

Commonwealth Government Response to the
report of the Parliamentary Joint Committee on
Corporations and Financial Services

***Opportunity not opportunism: improving
conduct in Australian franchising***

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Overview and executive summary

On 1 December 2008, the Parliamentary Joint Committee on Corporations and Financial Services (Joint Committee) tabled its report *Opportunity not opportunism: improving conduct in Australian franchising*. The Joint Committee considered that, by making the improvements to the Franchising Code of Conduct (Franchising Code) recommended in its report and by allowing the 1 March 2008 amendments to have an impact, the existing regulatory framework is developing into the most appropriate mechanism for fostering franchising in Australia. The Joint Committee made 11 recommendations to improve the operation of the Franchising Code.

The Government would like to thank the chair, Bernie Ripoll, and all members of the Joint Committee for the report. The Government would also like to thank those organisations and individuals who made written submissions, gave evidence at the Joint Committee's public hearings and engaged in Government consultations to assist in informing the response to the Joint Committee's report. The Government also acknowledges state parliamentary inquiries undertaken in Western Australia and South Australia.

The Joint Committee found that franchising has proved a very popular business model in Australia. According to a Griffith University Survey¹ of franchising in Australia in 2008 there are approximately 1,100 business format franchisors and over 70,000 franchisees, turning over around \$61 billion (in 2007)² and employing over 400,000 people. For franchisees, the appeal of a franchise is the potential benefits of being able to conduct a business under an established brand name using tested operational systems. In turn, franchisors are able to grow their business by allowing others to use the model they have developed, within an agreement that allows them to retain substantial control over its use but without the financial risks of significant capital expenditure.

Despite the popularity of franchising in Australia, the Joint Committee's report did find that the viability and success of individual franchise agreements can be impaired by:

- differing expectations about the obligations of each party to a franchising agreement; and
- an asymmetric power dynamic within franchise agreements, with potential to lead to abuse of power.³

¹ Frazer, L et al. *Franchising Australia 2008 Survey*, Asia-Pacific Centre for Franchising Excellence, Griffith University.

² When car dealerships and franchised fuel outlets are included, turnover increases to \$130 billion.

³ Parliamentary Joint Committee on Corporations and Financial Services "*Opportunity not opportunism: improving conduct in Australian franchising*" (December 2008) pxxiii.

The Government recognises the legitimate concerns that were raised during the Joint Committee's inquiry and understands the need for parties to a franchise agreement to behave in a reasonable manner. It also recognises that franchising by its very nature is a commercial relationship covering a diverse range of market requirements. As such, there must be flexibility in the franchising system to encourage innovation and growth, but commercial negotiations must be undertaken without blatant and unfair commercial practices.

The Government's response to the Joint Committee report is outlined below.

1. Improvements to the enforcement of the Franchising Code of Conduct and the Trade Practices Act

The Government will introduce a range of new enforcement powers under the Trade Practices Act, including additional powers to enforce the Franchising Code and other mandatory industry codes.

The Government will greatly strengthen protections for franchising businesses against unfair practices by other businesses. Penalties of up to \$1.1 million will apply to franchisors or franchisees who engage in unconscionable conduct, or make false or misleading representations in their dealings with each other, under the *Trade Practices Amendment (Australian Consumer Law) Bill 2009* currently before the Parliament.

The Government will enhance the investigative powers of the Australian Competition and Consumer Commission (ACCC) for franchising by amending the *Trade Practices Act 1974* (Trade Practices Act) to allow the ACCC to conduct random audits for the Franchising Code (and all other prescribed industry codes). At present, franchisees wishing to complain about franchisors not complying with the Franchising Code may fear reprisal from franchisors. The ACCC's random audit powers will strengthen franchisor compliance with the Franchising Code, while relieving franchisees of the fear of retaliation against them for complaining to the ACCC about franchisor behaviour.

Further, the Government will extend the public warning power available under the *Trade Practices Amendment (Australian Consumer Law) Bill 2009* to include breaches of the Franchising Code and other industry codes. This warning – or naming and shaming – power will alert the public to rogue or unscrupulous franchisors.

Under the reforms, where a large number of franchisees are harmed by the behaviour of a franchisor in breach of the Franchising Code, the ACCC will be able to apply for an order providing redress to all the franchisees, without requiring every franchisee to be party to the legal proceedings.

Finally, under the reforms, the ACCC will be able to issue substantiation notices. These notices will enable the ACCC to quickly and easily require businesses to provide information to substantiate claims they have made. They will be an effective means of seeking information which will assist in determining whether a contravention of the Franchising Code or other codes has occurred.

These powers will be added to the existing remedies for breaches of industry codes which include:

- injunctions under section 80 of the Trade Practices Act;
- damages under section 82;
- other remedial orders under section 87 and other provisions;
- declarations about the effect or operation of industry codes, under section 163A;

The Government will introduce legislation to enact this enhanced enforcement package in early 2010.

2. Measures to better balance the rights between franchisees and franchisors

The Government recognises the need for measures to deal with imbalances in bargaining power and unreasonable behaviours.

The unconscionable conduct and false and misleading representations sections of the Trade Practices Act will be strengthened and will serve as a powerful disincentive for parties in a franchising arrangement to engage in the most obvious and deliberate breaches of good faith. Amendments to the Trade Practices Act will make it clear that protection from unconscionable conduct relates not only to the process of settling a contract but to the terms and conditions of the contract and the ongoing behaviour of the parties to the contract.

