

11 May 2018

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: corporations.joint@aph.gov.au

Dear Committee Secretary

The operation and effectiveness of the Franchising Code of Conduct

The Small and Medium Enterprise Committee of the Business Law Section of the Law Council of Australia (**Committee**) is pleased to make this submission in response to the Parliamentary Joint Committee's enquiry into *The operation and effectiveness of the Franchising Code of Conduct (FCC)*.

The Committee has as its primary focus the consideration of legal and commercial issues affecting small businesses and medium enterprises (**SMEs**) in the development of national legal policy in that domain. Its membership is comprised of legal practitioners who are extensively involved in legal issues affecting SMEs.

Responses

(a) the operation and effectiveness of the Franchising Code of Conduct, including the disclosure document and information statement, and the Oil Code of Conduct, in ensuring full disclosure to potential franchisees of all information necessary to make a fully-informed decision when assessing whether to enter a franchise agreement, including information on:

(i) likely financial performance of a franchise and worse-case scenarios,

Committee members note that many franchisors simply choose not to provide franchisees with any meaningful information about the likely financial performance of the franchise business, particularly if they are "greenfield" sites or territories. Rather, both franchisors and various franchising advice bodies encourage franchisees to speak to as many existing franchisees as possible to obtain information about the likely financial performance of their franchise and the franchise system more generally.

Committee members are concerned that advising prospective franchisees to speak to existing franchisees about issues such as likely financial performance may result in those existing franchisees becoming exposed to legal liability for misrepresentation or omission, albeit unintentional, which they have gratuitously provided to the prospective franchisee. Based on our experience, most existing franchisees who do provide information to

prospective franchisees in this way do not appreciate that they may in fact be incurring potential legal liability.

(ii) the contractual rights and obligations of all parties, including termination rights and geographical exclusivity,

In our experience, the contractual rights and obligations of the parties to a franchise agreement remain highly skewed in favour of the franchisor. Many franchise agreements still provide franchisors with an ability to make unilateral decisions, at their complete discretion, about key terms of the agreement.

Whilst the Unfair Contract Terms (**UCT**) legislation for small business has had, and will continue to have, some impact in relation to such terms, the lack of any retrospective effect means that many UCTs have remained in force in franchise agreements entered into prior to 12 November 2016.

Furthermore, the UCT's laws will have no impact on UCTs contained in evergreen/perpetual franchises agreements entered into prior to 12 November 2016. Effectively, UCT provisions in evergreen/perpetual franchise agreements will remain in effect and enforceable against franchises in perpetuity.

In the Committee's view, consideration should be given to the steps which can be taken to address the existence of UCTs in evergreen/perpetual franchise agreements.

(iii) the leasing arrangements and any limitations of the franchisee's ability to enforce tenants' rights, and

The Committee had no observation to make in relation to this topic.

(iv) the expected running costs, including cost of goods required to be purchased through prescribed suppliers;

The Committee had no observation to make in relation to this topic.

(b) the effectiveness of dispute resolution under the Franchising Code of Conduct and the Oil Code of Conduct;

A significant anomaly which exists in relation to the dispute resolution provisions of the Code relates to evergreen/perpetual franchise agreements.

Clause 22 of the FCC provides:

A franchise agreement must not contain a clause that requires the franchisee to pay to the franchisor costs incurred by the franchisor in relation to settling a dispute under the agreement, and if it does, the clause is of no effect.

However, the above clause only applies to franchise agreement entered into from 1 January 2015 – see subclause 3(4) of the FCC.

As a result, many franchise agreements entered into prior to 1 January 2015, including a significant number of evergreen/perpetual franchise agreements, currently contain clauses which require that the franchisee pays all of the costs of settling a dispute under the agreement, often on an indemnity basis.

The following is an example of such a clause, which has been taken from a franchise agreement of a large national franchise organisation with over 100 perpetual franchise agreements:

Legal Costs

Upon the occurrence of an event of default by the Franchisee, the Franchisor will be entitled to recover from the Franchisee in addition to any applicable claim plus interest, legal fees, costs and expenses incurred by the Franchisor as a result of such default on an indemnity basis.

Committee members are aware of franchisees using such dispute recovery cost clauses as a means of pressuring franchisors to resolve legitimate disputes as quickly as possible, in a manner which is highly advantageous to the franchisor. In effect, franchisees are concerned at being liable not only for their own legal costs, but also for the franchisor's legal and other costs incurred in resolving a dispute.

(c) the impact of the Australian consumer law unfair contract provisions on new, renewed and terminated franchise agreements entered into since 12 November 2016, including whether changes to standard franchise agreements have resulted;

Based on Committee members' experience, the new UCT laws for small business have had a significant impact on the terms contained in the franchise agreements offered by larger, national franchisors. The impact of UCT laws in the agreements of smaller, more regionally based franchisors, has been more varied.

