FB 2010 Sub 97

Tuesday, February 1, 2011

Kristy Bryden
Research Officer
Economics & Industry Standing Committee
Parliament House
Perth WA 6000

laeisc@parliament.wa.gov.au

RE: PARLIAMENTARY INQUIRY – FRANCHISING BILL 2010

Dear Madam,

Please see attached the following in response to the Economics and Industry Standing Committee's inquiry into the Franchising Bill 2010 on behalf of Griffith University's Asia-Pacific Centre for Franchising Excellence, and the Franchise Advisory Centre.

This submission has followed the terms of reference as supplied, with additional commentary where necessary for greater clarification.

It should be noted that the authors of this submission are research and education practitioners in the field of franchising, and that responses to the terms of reference draw as much on firsthand participation in the franchise sector as on published research.

The Committee's attention is drawn also to an initiative pioneered by the Asia-Pacific Centre for Franchising Excellence (APCFE) launched on July 1 last year which makes free education about the advantages and disadvantages of franchising available to any potential entrant to the franchise sector freely available online at the Centre's website at www.franchise.edu.au.

As at the time of writing, more than 1,100 participants had commenced this education program, and as a result, are expected to make more informed decisions about franchising and undertake more effective due diligence on any future business or franchise investment.

Further support of this initiative, for which the enrolments to date demonstrate a clear need, is always welcome.

For further information in relation to this submission, please contact the authors.

Sincerely,

Lorelle Frazer

Lorelle Frazer
Director, Asia-Pacific Centre for Franchising Excellence
Ph: 07 3382 1179, email: l.frazer@griffith.edu.au www.franchise.edu.au
Logan Campus, Griffith University
University Drive, Meadowbrook QLD 4131

Jason Gehrke
Director, Franchise Advisory Centre
Ph: 07 3716 0400 email: [redacted] www.franchiseadvice.com.au
PO Box 15304, Brisbane City East QLD 4002

Parliamentary Inquiry – Franchising Bill 2010

The committee's terms of reference are to consider whether the passage of the proposed Franchising Bill 2010 in its current form would:

> ***1. be directly inconsistent with the Trade Practices Act 1974 and the Franchising Code of Conduct, with particular reference to the inclusion of provisions for:***
>
> ***a). the requirement to "act in good faith";***

It is noted that the 1 July 2010 changes to the Franchising Code of Conduct included a provision acknowledging Good Faith, but after careful consideration by a panel of independent experts appointed by the Commonwealth Government, determined that a definition of Good Faith could not be agreed while case law on this topic continued to evolve.

Creating a universal definition of Good Faith on the one hand risks such broad interpretation as to be meaningless, while on the other can be so entirely subjective as to create greater – not less - conflict arising from differences in interpretation which risks overshadowing the very issue that Good Faith would be expected to resolve.

In looking at the definition of Good Faith offered in 11(1) of the Franchising Bill 2010, the requirement to act "fairly, honestly, reasonably and cooperatively" depend in the main on the eye of the beholder for potentially widely varying interpretations. "Honest" and "honestly" are the least likely to be misinterpreted as one is either honest or dishonest – like black or white – with little or no grey in between.

However the other concepts which form the definition of Good Faith relating to fairness, reasonableness and cooperation hinge on subjective viewpoints that are unlikely to align at all times, and in particular, during franchise disputes.

These concepts also risk undermining the sanctity of contract.

Take fairness for example. The entire proposition of franchising is that it is a conditional grant from one party to another.

Common conditions found in such franchise grants include the limitation of time (ie. the franchise term) and the requirement to pay royalties or some other fee.

The fairness element of the good faith definition proposed potentially brings into question both the existence and quantum of these two conditions. Is it fair for franchisors to impose a time limit on a franchise agreement, and if so, what length of time is fair? The perspective of franchisor and franchisee will be polarized by their respective competing self interests. Likewise the common requirement to pay royalties – their existence and quantum is also brought into question by issues relating to fairness, which historically consenting parties have agreed to by contacting accordingly.

However, the Franchising Bill 2010 casts a pall over this contractual certainty. If the Good Faith definition is included in its current form, it risks creating a platform for widespread litigation by weakening the very platform on which the success of franchising as a business model is built – the conditional grant.

The other key elements of the Good Faith definition – reasonably and cooperatively – are perhaps less contentious but still subject to differences of perspective. There may well be legal tests for these concepts, but again these concepts risk fuelling conflict rather than resolving it. Reasonableness by one party may not be seen as such by another, and the perception of which in general may be dependent on experience in business or certain industries.

