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Industry, Science and Research**

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Mr Timothy Hughes
Principal Research Officer
Economics and Industry Committee
Legislative Assembly Committee Office
Level 1, 11 Harvest Terrace
West Perth WA 6005

Dear Mr Hughes

Submission to the Western Australian Economic and Industry Committee's 'Inquiry into the *Franchising Bill 2010*'

We refer to the Western Australian Economic and Industry Committee's 'Inquiry into the *Franchising Bill 2010*' (Inquiry).

Please find enclosed the Department of Innovation, Industry, Science and Research's (Department of Innovation) submission to the Inquiry.

Please feel free to contact me if you have any questions in relation to this submission.

The Department of Innovation appreciates the opportunity to address the Committee's terms of reference and wishes the Committee well in its deliberations.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Barry Jones'.

Barry Jones
A/g Deputy Secretary

19 January 2011



Australian Government

Department of Innovation
Industry, Science and Research

**The Western Australian Economics
and Industry Standing Committee
inquiry into the Western Australia
Franchising Bill 2010**

**Submission by the Department of
Innovation, Industry, Science and
Research**

January 2010

Overview

The Department of Innovation, Industry, Science and Research (Department of Innovation) regularly engages with the franchising sector and provides policy advice to the Commonwealth Minister for Small Business on franchising matters, given the sector's small business focus. At the Commonwealth level the Franchising Code of Conduct (Franchising Code) is a mandatory code under the *Competition and Consumer Act 2010* (Competition and Consumer Act).

The franchising sector has been the subject of four inquiries both at the State and Commonwealth level over the space of three years. The Department of Innovation assisted with the implementation of regulatory changes to the Franchising Code which came into effect on 1 July 2010. These reforms to the Franchising Code stem from the Government's responses to the two most recent Commonwealth reports on franchising and related matters – the 2008 Parliamentary Joint Committee on Corporations and Financial Services' report, *Opportunity not opportunism: improving conduct in Australian franchising* (Joint Committee report), and a 2010 Expert Panel report, *Strengthening statutory unconscionable conduct and the Franchising Code of Conduct* (Expert Panel report).

The Department of Innovation also assisted with the implementation of the outcomes of an earlier review of the disclosure provisions of the Franchising Code, undertaken in late 2006. Following this review, the Franchising Code was amended to increase the transparency, quality and timeliness of disclosure of information by the franchisor to existing and prospective franchisees. The amendments came into effect on 1 March 2008.

The Commonwealth Government's detailed consideration and response to the main issues raised in recent Commonwealth reviews of the Franchising Code is publicly available at:
<http://www.innovation.gov.au/SmallBusiness/CodesOfConduct/Pages/FranchisingCodeofConduct.aspx>.

Background

The Franchising Code prescribes certain minimum conditions in franchise agreements, requires franchisors to disclose specific facts to franchisees and to follow set procedures to assist franchisees undertake their due diligence prior to entering into the franchise agreement. The Franchising Code also prescribes a dispute resolution procedure. The Department of Innovation administers the contract for the Government funded Office of the Franchising Mediation Adviser (OFMA). OFMA was set up in 1998 and offers mediation services to assist franchisors and franchisees resolve their disputes through mediation.

The Australian Competition and Consumer Commission (ACCC) is responsible for investigating complaints and, where necessary, taking enforcement action against anyone who fails to comply with the Competition and Consumer Act, including the Franchising Code.

There have been a small number of vocal proponents of further franchising reforms on the basis that the sector is characterised by significant disputation between franchisees and franchisors.