The Committee believes that the Australian Competition and Consumer Commission (**ACCC**) and other relevant regulators may need to undertake further educational activity in relation to small franchisor sector to reinforce their understanding of their obligation to ensure that franchise agreements comply with UCT laws. One approach to achieve this outcome may be for the ACCC to reach out to the primary legal and financial advisors to this sector, namely suburban solicitors and local accountants.

d) whether the provisions of other mandatory industry codes of conduct, such as the Oil Code, contain advantages or disadvantages relevant to franchising relationships in comparison with terms of the Franchising Code of Conduct;

The Committee does not believe that other mandatory codes of conduct contain advantages or disadvantages which are relevant to franchising relationships.

(e) the adequacy and operation of termination provisions in the Franchising Code of Conduct and the Oil Code of Conduct;

Overall the termination provisions of the FCC are adequate.

Having said that, Committee members are aware of some confusion amongst franchisors and franchisees alike over the precise meaning of paragraph 29(1)(g). This paragraph provides that a franchisor can terminate a franchise when the franchisee:

(g) acts fraudulently in connection with the operation of the franchised business.

It appears to Committee members that some franchisors interpret this clause to apply to relatively minor instances of non-compliance by the franchisor. In effect, some franchisors

see any instance of dishonest conduct by a franchisee as constituting a fraudulent act without recognising that a much higher evidentiary onus applies to allegations of fraud.

(f) the imposition of restraints of trade on former franchisees following the termination of a franchise agreement;

The Committee considers the restraint of trade provisions of the FCC as contained in clause 23 to be adequate. The only observation concerning this issue is that from our experience these provisions are not well understood by franchisees at the time they enter into their franchise agreement. Whilst termination of a franchise agreement is different to the expiry of an agreement, the Committee is not advocating any need to extend the application of clause 23 to termination.

(g) the enforcement of breaches of the Franchising Code of Conduct and the Oil Code of Conduct and other applicable laws, such as the *Competition and Consumer Act 2010 (Cth)*, and franchisors;

The ACCC's level of activity in investigating and taking enforcement action in relation to breaches of the FCC, and other mandatory codes, remains low. The following information (which has been taken from the ACCC's website) shows the level of ACCC enforcement action in relation to the FCC over the last eight years:

Year	Enforcement actions
2010	5
2011	0
2012	0
2013	0
2014	2
2015	2
2016	1
2017	5
Total	15

Source: <https://www.accc.gov.au/business/industry-codes/franchising-code-of-conduct/franchising-code/franchising-investigations>

In other words, the ACCC has taken 15 enforcement actions in the franchising sector over the last eight years.

In addition, many of the ACCC enforcement actions have been against small franchisors, with limited market presence and little brand recognition.

Accordingly, the Committee questions the level of general deterrence which the ACCC has been able to achieve through a handful of enforcement actions against largely unknown franchise systems.

The Committee also understands that in recent times the ACCC has issued approximately ten section 51ADD random compliance check notices a year. As has been noted in other submissions to this enquiry, this is a very low number of compliance checks given there are approximately 1100 franchise systems in Australia.

The Committee is not aware of any ACCC enforcement actions in relation to the Oil Code.

(h) any related matter.

Pre-vetting/post-vetting

Many franchisor/franchisee disputes still emanate from the lack of information or incorrect information contained in disclosure documents. This can be as a result of many factors including ambiguous wording of existing specific items, poor interpretation of what information is required and the degree of aptitude and experience a franchisor or its advisor has in preparing disclosure documents.

Pre-vetting (and post-vetting) would be a useful measure in some form. It would assist to remove interpretation issues and improve baseline disclosure standards. Greater enforcement activity by the ACCC such as increasing their use of the existing section 51ADD power from the current 10 notices per year to a much more significant number should identify patterns of poor disclosure (and unfair contract terms) and ultimately result in more effective compliance.

Grandfathering provisions and evergreen/perpetual franchises

The Committee believes that the Government should be alert to the problem faced by franchisees that are under evergreen/perpetual franchises. Primarily, that the grandfathering of some specific clauses (namely clauses 20(1)(b), 21(2), 22 and 23 of the FCC) that is set out in clause 3(4) only ceases to apply where those evergreen/perpetual agreements are varied or transferred.

Accordingly, one possible proposal to protect franchisees with evergreen/perpetual franchises would be to give consideration to expanding the circumstances in which the grandfathering ceases to apply for example by imposing a final date after which those clauses will apply to every franchise agreement including evergreen/ perpetual franchises even if they have not been renewed or transferred.

Independent advice

An issue of concern to Committee members is the high incidence of franchisees obtaining franchising advice from advisors with limited or in some cases no experience in franchising matters. As a result, the advice received by many franchisees has been of limited value in

terms of the franchisee being able to make an informed decision about whether to enter into the franchise agreement.

Unfortunately, it is also our member's experience that many franchisees who do receive appropriate independent advice, do not heed that advice if it conflicts with their pre-existing desire to enter into the particular franchise agreement.