Cooperatively – the last element of the Good Faith definition – is perhaps the least contentious. A contract is a form of documented cooperation, so a cooperative approach

between parties is plausible *subject to their common interests.* However, if their common interests erode or cease to exist altogether, a cooperative approach may be impractical at best, and impossible at worst.

b). civil monetary penalties;

The burden of proof required under this part of the Franchising Bill (Part 4 – Enforcements and Remedies) is only for "the balance of probabilities" and not "beyond reasonable doubt".

Given the relative ease with which such an action can be brought by "an application made by the Commissioner or any other person" (including those not party to a franchise agreement), this provision risks creating a platform for speculative and vexatious actions where a low burden of proof may result in substantial commercial damage to the defendant vis a vis the penalties alone (not including the legal cost of defending such a action).

Penalties in the Bill are proposed to be up to $10,000 for individuals, and up to $100,000 for bodies corporate. The enforcement of the maximum value of financial penalties may have little or no bearing on an individual or organisation's capacity to pay.

A potential consequence would be the financial crippling of small franchisors, leaving them unable to maintain support and service obligations to their franchisees, or resulting in their insolvency altogether, which is likely to have a negative financial effect on the rest of the network.

Additionally, nothing in the Franchising Bill prevents monetary penalties being applied to an act which has already been prosecuted under the Trade Practices Act (TPA), for which a non-financial penalty has been applied. This can result in a party being prosecuted and penalized twice for the same thing, without consideration as to the consequences of one or the other prosecution combined.

For example, while the Bill states that a pecuniary penalty cannot be applied for an act for which a pecuniary penalty has already been ordered under the TPA, this fails to consider other remedies under the TPA such as court-enforceable undertakings which themselves may create significant financial obligations (for example, a court-enforceable undertaking to conduct corrective advertising, refund monies, undergo compliance training, etc).

The Bill in its current form allows for double prosecution in instances above where a court-enforceable undertaking has been ordered under the TPA and a fine of up to $100,000 can still be applied by courts under the Bill.

c). injunctions;

As with the application for civil monetary penalties above, a fundamental difficulty with this provision is that it provides a platform for anyone – not just parties to a franchise agreement or a law enforcement officer – to seek injunctive relief.

This not only creates potential for vexatious behaviour by parties to a franchise agreement, but can potentially distort market forces by allowing any other person, including competitors, landlords, suppliers and others to seek speculative injunctions in order to gain commercial advantage well beyond the injunctive relief provisions already available within the TPA.

There is a real and considerable risk that this, and the provision dealing with civil monetary penalties, will be open to abuse and stimulate systemic litigation rather than address any perceived deficiencies in the Franchising Code of Conduct.

Additionally, part 13(2) of this provision which prohibits franchisees from giving undertakings as to damages increases the opportunity for speculative and potentially vexatious applications whose sole intention is to disrupt the business activities of the other party and create cost and inconvenience.

Furthermore, this provision is silent on the issue as to the level of proof – if any – that will be required for a court to approve an injunction and conceivably will lead to applications being sought on the basis of hearsay and rumour, rather than factual evidence.

d). redress orders;

Section 14 of the Franchising Bill dealing with redress orders has significant, far-reaching and potentially damaging consequences for the franchise sector.

This part of the bill duplicates much of the effect of court-enforcable undertakings as a remedy already available under Section 87 of the TPA. The purpose of replicating this in the WA Bill is unfathomable, and again represents a platform for potentially speculative and vexatious litigation.

Under 14(2), persons who can apply for a redress order are not limited to parties to a franchise agreement, and again, highlights the distinct potential for the distortion of market forces by applications from competitors, landlords, suppliers and others as outlined in the commentary provided in relation to injunctions above.

In addition to redress orders, 14(3) of the Bill provides for a defendant to also be hit with civil monetary penalties as these are not mutually exclusive, and can be applied on top of other penalties that may be applied under the TPA as discussed earlier (see *civil monetary penalties* above).

There is a very real concern that the inclusion of provision 14(4) in relation to a six year window following a breach of the Franchising Bill will massively undermine confidence in franchise growth in WA. This is akin to a customer coming back to a restaurant six weeks after they had a bad-tasting meal and demanding a replacement – it is beyond reason (the customer should have complained when they first tasted the meal) and without precedent (the Franchising Code of Conduct requires franchisors to disclose franchisee contact details for the last three years, but under this provision in the WA Bill, a franchisee who no longer needs to be included in a disclosure document can pose an ongoing risk the business of the franchisor and subsequent franchisees in the same location).

