquiry drew the committee's attention to a letter dated 13 October 2008 that he had received from a representative of a legal firm. The letter contained the following statement:

> *Our client reserves its rights to take action in relation to any defamatory or libellous comments in the written submission, and is concerned to ensure that your client does not repeat them in verbal comments to the Federal inquiry. Given this warning, our client will view any repeat of the allegations to be deliberate and calculated to defame it.*

1.4 The correspondence received by the committee provided clear evidence that the person who had made the submission was being threatened with a 'penalty or injury' as a direct result of making that submission.

1.5 When this letter was brought to the committee's attention, the committee directed the committee secretary to write, as a matter of urgency, to the person who wrote the letter that threatened the submitter, and warn them that the letter may constitute a contempt of Parliament and a criminal offence. This was done the same day, on 15 October 2008.

1.6 On 16 October, the committee received a response advising that the letter of 13 October had been unconditionally withdrawn. In that response, the writer also unreservedly apologised on behalf of himself and his clients. The committee was also provided with a copy of a letter sent to the person who had made the complaint to the committee, putting into effect the undertakings given to the committee and offering conciliatory terms.

1.7 The committee considers this to have been a serious incident. However, the committee has concluded that the purpose of the parliamentary resolutions, which is to

protect witnesses, has been fulfilled. As such, the committee does not consider that any further action in relation to this matter is warranted.

1.8 For the completeness of the record, the committee has attached all correspondence received and sent in relation to this matter in the following pages.

Mr Bernie Ripoll MP
Chairman

Deacons

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People's Republic of China
Singapore
Taiwan
Thailand
Vietnam

13 October 2008

Mills Oakley Lawyers
St James Building, 4th Floor,
121 William St, Melbourne 3000

Attention: Warren Scott

Our Ref: 2650971

Dear Warren

Poolwerx Kew

We refer to the Terms of Settlement signed between your clients Skydive Hervey Bay Pty Ltd and Damien Hansen and our client Poolwerx Corporation Pty Ltd, and to subsequent dealings between the parties.

We are instructed that the current situation is as follows:-

1. Your clients have failed to cooperate to achieve the immediate sale of the Poolwerx Kew franchise, contrary to clause 2b of the Terms of Settlement. A cash offer of $100,000 was made by a third party, Scott Carlile, but rejected by your client. Your client has made no meaningful effort to sell the business, and no other offer has been received. Our client considers $100,000 to be a reasonable price.

2. Your clients failed to pay the Arrears of $24,124.67 on June 30, 2008.

3. Your clients have failed to pay fees set out in the Franchise Agreement from 1 April, 2008 and currently owe our client a further $17,790, being:-

    a. Additional franchise fees from 1 April, which our client estimates at $9,543 plus GST

    b. Additional marketing fees, which our client estimates at $5,640 plus GST

    c. Other sundry charges payable under the terms of the Franchise Agreement including mobile phone charges, technology charges: $827

    d. Interest on these amounts pursuant to the Franchise Agreement, which our client estimates at $890

    (As your client has not provided sales figures for July, August or September 2008 fees are estimates. Our client reserves the right to claim any additional amounts once the sales figures are ascertained.)

4. As set out in clause 2fii of the Terms of Settlement failure to pay the Arrears entitles our client to interest on the Arrears from 1 April 2008, meaning that as at the date of this letter your clients owe our client a total of $41,914, being:-

    a. $24,124.67; and

    b. $16,900; and

    c. $890

    d. As no sale has occurred your clients are not entitled to the credit of $15,000 described in clause 2g of the Terms of Settlement. If a sale occurs the credit will be allowed. However if our client has to terminate the Franchise Agreement no credit will be applicable.

5. Your clients failed to attend the Poolwerx National Convention in August, thereby breaching clause 14.3.17 of the Franchise Agreement and depriving them of the opportunity to increase their skill level and gain management information.

6. Your clients have not completed the requested direct debit authority in breach of clause 8.2 of the Franchise Agreement.

7. Your clients have failed to provide the sales and other information to our client as required by clause 9 of the Franchise Agreement. Such failure also inhibits PoolWerx's capacity to review your client's business and develop an understanding of your client's claimed lack of profitability.

Our client has served several notices of breach. None of the breaches has been remedied, and our client is able to immediately terminate the Franchise Agreement.

We are instructed to provide your client with one final opportunity to avoid termination of the Franchise Agreement. Realistically it seems that sale of the business to Scott Carlile is the only viable option that will leave your client with net funds, and will entitle your client to the $15,000 credit. However our client remains open to your client continuing as a franchisee provided the identified breaches are remedied.

Could you please obtain your client's urgent instructions on this matter and let us have your response before 5pm on Thursday October 16, 2008. If no response is received, or the response does not address the breaches of the Franchise Agreement set out above, our client intends to terminate the Franchise Agreement.

In the meantime could you also please remind your client of the obligations of confidentiality contained in the Franchise Agreement and the mediation arrangements. We note your client has referred to our client by name in a written submission to the current Federal Inquiry concerning the Franchising Code of Conduct, and may intend making subsequent verbal representations to the Inquiry. Our client disputes the truth and accuracy of most of your client's remarks. In addition the written submission raises issues that were central to the mediation, and comments inappropriately and in our view inaccurately on the conduct of the mediator and others in the mediation as well as the outcome of the mediation. This is a clear breach of the Mediation Agreement and the general principles under which mediation is conducted.

