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Secretary
Parliamentary Joint Committee on Corporations and
Financial Services
Department of the Senate
PO Box 6100
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CANBERRA ACT 2600

Dear Committee Secretary

SUBMISSION TO THE INQUIRY INTO THE FRANCHISING CODE OF CONDUCT

The Western Australian Small Business Development Corporation (SBDC) welcomes the opportunity to provide this submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Franchising Code of Conduct.

The SBDC facilitates the development and growth of small businesses in Western Australia by providing information, guidance, referral and business facilitation services and by delivering programs to address specific needs within the small business sector. The SBDC promotes the sector through research, advocacy, liaison and communication activities, and supports the Small Business Centre network (elsewhere known as Business Enterprise Centres) throughout the State.

Among the SBDC's key strategic goals, the agency is committed to:

- Taking a leading role in influencing the policy and regulatory environment for small business;
  Improving the skills and knowledge base of the small business sector; and
  Driving small business growth in Western Australia.

The SBDC recognises the significant contribution that the franchising sector makes to the State and national economies, and the fact that the franchise business model is by and large a successful form of enterprise in Australia. In line with our commitment to knowledge and skills development, the SBDC provides information and guidance to franchising participants on all aspects of the franchise business model through our expert team of business advisors.

When a prospective franchisee visits the SBDC for guidance, they are strongly encouraged to seek professional advice before making a commitment to enter into a franchise agreement in order to fully inform themselves about the franchising relationship, the rights and responsibilities of respective franchising participants under the Franchising Code of Conduct ("the Code"), and general business practices. Prospective franchisees are advised to undertake extensive evaluation and appropriate due diligence about the franchise system in order to make an informed decision prior to committing to a particular franchise.

Western Australian Government Inquiry into Franchising

While the contractual relationship between franchising participants is reasonably well regulated through the disclosure provisions and dispute resolution framework of the Code, and more generally through the conduct prohibitions under the *Trade Practices Act 1974* ("the TPA"), disputes and problems between franchisors and franchisees continue to prevail. In recent times, the sector has received considerable negative press as a result of high profile disputes, business collapses and litigation.

Towards the end of 2007, a prominent dispute between parties involved in a national franchise system in Western Australia led the State Government of the day to initiate an inquiry into fairness in franchise arrangements. Specifically, concerns were raised with the then Government of Western Australia and the Parliament about end of contract arrangements and the non-renewal of franchise agreements within the KFC chain of fast food outlets.

In response to these concerns, the then State Government undertook an Inquiry into the Operation of Franchise Businesses in Western Australia ("the WA Inquiry") **to examine issues to do with fairness in franchising operations and to make recommendations to enhance the franchising business environment in Western Australia**. The WA Inquiry **was tasked with:**

1. Reviewing the adequacy of existing legislative provisions, both State and Federal.
2. Identifying whether emerging trends in the franchising industry disclose patterns of unconscionable conduct that may not be covered under existing laws.
3. Examining whether existing remedies available to franchisees are adequate and, where appropriate, recommend changes.
4. Reviewing existing practice in other jurisdictions, Australia and internationally, on unconscionable conduct and renewal of licences.

The WA Inquiry **was independently chaired by Mr Chris Bothams, (now immediate past) Manager of the South East Metro Small Business Centre and a former successful franchisee**. The SBDC provided **secretariat services to the** WA Inquiry.

As part of the consultative process, the WA Inquiry released in December 2007 a Background Paper calling for public submissions and held public hearings in Perth and Bunbury during February 2008. In total, the WA Inquiry received 93 written submissions and eight oral submissions from a wide range of interested stakeholders from around Australia, including from franchisors,

franchisees and ex-franchisees, industry and training bodies, academics and government agencies.

Additionally, the Centre for Advanced Consumer Research ("the CACR") at the University of Western Australia was engaged to research and advise the WA Inquiry on the fourth term of reference relating to the review of existing practice in other jurisdictions. The work also informed, in part, the first and third terms of reference.

The following discussion is based on the findings of the WA Inquiry and the resulting reaction by government and industry to the report's recommendations.

