FEDERAL GOVERNMENT REVIEW

Submission from

AUSTRALIAN RETAILERS ASSOCIATION

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Executive Summary

The Australian Retailers Association (ARA) is the peak industry body for retailing in Australia also representing franchise retailing. The ARA retains the view that retail franchising is over regulated but is supportive of the regulatory environment as it provides certainty to a competitive market.

It is the ARA's view that no other sector of retailing has been investigated as thoroughly as franchising and it is important to question why this level of scrutiny is needed when every Inquiry finds the state of franchising to be adequate within the market. It remains that some commentators and indeed politicians seduced by the unsubstantiated claims of failed business operators believe their failure was due to the franchise law … nothing could be further from the truth.

All stakeholders within the sector, be they franchisors, franchisees, financiers, consultants in their various forms, academics and others including media and politicians share a genuine desire to ensure fairness prevails. The Franchising Code of Conduct and the Trade Practices Act provide important protection for franchisees, and the Australian Competition and Consumer Commission has been a highly effective industry regulator.

Disputation within the sector normally driven by a perception of unfairness by one party, in some cases takes an inordinate degree of overstatement. This overstatement can usually be aligned to inordinate expectations and the failure of proper due diligence by either party before entering a commercial agreement. In recent times these overstated disputes have taken on supporters seeking changes to a legislative regime which already provides fairness if both parties comply with the law.

It is the ARA's view that the law concerning franchising is adequate but it does have weaknesses surrounding it and perhaps this should be the focus of the legislators, as opposed to consistently trying to fix a law to protect the failed business operators who perhaps have nothing other than themselves to blame.

Our position is clear – if some one breaks the law then treat them harshly.

Conversely don't allow unsatisfied failed business operators to engage in a campaign of disruption and brand attack with no substance to their claim. Indeed recent claims by a failed business operator blaming a major national retail brand franchisor have been adequately investigated by the ACCC and found to be without foundation; yet, that person and indeed their supporters including politicians continue to seek redress. The question then should be raised, whilst there continues to be a willingness to investigate these claims at a parliamentary level uncertainty within the sector will prevail reducing investment confidence.

If a party to a franchise breaches the law then allow the law to provide sanction. The trouble though is that the law does not prescribe sanction thus diluting intent. It also does not encompass all parties in the franchise relationship particularly consultants acting on behalf of either the franchisor or franchisee.

A government cannot legislate for business success nor can it prescribe mitigation for poor business decisions. What it can do is set the rules and allow the market to work. On any measurement, franchising in Australia is a success. The clear majority of stakeholders subscribe to the law and many draw success. Success is usually driven by hard work. Yet there are some who sincerely believe that the law does not protect them from supposedly unscrupulous business operators.

It is reported that Australia's level of disputation in franchising, at just over 1%, is substantially lower than other countries and almost 75% of disputes in Australia are successfully resolved by mediation.

With these success rates how then can the current system be criticised. The answer lies not in the law but the application of the law.

A system of dispute resolution introduced to the market to provide low cost access for franchisees is being used more and more by franchisors due to breach disputation. Although this system of mediation promotes a resolution 25% do not obtain satisfaction – and still some claim that this popular form of resolution is too expensive compared to other costs of resolution such as a court. Unless there is a "no cost" form of resolution then there will be no pleasing some parties within the dispute process.

Clearly from any statistical measurement Australian franchising is in good shape and perhaps can even be considered world's best practice.

Yet political angst usually driven by a few disaffected franchisees via media and other political campaigns continues to raise uncertainty to the broader franchise community.

The ARA supports the work of yet another review of the franchise sector for it is convinced that the Inquiry will find nothing systemically wrong within the sector. We do however within our submission provide recommendations for improvement of the regime to reduce the angst that continues amongst a small minority within the sector.

Current research and anecdotal evidence from those associated with franchise complaints confirms that the level of complaints is low. Statistically, from sector research, reporting and academic papers, franchisee non-compliance with the system has been identified as the most significant cause of disputes. Anecdotally there also appears to be a strong correlation between complaints and a failure on the part of the franchisee to conduct due diligence and obtain independent legal, accounting and business advice.

This is a significant aspect of the complaints. It seems some franchisees have an expectation of success yet do not do adequate due diligence; do not provide pre entry education; do not speak to others in the market and then do not follow the system. When failure follows they blame the franchisor.