Good faith

The Government agrees in principle with the views expressed in the Joint Committee's report to ensure that franchisors and franchisees undertake their business in good faith. However, it will deliver improvements in a more certain and targeted way. In summary, the Government's response to the Franchise report's recommendations on good faith will:

1. amend the Franchising Code to deal specifically with end-of-term arrangements for all new franchising agreements entered into after the commencement of the amendments;
2. amend the Franchising Code to include a list of necessary and desirable behaviours to encourage parties to approach a dispute resolution process in a reconciliatory manner;
3. refer specific behavioural issues (identified through consultation) to an expert panel for advice on whether further specific amendments to the Franchising Code are required to address those behaviours; and
4. amend the Franchising Code to provide that nothing in the Code limits any common law requirement of good faith in relation to a franchise agreement to which the Code applies.

The Government made a pre-election statement noting its belief that the Franchising Code should include good faith obligations as long as the scope of this obligation is well defined. Concerns were expressed during the consultation process on the options paper which was issued to prepare this response that a general notion of unfairness or of acting in good faith would have the effect of increasing risk, increasing business costs and potentially jeopardising small business financing. Moreover, if the obligation to act in

good faith were expressed in very general and high-level terms, it may provide little practical protection to the parties. The Government's approach would avoid this uncertainty.

Further, proposals from franchisee representatives for the inclusion of a good-faith obligation in the Franchising Code have generally been motivated by specific issues that arise during the term of a franchise agreement such as non-renewal, unforeseen capital expenditure and unreasonable unilateral variations to the agreement.

The Government considers that specific issues identified through the Joint Committee inquiry should be dealt with by measures which will address specific behavioural concerns.

End-of-term arrangements

The Government will amend the Franchising Code to require franchisors to disclose to franchisees the process that will apply in determining end-of-term arrangements, including whether or not there is a right of renewal beyond the term of the agreement. Any exit arrangements should give due regard to the potential transferability of equity in the value of the business as a going concern.

The disclosure of this information is likely to assist in mitigating disputes where one party has an expectation (not shared by the other party) that the franchise agreement will be renewed. It will also help to address imbalances in power between franchisees and franchisors by assisting prospective franchisees to undertake their due diligence to adequately assess the business opportunity prior to entering into a franchise agreement.

The Government will also introduce amendments to the Franchising Code requiring franchisors to inform franchisees, at least six months prior to the end of the franchise agreement, of their decision either to renew or not renew a franchise agreement. Where franchise agreements are for a term less than six months, franchisors will be required to inform franchisees at least one month prior to the end of the franchise agreement of their decision to renew or not renew a franchise agreement.

It is the Government's clear intention that these new end-of-term arrangements will apply for franchise agreements signed after the date of amendments to the Franchising Code. For agreements already in existence, the end-of-term arrangements can be included by the voluntary agreement of both parties but will not be obligatory.

Dispute resolution process

A second major area of concern identified by the Joint Committee was inappropriate practices undertaken by parties in dispute mediation processes. The Government will amend the Franchising Code to include a list of necessary and desirable behaviours aimed at discouraging behaviour which may impede the effectiveness of the dispute resolution process under the Code. This list should help encourage parties to a franchise dispute to approach their dispute in a reconciliatory manner.

Expert panel

Several areas where parties may engage in opportunistic behaviour were identified in the Joint Committee's inquiry process. The Government will appoint an expert panel to inquire into and report on the need to introduce measures into the Franchising Code to prevent specific behaviours that are inappropriate in a franchising arrangement, with particular reference to:

- Unforeseen capital expenditure;
- Unilateral contract variation;
- Attribution of legal costs;
- Confidentiality agreements; and
- Franchisor-initiated changes to franchise agreements when a franchisee is trying to sell the business.

The panel will consult with franchising and retail tenancy representatives, small business organisations, the Australian Competition and Consumer Commission (ACCC) and other interested parties.

The same panel will also inquire into and report on the need to introduce a list of examples that constitute unconscionable conduct, or a statement of principles, in the Trade Practices Act.

3. Other reforms

The Government will change the name of the Office of the Mediation Adviser to the Office of the Franchising Mediation Adviser to aid the sector's understanding of the role of this Office.

The Government supports the public release of broad ACCC data on trends of inquiries and complaints from small businesses and franchising businesses as an indicator of concerns within the franchising sector as compared with small businesses more generally. This, along with other measures discussed in the Government's response, will help increase the Government's understanding of disputation within the franchising sector.

The Government will also introduce amendments to the Franchising Code to require a statement in the disclosure documents that franchising is a business and that like any business the franchise (or franchisor) could fail during the franchise term. The Government will also ask the ACCC to develop additional educational information on the potential consequences and liabilities franchisees could be exposed to in the event of franchisor failure. These changes will alert prospective franchisees and their advisers to the risk of franchisor failure and will assist them in undertaking their due diligence to adequately assess the business opportunity.

The Government will review the efficacy of these amendments, and the 1 March 2008 amendments, in 2013.

Government response

The Joint Committee's recommendations and the Government's response to those recommendations are set out below under the following categories:

- Compliance and enforcement: the Franchising Code of Conduct and the Trade Practices Act (Recommendations 9, 10, 11 and 2);
- Measures to better balance the rights between franchisees and franchisors (Recommendations 8 and 5);
- Mediation (Recommendation 6);
- Franchising statistics (Recommendation 7);
- Franchise failure (Recommendations 1 and 4); and
- Future review of the franchising sector (Recommendation 3).

Compliance and enforcement: the Franchising Code of Conduct and the Trade Practices Act - Recommendations 9, 10, 11 and 2

Recommendation 9

The committee recommends that the *Trade Practices Act 1974* be amended to include pecuniary penalties for breaches of the Franchising Code of Conduct.

Recommendation 10

The committee recommends that consideration be given to amending the *Trade Practices Act 1974* to provide for pecuniary penalties in relation to breaches of section 51AC (Unconscionable Conduct in business transactions), section 52 (Misleading or Deceptive Conduct), and the other mandatory industry codes under section 51AD.