Furthermore, the inclusion of renewal orders for franchise agreements throws uncertainty over existing franchise businesses where a lawful buyer – according to this Bill – could potentially be dispossessed of their business so that it could be reinstated to a former franchisee who had departed the system anywhere up to six years previously.

This provision alone creates great danger of undermining the capital value of franchise businesses for sale as any buyer must weigh up the risk that the business could be potentially taken off them in future and be returned to a previous franchisee. (To some degree, this puts buyers of existing franchise businesses into the same situation as an unwitting recipient of stolen goods – it's theirs until a prior owner claims it back and leaves them empty-handed and without compensation).

e). damages;

Section 15 of the Bill does not limit who may apply for damages arising from harm, defined by the Bill as any kind including economic harm.

This provision is incredibly broad, does not limit actions for damages to parties to a franchise agreement, and leaves the door open for vexatious or speculative claims by competitors, suppliers, and landlords, as well as employees and others such as spouses or children of franchisees, employees, etc.

This wide scope must inevitably create abuse of the Bill through opportunistic claims by parties linked directly to franchise agreements, as well as those with highly tenuous and indirect links to franchise agreements.

The nature of the harm itself is beyond the scope of a business agreement. Economic loss is understandable, but personal injury including impairment of a person's physical or mental condition must inevitably require some assessment of these factors not only after the event occurred which supposedly led to the harm, but also long beforehand (perhaps at the point of recruiting franchisees) as well as an exhaustive elimination of other factors unrelated to the franchise that may have caused such conditions.

This definition of harm, plus the failure to restrict it to parties to the franchise agreement, creates such an onerous set of contingent liabilities on any franchisor as to make the establishment of franchise operations in WA manifestly undesirable.

Provisions such as this serve also to risk diminishing the level to which individuals should take responsibility for their own actions, and make it lawfully and socially acceptable to seek recourse from others after a transaction rather than focusing attention on undertaking thorough and comprehensive due diligence before committing to a transaction.

2) enhance the purpose of the Franchising Code of Conduct, which is to regulate the conduct of participants toward each other;

In short, the passage of this Franchising Bill would not enhance the conduct of participants in the franchise sector as outlined in Part 1(2) of the Franchising Code of Conduct because the Bill's approach is highly adversarial, punitive, and creates opportunities for widespread litigation.

The Bill and its explanatory memorandum indicate the existence of a Commissioner for Consumer Protection, but nowhere in the Bill is there any reference to any form of alternative dispute resolution other than that already included in the Franchising Code of Conduct itself. By failing to consider any form of ADR itself, the Bill by its very nature and drafting promotes litigation which in essence was one of the very things that mediation provisions of the Franchising Code of Conduct were designed to reduce.

3) result in a cost impact on the State or participants in franchising.

It is not within the means of the authors in compiling this submission to conduct a full assessment of the impact of the Franchising Bill on the economy of Western Australia, nor a costing of its impact on participants in the sector.

The conduct of such an economic assessment should be a necessary pre-requisite prior to adopting or modifying any legislation, and represents proper governance. Additionally, consultation with affected stakeholders should be held across the whole of any proposed Bill, rather than limited to only certain components.

However, for the purposes of this submission, the following may be useful:

1. The *Franchising Australia 2010* found that there were 1,025 franchise systems operating in Australia, employing approximately 690,000 people through 69,900 outlets turning over approximately $128 billion per annum.

2. Nearly half of all franchise systems (47%) have 20 or fewer franchisees. A further 21% of franchise systems have between 21 and 50 franchisees, meaning that the overwhelming majority of franchise systems operating in Australia are relatively small (ie. less than 50 outlets).

3. Approximately 13% of franchise outlets operate in Western Australia (*Source: Franchising Australia Survey 2006*), or approximately **9,000 outlets** when this percentage is applied to the current population of outlets.

4. No statistics are currently available as to the number of franchise systems operating in Western Australia. It could conceivably be as high as all 1,025 systems known to be operating in Australia.

5. Assuming all franchise systems operating in Australia (1,025) have a presence in WA, this makes for an average of just 9 outlets per system. If only half of franchise systems have operations in WA (1,025 / 2 = 512), then this increases the average number of franchisees per system in WA to 18.