Yet it is a requirement within the Code that the franchisee seek advice from both legal and accounting advisers to ensure they fully understand the risks associated with their business decision to join the franchise system. Incomprehensively many franchisees do not seek this advice and in some cases reported in the national parliament ignore such advice and continue with the decision to invest. In the case reported in parliament in a recent Motion debate (August 2008) they blame the franchisor yet were warned by their bank to not enter the commercial arrangement yet still went ahead. It seems now the franchisee's political advocate would prefer to refund the money although the franchisee made a poor decision. This position is contrary to standard business and legal practice.

It is the view of the ARA that complaints about the franchise regime appeared to be;

- failure to undertake due diligence or seek independent legal, business and accounting advice prior to entering into the commercial arrangements although required to do so;

- differences of commercial opinion as part of the ongoing franchise relationship, in other words the franchisee not following the franchise system as required;

- poor advice received from inadequate consultants more focused on their own revenue rather than providing proper advice to either the franchisee or franchisor;

- conduct by a franchisor that would appear to be illegal by virtue either of the Code or s52 of the Trade Practices Act;

- conduct of third parties such as landlords;

- a misunderstanding of business risk and the expectation of work loads required for success;

- inadequate capital and cost overruns.

The ARA remains concerned that campaigns against franchising continue to change the law when there is no substance to the complaints which reflects upon the law.

The ARA remains of the view that it is not the law per se but its application at pre entry, during and post the franchise agreement that needs addressing and we submit recommendations that may help.

We would welcome the opportunity to address any queries arising from our submission, or to respond to matters raised by any other submissions.

Franchising is not risk free

Greg Nathan, a respected psychologist and author of publications on the franchise relationship, a former franchisee and franchisor, has observed in his publications that no matter the amount of help and support a franchisee has, when they have failed, they will frequently remain embittered towards the franchisor and claim they are to blame for the failure of the franchisee. This is a basic psychological trait. No matter the legal system and the structures within the Code supporting the franchisee and protecting them, failure will happen.

It therefore follows that complaints against franchisors will continue. Does this mean that the law is inadequate?

The answer is clearly no but perhaps there could have been greater work done to ensure the franchisee who fails knew with greater certainty that business, franchise or not, is risky and failure is but one poor decision away.

Entering into a commercial venture takes significant resources and requires significant sacrifice of time and other personal values. The Franchising Code of Conduct has mitigated risk for small business investors but risk still remains and there is no guarantee of success.

Perhaps franchisee education could further emphasis the risk of failure, as sometimes the publicity of the success of franchising, and even the increased security provided by the regulatory environment, makes prospective franchisees too optimistic. However it is hard to image more strident mandatory warnings than currently appear on the front of all disclosure documents.

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.

ARA responds to popular concerns

Poor advice received

A far bigger problem is franchisees failing to seek advice.

There is an argument that franchise advice and education should be mandatory prior to entry into a franchise system however this then becomes a philosophical question which raises issues of government control in the economic structure of the country. Education is vital but should it be mandatory?

There is strong anecdotal evidence to suggest the Code does not envelope the advisers within the sector who are free to provide advice which could be contrary to proper practice of the Code. These advisers include financiers, consultants, brokers, lawyers and accountants who mostly have professional ethical demands yet do not have to adhere to the Code in a statutory sense.

There is much work to be done in this area of aligned behaviour within the sector and advisers for emerging franchise brands do not responsibility under the Code and perhaps an accreditation system with sanctions should apply for these consultants. A franchisor could invest $60,000 in the preparation of documents but these could breach the Code without their knowledge. Yet when a breach is discovered the consultant is not considered to be at fault, rather it is only the franchisor.

Churning

This term is used to describe the alleged behaviour of a franchise that deliberately sets out to force failure upon an unsuspecting franchisee with the intention to resell and start the process again gaining advantage from the franchise fees.

Commercial retail reality would suggest that this alleged behaviour does not exist as the reputation of the retail brand by a poorly performed franchisee is far more significant to the franchisor than this notion of "churning". To suggest that a franchise can deliberately run a poor performing location to continue to create opportunity for an investor is contrary to normal retail business practice.