Recommendation 11

The committee recommends that the ACCC be given the power to investigate when it receives credible information indicating that a party to a franchising agreement, or agreements, may be engaging in conduct contrary to their obligations under the Franchising Code of Conduct.

Recommendation 2

The committee recommends that the government investigate the benefits of developing a simple online registration system for Australian franchisors, requiring them on an annual basis to lodge a statement confirming the nature and extent of their franchising network and providing a guarantee that they are meeting their obligations under the Franchising Code of Conduct and the *Trade Practices Act 1974*.

The Government is committed to improving the enforcement regime of the Trade Practices Act and the Franchising Code to ensure that the legitimate interests of franchisees and franchisors are protected.

The Government plans to introduce:

- pecuniary penalties for blatant abuse of a stronger bargaining position;

- targeted enforcement measures for problems in the franchising sector; and
- improved enforcement and investigative powers for the ACCC.

Pecuniary penalties for breaches of section 51AC and 52 of the Trade Practices Act

The *Trade Practices Amendment (Australian Consumer Law) Bill 2009*, introduced on 24 June 2009, will increase the range of penalties and enforcement measures available for the unfair practices and unconscionable conduct provisions of the Trade Practices Act, and these will be applicable in a franchising context.

The Government will introduce civil penalties for breaches of the unconscionable conduct provisions in Part IVA of the Trade Practices Act, including section 51AC. This will allow the ACCC to respond appropriately to egregious conduct, by applying to the Court for a civil pecuniary penalty.

The Government will also introduce civil pecuniary penalties for many of the unfair practices provisions of the Trade Practices Act, such as section 53, which prohibits false or misleading representations in a number of specific circumstances. Because section 53 prohibits more defined conduct than the general norm of conduct in section 52, the Government considers it appropriate to apply civil penalties to this specific conduct. Prohibitions under section 53 that are relevant to the franchising sector include conduct that:

- falsely represents that goods are of a particular standard, quality, value, grade, composition, style or model or have had a particular history or particular previous use (paragraph (a));
- falsely represents that services are of a particular standard, quality, value or grade (paragraph (aa));
- falsely represents that a particular person has agreed to acquire goods or services (paragraph (bb));
- represents that the corporation has a sponsorship, approval or affiliation it does not have (paragraph (d));
- makes a false or misleading representation with respect to the price of goods or services (paragraph (e));
- makes a false or misleading representation concerning the availability of facilities for the repair of goods or of spare parts for goods (paragraph (ea));
- makes a false or misleading representation concerning the existence, exclusion or effect of any condition, warranty, guarantee, right or remedy (paragraph (g)).

When the new arrangements are in effect, the ACCC will be able to apply for civil pecuniary penalties in response to unconscionable conduct and false and misleading representations. Maximum penalties for this conduct will be \$1.1 million for corporations and \$220,000 for individuals.

The Joint Committee recommended that civil pecuniary penalties also apply to section 52 of the Trade Practices Act. The Government does not agree with this recommendation.

Section 52 is a general prohibition of misleading or deceptive conduct in trade or commerce. Because it is a general norm of conduct and not a specific prohibition, there are no criminal sanctions for contraventions of section 52. Provisions which attract criminal liability or civil penalties for breaches are directed at specific wrongdoing which requires sanction, rather than general behaviour. Since section 52 is not directed at specific wrongdoing, the Government does not consider that civil penalties would be an appropriate mechanism for enforcing it, and believes that existing civil remedies are an appropriate response to breaches of section 52.

The availability of civil and criminal penalties for conduct governed by section 53 will provide adequate responses to the most serious misleading and deceptive conduct.

Enforcement of the Franchising Code

Part VI of the Trade Practices Act creates a number of civil remedies which are available to those harmed by a breach of an industry code. A franchisor or franchisee who is adversely affected by the other party's contravention of the Franchising Code could apply for:

- an injunction, under section 80, to prevent the other party from continuing with conduct that is causing detriment;
- damages, under section 82, to restore the wronged party to the financial position it would have been in had the breach not occurred; or
- other orders, under section 87, which can be framed in such terms as the Court thinks will provide appropriate compensation, or prevent or reduce the loss or damage suffered as a result of the breach.

The Government will augment this range of remedies with an enhanced enforcement package for all industry codes, which is described in detail below. Briefly, the new remedies for breaches of industry codes will include:

- non-party redress, allowing the Court to order redress for large numbers of businesses affected by a breach of an industry code. This means that when a large number of franchisees are harmed by the conduct of a franchisor in breach of the Franchising Code, the ACCC will be able to apply for an order providing redress to all effected franchisees, without requiring every franchisee to be party to the legal proceedings.
- substantiation notices requiring persons subject to industry codes to substantiate the claims they make in promoting their goods or services; and
- public warning notices, allowing the ACCC to alert the public to conduct which may be in breach of an industry code.

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. The Government will introduce legislation to enact the enhanced enforcement package in early 2010.

Further, the Government will develop and release a new policy document setting out the framework of Part IVB and the principles used in determining whether codes of conduct are appropriate and how they should be framed. This document will provide guidance to industry, consumer and community stakeholders about the Government's approach to prescribed codes of conduct.

ACCC investigative powers

The Joint Committee recommended that the ACCC be given the power to investigate when it receives credible information indicating that a party to a franchising agreement, or agreements, may be engaging in conduct contrary to their obligations under the Franchising Code. Several industry codes apply to industries characterised by disparities in bargaining power, and this leads to fear that more powerful businesses may threaten reprisal action against less powerful businesses that complain about non-compliance. Under these conditions, less powerful businesses may bring complaints to the ACCC only on condition of anonymity, or may not make complaints at all, and this makes it difficult for the ACCC to monitor industries for compliance with codes.