We also note that your clients have in clause 2i of the Terms of Settlement agreed to a mutual release of all claims, actions, costs and demands.

Our client reserves its rights to take action in relation to any defamatory or libellous comments in the written submission, and is concerned to ensure that your client does not

repeat them in verbal comments to the Federal Inquiry. Given this warning, our client will view any repeat of the allegations to be deliberate and calculated to defame it.

We await your urgent response.

Yours faithfully

Stephen Giles
Partner
Deacons
Direct line: +61 (0)3 8686 6965
Email: stephen.giles@deacons.com.au

PARLIAMENT OF AUSTRALIA

PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES
PARLIAMENT HOUSE, CANBERRA ACT 2600

15 October 2008

Mr Stephen Giles
Partner
Deacons
RACV Tower
485 Bourke St
MELBOURNE 3001

Dear Mr Giles

I refer to your letter of 13 October (ref 2650971) to Mr Warren Scott, Mills Oakley Lawyers, representing Skydive Hervey Bay and Damien Hansen.

In your letter at pages 2 and 3, you state the following:

> *Our client reserves its rights to take action in relation to any defamatory or libellous comments in the written submission, and is concerned to ensure that your client does not repeat them in verbal comments to the Federal inquiry. Given this warning, our client will view any repeat of the allegations to be deliberate and calculated to defame it.*

This letter was today brought to the attention of the Parliamentary Joint Committee on Corporations and Financial Services, which is conducting an inquiry into franchising.

The committee has considered this letter and has directed me to write to you to warn you that the letter may constitute a contempt of Parliament and a criminal offence. Relevant Parliamentary resolutions provide:

> ***Interference with witnesses***
> *(10) A person shall not, by fraud, intimidation, force or threat of any kind, by the offer or promise of any inducement or benefit of any kind, or by other improper means, influence another person in respect of any evidence given or to be given before the Senate or a committee, or induce another person to refrain from giving such evidence.*
>
> ***Molestation of witnesses***
> *(11) A person shall not inflict any penalty or injury upon, or deprive of any benefit, another person on account of any evidence given or to be given before the Senate or a committee.*

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E-mail: corporations.joint@aph.gov.au
Internet: www.aph.gov.au/Senate/committee/corporations_ctte

Such action may also constitute a criminal offence under Section 12 of the *Parliamentary Privileges Act 1987*. Penalties may include fines or imprisonment not exceeding six months.

I recommend that you warn your client of the potential implications of threatening or seeking to influence Mr Hansen in any way that may be linked to his submission or any evidence that he may give, and that you also withdraw the letter.

However, you should also be aware that the committee has decided that it will report the facts and its conclusions on this matter to the Senate, which will then decide whether the matter should be referred to the Standing Committee on Privileges. As such, further investigation and action by that committee is possible.

Any further communication on this matter should be directed to:

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Phone: +61 2 6277 3583
Fax: +61 2 6277 5719
Email: corporations.joint@aph.gov.au

Yours sincerely

Peter Hallahan
for Secretary
Parliamentary Joint Committee on Corporations and Financial Services

Deacons

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Indonesia
Malaysia
People's Republic of China
Singapore
Taiwan
Thailand
Vietnam

16 October 2008

Email: corporations.joint@aph.gov.au

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Attention: Peter Hallahan

Your Ref: Peter Hallahan
Our Ref: 2650971

Dear Sir

Poolwerx Corporation Pty Ltd, Damien Hansen and others

We refer to your letter of 15 October 2008 which refers to our letter to Mills Oakley Lawyers dated 13 October 2008 in relation to the above matter.

We have written to Mills Oakley on behalf of our client (copy enclosed) unconditionally withdrawing our letter of 13 October. You will note that our client has confirmed that it has no objection to Mr Hansen speaking fully and frankly to the Joint Parliamentary Committee and the Senate, and has waived all its rights to insist on confidentiality in relation to the mediation and Terms of Settlement signed by it and any related matters.

Our client and I are very supportive of the Joint Committee and its deliberations and apologise unreservedly to the Senate and the Committee.

If there are other measures the Committee or the Senate considers to be appropriate in the circumstances please let us know.

Yours faithfully

Stephen Giles
Partner
Deacons
Direct line: +61 (0)3 8686 6965
Email: stephen.giles@deacons.com.au

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16 October 2008

Mills Oakley Lawyers
St James Building, 4th Floor,
121 William St, Melbourne 3000

Attention: Warren Scott

Our Ref: 2650971

Dear Warren

Poolwerx Kew

We refer to our letter dated 13 October, 2008.

Our client unconditionally withdraws the letter. Further our client expressly confirms that our client has no objection to your client giving any evidence whatsoever to the Parliamentary Joint Committee on Corporations and Financial Services or the Senate. To the extent necessary our client waives all its rights to insist on confidentiality in relation to the mediation and Terms of Settlement signed by it and any related matters.

In relation to the dispute itself, if the Terms of Settlement no longer reflect your client's agreed position our client would be prepared to attend a further mediation or a meeting to endeavour to resolve the matter.

Yours faithfully

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