Retail consumer confidence is mostly thin and a poor brand providing poor performance will not attract demand. It is therefore in the best interests of a retailer to protect the brand, not drive it into the ground and then have the whole process start again for the sake of a fee.

Yet the term is used widely but to date there is no clear evidence of the alleged tactic being used within retail franchising.

The Code provides for potential franchisees to have a complete history of a site and the contact details of current and former franchisees to discuss the

system and its requirements. If the franchisee does their due diligence then they would be forewarned of this alleged tactic – yet there are those such as poorly informed politicians who remained convinced churning still exists.

The Code and its amendments has been drawn to eradicate this alleged behaviour yet the common cry from failed franchisees is that they are victims of churn. Evidence to this claim must be provided before changes to the Code should be made.

Franchisor has too much power

The franchisor generally has more risk and money invested, has developed the brand and requires trading consistency within the market. Therefore the franchise business format model requires the franchisor to control aspects of the franchisee's behaviour that are relevant to the brand and the performance of the network. Decisions may need to be made that could affect the franchisee. This is the nature of franchising, and is clearly outlined within the franchise agreement. It should not be a surprise if a franchisee has undertaken appropriate due diligence.

The franchise relationship is not a relationship of equals.

Understanding the franchise relationship and the rights the franchisee has is a vital element within the relationship and this is why the Government advised within the Code franchisees to seek advice prior to entering the agreement.

Franchisor does not fully disclose

The Code requires franchisors to disclose more than 250 items as a starting point to the franchisee's due diligence.

Franchisees are clearly warned within Disclosure documents to "*take your time, read all documents carefully, talk to other franchisees and assess your own financial resources and capabilities to deal with requirements of the franchised business"*. Franchisees are also advised to *"make your own enquiries … get independent legal, accounting and business advice … prepare a business plan and projections for profit and cash flow … and consider educational courses, particularly if you have not operated a business before."*

The disclosure document is not intended to be an exhaustive source of all information and it is a requirement of the Code that franchisees seek further advice. They then cannot simply assert that the franchisor did not "fully disclose."

Further, s52 of the TPA applies to disclosure. Irrespective of the Code requirements, if a franchisor provides a compliance disclosure document but fails to disclosure a material fact that would have altered the franchisee's decision to proceed the franchisor is likely to have breached s52 of the TPA.

The Code does not provide a defence to a s52 claim – that claim is judged on its separate merits.

Therefore if the law clearly states that a franchisor must not only disclose within the Disclosure documents but also any other material fact and does not then they are in breach of the law and must therefore be sanction. Therefore the law is not at fault but rather the sanction regime.

Franchisor does not disclose trade figures

There is no obligation on a franchisor to do so, and considerable risks in the context of a potential s52 claim should the franchisor provide any financial information.

A prospective franchisee has access to existing and former franchisees, and can thereby obtain much of this information other than via the franchisor. Ultimately this is a factor for the franchisee to consider when making an informed decision – if figures can not be substantiated, the franchisee should not proceed.

The franchisor is restricted in providing income projections by the Code and is restricted to historical information unless the franchisor wishes to take on the additional liability for projections contained in s51A of the TPA. Some franchisors provide a variety of trading actuals from franchisees within the system. Others provide full disclosure of all franchisees trading. Others provide nothing fearing the implications of Section 51A and 52 of the Trade Practices Act.

ARA Concerns

There were a number of issues that could be addressed by the Inquiry when considering changes to the franchising sector.

Fraud – if a franchisor is committing fraud then the full weight of the current laws should be applied to ensure this practice does not continue.

There are adequate laws within the Australian judicial system to accommodate action against fraud.

Misrepresentation – there was adequate provisions within the Trade Practices Act to apply such provisions to those franchisors misrepresenting franchisees with the process of information and sales.

There is however a gap when this misrepresentation applies to the consultants and other stakeholders peripheral to the relationship between the franchisor and franchisee that could be attended to with modifications to the Code to accommodate for this sector of the franchise community.

Franchisees are frequently victims to fraud and misrepresentation when they do not have advice about the franchise system they are about to invest in. So whilst franchisees forego their rights for advice, fraud and misrepresentation will continue from unscrupulous franchisors.