The Department of Innovation notes that disputes between businesses are not uncommon in the broader Australian business environment. A survey of small business disputation (excluding the franchise sector) released by the Department of Innovation on 18 November 2010 notes that about 6.5 per cent of small businesses reported a serious dispute that required either legal or third party involvement.¹

The Department of Innovation monitors industry representations and OFMA statistics with a focus on identifying any systemic problems faced by the franchising sector. The Department is also guided by ACCC

¹ The media release by Senator the Hon Nick Sherry, Minister for Small Business on 18 November 2010 which discusses the survey can be accessed at: <http://minister.innovation.gov.au/sherry/Pages/SURVEYSHEDSLIGHTONSMALLBUSINESSDISPUTES.aspx>.

data on the enquiries it receives from the franchising sector and records in its national database, as well as the Griffith University surveys of franchising.²

The 2010 Griffith University Franchising Survey states that although franchise agreements are typically for a five year term, franchisees remain in the system for a median of seven years. The latest ACCC report from 1 May 2010 to 30 September 2010 indicates that 1.2 per cent of the total approaches (from business and consumers) to the ACCC relate to franchising. In addition, the number of dispute enquiries received by OFMA each year is generally stable, averaging around 330 enquiries each year since the establishment of OFMA in 1998. Where franchisees and franchisors do experience problems, OFMA exists to help them. OFMA has a success rate of around 75 per cent in mediation. There are almost 70,000 franchise businesses in the sector. Taken together, the figures would appear to indicate that the majority of franchisors and franchisees who access mediation services when they do face disputes want to work together to achieve commercial success.

ISSUES

As part of its response to the Joint Committee report, the Government recognised that certain issues faced by franchisees can be particularly devastating given the length of some franchise business relationships. Submissions to the Joint Committee noted that where the franchisee has invested substantial resources and spent the larger part of their working life in operating the franchise business, they have likened the end of the franchise relationship to a personal relationship breakdown or even death. Other franchisees in the network also suffer as a consequence of the negative publicity associated with disputes (brand damage).

The Franchising Code was introduced, in part, in recognition of the imbalance in bargaining power between franchisors and franchisees. The objective of the Competition and Consumer Act is to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection. The Franchising Code contributes to the overall objective of the Competition and Consumer Act by ensuring transparency in dealings between franchisees and franchisors. The policy underpinning the Franchising Code recognises that informed decision making by businesses furthers competition in the Australian market, which contributes to consumer welfare.

The Franchising Code does not prohibit both parties from pursuing their own individual interests nor does it prohibit normal commercial dealings which may be perceived as disadvantaging one party over the other. The policy underpinning the Franchising Code recognises that while franchisees should benefit from minimum disclosure and procedural requirements that must be followed by franchisors in their dealings with them, the Franchising Code provisions should not unreasonably constrain franchisors from making business decisions in not only their own interests, but also for the benefit of the entire franchise system.

Unreasonably constraining commercial business decisions, additional compliance burdens and costs imposed on franchisors may result in sub-optimal investment in franchising if franchisors, unable or unwilling to absorb the risk, pass it on to franchisees in the form of extra fees for joining the system. An increase in the compliance burdens for the sector may also act as a disincentive for franchise business growth by constraining business decisions and, accordingly, consumer welfare could suffer.

The main policy rationale behind the Commonwealth Government's recent changes to the Franchising Code is to achieve a balance between appropriate disclosure of key elements of the franchise agreement for franchisees without imposing undue compliance burdens on businesses.

Accordingly, the recent changes to the Franchising Code were drafted to address specific problems, with a focus on behavioural standards and disclosure. They were also drafted so that they could be clearly interpreted by industry participants, enforcement agencies and by the Court. Being in the nature of light-touch regulation, the changes are not intended to be punitive.

² Frazer, L et al. Franchising Australia 2010 Survey, Asia-Pacific Centre for Franchising Excellence, Griffith University, 2010

The Franchising Code does not seek to confer substantive contractual rights on franchisees beyond minimum conditions that are aimed at increasing transparency in dealings between franchisees and franchisors and improving franchisees' due diligence. For example, there is no automatic right of renewal of franchise agreements for franchisees provided under the Franchising Code. In accordance with the policy rationale underpinning the Franchising Code as outlined above, the Government response recognised that any commercial terms under a franchise agreement were matters for negotiation between the individual parties in question.

