LEGISLATIVE COUNCIL

Deputy Leader of the Opposition in the Legislative Council
Shadow Minister for Industrial Relations
Shadow Minister for Small Business

The Honourable Adam Searle MLC

Mr Alan Wein
Review of the Franchising Code of Conduct
c/o Franchising Code Review Secretariat
Business Conditions Branch
Department of Industry, Innovation, Science,
Research and Tertiary Education
GPO Box 9839
Canberra ACT 2601

Dear Mr Wein,

Thank you for your invitation to make a submission to your Review of the Franchising Code.

While NSW Labor does not have a specific policy regarding franchising, our approach to supporting the small business sector generally (including franchised small businesses) is contained in our *Small Business Commissioner and Small Protection Bill* 2012.

This Bill was introduced into Parliament last year, after consultation with small business operators across a range of industries. The views and experiences of franchisees was of particular significance in the formation of the ideas contained in the Bill.

A copy of the Bill is attached to this letter, together with my second reading speech setting out its key features. I also attach a copy of Professor Peden's seminal work on harsh and unjust contracts, which remains as relevant today as it was when written in 1976.

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The Bill provides measures to protect small business from unfair commercial practices and also provide a comprehensive legal framework for the role and functions of the Small Business Commissioner.

The broad definition of *'small business'* contained in the Bill would extend to cover franchised businesses.

We believe there is a need for the franchising sector to have an active regulator of the kind we propose for NSW, legally enforceable Codes of Practice setting out requirements for fair treatment of small businesses by larger businesses and government, with small business having access to an unfair contract regime similar but superior to that contained in the *Independent Contractors Act* 1996 (Cth).

The attached submission speaks to these themes, with particular reference to the matters specifically identified in your discussion paper; namely:

- Good Faith in franchising;
- End of term arrangements for franchising agreements;
- Dispute resolution in franchising; and
- Enforcement of the Franchising Code.

Warm Regards,

The Hon. Adam Searle MLC
Shadow Minister for Small Business

Review of Franchising Code of Conduct

Submission

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REVIEW OF THE FRANCHISING CODE OF CONDUCT 2013

SUBMISSION BY ADAM SEARLE MLC,
NSW SHADOW MINISTER FOR SMALL BUSINESS

Introduction

The Franchising Code of Conduct was first introduced in 1998 and has been subsequently reviewed and modified in each of 2007 and 2010. Those amendments are helpfully summarised in the *Discussion Paper* issued by this Review at pages 34-37.

In essence, the Code is primarily directed to ensuring there is disclosure to prospective franchisees of matters that are material to deciding whether a person or body would enter a franchise agreement. Clause 18 of the Code, titled *Disclosure of materially relevant facts*, is of particular significance in this regard.

In addition, there are additional requirements on franchisors, to not enter into franchise agreements unless a prospective franchisee has had a reasonable opportunity to read and understand the disclosure document and the Code, has received legal, business or accountancy advice. Requirements in connection with marketing and co-operative funds, requirements in connection with terminating franchise agreements, and mediation in the event of disputes, are also provided for.

The two Annexures to the Code set out in detail the matters which must be disclosed by franchisors to prospective franchisees and the manner in which the disclosures must be set out.

While the matters contained within the Code are important, and the changes in 2007 and 2010 have no doubt improved it, the feedback from the franchising sector remains that it is largely ineffective in providing protection to those who enter into franchise agreements. This is for two related reasons.

Firstly, the law with regard to franchising, like commercial law generally, presupposes parties that are equal. The reality in franchising is that, often, this is not the case. The Franchising Code in its present form does not recognise this, or make adequate provision for evening up the playing field where needed.

Secondly, the incidence of franchisee failures, discontent, and litigation that has arisen in the area of franchising, as evidenced in a number of inquiries held over the last several years, strongly suggests there is a need for a clear and strong legislative framework of the kind we are proposing in NSW to protect those engaged in franchising. The absence of provisions of the kind the NSW Opposition are proposing in the *Small Business Commissioner and Small Business Protection Bill* 2012 contribute to the inability of the Franchising Code to properly afford protection to prospective and current franchisees.