WA Inquiry Findings

Overall, the WA Inquiry found that the franchising sector is operating with a great deal of success in Australia, with the existing legislative framework adequately protecting the majority of franchising participants from serious misconduct and misbehaviour. However, a number of current and former franchisees alleged in their submissions to the WA Inquiry that they were victims of improper conduct by their franchisor. The consequences of this misconduct were devastating in some cases, often leading to significant personal and family costs including financial hardship and bankruptcy, marriage and relationship breakdowns, ill health and even suicide.

As the WA Inquiry was not an investigation and was not backed by legislative powers, the allegations made in many of the submissions could not be verified. Importantly though, the WA Inquiry did not detect any emerging or endemic trends that disclosed patterns of unconscionable behaviour that were not already covered under existing laws.

It did, however, identify a number of significant issues which needed to be addressed to further improve the franchising business environment for all participants. These issues related to franchise education, disclosure and due diligence, end of agreement arrangements, dispute resolution, and enforcement. The SBDC does not intend to discuss these issues in detail, except where they apply to the Parliamentary Inquiry's terms of reference, as it is understood that the Committee has already considered the report of the WA Inquiry in detail.

Given the fact that franchising often involves national brands operating across Australia, and that the conduct of franchising participants is regulated through the Code and the TPA, the WA Inquiry recommended that regulatory changes to the sector be undertaken by the Commonwealth Government. Put differently, there was no desire for the then Western Australian Government to introduce any State-specific legislation in response to the WA Inquiry's findings, particularly in relation to granting a guaranteed right of renewal to existing franchisees or providing compensation to franchisees on expiration of a franchise agreement, as this would introduce unnecessary duplication and add complexity to franchising arrangements in Australia.

Instead, the 20 recommended remedies provide the Commonwealth Government with a blueprint to address some of the key concerns raised in relation to fairness in franchising arrangements. The SBDC believes that if all

WA Inquiry recommendations are adopted, the franchising business environment would be one where participants are better informed, are more likely to be successful in their enterprises, enjoy greater equity and, should the need arise, have more timely and efficient access to dispute resolution.

Franchise Council of Australia response to the WA Inquiry

The Franchise Council of Australia ("the FCA") is the peak industry body for the franchise sector and represents - according to the FCA - the vast majority of franchisors, franchisees, advisors and suppliers involved in franchising in Australia. The FCA advocates on behalf of the sector in discussions with government, and conducts educational and networking activities throughout the country. Given this role, the FCA provided significant input into the WA Inquiry, via both a detailed written submission and in-person consultation with the Inquiry Chair.

In unofficial FCA 'observations' on the WA Inquiry findings (made via a Deacons Legal Update[1]), Deacons' partner and FCA Board Member, Mr Stephen Giles, generally welcomed the report recommendations and noted that "The Report contains a careful consideration of the broader issues in franchising, and makes a worthwhile and balanced contribution to the franchising debate". He was particularly supportive of the recommendations relating to pre-entry education, indicating that these are likely to have the most significant impact on the sector if implemented.

Mr Giles noted, however, that some recommendations "are likely to be considered somewhat aspirational or to have implementation problems". Specifically, he claims that a number of the proposed remedies:

> will have significant implementation difficulties or will be opposed by industry, notably those relating to rebates (on the basis of disclosure of confidential information to competitors) and risk statements (on the basis that this cuts across the thrust of the Code to place a due diligence obligation on prospective franchisees).

It is important to be mindful that the FCA is predominantly concerned with promoting the interests of its franchisor members. It therefore follows that the response from Mr Giles is somewhat predictable and should not be considered fully representational of the franchising sector's reaction to the recommendations of the WA Inquiry. Indeed, from the informal feedback received by the SBDC following the release of the report, the recommended remedies have been welcomed by many franchising participants as striking an appropriate balance between franchisor and franchisee obligations and providing for greater up-front clarity and certainty on the respective rights, roles and responsibilities of parties to a franchise agreement.