The Department of Innovation provides comments from a policy perspective against the key issues to be considered by the Committee in accordance with its terms of reference. The Department of Innovation is unable to comment on the first element (concurrent operation of the Franchising Code and the WA Franchising Bill) given that the issue is a matter of legal opinion.

Good faith

The WA Franchising Bill includes a good faith requirement which states that all parties must act fairly, honestly, reasonably, and cooperatively in any dealing or negotiation in connection with a franchise agreement.

The Joint Committee recommended the inclusion of a broad and undefined reference to good faith in the Franchising Code (Recommendation 8). The Commonwealth Government response did not support the inclusion of an undefined reference to good faith in the Franchising Code. Since the law on good faith is still evolving, there is not a single definition or standard set of behaviours that constitutes good faith. Since good faith could not be defined and, given that proposals for the inclusion of a good faith obligation in the Franchising Code have been motivated by disputes over specific issues that arise during the term of a franchise agreement, the Government considered the best way to proceed was to identify those issues and implement policies to deal directly with those behaviours.

Additionally, appreciating that the common law on good faith continues to develop, the Commonwealth Government's recent amendments to the Franchising Code provide that nothing in the Code limits any common law obligation of good faith that applies to the parties to a franchise agreement.

In terms of the definition of good faith in the WA Franchising Bill, in any given situation, one party's view on what amounts to 'fair, honest, reasonable or cooperative' conduct is likely to differ from the other party's. Businesses would need to take court action to determine what 'good faith' means for them and whether parties have acted in good faith. This is likely to result in compliance costs and uncertainty for franchise businesses.

A statutory obligation of good faith is not consistent with current Government policy on making industry codes of conduct enforceable under the Competition and Consumer Act. The Commonwealth Government policy is that Code requirements should be drafted to address specific problems. Codes should be drafted in terms of requirements and obligations, not aims and ideals. Enforceable provisions within codes of conduct under the Competition and Consumer Act must be drafted in clear, unambiguous language that can be clearly interpreted by industry participants, consumers, investigators and by the Court.

Specific behavioural concerns that generally motivated proposals from franchisee representatives for the inclusion of a good faith obligation in the Franchising Code were:

- franchisee uncertainty over end-of-term arrangements;
- obstructive conduct by parties in approaching dispute resolution under the Franchising Code;
- capital expenditure imposed on franchisees that was unanticipated or unforeseen by the franchisee;
- unilateral contract variation by the franchisor;
- attribution of legal costs by the franchisor to the franchisee;
- confidentiality agreements imposed on the franchisee by the franchisor; and
- franchisor initiated changes to the franchise agreements when a franchisee is trying to sell the business.

The latter five behaviours were referred by the Government to the Expert Panel for further consideration and advice. The Government fully endorsed the findings of the Expert Panel. Changes to the Franchising Code arising from the Government response to the Expert Panel report require franchisor disclosure of:

- the circumstances in which unilateral variations to franchise agreements may take place and the circumstances in which the franchisor has unilaterally varied a franchise agreement in the past three financial years;
- whether the franchisor will require the franchisee through the franchise agreement, the operations manual (or equivalent), or any other means, to undertake significant capital expenditure that was not disclosed by the franchisor before the franchisee entered into the franchise agreement;
- whether the franchisor will consider any significant capital expenditure undertaken by the franchisee during the agreement, in determining the arrangements that apply at the end of the agreement (for example, renewal of the franchise agreement);
- whether the franchisor, during the last three financial years, considered any significant capital expenditure undertaken by franchisees, in determining the arrangements to apply at the end of their agreements;
- the fact that the franchise agreement could be changed even when the franchisee is trying to sell the business;
- whether the franchisor will attribute their costs, incurred in dispute resolution, to the franchisee; and
- whether franchisees may be subject to confidentiality agreements.