The Government notes that the ACCC described this power to the Joint Committee as an 'audit power', and agrees that this is an appropriate enforcement mechanism in the context of the Franchising Code, as well as other prescribed industry codes.

The ACCC will be given the power to request copies of documents or other information from persons subject to an industry code. The ACCC will not be required to have any belief about compliance with the Franchising Code before conducting an audit. To minimise compliance costs, the power will be restricted to information that is required to be kept under a prescribed industry code. For example, the ACCC will be able to request a franchisor to produce a copy of its disclosure document. The Franchising Code provides that such a document must be kept, and allowing the ACCC to request copies of disclosure documents, at random, will enable it to ensure compliance with the Code's obligations. The ACCC's random audit powers will also relieve franchisees of the risk of retaliation against them for complaining to the ACCC about franchisor behaviour.

Where the documents obtained by the ACCC uncover information that justifies further investigation, the ACCC will be able to use its existing and additional investigative powers (for example, its power to obtain information, documents and evidence under section 155 of the Trade Practices Act, or the power to issue substantiation notices) to pursue the matter further and, if warranted, take enforcement action.

Pecuniary penalties for breaches of the Franchising Code

The Government has considered the Joint Committee's concerns about the enforcement of the Franchising Code and its recommendation that pecuniary penalties be introduced for breaches of the Code. Industry codes are an important part of Australia's regulatory framework, and it is vital that they are enforced effectively. Industry codes are a more flexible form of regulation that, while not a substitute for direct legislation, involve industry, consumers and other stakeholders in a co-regulatory approach to problems identified in specific industries, including the franchising industry. In order to ensure that industry codes adequately address these problems, as outlined in this response, the Government will act to make their enforcement more effective.

The Franchising Code is designed to ensure franchisees and franchisors treat each other at least with a certain minimum standard of fairness, and the Government's proposed changes to the Franchising Code will improve its effectiveness in promoting fairness and good practice. When a party to a franchise agreement fails to meet that minimum standard, and the other party suffers as a result, it is appropriate that the law provide a mechanism for the wronged party to achieve redress. This redress can be achieved through the payment of compensation or the rectification of contravening conduct.

At this stage, the Government does not propose to introduce civil pecuniary penalties for breaches of industry codes. However, the Government will keep this matter under review and allow time for the extensive improvements which will be made to the Franchising Code to take effect.

Online registration system for Australian franchisors

The Government has investigated the benefits of an online registration system for franchisors and considers that there are two elements to the Joint Committee's Recommendation 2.

The first element of the online registration system proposed by the Joint Committee was to assist those considering entering a franchise agreement and for those monitoring the sector by acting as a research tool and assisting with data collection on the sector.

Based on the *Australian Government Cost Recovery Guidelines* the cost to the Government of establishing a franchisor registration system would need to be covered by a fee which would apply to all businesses within the franchise sector.

Industry input indicates that prospective franchisees, when considering whether to enter into a franchise system, are interested in the performance of that particular franchise system and business rather than broad statistics on the franchising sector. The information (that is the name, nature and size of a franchising system) that would be available to prospective and existing franchisees through a system of franchisor registration is unlikely to provide greater benefit than existing broad statistical information available to the sector through private industry surveys. Therefore, the benefit of a system of registration for the purposes of statistics collection is unlikely to outweigh the cost to businesses within the sector.

The second element of the Joint Committee's proposed online registration system was aimed at improving franchisors' compliance with the Franchising Code. The Joint Committee considered that this could be achieved through an online system of annual registration of Australian franchisors requiring them to lodge a statement providing a guarantee that they are meeting their obligations under the Franchising Code and the Trade Practices Act.

The Joint Committee considered that it is the proper role of legal advisers to determine whether disclosure documents and agreements are in compliance with the Code and other relevant regulation and legislation. The Joint Committee also considered that government resources are better directed to educational and enforcement responsibilities. As the Government would not be involved in verifying the accuracy of franchisors' statements of guarantee, a system of registration of guarantees is unlikely to provide franchisees with

any extra benefit as they would still need to undertake their own due diligence to confirm the accuracy of information on the register. A system of registration of franchisors could also create an expectation that the franchise has received the endorsement of the regulator.

The Government also considers that the extended powers for the ACCC outlined above (in response to Recommendations 9, 10 and 11) will encourage franchisor compliance with the Franchising Code and the Trade Practices Act.

Measures to better balance the rights between franchisees and franchisors – Recommendations 8 and 5

Recommendation 8

The committee recommends that the following new clause be inserted into the Franchising Code of Conduct:

6 Standard of Conduct

Franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement.

Recommendation 5

The committee recommends that the Franchising Code of Conduct be amended to require franchisors to disclose to franchisees, before a franchising agreement is entered into, what process will apply in determining end of term arrangements. That process should give due regard to the potential transferability of equity in the value of the business as a going concern.

The Government recognises that during the Joint Committee's inquiry legitimate concerns were raised involving unreasonable and unfair commercial practices and appreciates the need for parties to a franchise agreement to behave honestly, reasonably and fairly.

Unconscionable conduct

As mentioned above, under the Government's *Trade Practices Amendment (Australian Consumer Law) Bill 2009*, the ACCC will be able to apply to the Court for an order that a person pay a pecuniary penalty for a contravention of the unconscionable conduct provisions and certain unfair practices provisions of the Trade Practices Act. The maximum pecuniary penalty available will be \$1.1 million for corporations and \$220,000 for individuals.