1 Deacons Legal Update, "WA Franchise Inquiry Report released", 1 May 2008, see www.deacons.com.au

While being cognisant of not adding significantly more compliance burdens on franchising participants, the WA Inquiry found that the high costs associated with business failure - individually and across a franchise system - would outweigh any additional impost on franchisors as a result of prescribing further disclosure provisions and the registration of franchise systems and disclosure documents. It is the SBDC's view that if all recommendations of the WA Inquiry were implemented, the number of disputes currently afflicting the sector would be substantially reduced.

In July 2008, the FCA released its formal response to the WA Inquiry, along with its formal response to the Parliament of South Australia Economic and Finance Committee Inquiry into Franchising ("the SA Report").2 In this response, the FCA found that the "WA Report is consistent with the conclusions of previous Federal inquiries, is suite balanced, and its recommendations more thoughtful than the SA Report." Overall, the FCA was supportive of many of the WA Inquiry recommendations, including improving franchise education, the provision of a standard risk statement to franchisees, periodic reviews of the Code, and the disclosure of information relating to end of agreement arrangements.

End of Agreement Arrangements

A key focus of the WA Inquiry was on issues relating to non-renewal of the franchise agreement and rights at the expiry of the contract. This is an area that the current Code provisions is relatively silent on, and needs to be addressed in order to facilitate better informed decision making and business due diligence. Specifically, prospective franchisees should be made aware up-front what they will be entitled to, if anything, at the end of their agreement term.

The WA Inquiry **as such recommended that franchisors provide better up-front disclosure** of this very **important condition. If implemented, the proposed measures in this regard would go some way to addressing the issue of 'franchisor opportunism', whereby the franchisor takes over individual franchised outlets (typically those that are profitable) without compensating the franchisee for building up the business.**

Other important measures recommended by the WA Inquiry, which are based on legislative practice in some states of the United States, are to require franchisors to conduct a pre-expiry review of the franchised business at least a year prior to the expiry of the franchise agreement, and to require franchisors to provide adequate notification of their intention not to renew the franchise agreement.

The SBDC notes that in its response to the WA Inquiry, the FCA endorsed these recommended remedies relating to end of agreement arrangements, indicating that it:[4]

2 "Response by the Franchise Council of Australia to:- (1) The Inquiry into the Operation of Franchise Business in Western Australia; and (2) The Parliament of South Australia Economic and Finance Committee Inquiry into Franchises", FCA, July 2008, see www.franchise.org.au

3 Ibid, pg.4

4 Ibid, pg.21

- "has no concern with the recommendation to provide specific information in the disclosure document in relation to end of agreement arrangements";
- "supports Recommendation 3.3 that the Code be amended to require franchisors to conduct a pre-expiry review with the franchisee at least one year prior to the expiry of the franchise agreement"; and
- "supports the recommendation that the Code be amended to require franchisors to specify, in the disclosure document, a reasonable period of .notification in which to inform the franchisee of their intention not to renew the agreement. The FCA suggests that .. the provision specify a maximum reasonable period."

Accordingly, further industry consultation on this would be required in order to deal with transition and other issues (for example, existing agreements may need to be exempted from this requirement).

Resolving Disputes

One of the main findings of the WA Inquiry **was that the mandatory process of dispute resolution prescribed under the Code, in the form of mediation , was not effective in many cases, especially in terms of providing early resolution of a dispute and holding parties accountable** (**to not only attend mediation but to act positively to resolve the matter**). **This was neatly put in a submission** to the WA **Inquiry by an ex-franchisee as follows** (**refer to page 26 of the report):**

> Whilst mediation is often reported to be a more cost effective and arguably more successful means of alternative dispute resolution, it can only be as effective as the respective parties allow it to be. For many franchisees it is the only possible means of being heard given the cost of lawyers and litigation. .. In practice, mediation only provides the franchisor with another opportunity to assert their dominance, but under a shield of confidentiality.

Figures provided to the WA Inquiry by the Office of the Mediation Adviser (OMA), which was established by the Commonwealth Government in 1998 to appoint mediators to resolve franchising disputes, reveal that around three quarters of disputes referred to it over the past decade have been settled through mediation. However, it should be noted that there is some ambiguity over the OMA's definition and efficacy of what constitutes a "resolved" dispute; settlement at mediation does not necessarily equate to a satisfactory nor equitable resolution for all parties to a dispute.