In addition, the Government recognised the need to encourage parties to a franchise dispute to approach their dispute in a reconciliatory manner. The Franchising Code has been amended to include a list of behaviours that would facilitate mediation between parties to a franchise dispute. This list of behaviours is similar to the list of behaviours expected in 'good faith' collective bargaining under the *Fair Work Act 2009*, for example, participating in meetings at reasonable times.

In discussing the insertion of a good faith obligation into the Franchising Code, some stakeholder submissions to the Joint Committee report asserted that inserting a good faith obligation in the Code would assist franchisees in situations where a franchisor did not renew a franchise agreement. However, the insertion of a broad good faith obligation within the Franchising Code is unlikely to provide any rights in relation to renewal of franchise agreements beyond what is agreed in the franchise agreement. If the obligation to act in good faith were expressed in very general terms, it may provide little practical protection to the parties to a franchise agreement. The law on good faith recognises that parties are not prevented from acting in pursuit of their commercial interest and does not require a party to restrict decisions and actions reasonably taken which are designed to promote the legitimate interests of a party and which are not otherwise in breach of an express term of their contract.³ Therefore, any statutory obligation of good faith would not assist franchisees in achieving such a right to renewal. At worst, a statutory obligation of good faith would create a false sense of expectation that the obligation would provide rights under the franchise agreement that were not negotiated between the parties in the first place. A broad obligation to act in good faith is unlikely to confer a right of renewal for franchisees under a franchise agreement if it is not expressly provided in the agreement.

Civil monetary penalties

The WA Franchising Bill allows for penalties to be granted by the State courts. The penalties must not exceed \$100,000 for a body corporate, or \$10,000 for an individual.

As noted above, industry codes seek to include mutual obligations by way of information exchange and disclosure on businesses within a sector, such as franchising. Therefore, the Government did not consider it appropriate to impose punitive measures in the Franchising Code on the business sector for breaches of industry codes given that industry codes are in the nature of light-touch regulation.

The Government has included financial penalties for breaches of the *Australian Consumer Law* (the ACL, which commenced on 1 January 2011 and is found in Schedule 2 of the Competition and Consumer Act), which

³ See for example *Jobern Pty Ltd v BreakFree Resorts (Victoria) Pty Ltd & Ors* [2007] FCA 1066, per Gordon J.

includes prohibitions on unconscionable conduct, misleading and deceptive conduct, false and misleading representations and other specifically prohibited conduct which can protect those entering into franchising agreements. The ACL is a single national fair trading and consumer protection law, which applies as both a law of the Commonwealth and of each State and Territory. As such, it is enforced and administered jointly by the ACCC, Australian Securities and Investment Commission (ASIC) and the state and territory consumer agencies.

Breaches of the unconscionable conduct and unfair practices provisions of the ACL may be penalised by civil penalties of up to \$1.1 million for corporations and \$220,000 for individuals. Less serious instances of conduct in breach of the ACL may also be dealt with through infringement notices, which allow the regulator to seek the payment of a penalty of \$66,000 for a listed corporation, \$6,600 for other corporations and \$1,320 for individuals, without the need for court proceedings.

The ACL also provides for a range of other tools which may be used to deal with franchising issues, including:

- the issuing of substantiation notices by the ACCC, ASIC or a state or territory consumer agency to request information to substantiate claims made by that person or business in the marketplace; and
- the issuing of public warning notices by the ACCC, ASIC or a state or territory consumer agency to inform the public about conduct by named persons which may be in breach of the ACL.

The ACCC, ASIC and the state and territory consumer agencies have jointly developed and published guidance on the ACL, including a guide to compliance and enforcement, which is available at www.consumerlaw.gov.au.

The Department of Innovation also notes that supporting financial penalties for breaches of industry codes opens up the possibility of such penalties applying to franchisees as well as franchisors for inadvertent breaches of the Code. Furthermore, it can be considered that for trivial breaches of the Franchising Code (for example where a franchisor provides an out-of-date copy of the Code to a franchisee (clause 10)), such penalties would be disproportionate to that breach.