6. The cost of complying with the Franchising Bill 2010 would include the following:

    a. Legal costs to obtain professional advice and to amend franchise agreements and disclosure documents for Western Australia to include reference to the Franchising Bill 2010;

    b. Cost of compliance training and development of compliance procedures for franchisor personnel based in WA, as well as franchisor personnel in head offices servicing WA franchisees from outside the state;

    c. Costs in 6a and 6b above would be estimated at up to $10,000 per franchisor, or up to $10 million for the sector as a whole.

    d. Franchisors may seek to recover these compliance costs by increasing the investment cost of any new franchise to be opened in WA, increasing transfer fees on existing WA franchises sold to new franchisees, or applying a differential royalty structure for franchisees operating in WA;

    e. Additional costs to franchisors beyond up-front out-of-pocket compliance expenditure will include:

        i. Contingent liability costs relating to the six-year provision for damages actions under Section 15 of the Bill;

        ii. Legal and personnel costs in defending speculative and/or vexatious claims made possible by provisions of the Bill;

        iii. Increased insurance premiums for professional indemnity and public liability coverage for franchise systems with exposure to the WA Bill;

        iv. Foregone revenues from outlets <u>not</u> opened in order to limit contingent liabilities to those of existing outlets only;

        v. Again, such costs will likely be passed through to franchisees by way of higher initial franchise fees, higher royalties, reduced support services or any combination of these or other responses.

    f. Costs to franchisees that may arise from the passage of the Franchising Bill 2010 would include those passed on by franchisors as outlined in 6a to 6e above, as well as:

        i. Increased borrowing costs from financial institutions to offset the risk of default on business loans arising from redress or renewal orders applying to businesses that have changed hands but are subject to the six-year claim period. (In other words, existing franchisees may be forced out by litigation under the Bill from former franchisees, with existing franchisees left with no business and no means to repay their business loans).

ii. Increased bank guarantees for rent on retail and commercial premises to offset landlord exposure to non-payment of rent in the event of litigation brought under the Franchising Bill;

iii. Any tax, levy or additional stamp duty charge on franchise agreements applied by the Western Australian government to recoup the costs of implementing and enforcing the Franchising Bill and the office of its Commissioner.

iv. A further cost to franchisees would be the loss of all protections under this Bill and the Franchising Code of Conduct itself if franchisors seek to change their business arrangements from franchises to licenses, which are not covered by either pieces of legislation. Such a move would not only be conceivable, but may even be advisable to reduce franchisor business risks and lower investment costs for licensees.

v. Not only would such a move defeat the purpose of the Bill, it would leave licensees without any obligation to receive disclosure documents, mediation, 7-day cooling-off periods and so on which are currently mandatory under the Franchising Code. In turn this would expose licensees to much higher business risks in direct response to a legislative attempt to actually decrease those risks.

7. Costs to the state of Western Australia would potentially include but may not be limited to:

   a. Establishment costs for the office of the Commissioner / agency with responsibility for enforcing the Code;

   b. Costs to the judicial system with the Bill expected to stimulate a logjam of initial claims, presumably from some of its most vocal proponents;

   c. Foregone state revenues relating to stamp duties, payroll taxes (where applicable) resulting from reduced or frozen system growth due to concerns by franchisors over compliance costs, etc;

   d. Potential flow on-costs and damage to the state's reputation for business investment by the creation of state-based legislation for a sector that is already regulated nationally. (Setting a precedent that if WA can create additional legislation for one area already regulated nationally, what else will be next?)

   e. Costs arising from any potential challenge to the Bill itself in the courts.

A note about the terms of reference for this inquiry:

The scope of the terms of reference for this inquiry appear relatively narrow and do not readily lend themselves to broader comment about the practicalities of this proposed legislation.

However there are two additional comments worth noting.

One is that the Bill in its current form will have greater extraterritorial application than appears to have been originally intended. Its application to agreements relating to business even partly conducted in Western Australia can be interpreted to include almost any franchise system by virtue of their presence on franchise directory websites (as well as their own website), where they may be promoting their goods or services or franchise offers.

Secondly, the Bill itself as well as the Explanatory Memorandum and all references to the Bill in Hansard do not include any reference to the critical role of pre-entry education to improve the prior understanding of franchising and the due diligence required by potential franchisees before committing to a business investment.

The Asia-Pacific Centre for Franchising Excellence has since 1 July 2010 hosted a free online education program for potential franchisees which to date has received more than 1,100 enrolments with relatively little promotion.

The Western Australian government is strongly recommended to support pre-entry education to inform and empower potential franchisees through this or other initiatives in order to take a pro-active approach to seek improvements in the conduct of franchise sector participants toward one another.

Finally, it is understood that the Commonwealth Government has publicly announced it will further review the Franchising Code of Conduct in 2013. Rather than creating its own legislation in the meantime, the Committee is encouraged to submit its recommendations for improving the conduct of participants in the franchise sector toward one another to the Commonwealth for inclusion in the forthcoming review.