The WA Inquiry concluded that if mediation was not practicable or did not satisfactorily resolve a dispute, the aggrieved party has few alternatives but to privately pursue the matter through the courts (which is prohibitively expensive and time consuming) or drop the disputation. As evidenced by the figures provided to the WA Inquiry, the lack of success by the Australian Competition and Consumer Commission ("the ACCC") in prosecuting alleged breaches of the Code and improper conduct by franchising participants reinforces the enforcement agency's apparent ineffectiveness in investigating claims and neglect of the sector.

In order to tilt the inherent power imbalance between the franchisor and the franchisee towards a more equal footing, the WA Inquiry **recommended that the current mediation process be amended to make it mandatory for parties to attend and to attempt to resolve disputes in a timely fashion**, **with the inclusion of prescribed penalties for parties failing to adhere to mediation obligations. The SBDC notes that the SA Report similarly recommended that the Code be amended to introduce specific penalties for breaches of the disclosure requirements under the Code** (**refer to Recommendation** 7.2.9).

In response, the FCA **indicated that it "is comfortable with the recommendation that mediation of disputes be made mandatory**".5 Further, **in his earlier response**, **Mr Giles conceded that "the intent behind the [mandatory mediation] clause recognises that there are still franchisors and franchisees that have not embraced mediation as a dispute resolution mechanism" but recognises that "pecuniary penalties .. in place of other remedies .. could be appropriate".6**

The WA Inquiry **further recommended that the Commonwealth Government review the current mediation processes with a view to implementing an earlier, more cost-effective and accessible dispute resolution system that provides binding decisions. In particular**, **such a reform is essential in order to address minor disputes in a timely fashion before the franchise relationship completely breaks down or the matter escalates into court action.**

Various alternative dispute resolution processes were suggested to the WA Inquiry, including peer counselling or a peer review panel, the establishment of a national tribunal system or low-cost arbitration system, and the appointment of a national franchising Ombudsman or Commissioner.

The SBDC notes that the FCA's response to the suggestion for the introduction of alternative dispute resolution processes is somewhat ambivalent; on the one hand, "The FCA supports measures to augment and further streamline dispute resolution .. [and] remains open to the idea of a separate franchising arbitration system",' but on the other, argues that it:

> does not at this point support the creation of a Franchise Ombudsman, or a Franchise Tribunal, or a specific Franchise Arbitration Unit within the ACCC or other relevant entity to administer the enhanced dispute resolution system. The FCA considers any new tribunal or process will simply add cost, and invite an adversarial approach to disputes.8

Nevertheless, the FCA claims[9] - and the SBDC agrees - that more work would need to be done to address such issues as the following:

5 Ibid, pg.30
6 Deacons Legal Update, 1 May 2008
7 FCA Response, July 2008, pgs.21-22
8 Ibid, pg.9
9 Ibid, pg.22

- the source of its authority;
- whether it would be legal or administrative;
- would decisions or awards be enforceable in the courts in Australia and overseas;
- how it would be funded;
- who would be appointed to it;
- where it would sit;
- how frequently it would sit;
- an indication of timeframes, including waiting periods to have a matter heard, and how long a decision would take; and
- how much it would cost parties to appear before it.

The SBDC's **preferred alternative to resolve minor procedural disputes involving franchising participants would be a free or low-cost system of arbitration that is able to make binding determinations**. **Serious breaches of the Code or improper conduct that offends** the TPA should **of course continue to be dealt with by the** ACCC; **though a bolstered focus on the franchising sector within the enforcement agency is required.**

One such potential model for consideration within the franchising context is the dispute resolution process under Western Australia's workers' compensation system. In Western Australia, WorkCover WA's independent Dispute Resolution Directorate (DRD) is the sole legal jurisdiction for resolving or settling disputed workers' compensation claims. Specifically, the objectives of the DRD are to:

- provide a fair and cost effective system for the resolution of disputes;
- reduce administrative costs across the workers' compensation system; and
- provide a dispute resolution system that:
  - o is timely and ensures workers' entitlements are paid promptly;
  - o is accessible, approachable and professional;
  - o is effective in settling matters; and
  - o leads to durable agreements between the parties.