"Labor's approach in NSW"

Small businesses are the core of our economy. They are estimated to comprise some 96 per cent of all businesses and there are two million across Australia. Together, these enterprises provide half of the employment opportunities in our society.

In New South Wales there are 650,000 small businesses providing employment for half of the workforce. The health of our small business sector is and should be a matter of vital concern for our Government and for everyone in public life.

One area of common experience for small business is the difficulties experienced when dealing with larger businesses and governments at each level.

While excesses of behaviour are often caught by trade practices legislation—the *Competition and Consumer Act* 2010 at the Federal level and fair trading laws at the State level—there is a large and growing gap in the law where small business is often at the mercy of bigger business without effective protection or remedy when relationships break down.

This uncertainty has caused and continues to cause practical difficulties for the small business sector.

Of particular concern is where there exists significant inequality of bargaining power. Another area is form contracts, where the commercial relationship is offered on a "take it or leave it" basis and is not the subject of meaningful discussion or negotiation. This has long been recognised as unsatisfactory and in need of reform.

The law continues to assume that the commercial landscape is populated only with legally sophisticated parties dealing with one another as equals. The reality is often otherwise, with the small business operator being in reality a sole trader, or a mum and dad or family operation.

These observations apply particularly to franchising.

Governments and Parliaments must act to provide better protection and certainty for franchise operators.

As is acknowledged on page 3 of the O'Farrell Government's extremely belated discussion paper on the role of a Small Business Commissioner, the issues faced by small businesses are *unfair* practices or *unfair* issues that arise in their dealings with larger businesses. This applies particularly in the franchising sector.

Often these behaviours are not illegal or contrary to any commercial contract they have entered into and often is not the kind that is susceptible to remedy under existing laws. The effect of this on small business is to cause economic hardship, inhibit growth and often is anticompetitive, but not in a way that transgresses the high standards required by the *Competition and Consumer Act* or *Fair Trading* legislation. Even where it does breach those legislative regimes, franchisees lack the capacity to enforce the law due to knowledge or financial constraints.

Small businesses, including franchisees, which are run by hardworking Australian families and individuals, are damaged. That creates social hardship and, in a wider sense, inhibits economic growth more broadly in our society.

Where a small business is perceived not to have any black letter legal rights, or accessing them will be considerably expensive, the degree of willingness to meet the other party halfway, as it were, often will be lacking. Consequently, the provision of additional, meaningful legal rights that are accessible to small business, including franchisees, must be an indispensible part of any real reform.

In NSW, the Labor Opposition has been advocating that all small businesses should have access to the arrangements already provided in the *Contracts Review Act* 1980 (NSW), with some modifications, including allowing such claims to be brought in the Consumer, Trader and Tenancy Tribunal, a more informal body than the Supreme Court.

This would permit contracts that are or have become *"unjust"* to be set aside or modified appropriately.

Far from undermining business confidence, such a law would go a long way to increasing confidence in the small business sector that they will have protection from exploitation of the kind that regularly occurs now.

This would create an environment in which more people can start their own business knowing that the law will provide for them a more equal playing field when they deal with larger businesses.

However, this should not occur in a vacuum. Under the Bill, the Small Business Commissioner would have a comprehensive role to assist small businesses, including franchisees. This would include:

- Receiving and investigating complaints and resolving them if possible through mediation or advocacy, and to providing information to small businesses to assist them in making decisions about their commercial dealings with other businesses or government agencies;
- Monitoring, investigating and advising the Minister on market practices that may negatively affect small business. This can provide the foundation for the making of the codes of practice to promote fair treatment of small businesses;
- Reporting each year to NSW Parliament specifically on ways to reduce red tape and the regulatory burden on small businesses as well as laws (legislative, procedural or administrative) that burden small businesses and recommendations for alleviating it.