The Government will also introduce amendments to the Trade Practices Act to emphasise that the terms and progress of a contract are relevant to the finding of unconscionable conduct. This amendment will increase the understanding and clarity of the unconscionable conduct provisions.

The Government will appoint an expert panel, which will work with the franchising sector and other small business organisations, to inquire into and report on the need to introduce a list of examples that constitute unconscionable conduct, or a statement of principles concerning unconscionable conduct, into the Trade Practices Act. This will give greater clarity for the franchise sector in understanding what their obligations are.

The Franchising Code of Conduct and good faith

The Government made a pre-election statement noting its belief that the Franchising Code should include a good faith obligation as long as the scope of this obligation is well defined. In contrast, Recommendation 8 of the Joint Committee's report recommended the introduction of a broad and general reference to 'good faith' within the Franchising Code.

While accepting the intent of Recommendation 8, there are several problems with the suggested approach:

- The law on good faith is still evolving. The scope of the requirement is unclear. From a commercial perspective, uncertainty would be increased by an express statement of the requirement in the Franchising Code. Neither franchisors nor franchisees would be certain of the occurrence of a breach. Indeed, it would require court proceedings to establish that.
- From an economic perspective, in any given situation it is almost certain that the franchisor's perspective on the scope of the concept will differ from that of the franchisee. While the franchisor may have ready access to legal advice on what good faith means, a franchisee will not, so that there will be an information gap.

The extra uncertainty created by the inclusion in the Franchising Code of a general, undefined good-faith obligation could be expected to have adverse commercial consequences for franchisees. Franchisors would seek compensation for the extra risk they faced through larger franchise fees and more onerous terms and conditions in other parts of the agreement. And banks and other financiers would be more reluctant to provide credit to the franchisees and franchisors in these more risky commercial circumstances.

The Government's response to Recommendation 8 involves:

1. amending the Franchising Code to deal specifically with end-of-term arrangements for all new franchising agreements entered into after the commencement of the amendments;
2. amending the Franchising Code to include a list of necessary and desirable behaviours to encourage parties to approach a dispute resolution process in a reconciliatory manner;
3. referring specific behavioural issues (identified through consultation) to an expert panel for advice on whether further specific amendments to the Franchising Code are required to address those behaviours; and
4. amending the Franchising Code to provide that nothing in the Code limits any common law requirement of good faith in relation to a franchise agreement to which the Code applies.

The Government's response to Recommendation 8 addresses the Joint Committee's intent in a way that is legally feasible and avoids undesirable commercial consequences for franchising. This alternative approach avoids unnecessary uncertainty and associated extra costs for franchisees and franchisors. Inserting a general good-faith obligation in the Franchising Code would increase risks for franchisors who would seek to pass the cost of

that risk back to franchisees in the form of higher franchise fees. Further, financiers (banks and other lenders) could be expected to be more reluctant to lend to franchises (franchisors and franchisees) in circumstances where the soundness of contracts is in question. Small business organisations are already claiming that banks are being too harsh in their small business lending practices. Inserting a general, ill-defined good faith obligation into the Franchising Code would only make matters worse.

Rather than introducing a general but uncertain solution, the Government will appoint an expert panel to inquire into and report on the need to introduce measures into the Franchising Code to prevent specific behaviours that are not appropriate in a franchising arrangement. Based on consultations, these behaviours relate to:

- end-of-term arrangements;
- dispute resolution;
- unforeseen capital expenditure;
- unilateral contract variation;
- attribution of legal costs;
- confidentiality agreements; and
- changes to franchise agreements when a franchisee is trying to sell the business.

End-of-term arrangements

The Joint Committee noted that end-of-term arrangements are one of the largest areas of dispute in the franchising sector. The Government supports the Joint Committee's view that franchisors should be entitled to decline to renew franchise agreements on expiration if that is their choice. The Joint Committee did not support an automatic right to renewal or the requirement for good cause to be shown for not renewing a franchise agreement.

The Government recognises that prospective franchisees' 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. The Government agrees that franchise agreements should clearly stipulate what (if any) the end-of-term arrangements and processes will be, and that these arrangements should be fully and transparently disclosed to prospective franchisees. The disclosure of this information is likely to assist in mitigating disputes where one party has an expectation (not shared by the other party) that the franchise agreement will be renewed. It will also help to address imbalances in power by assisting prospective franchisees to undertake their due diligence prior to entering into a franchise agreement.

Therefore, the Government will amend the Franchising Code to require franchisors to disclose to prospective franchisees the process that will apply in determining end-of-term arrangements (**Recommendation 5**). This process should outline what, if any, exit arrangements would apply. Any exit arrangements should give due regard to the potential transferability of equity in the value of the business as a going concern. Without limiting

the items that would need to be disclosed when developing end of term arrangements the following issues should be considered:⁴

- Would the prospective franchisee have any options to renew or extend the agreement beyond the original term? If so, what processes would the franchisor use to determine whether or not to renew or extend the agreement?
- Information on whether or not the prospective franchisee would be entitled to an exit payment at the end of the term and, if so, how the exit payment would be determined and/or earned.
- Details on what arrangements would apply to unsold stock, or equipment purchased at the beginning of the term, at the end of the agreement. For example would the franchisor buy the stock and/or equipment back at the end of the term? If so, how would price be determined?
- Details on whether or not the prospective franchisee would have the right to sell the business at the end of the term. If the franchisor would have first right of refusal on any right to sell the business, how would market value be determined?

The Government also considered the benefit of mandating a pre-expiry notice review as recommended by the Western Australian Government franchising inquiry in 2008. The Government will introduce amendments to the Franchising Code requiring franchisors to inform franchisees, at least six months prior to the end of the franchise agreement, of their decision either to renew or not renew a franchise agreement. Where franchise agreements are for a term less than six months, franchisors will be required to inform franchisees at least one month prior to the end of the franchise agreement of their decision to renew or not renew a franchise agreement.