The DRD is able to determine most disputes concerning a workers' compensation claim under the *Workers' Compensation and Injury Management Act 1981 (WA).* Under the DRD system, many disputes can be 'fast tracked' because the arbitrator may make a decision based on the initial application without holding a hearing. These decisions are final and binding on the parties and cannot be appealed.

Applications involving more complex issues are generally listed for an initial teleconference to try to resolve the dispute informally and if the dispute remains unresolved, a conciliation conference, then an arbitration hearing, may be required. In such cases, an arbitrator is not able to make a formal determination without first using their best endeavours to bring the parties in the dispute to a settlement acceptable to all of them. Additionally, hearings and conferences before an arbitrator are generally conducted in private.

Any party applying to have a matter determined by the DRD may have legal representation, or be represented by a registered agent. Legal representation is not a requirement, however, and parties can proceed without representation. In

any proceeding, an arbitrator may refuse to permit an employer or an insurer to be represented by a legal practitioner or registered **agent** if a party who is a worker is not represented by a legal practitioner or registered agent.

A Costs Committee determines maximum costs for legal services and registered agent services incurred while representing parties in disputed matters. The costs represent a fee for service and are structured to promote the early settlement of issues and disputes by agreement, and discourage unnecessary delay, unwarranted attendances and excessive preparation of documentation.

For further information on Western Australia's workers' compensation dispute resolution process, please refer to www.workcover.wa.gov.au.

Good Faith in Franchising

According to the Matthews Committee,[10] good faith generally embraces the following concepts:

- an obligation on the parties to cooperate in achieving their contractual objects;
- compliance with honest standards of conduct; and
- compliance with standards of conduct which are reasonable having regard to the interests of the parties.

As part of its terms of reference, the WA Inquiry undertook an extensive review of national and international laws and practices pertaining to unconscionable conduct (and similar legal principals) and renewal of licences. According to this research, there is currently no uniform acceptance within Australian jurisdictions of a coherent, separate legal concept of good faith in contract law.

While it is acknowledged that a copy of the report of the WA Inquiry has been considered by the Parliamentary Inquiry, the SBDC believes it is worthwhile including in this submission the WA Inquiry's findings relating to the implied duty of good faith in Australian case law and specific references to good faith in Australian legislation (refer to pages 9-11 of the report for appropriate case references).

The recognition* of an *implied duty* of good *faith in Australia

A number of recent cases have looked favourably on the implication of a duty of good faith into a variety of contracts, including franchising agreements. While some doubts remain as to whether Australian law has unequivocally accepted a duty of good faith in the performance and enforcement of contracts generally, and the High Court has not reached a binding conclusion on the issue, there has been an acceptance of the duty

10 "Review of the Disclosure Provisions of the Franchising Code of Conduct - Report to the Hon Fran Bailey MP Minister for Small Business and Tourism", Franchising Code Review Committee, October 2006, pg.46

as an implied legal incident in particular classes of contract, for example, franchise agreements, commercial leases and tenders.

Despite earlier concerns as to how good faith could be defined, and fears of such a principle undermining certainty in contract law, some courts have indicated their preparedness to utilise good faith principles in Australian law.

In Royal *Botanic Gardens and Domain Trust v South Sydney City Council,* High Court Justice Kirby pondered the breadth of the implied duty of good faith, particularly "the extent to which, if such were to be the law, a duty of good faith might deny a party an opportunistic or commercial exercise of an otherwise lawful commercial right."

Recently, in *J F Keir Pty Ltd v Priority* ***Management*** *Systems Pty Ltd (administrators appointed),* **Acting Justice Rein accepted submissions made by a franchisee that when the franchisor exercised its powers under the franchise agreement, the implied duty of good faith required the franchisor to act:**

(i) reasonably and honestly;
(ii) objectively;
(iii) without simply relying on information provided by third parties or 'wilfully shutting (ones) eyes' or refraining from making inquiries, but exercising the degree of 'caution and diligence to be expected of an honest person of ordinary prudence';
(iv) without some ulterior motive;
(v) with recognition and regard to the legitimate interests of both parties in the enjoyment of the fruits of the contract; and
(vi) to avoid action rendering the plaintiff's interests under the agreement 'nugatory, worthless, or... seriously undermined'.