In addition, in recognition of the fact that many small businesses do not have the resources to engage in litigation, we propose the creation of codes of practice for the fair treatment of small business that can be enforced by the Commissioner.

The Small Business Commissioner would administer the codes of practice, and also monitor, investigate and advise the Minister on non-compliance with the codes, as well as be able to enforce them through the courts.

The matters which were specifically highlighted in the Review *Discussion Paper* are discussed below.

"Good Faith"

One area that has been hotly contested in the small business field, and franchising in particular, is the issue of "good faith" and whether there needs to be a statutory provision that requires good faith dealings, or includes good faith obligations, in commercial contracts.

At present, the law simply does not recognise the particular challenges faced by small to medium sized enterprises, but continues to assume that all commercial parties are on an equal footing. This simply does not match up with reality.

The incidence of small business failures, discontent, and litigation in the franchising sector suggests strongly that there is a need for good faith obligations to be included.

In Australia at present, rogue franchisors appear to be able to act with impunity under the existing Franchising Code of Conduct, which suggests that it is not enforceable in a way that actually affords small business any protections, or simply is not directed to the right issues. There are also issues associated with its enforcement, or enforceability, which will be discussed later.

Inquiries over the last 6 years into franchising have each concluded that there needs to be reform to the balance of power between franchisors and franchisees, most notably the need to introduce an obligation on all parties to act towards each other in *"good faith"*.

The *Review of the Disclosure Provisions of the Franchising Code of Conduct Report to the Hon. Fran Bailey MP, Minister for Small Business and Tourism* (2006) conducted by Mr Graeme Matthews, National Managing partner, KPMG Middle Market Advisory, recommended that a *"statement obligating franchisors, franchisees and prospective franchisees to act towards each other fairly and in good faith be developed for inclusion in Part 1 of the Code."*

The Commonwealth Parliamentary Joint Committee on Corporations and Financial Services, chaired by Mr Bernie Ripoll MP, produced a unanimous report, *Opportunity Not Opportunism: Improving Conduct in Australian Franchising*. The Committee was of the opinion, having heard a significant body of evidence, that there was a demonstrated need to explicitly include in the Code that *"franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement."*

To date, the Commonwealth has taken the view that the law on good faith is still evolving and there is not a single, universally-accepted definition that can be included in any mandatory Code. Because of this, the view has also been taken that the inclusion of a

general obligation of good faith in the Franchising Code would increase uncertainty in franchising.

The South Australian Parliament has undertaken two inquiries that directly address the issue. In its final report, the Committee found that there currently exist unacceptable limits on the ability of franchisees to seek redress in cases where franchisors abuse their contractual discretions and powers. As a result, the Committee recommended that the *Franchising Code of Conduct* should be amended by inserting a provision imposing a duty to act in accordance with good faith and fair dealing by each party of the franchise relationship, including when conducting negotiations in connection with renewing or extending an existing franchise.

The South Australian Government responded by creating by statute a Small Business Commissioner who can not only receive and investigate complaints, and offer mediation between disputing parties, but can also enforce mandatory Codes of Practice of conduct that carry money penalties for breaches.

In Western Australia there was a 2008 inquiry resulting in a report titled *Inquiry Into the Operation of Franchise Business in Western Australia* and an inquiry by the WA Parliament's Economic and Industry Committee into the Franchising Bill 2010 (WA). The latter Committee determined that it would see if the 2010 changes to the Franchising Code appropriately lifted the standards of conduct in franchising; if those changes proved inadequate, the Committee was no opposed to a general duty to act in good faith being included in the Code or in national law. Efforts to regulate franchising have also occurred through two private members' bills: the *Franchising Bill* 2010 (WA), defeated in November 2011; and the *Franchise Agreements Bill* 2011 (WA) which lapsed in December 2012 on the prorogation of the WA Parliament.