Injunctions and Damages

The provisions of the WA Franchising Bill, which provide for injunctions and damages, appear to be duplicative given that such provisions already exist under the Commonwealth legislative regime.

A breach of the Franchising Code is a breach of section 51AD of the Competition and Consumer Act. Section 51AD of the Competition and Consumer Act pertains to contravention of industry codes and states that a corporation must not, in trade or commerce, contravene an applicable industry code.

Any person who has suffered loss or damage as a consequence of a breach of section 51AD of the Competition and Consumer Act may take private action to recover damages under section 82. Remedial orders under section 87 and injunctions under section 80 are also available.

The application of remedies for breaches of the Franchising Code under the Competition and Consumer Act is ultimately the court's decision. The courts may order the following remedies:

- injunctions (to prevent the continuation/repetition of prohibited conduct or to require a person to do a specific act or thing) (**section 80**);
- payment of damages by one party to another (**section 82**); and
- other orders, including: (**section 87**):
 - declaring the whole or part of a contract void;
 - varying contracts or arrangements;
 - directing the person who has contravened the Code to refund money or return property;
 - undertaking repairs or supplying parts; and
 - providing specified services.

Under the Competition and Consumer Act, the ACCC may now also seek redress from the Federal Court of Australia on behalf of a group of franchisees for breaches of either the Franchising Code or the Act.

The existing civil remedies and enhanced enforcement tools will together comprise a flexible and robust enforcement package, ensuring that industry codes, such as the Franchising Code, have the desired effect on the industries to which they apply.

Redress orders (renewal)

The WA Franchising Bill has an option for a court ordered renewal of a franchise agreement, with the terms of the previous agreement applying, if it is found that the franchisor is not acting in 'good faith'.

Issues relating to the renewal of franchise agreements were also considered by the Commonwealth Government, separate to the issue of the duty of parties to a franchise agreement to act in good faith. The Commonwealth Government did not support an automatic right to renew or the requirement for good cause to be shown for not renewing a franchise agreement. The Government response noted that both franchisors and franchisees should be entitled to decline to renew franchise agreements on expiration, if that is their choice.

Instead, the Government recognised that parties' expectations about renewal need to be better managed, and the financial implications of non-renewal need to be better understood, before fixed term franchise agreements are initially signed. As part of the Government's reforms of the Franchising Code, franchisors will now be required to:

- disclose end-of-term arrangements, including any right of renewal, to prospective franchisees;
- clearly spell out – at the time of entering the franchise agreement – the process for the sale of the business (including if an exit payment will be determined or earned); and
- inform franchisees six months before the end of the agreement whether or not they intend to renew (pre-expiry notice period).

The Department of Innovation notes that a pre-expiry notice period was considered in the report following the *Inquiry into the Operation of Franchise Businesses in Western Australia* (WA Report), delivered in April 2008. The need for a notice period was subsequently considered and accepted by the Commonwealth Government as part of its response to the Joint Committee report as indicated above.

Enhancing the purpose of the Franchising Code of Conduct, which is to regulate the conduct of participants toward each other

The Department of Innovation notes that overall the framework for the WA Franchising Bill aims to confer rights on franchisees and franchisors beyond those negotiated in the franchise agreement. For example, a right of renewal of the franchise agreement if the parties are not acting in 'good faith'. Given this, the policy framework for the WA Franchising Bill would be inconsistent with the current policy framework underpinning the Franchising Code.

Cost impact on the state or participants in franchising

The Department of Innovation notes recent media coverage which states that, as a result of the WA announcements, franchise giant Quick Service Restaurant Holdings has threatened to move its corporate headquarters and 3,800 jobs to the eastern seaboard if the WA Franchising Bill is approved by the state's Parliament.⁴ It is also reported that Snap Printing has indicated that it would consider relocating its head office interstate if the Bill becomes law. The prospect of separate state-based franchising legislation creates uncertainty for franchise businesses in those states and national franchise systems that operate across all states. They face the prospect of regulatory duplication and additional compliance burdens. These reforms are also likely to act as a disincentive for franchisors to grow their operations or open new operations in Australia because of the compliance costs of ascertaining their rights and obligations under differing legislative and regulatory schemes across Australia.

