

Trade Practices (Industry Codes - Franchising) Regulations 1998

1998 No. 162

EXPLANATORY STATEMENT

Statutory Rules 1998 No. 162

(Issued by authority of the Minister for Workplace Relations and Small Business for the Treasurer)

Trade Practices Act 1974

Trade Practices (Industry Codes - Franchising) Regulations 1998

Section 51AD of the *Trade Practices Act 1974* (the Act) provides that a corporation must not in trade or commerce, contravene an applicable industry code.

Section 172 of the Act provides that the Governor-General may make regulations for the purposes of the Act.

Section 51AE allows the regulations to prescribe an industry code. An industry code is a code regulating the conduct of participants in an industry towards other participants in an industry. The regulations may declare the industry code to be a mandatory or a voluntary industry code.

The Regulations prescribe the *Franchising Code of Conduct* as a mandatory industry code under the Act. Attachment A to this Memorandum outlines in more detail the specific provisions of the Code.

The operation of the franchising sector has been of concern for Government for many years. In 1991 a Task Force was established to examine the problems experienced in the sector. As a result of the Task Force recommendations, a voluntary Franchising Code of Practice was introduced on 1 February 1993 for a two year trial period and was administered by the then Franchising Code Administration Council.

In early 1994, the voluntary code was reviewed in response to continued complaints by industry participants about its lack of effectiveness. Despite increased resources, the coverage of the Voluntary code extended to around only 65 per cent of industry participants. After a Budget decision to cease funding beyond 1996/97, the Council decided to cease trading in December 1996.

The franchising sector is characterised by high dispute levels generally arising out of the imbalance of power between franchisors and franchisees. Around 13% of franchisors have litigation with a franchisee and a further 12% claim to have a major dispute with a franchisee.

Major problems in the sector include:

- inadequate disclosure by franchisors before entering into franchise agreements;
- misrepresentation by franchisors;
- difficulties experienced by franchisees in obtaining redress from infringing franchisors;
- the high cost of actions under the Act;
- encroachment of company stores on franchisees' areas; and

- franchisees' lack of understanding of the skills, experience and capital necessary to succeed.

The report of the Inquiry into Fair Trading held by the House of Representatives Standing Committee on Industry, Science and Technology, *Finding a Balance* (May 1997), recommended that the Government introduce franchising specific legislation to address the problems of the sector.

In September 1997, the Government released its *New Deal. Fair Deal* reform package for small business, which included a commitment to introduce a mandatory Franchising Code of Conduct underpinned by the Act. In April 1998, Parliament passed amendments to the Act to allow for the prescription of mandatory industry codes.

In the *New Deal: Fair Deal* package, the Government established the Franchising Policy Council, comprising franchisor and franchisee representatives and industry advisers, to advise on the proposed code, in consultation with industry. The Council was established in March 1998 and has consulted extensively with industry parties, including the Franchising Council of Australia, Motor Traders Association of Australia, Federal Chamber of Automotive Industry, Tractor and Machinery Association, legal bodies, and franchisee representative bodies, regarding the form of the code. The Council has met twelve times, including five consultation meetings with key industry parties.

The purpose of the Code is to regulate the conduct of participants in franchising towards other participants in franchising, in particular to:

- address the imbalance of power between franchisors and franchisees;
- raise the standards of conduct in the franchising sector without endangering the vitality and growth of franchising;
- reduce the cost of resolving disputes in the sector, and
- reduce risk and generate growth in the sector by increasing the level of certainty for all participants.

The Code aims to provide protection for all franchisees through the establishment of -minimum standards of disclosure and conduct. Franchisees will have access to the remedies and sanctions available under the Act.

The Code will be administered by the Australian Competition and Consumer Commission (ACCC). As the Code will affect the responsibilities of the Minister for Customs and Consumer Affairs and the Treasurer, they have been informed of these matters accordingly.

Attachment B to this Statement contains a Regulation Impact Statement.

The regulations commenced on 1 July 1998.

Attachment to Explanatory Statement for *Trade Practices (Industry Codes - Franchising) Regulations 1998*

There are four parts to the mandatory code as follows:

- Preliminary (Definitions and coverage of the code)
- Disclosure
- Conditions of agreement
- Dispute resolution

Part 1 - Preliminary (Definitions and coverage of the Code)

Clause 1 provides that the name of the code is the *Franchising Code of Conduct*.

Clause 2 provides that the purpose of the code is to regulate the conduct of participants in franchising towards other participants in franchising.

Clause 3 defines various terms used in the code.

Franchise agreement

Clause 4 defines 'franchise agreement' for the purposes of the code. A franchise agreement is defined as an agreement which has the following characteristics:

- One party (the franchisor or subfranchisor) grants the right to another person (the franchisee or subfranchisee) to conduct a business and is able to exert substantial control over the operation of that business
- The business will be associated with a trademark or symbol owned, used or specified by the franchisor or an associate
- The franchisee is required to pay, or agree to pay, a fee before starting business.