I do not here repeat the content of the reports referred to above, or the significant body of persuasive material which came before them regarding the need for good faith obligations to be included in franchising. Suffice it to say that this body of material discloses that the current regulatory framework applicable to franchising needs to be improved so it is safer for people to risk their money, health and their future in entering a franchise business.

This material contributed significantly to the development of the NSW Labor Opposition's *Small Business Commissioner and Small Business Protection Bill* 2012, noted at page 10 of the Review *Discussion Paper,* which was recently defeated in NSW Legislative Council. That Bill, if it had been enacted, would provide an option for good faith obligations to be included in legally enforceable Codes of Practice designed to promote fair dealing and the fair treatment of small business. The Codes would be able to be enforced through injunctions, as well as through the imposition of money penalties for breach.

I am of the view that, although the law in this area of good faith is still developing (like all areas of law), it is sufficiently well-understood for this to be done successfully, if there is a will to do so. The current situation perpetuates uncertainty for franchisees and their families.

Any such good faith obligation should be able to be enforced through injunctions, to secure compliance. Money penalties should also be available for breaches, but it should not be the only remedy. The public policy objective must be to achieve better outcomes through improved behaviours in franchising.

"End of term arrangements for franchise agreements"

I note the content of the Review Discussion Paper at pages 24-25, and the question posed, whether the 2010 amendments to the Franchising Code *"regarding end of term arrangements and renewal notices been effective in addressing concerns about inappropriate conduct at the end of the term of franchise agreements?"*

Based on the information I have been provided by current and former franchisees, and from my prior experience as a barrister involved in proceedings connected with franchise agreements, I would say that the disclosure requirements contained in the Franchising Code have not addressed this matter in the way intended or hoped for.

The disclosure requirement found at clause 9C of Annexure 1 to the Code requires a franchisor to disclose the details of the process that will apply at the end of the franchise agreement. A range of further matters are also specified, including whether there will be options to renew or extend the franchise agreement, or its scope, and if so what process will be used by the franchisor to determine this. The franchisor is also required to disclose whether a prospective franchisee will be entitled to an exit payment at the end of the franchise agreement and, if so, how this will be determined. Details of arrangements that will apply to unsold stock, whether the franchisee will be able to sell the business, and what conditions will apply to any such sale, are also present, with other matters.

While it is important that such matters are disclosed to a prospective franchisee, mere disclosure has not been adequate to remedy the concerns held in the industry. This is because all franchise agreements that I have seen still confer extraordinary discretions upon the franchisor as to these and other matters that arise at the end of term. The disclosures made do not constitute some definitive formula by which a prospective purchaser is able to determine with precision everything that may occur when the term of the agreement expires.

In addition, those entering into such important and intimate contractual relations do so with a view to them being successful and mutually beneficial. The absence of clear or definitive rights on termination or expiry of a franchise agreement will not properly prepare a prospective franchisee for the range of detrimental outcomes that may arise either at the expiry of the agreement or if the relationship breaks down and is terminated.

I will provide one example, for illustration. Clause 7A of Annexure 1 to the Code requires a franchisor to disclose whether it will require the franchisee to undertake *'unforseen significant capital expenditure'* that was not disclosed by the franchisor before the franchisee entered into the franchise agreement. To my knowledge, use of such a requirement is a regular feature in franchising. Where it is disclosed in accordance with the Code, it is usually in terms that leaves the matter to the franchisor's unrestricted discretion. My understanding is that the franchisor explains that this will only be used to ensure that the highest standards of the *'brand'* are upheld. It is often the case that this

discretion is used to require the franchisee to incur *'unforseen significant capital expenditure'*, often at a time when the franchise business is unable to recoup this investment prior to the expiry of the franchise term. If the franchise is not renewed, the franchisee can lose out financially, sometimes to a significant degree. In this circumstance, the absence of an *'exit payment'* or any arrangement for the franchisee to be given fair payment for unsold stock contained in the franchise agreement can compound the financial loss and render the whole agreement harsh or unfair in the way it operates. The absence of an exit payment in the franchise agreement, or other end of term arrangements for the benefit of a franchisee, may not appear significant when a prospective franchisee is considering whether the enter into such an arrangement, but can take on new significance depending on what discretionary powers in the agreement are used and in what way they impact the franchisee.