Franchisors in Australia are free to pursue their legitimate business interests but may offend the implied good faith principles through the pursuit of some extraneous purpose. Importantly, an implied covenant will only aid and further the explicit terms of the agreement and will never impose an obligation which would be inconsistent with other terms of the contractual relationship.

References ***to good faith in Australian legislation - TPA***

Section 51AC(3)(k) of the TPA invites the court to consider the good faith of the parties when determining whether conduct is unconscionable. Several cases, including cases dealing with franchise or dealership terminations, have examined good faith in the context of s51AC. Australian franchise cases often equate a failure to act in good faith with unconscionable conduct. Whether this is correct is the subject of considerable debate.

Good faith is not defined in the TPA and therefore recourse could be made to the common law authorities. Interestingly, as the reference in s51AC is to conduct rather than to a contract, the potential operation for good faith in

> the s51AC context **would seem to be broader than the common law position.**

The review of international practices also revealed that the implied covenant of good faith is well recognised in civil law jurisdictions and the United States of America, and is gradually gaining traction amongst common law jurisdictions.

A copy of the **research undertaken** on behalf of the WA Inquiry by the CACR is **attached for the Parliamentary** Inquiry's **information and use**. However, the **SBDC requests that this research be kept confidential and not released** publicly.

The SBDC also notes that in its Franchising Policy Statement released in the lead-up to the last federal election, the ALP indicated its support for good faith obligations to be included in the Code (as long as this obligation was well defined). In its consideration of the WA Inquiry report, State Cabinet supported the Commonwealth Government's commitment to consider the introduction of an obligation to act in good faith, in the interests of improving the franchising business environment and the manner in which franchise agreements are negotiated.

This Western Australian Government position was then taken to the meeting of the Small Business Ministerial Council (SBMC) on 23 May 2008. At the meeting, Small Business Ministers noted that the Commonwealth Government will, consistent with its pre-election commitment, consider the introduction of a well defined obligation for parties to bargain and negotiate in good faith as part of the Code.

However, **the issue of a statutory obligation to act in good faith was a major sticking point** for the FCA, **which categorically stated in its response** to the WA Inquiry **report that it:**

> does not support the amendment of the Code by inserting a provision imposing a duty to act in accordance with good faith and fair dealing by each party of the franchise relationship. There is already a duty implied at law, and any new definition will simply add cost and create uncertainty where none currently exists. The FCA is also concerned that such a proposal may be used to create a de facto automatic right of renewal of franchise agreements."

While not against the introduction into the Code of an explicit obligation for franchisors, franchisees and prospective franchisees to act in good faith per se, the SBDC is cautious about this approach as we remain unconvinced about whether 'a well defined obligation for parties to bargain and negotiate in good faith' would add sufficient legal certainty to adequately (and efficiently) address concerns in the franchise relationship.

After reviewing the extensive CACR research into international practices relating to good faith and fair dealing, the SBDC came to the conclusion that,

[11] FCA Response, July 2008, pg.9

overarchingly, there is a tendency for the courts to shy away from imposing obligations where there is no contractual right to do so. A specific example of this from the WA Inquiry relates to an obligation to renew a franchise agreement where no such right exists in the agreement.

Rather than impose a statutory right for parties to negotiate in good faith, the SBDC arrived at the view that in the area of non-renewal of franchise contracts, it was more effective to explicitly state in the Code the behaviour required of parties regarding the renewal of agreements. In other words, the respective rights of parties in relation to renewing agreements should be disclosed up-front as part of the disclosure documentation.

In reaching this position, the SBDC is concerned that the courts in Australia might take a similarly conservative view of a statutory obligation to act in good faith as they have in relation to unconscionable conduct in business to business relationships. In turn, this could have the effect of exposing businesses to expensive litigation that they can ill-afford with little hope of a positive outcome.

Yours sincerely

Stephen Moir
MANAGING DIRECTOR

25 September 2008