Marketing funds

The Committee believes that there is anecdotal evidence of a significant degree of non-compliance in the franchise sector in relation to the transparency and administration of marketing funds. Accordingly, in order to improve compliance with these obligations it may be appropriate to make clause 31 of the FCC a civil penalty provision. Clause 31 of the FCC sets out the rules for operating the marketing fund including the types of expenses which may be legitimately incurred. Relevantly, only clause 15 of the FCC, which governs the preparation and distribution of marketing and cooperative fund financial statements is a civil penalty provision.

A further concern is the lack of guidance which currently exists in relation to the content of audit statements for marketing and cooperative funds. The Australian Audit and Assurance Standards Board (**AUASB**) has prepared a guidance document (*GS018*) in relation to Item 21 of Annexure of the FCC. However, no similar guidance exists in relation to clause 15. Accordingly, it may be appropriate for the Government to direct the AUASB to prepare a guidance document in relation to the auditing of marketing and cooperative funds under clause 15 of the FCC.

Non-renewal

The Committee is aware that non-renewal of a franchise is currently a significant area of dispute in the franchising industry. The Committee believes that these disputes arise from a lack of clarity in the drafting of the end of term clauses of the FCC that deal with the end of term issues including good faith and end of term notices.

End of term

In the Committee's view, the drafting used to give effect to the recommendations arising from the Wein review of the FCC is in many places inconsistent and unclear. We believe that the Government should seek to improve the clarity of terminology in clauses 6, 18, 23, and Item 18 to ensure consistency. There is also a need to clarify whether an agreement reached to hold over a franchise after expiry on a month by month (or lesser term) basis is or is not intended to be included within the definition of "extend". This applies to agreements which may have a holding over clause, as well as those that do not contain a holding over clause.

Cooling off and non-refundable money

The Committee also believes that the drafting used in clauses 9(1) and 10(1)(e) of the FCC is inconsistent. A franchisor and prospective franchisee should clearly know when a non-refundable payment (such as to cover legal costs for the preparation of a disclosure document) can be retained by the franchisor. The lack of consistency is also reflected in the drafting of clause 26 of the FCC and when the cooling off right arises in circumstances when a payment is made before an agreement is entered into. These issues need to be made much clearer.

Under the FCC, a franchisor is required to give disclosure in Item 14.1 and 14.2 about the franchisee's right to a refund of money paid before an agreement is entered into. In many cases, the information disclosed by franchisors about the refund right may mislead a prospective franchisee into believing a payment (in whole or in part) is non-refundable when it is in fact refundable.

In our view, paragraph 26(1)(a) is also inconsistent with the warning statement in Item 1.1(e) of the Annexure 1 because the warning statement tells the prospective franchisee that the cooling off period starts when the franchisees "signs the agreement". However, no reference is made to whether the refund period starts earlier when the payment is made before the agreement is entered into. In our experience, this drafting causes immense confusion for franchisors and prospective franchisees but could be fixed quite easily.

Site selection

An issue of particular concern in the franchise sector relates to site selection. While the Committee accepts that prospective franchisees should bear a significant degree of responsibility for undertaking their own research in relation to the viability of an existing franchise business, different considerations should apply in relation to a new or greenfield site.

In many cases the franchisor will have selected the site or territory for a new franchise business (as opposed to being asked to approve a site or territory that a franchisee has selected) after conducting extensive market research. Accordingly, where the franchisor is responsible for the site selection it should bear a higher degree of responsibility for the viability of that particular franchise.

Unfortunately, most franchisors seek to exclude their liability in relation to decisions to establish a new franchise business in a poor location, for example in a shopping centre with very low levels of foot traffic or at a location which is in close proximity to an existing franchise business.

Committee members are aware of large national franchisors which have made very poor site selection decisions and which have refused to acknowledge those poor decisions and to compensate the franchisee accordingly when the franchise failed. For example, one large national franchisor established a new franchise business in a centre at a cost of over \$400,000 without apparently being aware that the shopping centre owner had plans to undertake a complete renovation of the food court area within the next 12 months.

Anomaly in relation to Oil Code

The Committee notes that the Oil Code, which was amended as recently as 1 April 2017, does not contain the "good faith" bargaining provisions that now exist in both the FCC and Horticulture Code, nor the civil penalties regime available to the ACCC under the FCC. In our view, this constitutes a significant anomaly as all of the disputes currently being dealt with under the Oil Code are franchising disputes which pursuant to paragraph 3(2)(a) of the FCC must be dealt with under the Oil Code.

The Committee would be pleased to discuss this submission, if that would be helpful.

Please contact, Meghan Warren, the Chair of the SME Committee on in the first instance, on 0439 467 800 or mwarren@burkes-law.com if you require further information or clarification.

Yours sincerely

A handwritten signature in black ink, appearing to read 'RMS', written in a cursive style.

Rebecca Maslen-Stannage
Chair, Business Law Section