It is the Government's clear intention that these new end-of-term arrangements will apply for franchise agreements signed after the date of amendments to the Franchising Code. For agreements already in existence, the end-of-term arrangements can be included by the voluntary agreement of both parties but will not be obligatory.

To ensure the new end-of-term arrangements are implemented effectively, the Government will ask the ACCC to develop guidelines on how to disclose end-of-term arrangements. This will assist franchisors and prospective franchisees to understand their obligations under the amendments to the Franchising Code noted above.

Dispute resolution

Submissions to the Joint Committee suggest that some parties may be stalling negotiations and acting to deplete resources of the other party to frustrate the dispute resolution process under the Franchising Code. Examples highlighted in the Joint Committee report that may act to further drain the finances of franchisees and franchisors in mediation include:

- Having representatives attend mediation without having full authority to negotiate an outcome (despite this being a requirement under the Franchising Code);

⁴ This list is not intended to be exhaustive or indicative of information that must be provided by a franchisor in their disclosure document. The Government recognises that information provided by franchisors in detailing their end of term arrangements is a commercial matter that is best determined by the individual parties.

- The franchisor not disclosing its main aim in attending mediation; and/or
- The franchisee utilising the current mediation and disclosure requirements in the Franchising Code to use, or threaten to use, litigation proceedings as a leverage to extract settlements or concessions from franchisors (there is a requirement to disclose litigation proceedings in disclosure documents which may have the potential to affect the franchisor's brand).

The Franchising Code (clause 29(6)) currently obliges parties to 'attend the mediation and try to resolve the dispute'. It is also implicit that parties must have the authority to settle the dispute when they attend mediation.⁵ However, there are no detailed specific obligations enumerated under the Franchising Code in relation to procedural obligations that could be followed by parties to demonstrate that they are trying to resolve their dispute (in accordance with clause 29(6)).

The Government recognises the need to encourage parties to a franchise dispute to approach their dispute in a reconciliatory manner. Therefore, the Government supports a targeted policy response to the concerns within the franchising sector in relation to unconstructive conduct by parties to franchise mediations.

Currently, it is a requirement under the Franchising Code that parties to a dispute must attend the mediation and try to resolve the dispute. The Government will introduce amendments to the Franchising Code to include a non-exhaustive list of behaviours aimed at discouraging behaviour which may impede the effectiveness of the dispute resolution process under the Franchising Code. However, the Government notes these behaviours would not require either party to subordinate its own interests or to act outside of its interests, in recognition of the commercial nature of the franchising relationship.

The list of behaviours covers a number of different aspects of dispute resolution and mediation and is aimed at discouraging behaviour which is impeding the effectiveness of the dispute resolution process under the Franchising Code. The Franchising Code currently provides that parties must try to resolve their dispute at mediation. The list of behaviours clarifying the nature of this obligation would include:

- Attending and participating in meetings at reasonable times. In determining a reasonable time for meetings, parties should consider whether it is appropriate to hold meetings within standard business hours and consider any travel requirements of parties in different locations.
- Making intentions clear at the outset of the mediation. That is, if the aim is to negotiate an exit arrangement, rather than a resolution to enable continued trading, this should be disclosed.
- Observing confidentiality obligations during and after the mediation process.
- Not damaging the franchise brand during the dispute including by providing inferior goods, services, or support.

⁵ Clause 29(7) provides that a party is taken to attend mediation if the party is represented at the mediation by a person who has the authority to enter an agreement to settle the dispute on behalf of the party.

Expert panel

The Government will establish an expert panel to inquire into and report on the need to introduce into the Franchising Code a list of specific measures to prevent behaviours that are inappropriate in a franchising arrangement with particular reference to:

- Unforeseen capital expenditure;
- Unilateral contract variation;
- Attribution of legal costs;
- Confidentiality agreements; and
- Franchisor-initiated changes to franchise agreements when a franchisee is trying to sell the business.

This panel process could result in more defined concepts that could be inserted into the Franchising Code as clear prohibitions for franchisees and franchisors. To minimise any negative impact on the viability of the franchising model, the expert panel will also be asked to consider the potential impact any proposed measures to address inappropriate behaviours could have on franchising. This inquiry will be undertaken by the same expert panel that will inquire into and report on the need to introduce a list of examples that constitute unconscionable conduct, or a statement of principles, in the Trade Practices Act.

Unforeseen capital expenditure

During franchising consultations, concerns were raised that the terms of a franchise agreement may not be long enough for franchisees to recoup their capital expenditure. For example, franchisees could be required to purchase new equipment or undertake store refurbishments in the months before the agreement term ends. This could cause significant financial hardships for franchisees if the agreement is not renewed.

The Government recognises that the negotiation of and agreement to the terms of a franchise agreement is a commercial issue and that it is the responsibility of both parties to an agreement to ensure that the terms of an agreement are long enough to recoup possible expenditure. However, the Government recognises the potential financial implications capital expenditure can have on franchisees.

The Government notes that unforeseen capital expenditure is one of the issues to be considered as a part of the expert panel's inquiry process.

Unilateral variation

The Joint Committee received submissions expressing concern that the Franchising Code does not prohibit unilateral variation of contracts. The Committee noted similar concerns relating to the inclusion of a clause in franchise agreements stipulating that a franchisee will comply with an operations manual supplied by the franchisor, the contents of which are subject to change at any time. Similar concerns were raised during consultation.

The Government recognises that franchisors need to make commercial decisions to maintain and revitalise their franchise model. While acknowledging the commercial

nature of franchising, the Government recognises that unilateral changes to a franchise may change the viability of the franchise for individual franchisees.