A motor vehicle dealership is specifically identified as a 'franchise agreement'.

The code exempts landlord/tenant relationships, employee/employer relationships, partnership relationships, cooperative agreements recognised under State and Territory law and fractional franchises.

Clause 5 provides for the timing of the code's application.

For franchise agreements made before 1 October 1998:

- clauses 14 (Copy of lease), 15 (Association of franchisees) and 17 (Marketing and other cooperative funds) of the code apply on and after 1 July 1998; and
- the rest of the code applies on and after 1 October 1998.

For all franchise agreements entered into, transferred, renewed or extended on or after 1 October 1998, the code applies on and after 1 October 1998.

Part 2 - Disclosure

Clause 6 provides for the circumstances in which a disclosure document must be produced.

Among others, a disclosure document must be given:

- by a franchisor to a prospective franchisee or a franchisee proposing to renew or extend an agreement; and
- by a franchisee to a proposed transferee on transfer of a franchise.

All issues contained in Annexures 1 or 2 of the code (whichever is relevant) must be addressed.

The intent of this provision is to ensure disclosure of information between franchisors and franchisees, and franchisees and transferees, which is likely to significantly affect the operation of the business.

Clause 7 specifies the required layout of a disclosure document.

Clause 8 outlines the application of Division 2.2 of the code.

Clause 9 specifies the purpose and required content of a disclosure document.

Clause 10 provides that a franchisor must give a disclosure document to a prospective franchisee or franchisee at least 14 days before specified events occur.

Clause 11 prohibits a franchisor from entering into a franchise agreement before he or she has received statements from the franchisee or prospective franchisee, including that the latter has received legal and/or business advice or has decided not to seek it.

Clause 12 requires a person who proposes to transfer a franchised business to give a disclosure document to a proposed transferee under Annexure 2. This requirement may be waived by a proposed transferee who is also the franchisor.

Part 3 - Conditions of franchise agreement

Cooling off period

Clause 13 provides that a franchisee may end a franchise agreement within seven days of signing the agreement or paying any money under the agreement, whichever is earlier.

Copy of lease

Clause 14 provides that where a franchisor (or an associate of the franchisor) enters into a lease for premises occupied by the franchisee, the franchisor (or the associate) must provide a copy of the lease or agreement to lease to the franchisee within one month of signing the lease or agreement to lease.

Similarly, where a franchisee occupies, without a lease, premises leased by the franchisor (or an associate of the franchisor), the franchisor (or the associate of the franchisor) is required to provide a copy of the franchisor's (or associate's) lease or agreement to lease, or a copy of the documents giving the franchisee rights to occupy the premises, or written details of the

conditions of occupation, to the franchisee within 1 month after occupation commences or after documents giving rights to occupy are signed.

Association of franchisees

Clause 15 prohibits a franchisor from inducing a franchisee to not associate with other franchisees for a lawful purpose. The provision seeks to ensure freedom of association for franchisees who wish to communicate with other franchisees.

Prohibition on general release from liability

Clause 16 prohibits a franchise agreement from containing, or requiring a franchisee to sign, a general release from liability towards the franchisee. However, a franchisee is able to settle a claim against the franchisor after entering into a franchise agreement.

Marketing and other cooperative funds

Clause 17 requires information to be provided to franchisees who are required to make financial contributions into a general marketing or cooperative fund.

The provision requires an annual audited statement on marketing expenditure to be prepared within 3 months after the end of the last financial year and to be provided to the franchisee, on request, within 30 days after the request. A vote by 75% of franchisees in the franchisor's franchise system in any year may waive the requirement for the audit.

Disclosure of materially relevant facts

Clause 18 requires the franchisor to disclose listed issues within 60 days of the franchisor becoming aware of the fact(s). The facts to be disclosed are limited to the sale of an interest in a franchise, details of certain types of litigation, other legal proceedings and insolvency matters.

Current disclosure document

Clause 19 requires franchisors to provide a franchisee with a current disclosure document within 14 days after the franchisee requests, in writing, a copy of the disclosure document. A franchisee can request a disclosure document only once in any 12 month period.

Transfer of the franchise

Clause 20 prohibits a franchisor from withholding consent to the sale or assignment of a franchise unless it has good reason to do so. Acceptable reasons for withholding consent are not exhaustively defined but include where the purchaser does not meet the selection criteria of the franchisor, or is unlikely to be able to meet the financial obligations required under the franchise agreement.

Termination

Clauses 21 to 23 require a franchisor to give a franchisee reasonable notice that it intends to terminate a franchise agreement:

Where a franchisee breaches a franchise agreement and the franchisor proposes to terminate the agreement, the franchisor is required to give the franchisee an opportunity to remedy the breach within a reasonable time.