Where the legal system fails the franchisee is when they do not seek adequate advice from experts within the franchise field to understand when fraud and misrepresentation is happening to them. Thus the weakness of the Franchising Code is the actual application of protections within the Code for franchisees, which could be at the core of much of the complaint.
Increasing protection for franchisees will not protect pre entry franchisees from fraud and misrepresentation because they may still continue to forego advice as required under the Code.

Poor advice – There is no protection for franchisees and indeed franchisors from poor advice. Although there is franchise education within the market there is no compulsion or licensing arrangement to ensure best practice.

The ARA recommends a licensing regime or a registration process be considered to manage franchise advisers so that the market can act with confidence.

Registration - The ARA considers it important for a registration process to be implemented as a step to clearing out potential fraud and misrepresentation. However the ARA believes the process of funding and the liabilities associated with such a regime may be too extreme for implementation when the problem within the market wasn't great enough to warrant such a regulatory action.

End of term disclosure – The ARA recommends end of term disclosure is included in the Disclosure Document as well as the Franchise Agreement. This will allow the franchisee to fully understand what will happen at the end of term or for any other exit circumstance including a breach of the franchise agreement.

This may reinforce to the franchisee what their rights and what they are entitled to at the end of term. They are after all renting the franchise system, and like any other lease that has no security at the end of term, franchisees must understand their need to return their investment within the available period of the franchise agreements.

Lack of pre entry education – Pre entry education is vital for franchisees yet many do not seek such education. The question then becomes; if a franchisor encourages education and good advice and the franchisee foregoes it then who is liable if the operation fails?

Managing Expectations – Franchising is not a guaranteed success formula. It is a system of applying a business model which if followed may lead to success. Yet when a franchisee fails they too often blame the franchisor. Yet others in the system are successful working the same formula which leads to the assumption that perhaps the operation of that franchisee may have been the issue for failure.

It is clear when a franchisor is in trouble - the entire system is struggling.

Yet if one unit in a large retail franchise system is blaming the franchisor, the franchise model, the Franchising Code of Conduct or the ACCC then perhaps it is the management of the franchisee expectation that has failed.

Surprisingly though the current political climate with the third Inquiry in 2008 suggests that a successful retail franchise system is at fault when one or more franchisees fail although the clear overwhelming majority of other franchisees within the same system are successful. Is it the franchise system or the franchisees operation?

Current System limitations

Franchisee reading the documents – the Code requires the prospective franchisees to get advice and at the very least read the documents. It is a commercial business transaction involving an investment of funds yet too many franchisees are not even reading the document. There is really no excuse for this, and no legislative remedy can resolve the problem. The current wording of the Code could not be clearer in this area.

Lack of due diligence – as with not reading the documents it seems many people don't properly research the market. They don't properly understand the business, the costs involved, the time required, the impact upon their lives and family, the exposure to risk or indeed the franchisor.

This is a serious problem and even though the Code provides for seeking advice; it does not address adequate due diligence. Perhaps franchisees should be required to verify the extent of their due diligence to the franchisor?

Lack of or ignoring advice – the Code requires advice to be sought but this is not mandatory and therefore due to costs and other reasons is often foregone.

Pre – entry education – there is a vital need for pre entry education yet this is not a requirement and many franchisees believe they do not need it.

Lack of understanding the rights of franchisee – the Code provides for disputation to be resolved which is normally set out within the franchise agreement however it is common for franchisee to not fully understand their rights under the Code.

This points to lack of due diligence, poor advice and not reading the documents.

False and misleading commentary – no matter the issue; no matter there has not been a breach of the Code; no matter there has been no fraud or misrepresentation; no matter Mediation could not resolve the issue – if a franchisee feels aggrieved and believes they have been poorly managed which has lead to their failure they will continue to blame others.

This type of behaviour from failed franchisees who cannot accept any blame leads to media interest which leads to false and misleading commentary about the franchise sector.

ARA Recommendations

Pre Entry education

Chapter Seven of the Fair Trading Inquiry in 1997 recommended greater emphasis on small business education prior to entry. The issue remains very relevant and it seems small business failure can be apportioned to some extent from poor education and competence prior to entry.

It is therefore recommended that the Government support specific franchise education programs through increased funding to the ACCC and the peak industry education arms to provide ongoing education programs.