The Government notes that unilateral contract variation is one of the issues to be considered as a part of the expert panel's inquiry process.

Attribution of legal costs

During franchising consultations, concerns were raised that the terms of some franchise agreements include a requirement for the franchisee to pay the franchisor's legal costs and other expenses incurred in the enforcement of the agreement. Consultation suggests that these types of clauses are being used by franchisors to require franchisees to pay the costs of mediation of disputes under the franchise agreement.

As noted above, the Government recognises the need to encourage parties to a franchise dispute to approach their dispute in a reconciliatory manner. The Government considers that the inclusion of a clause in a franchise agreement requiring a franchisee to pay for the costs of mediation of disputes could provide a significant financial disincentive for a franchisee to initiate dispute resolution procedures or legal action against their franchisor.

The Government considers that parties engaged in trade and commerce should have a high degree of freedom to contract as the parties to the contract are best placed to determine commercial matters. However, the Government recognises that the attribution of legal costs to one party could negatively affect that party's ability to access the dispute resolution processes under the Franchising Code. The Government notes that the attribution of legal costs in franchise agreements is one of the issues to be considered as a part of the expert panel's inquiry process.

Confidentiality agreements

During consultations, concerns were raised that some franchise agreements contain confidentiality clauses that restrict the information that current and past franchisees can provide to prospective franchisees.

Under the Franchising Code, a franchisor is required to provide prospective franchisees with the contact details of existing franchisees and certain past franchisees.⁶

The Government recognises that confidentiality agreements may be necessary to protect a franchisor's intellectual property and as noted above, the Government considers that parties engaged in trade and commerce should have a high degree of freedom to contract. However, the Government notes that information provided by current and past franchisees could aid the decision-making process of prospective franchisees. The Government notes that confidentiality arrangements are one of the issues to be considered as a part of the expert panel's inquiry process.

⁶ Item 6.4 to 6.6, Annexure 1 of the Franchising Code of Conduct

Changes to franchise agreements when a franchisee is trying to sell the business

During franchising consultations, concerns were raised that when franchisees try to sell the business franchisors can change the terms of the franchise agreement, and this may reduce the viability of the business and make it harder for the franchisee to sell.

The Government recognises that franchisors need to make commercial decisions to maintain and revitalise their franchise model. While acknowledging the commercial nature of franchising, the Government recognises that changes to a franchise agreement when a franchisee is trying to sell the business may impact on the franchisee's ability to maximise the return on their investment.

The Government notes that franchisor-initiated changes to a franchise agreement, when a franchisee is trying to sell the business, is one of the issues to be considered as a part of the expert panel's inquiry process.

Mediation – Recommendation 6

Recommendation 6

The committee recommends that the name of the Office of the Mediation Adviser be changed to the Office of the Franchising Mediation Adviser and that the Franchising Code of Conduct be amended to reflect this change.

The Government recognises the importance of ensuring franchisees and franchisors seeking assistance in dispute resolution are aware of and understand the role of the Office of the Mediation Adviser.

The Government accepts the Joint Committee's finding that a name change will aid understanding and recognition within the sector of the role that the Office (of the Mediation Adviser) plays in dispute resolution in franchising. The Government agrees to change the name of the Office of the Mediation Adviser to the Office of the Franchising Mediation Adviser.

Franchising statistics – Recommendation 7

Recommendation 7

The committee recommends that the government require the Australian Bureau of Statistics to develop mechanisms for collecting and publishing relevant statistics on the franchising sector.

The Joint Committee considered that it is difficult to assess the efficacy of current mediation provisions in the Franchising Code in the absence of a reliable understanding of the true extent of disputation in the sector. The Joint Committee therefore recommended that the Government require the Australian Bureau of Statistics (ABS) to develop mechanisms for collecting and publishing statistics relating to the franchising sector (Recommendation 7), with a focus on franchise disputation and dispute-related franchisee turnover, using information collected from both franchisees and franchisors.

The Government agrees that there is a need to develop mechanisms for collecting and publishing relevant statistics on the franchising sector. However, the Government considers that only collecting data on franchising disputes or other indicators of stability in franchising would provide limited insight into the issues faced by the sector. To fully understand the issues faced by the franchising sector, comparative data on disputes within other small businesses would need to be collected. Such data would provide a meaningful benchmark with which to determine whether the franchising sector is facing burdens over and beyond those faced by Australian business more generally.

Collection of data on disputes faced by Australian business, of which franchising is a subset, would impose considerable compliance burdens on the broad business community. The Government does not support the imposition of additional compliance burdens on the broader business community for the sole purpose of determining the stability of the franchising sector.

Although the Joint Committee recommended the ABS should develop mechanisms for collecting and publishing relevant statistics on the franchising sector, ABS surveys are only one way to gain an understanding of the stability of the franchising sector. In line with the Government's objective of limiting compliance burdens on business, the Government supports exploring existing mechanisms of data collection.

The ACCC currently collates a summary of the statistics it collects in relation to small business disputes and enquiries, and franchising related disputes and enquiries (ACCC enquiries data). This information may be used as a possible indicator of trends and patterns of concerns within the franchising sector as compared with small business more generally.

In addition, the Australian Research Council (ARC) and the ACCC have commissioned Griffith University to research conflict in the franchising sector. The research project commenced in 2008 and is to be conducted over two years. The research is to produce an analysis of the most effective methods for anticipating and avoiding conflict. The ACCC will use the results of this survey to assist it with its education efforts in relation to the sector.

The Government supports the public release of broad ACCC data on trends of inquiries and complaints from small businesses and franchising businesses as an indicator of concerns within the franchising sector as compared with small businesses more generally. The ACCC and ARC commissioned Griffith University research on conflict in the franchising sector would also add to the Government's understanding of disputation within the franchising sector.