In short, mere disclosure is not sufficient to deal with all the complexities that can arise in such a commercial relationship over, and the end of, its term. As a result, significant financial hardship can and often does arise. Merely saying, well that is the risk of being in business is not in my view an adequate response.

Furthermore, because of the complexities referred to, I do not think it is possible to set out a rigid formula for what should occur at the end of term that would apply to all circumstances.

In NSW Labor's small business protection bill, referred to earlier, this is dealt with in two ways.

Firstly, there is the capacity to deal with the matter by way of a Code of Practice, a legislative and legally enforceable instrument that may be made after consultation with industry. This mechanism could develop a range of standard provisions or processes that could meet the circumstances that arise most commonly at this point in franchising.

Secondly, the bill confers on franchisees (and other small businesses, whether incorporated or not) access to the unfair contract regime contained in the *Contracts Review Act* 1980 (NSW). This legislation permits a contract to be found to be unjust if one or more of the criteria contained in s9(2) are present. They include whether there was any material inequality in bargaining power between the parties; whether the terms of the contract were the subject of negotiation; whether it was reasonably practicable for the party seeking relief to negotiate for the alteration or reject any of the provisions of the contract. This is particularly apposite in franchising where the franchise agreement is offered only on a *"take it or leave it"* basis.

Where a contract is found to be *'unjust'* the contract may be made void or varied, in whole or part. While the remedy is wide and powerful, the *'gateway'* is clear and has been used with restraint by the Supreme Court of NSW.

Another feature of the NSW Labor Bill is to enable access to this regime through the Consumer, Tenancy and Trader Tribunal, as a quicker, less formal and less expensive alternative to court action.

It seems fair and appropriate that where there are *'end of term'* franchise disputes, the franchisee should have access to a legal regime of this nature. This would, in my view,

promote greater certainty for franchisees and prospective franchisees and contribute positively to franchising in Australia.

"Dispute resolution in franchising"

I note the content of the Review Discussion Paper at pages 26-27. It is clear that the dispute resolution arrangements contained in Part 4 of the Franchising Code of Conduct, and in clause 29 more particularly, was designed to set out a regime of compulsory mediation. It is highly desirable that parties in dispute are encouraged to participate in and are provided with a swift, inexpensive alternative to costly litigation. This style of approach, with mechanisms for compulsory mediation, is also contained in NSW Labor's small business protection bill.

My understanding from many who have sought to use the Part 4 process, however, is that franchisors and their representatives still do not adequately engage in meaningful mediation and that the approach is very much one of formal compliance only.

An approach of this kind is often seen in disputes where one party has considerably greater financial resources than the other, of only engaging fully where there is a clearly identified legal exposure or waiting to see how serious a party is in pursuing a complaint. It is not unusual for parties with greater resources to only take seriously matters where legal proceedings have been commenced.

At its core is a cultural and not only a legal issue. To increase the effectiveness of mediation it not only has to be compulsory but the persons participating have to be those who have some *'skin in the game'* and who have the authority to make decisions regarding a matter. Particularly with larger organisations, it is easy to send someone from head office, or who has no direct experience of the other party or the matter, to a mediation with instructions from on high.

Consideration should be given to allowing a mediator to compel the attendance at any mediation of any person the mediator believes may assist the process and enhance the possibility of a successful outcome. Thought should also be given to whether the mediator should be able to require information or documents that may fulfil the same function.

It is expected there would be resistance to such an idea from franchisors, but it would significantly strengthen the Part 4 mechanism and enhance its credibility among franchisees.