Access to previous Disclosure Documents

As part of the due diligence processes it may be an advantage for the franchisee to have access to previous disclosure documents so comparative research can be made. The Code already contains a similar requirement for a copy of the current disclosure document to be made available on request so capped at three previous Disclosure Documents may help franchisee with their due diligence.

Franchisee disclosure of due diligence

The Code and the disclosure document contain strong warnings that prospective franchisees need to undertake due diligence, as purchasing a franchise is a very important business decision. The strengthening of the regulatory environment in 1998 pre-supposes that Franchisees should take responsibility for their decisions in entering a franchise system. There is clear evidence in many cases that they have not done so.

The ARA believes that potential franchisees must gain education and undertake proper due diligence before entering a franchise. In view of the instances where the Code processes encouraging the seeking of advice and facilitating the contact with existing franchisees are apparently ignored the ARA believes the due diligence processes needs to be strengthened.

The ARA recommends consideration be given to requiring franchisees to certify their financial structure, their training, whether they have followed the requirements of the franchisor's disclosure such as visiting other franchise outlets; whether they understand the impact of the business on their lives; and, whether they understand end of term rights.

An important aspect to this disclosure is the possible transference of liability if the franchisee fails. Just because the franchisor has seen the disclosure and therefore accepts the franchisee does not limit the franchisee's responsibility to ensure operational success.

It is therefore recommended that a franchisee be required to disclose accurately to the franchisor.

Mandatory Advice

The Code requires the franchisee to seek advice prior to entering the franchise agreement. In many cases this requirement is waived by the franchisee, perhaps in order to save on costs. However if a franchisee is investing substantial funds then they must seek advice.

It is therefore recommended that if a franchisee is required to invest a sum greater than $100,000 the advice provisions within the Code are mandatory. Alternatively the advice certification should be changed so that it becomes even clearer to a prospective franchisee that they are taking a substantial risk by not seeking advice.

Registration of Disclosure Documents

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.

A registration process will also allow greater research opportunities of the sector. This was an original recommendation of the Fair Trading Report in 1998, but has not been implemented.

The issue then is raised as to who will manage and fund such a registration process?

It is recommended that the Government investigate the establishment of a franchisor registration process for franchise systems which will include the vetting of disclosure documents to ensure they comply with the Code and the law. Whilst funded by the Government it may be possible to establish this process with assistance from the industry bodies.

Certification of Advisers

Advice given in franchising can vary and franchise business operators can rely on advice which is not adequate. It therefore becomes important that advisers to the franchise sector are competent and have a certification process such as the CPA introduced to ensure reliable advice is given.

It is therefore recommended that a certification regime is introduced requiring advisers to meet certain immediate and ongoing standards.

End of term provisions

There is some confusion in the market when the end of a franchise agreement is reached and an expectation for renewal is denied. These issues are usually clearly spelt out in the franchise agreement, which the franchisee is obliged to read and on which independent advice should be obtained. However there is an argument to include a specific question on this issue in the disclosure document.

This will ensure the franchisee clearly understands what happens at the end of term; what funds are payable and under what terms a renewal will be given. It will also cover the conditions of breach of agreement and the formula for payout and what terms a payout is relevant.

The ARA recommends the end of term provisions are added to the Disclosure Document.

Application of the Code

The ARA recognises the excellent work of the regulator, the ACCC and the Office of Mediation Adviser (OMA).

However the ARA recognises that at times there are issues that require a decision or indeed assistance that do not fall within the authority of the ACCC or the OMA. They may not involve a breach of the law, but there may be an opportunity for successful third party intervention.

It is therefore recommended that the Government fund a Complaints Officer and subsidises an Advice Bureau allowing franchisees greater access a remedy to their issue or complaint which is less costly than the current process through the ACCC, OMA or the Courts.

Sanctions

There are no clear sanctions which apply to breach of the Code and perhaps if a franchisor knew the penalty the risk of breach may improve alleged poor behaviour within the sector.

Conversely sanctions should also apply to a franchisee that is in breach of the franchise agreement. Currently the only method of resolving a breach for a franchisor is mediation or termination. Perhaps there is an argument for a penalty if a franchisee persistently breaches the franchise agreement.

The ARA recommendations that prescribed sanctions are added to the Code so to assist the ACCC in ensuring both the franchisor and the franchisee comply with the Code and their franchise agreement.