The Government will work with industry, academics and the ACCC to gain a better understanding of the stability of the sector and will continue to investigate future opportunities to collect and publish statistics on the franchising sector, including ABS survey options.

Franchise failure – Recommendations 1 and 4

Recommendation 4

The committee recommends that the government explore avenues to better balance the rights and liabilities of franchisees and franchisors in the event of franchisor failure.

Recommendation 1

The committee recommends that the Franchising Code of Conduct be amended to require that disclosure documents include a clear statement by franchisors of the liabilities and consequences applying to franchisees in the event of franchisor failure.

The Government notes the recent franchise failures and recognises the need to better balance the rights between franchisees and franchisors.

The Government understands the Joint Committee's concerns about the implications that franchisor failure can have for franchisees and recognises that the implications for franchisees as a result of franchisor failure can be significant. Accordingly, the Government has explored avenues to better balance the rights and liabilities of franchisees and franchisors in the event of franchisor failure (Recommendation 4). The Government supports the development, by the ACCC, of additional educational information on the potential consequences and liabilities franchisees could be exposed to in the event of franchisor failure.

The Joint Committee considered that the Franchising Code should be amended to require that disclosure documents include a clear statement by franchisors of the liabilities and consequences applying to franchisees in the event of franchisor failure. However, the Government considers that individual franchisees, rather than franchisors, would be better placed to assess the liabilities and consequences applying to them in the event of their franchisor failing. In addition, such a statement may induce a belief among franchisees that, in the event of franchisor failure, they will not be exposed to any risks other than those noted in the disclosure document.

While the Franchising Code requires franchisors to provide detailed disclosure documents to prospective and existing franchisees, the disclosure requirements under the Franchising Code are intended to assist, not replace, standard due diligence processes. The obligation remains on a prospective franchisee, and their advisers, to adequately assess the business opportunity they are considering. Equally, there is an obligation on franchisors to provide accurate and full information during disclosure. Therefore, the Government does not support amendments to the Franchising Code that would require disclosure documents to include a clear statement by franchisors of the liabilities and consequences applying to franchisees in the event of franchisor failure (Recommendation 1).

If potential franchisees can identify and access the information needed to make a well informed business decision, they should have a better basis with which to negotiate a contract that meets their requirements. Parties engaged in trade and commerce should have a high degree of freedom to contract – the parties to the contract are best placed to determine commercial matters.

The Government will introduce amendments to clause 1.1(d) of Annexure 1 and clause 1.1(e) of Annexure 2 of the Franchising Code to state that franchising is a business and that like any business the franchise (or franchisor) could fail during the franchise term. This will alert prospective franchisees and their advisers to the risk of franchisor failure and will assist them in undertaking their due diligence to adequately assess the business opportunity.

As noted above, the Government will also ask the ACCC to develop additional educational information on the potential consequences and liabilities franchisees could be exposed to in the event of franchisor failure. This information, in addition to the amendments to the Franchising Code will assist in better balancing the rights and liabilities for franchisees and franchisors in the event of franchisor failure.

The Government notes that in the event of a franchisee becoming bankrupt, insolvent under administration or an externally-administered body corporate, the Franchising Code (under clause 23) provides franchisors with relief from the procedural requirements imposed by clauses 21 and 22⁷ of the Franchising Code. Clause 23 of the Franchising Code does not give a franchisor the right to terminate a franchise agreement. Whether a right to terminate exists in the circumstances enumerated in clause 23 will depend on the terms of the franchise agreement and the application of the general law. That is, in the event of a franchisee becoming bankrupt, insolvent under administration or an externally-administered body corporate, any right to terminate would come either from the franchise agreement itself or the general law.

The inclusion of an automatic right of termination for franchisees (in the Franchising Code) in the event of franchisor failure would give one area of small business an advantage over others (preferential treatment). It would also provide franchisees with an automatic right under the Franchising Code that is not available to franchisors. Therefore, while the Government acknowledges the serious implications that franchisor failure can have on franchisees, the Government does not consider it appropriate for the Franchising Code to provide franchisees with an automatic right of termination in the event of franchisor failure.

Future review of the franchising sector – Recommendation 3

Recommendation 3

The committee recommends that the government review the efficacy of the 1 March 2008 amendments to the disclosure provisions of the Franchising Code of Conduct within two years of them taking effect.

The Government accepts the Joint Committee's finding that some of the concerns about the disclosure process raised with the committee during its inquiry should be mitigated by the 1 March 2008 amendments if they function as intended. The Government also agrees with the Joint Committee's statement that it is too soon to judge their efficacy at this stage.

⁷ Clauses 21 and 22 set out procedural requirements with which a franchisor must comply when seeking to terminate a franchise agreement. Clause 21 applies if a franchisor proposes to terminate a franchise agreement in circumstances where a franchisee is in breach of the agreement. Clause 22 applies where a franchisee has not breached the franchise agreement, but where the franchisor seeks to terminate in accordance with the agreement, before its expiry, and without the franchisee's consent.

Therefore, the Government agrees to review the efficacy of the 1 March 2008 amendments, and any amendments to the Franchising Code proposed as part of this response to the Joint Committee report, in 2013 (Recommendation 3). This would allow for a review after an adequate number of contracts, established after the amendments were implemented, have run their course, noting that franchise agreements generally operate for 5-10 years.

The Government notes that the franchising sector has been subjected to four separate reviews, at Commonwealth and the state level, since 2006 and the Government is reluctant to subject the sector to another review in such a short timeframe. The Government considers that the franchising sector deserves some certainty and stability before instigating another review that could result in regulatory changes.