At present, I believe the dispute resolution process of the Code has very little credibility among franchisees. If this is to improve, and I think the public interest requires that it does improve, the mechanism needs to be significantly enhanced.

"Enforcement of the Franchising Code"

A common complaint from franchisees is that the Code is not enforceable. I note the content of the Review Discussion Paper at pages 28-33, particularly the list of possible legal consequences of breaching the Code at p28.

When the complaint regarding enforceability is examined, what emerges is that franchisees for the most part do not have the resources to engage in court action and it is said that the ACCC does not adequately respond to complaints made to it.

I am not in a position to assess the accuracy of such complaints made regarding the ACCC but note that it would not be the only government agency where demand for service outstripped its resources to respond.

A related factor is that the scope of the Code is limited and many of the issues that emerge in franchising are simply not covered by the Code.

Having said that, the fact there are not pecuniary penalties specifically for breaching the Code is an impediment to its effectiveness. I note the recognition at p29 of the Discussion Paper that a number of previous inquiries have recommended that this occur, to address concerns that it *'lacks teeth'*. I agree and this is in keeping with the approach in NSW Labor's small business protection bill regarding Codes of Practice.

While the imposition of large penalties on a franchisor may have the potential to affect the viability of its business, the level of penalty imposed in any given instance is a matter for a court and the financial position of a franchisor would be a factor relevant to deciding the level of any penalty. In any case, penalties comprise an important element in deterring breaches.

I note that it is suggested that the nature of the Code is such that the focus should be on compliance and not punishment for breach. In keeping with this notion, compliance with the Code should be able to be secured by injunctions granted by a court.

A more specific provision than s80 of the *Competition and Consumer Act* 2010 is required. A template that may be considered is found at Part 3, clause 11 of the *Small Business Commissioner and Small Business Protection Bill* 2012 (NSW) which accompanies this submission.

"Other Matters"

There are a range of matters contained in the Franchising Code of Conduct which warrant discussion and possible reform. However, the most pressing of these is the *Disclosure of materially relevant facts* found in clause 18. These are matters that have been felt are vital for potential franchisees to know about before they enter into a franchise agreement.

I have received significant feedback regarding limitations on the effectiveness of this provision. The most significant aspect on which I have received representations is the differential approach taken to the requirement to disclose different kinds of court action taken against a franchisor. In some instances, the mere fact of *'proceedings'* must be

disclosed and with others only *'judgments'* against a franchisor have to be disclosed. This is curious and the public policy considerations that give rise to such differential approaches are unclear and not sustainable by reference to an assertion that proceedings brought by a public authority warrant a higher form of disclosure.

The matters contained in clause 18(2)(b) and (c) of the Franchising Code are so directly relevant to a franchisor deciding whether or not to enter into a franchise agreement that, in my view, the fact of the bringing of such proceedings (whether they proceed to a judgment or not) should be required to be disclosed to a prospective franchisee. I would suggest that all litigation commenced against a franchisor by any franchisee over the previous decade should be required to be disclosed to a potential franchisee. While this may be said to be prejudicial to a franchisor, the franchisor then has the opportunity to explain fully to a potential franchisee the facts and circumstance of the matters. A franchisee is then in a much better place to decide if they wish to enter into the commercial relationship with that franchisor.

My information and experience has been that flaws in a franchise system, or problems experienced by a franchisee with their franchisor, are often reflected many times over with other franchisees. Full disclosure of the kind I suggest would enable the franchisee to better know who they will be doing business with. In addition, it also provides a franchisor to identify and work through issues so as to avoid problems experienced in the past being repeated. At present, there is no prompt for them to do so.

"Conclusion"

The Franchising Code of Conduct requires significant reform if it is to better achieve the public policy objectives for which it is created.

The ideas contained in the *Small Business Commissioner and Small Business Protection Bill* 2012 (NSW) are a good starting place when considering how this may best be done.

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