⁴ 'Franchisor threatens to move headquarters in protests over WA franchising laws, survey examines franchise disputes', James Thomson, *Smart Company*, 11 November 2010.

The Department of Innovation notes that to provide the sector with stability and confidence following the recent comprehensive reviews of the Franchising Code, the Commonwealth Government has indicated that it does not intend to review the Code again before 2013. The Government has noted that this would also allow sufficient time for the recent changes to the Franchising Code to operate in order to allow their effectiveness to be evaluated. This will also allow time for the ACCC to gather information in its role as enforcer of the Code; information which will assist in the future review of the Code.

Dispute resolution pre-entry education, and other Government supported initiatives

The Department of Innovation notes that while the terms of reference for the Committee do not require it to consider dispute resolution and pre-entry education for the franchise sector, these issues have featured heavily in recent inquiries both at the state and Commonwealth level. In addition, there were calls for better statistics on the franchising sector so that industry, academics, policy-makers and administrators had a better understanding of the stability of the sector. Accordingly, the Department will comment briefly on these issues.

Franchisees in their submissions to the Joint Committee noted their concerns with the poor quality advice they received from professionals prior to entering into a franchise agreement and being overwhelmed by the amount of information they received in their pre-contractual disclosure. Some franchisees also suggested that they may have entered into an agreement on the basis of the franchisor overselling the benefits of a franchise system. These issues were considered further by the Expert Panel who recommended a plain-English disclosure statement.

As recommended by the Expert Panel, franchisors have been asked by the Government to voluntarily provide prospective franchisees with a short, simple, plain-English document which sets out their rights and responsibilities. This short document would be additional to the current disclosure requirements under the Franchising Code and would emphasise the key costs, benefits and risks of the franchise system. The Department of Innovation notes that Griffith University has taken the lead on developing a *pre-entry franchise education program* which, consistent with the aims of the plain-English document, equips franchisees with relevant information. This will assist franchisees to make informed decisions before investing in a franchise system.

Griffith University and the ACCC collaborated to develop this *pre-entry franchise education program* for prospective franchisees. The program was launched on 1 July 2010 and to date more than 1000 people have registered. The program is offered free of charge to prospective franchisees (and other interested parties) and consists of a series of five eClasses that are accessible over the internet in a multi-media format. These modules broadly cover the regulatory environment, disclosure, franchisee fees, support services, intellectual property, site and territory selection, retail leasing, marketing and operations manual. Undertaking this online, interactive education program may reduce the risk of unrealistic expectations and surprises arising after a franchisee buys into a franchise.

Early Intervention Dispute Resolution Service

As part of the 2010-11 Budget, the Government announced \$2.7 million in funding to support the introduction of the early intervention service for businesses operating under the Franchising Code and the Horticulture Code of Conduct and the continuation of the existing dispute resolution services under various industry codes of conduct. This service is expected to be delivered in early 2011-12.

ARC Linkage Grant

Griffith University was awarded an Australian Research Council (ARC) Linkage Grant in 2009, which involves collaboration between the Department of Innovation, Griffith University and the Franchise Council of Australia (FCA). The ARC Linkage Grant was awarded to Griffith University to assist with research on survival factors for franchisees and independent small businesses during periods of economic uncertainty.

The Department of Innovation is a partner organisation in this project and has committed \$50,000 over two years. This contribution demonstrates the Government's commitment to further research in the franchise area to inform the policy underpinning the Franchising Code.

Griffith University's research in this area will add to the work previously undertaken by the University in gaining a better understanding of the sector, including the ARC and ACCC commissioned research into conflict in the franchising sector. That research produced an analysis of the most effective methods for anticipating and avoiding conflict. The survey results were aimed at assisting the ACCC with its education efforts in relation to the sector.