Where a franchisor unilaterally terminates a franchise agreement before it expires and the franchisee has not breached the franchise agreement, the franchisor is required to give the franchisee notice of the intention to terminate the agreement in writing.

A franchisor can unilaterally terminate a franchise agreement without providing notice to the franchisee and/or providing the franchisee with the opportunity to remedy a breach in certain serious circumstances which are listed in clause 23.

Either party is able to refer the matter to mediation if they wish (except where unilateral termination has occurred due to serious circumstances).

Part 4 - Resolving disputes

Clauses 24 to 30 makes provision in relation to dispute resolution procedures.

Clause 25 provides for the appointment of a mediation adviser.

Clause 26 requires franchise agreements entered into from 1 October 1998 to provide for a complaint handling procedure that reflects the process in clauses 29 and 30.

Clause 27 allows parties to a franchise agreement to access the process outlined in clause 29.

Clause 28 allows parties to a franchise agreement to access internal system processes in the first instance.

Clause 29 allows a complainant to seek a referral from the mediation adviser to a mediator to resolve a dispute. The outcome of any mediation is not binding on the parties.

Clause 30 provides that the procedures do not remove or replace a complainant's right to otherwise take legal proceedings under the franchise agreement.

Annexure 1

Annexure 1 details the minimum information required to be contained in a disclosure document to be provided to a franchisee or prospective franchisee.

Annexure 2 details the minimum information required to be contained in a disclosure document to be provided to a proposed transferee.

ATTACHMENT B

FRANCHISING CODE OF CONDUCT

REGULATION IMPACT STATEMENT

BACKGROUND

In September 1997, the Government released its *New Deal. Fair Deal* reform package for small business, which included a commitment to introduce a mandatory Franchising Code of Conduct underpinned by the *Trade Practices Act 1974* (TPA). In April 1998, Parliament passed amendments to the TPA to allow for the prescription of mandatory industry codes, such as the Franchising Code of Conduct. This Regulation Impact Statement is an adjunct to the Regulation Impact Statement prepared at that time (**Attachment 1**).

In the *New Deal: Fair Deal* package, the Government established the Franchising Policy Council, comprising franchisor and franchisee representatives and industry advisers, to advise on the proposed Franchising Code of Conduct, in consultation with industry. The Council was established in March 1998 and has consulted extensively with industry parties regarding the form of the code. Two Exposure Drafts of the code were released, which received over 130 submissions. Council has met 12 times including 5 consultation meetings with key industry parties in Sydney, Melbourne, Canberra and Brisbane.

PROBLEM

From 1993 to 1996, the franchising sector was regulated by the voluntary Franchising Code of Practice. This code failed to achieve sufficient market presence to bring about changes in the way franchisors and franchisees dealt with each other, primarily due to the lack of sanctions and lack of commitment by franchisors.

Notwithstanding the general success of franchising activities in Australia, this is an area where disputation between the parties has been a distinct feature since the mid-1970's. The high levels of disputation and litigation in the sector arise from the fundamental nature of franchising arrangements, which differ significantly from other business ventures. Essentially, franchising arrangements result in a separation between the ownership and the control of the capital assets of a business. A franchisee invests in the business and bears the majority of the risk associated with the operation of a particular outlet, while the franchisor maintains control over the design of the overall system and the quality of the output. Difficulties arise when a franchisor uses that control in an opportunistic manner for its own benefit rather than the benefit of the group as a whole.

Many businesses use franchising as a method of capital raising and expansion. Yet franchisors are specifically exempted from the disclosure requirements required under the prospectus provisions of the *Corporations Law*. As a result, many franchisees have invested in systems based on inadequate or incorrect information. This has resulted in a number of disputes over the performance of the business or the conditions under which the business operates.

The number of disputes in the sector is high. Independent research commissioned by the Franchise Code Council in 1996, indicated that 13 per cent of franchisors were in litigation or had a court action in place with one of its franchisees. A further 12 per cent claimed to have a major dispute and 23 per cent had minor disagreements with franchisees.

OBJECTIVES

What are the objectives of government action?

- To raise the standards of conduct in the franchising sector without endangering the vitality and growth of franchising.
- To reduce the cost of resolving disputes in the sector.
- To reduce risk and generate growth in the sector by increasing the level of certainty for all participants.
- To address the imbalance of power between franchisors and franchisees.

Is there a regulation/policy currently in place?

From 1993 to 1996 the franchising sector was regulated by a voluntary Franchising Code of Practice. The code's effectiveness was hampered by the lack of sanctions for breach of the code including the inability of the administering body to name those that breached the code for fear of

defamation action. This led to a large percentage of franchisors operating outside the code and effectively reduced its market impact.

OPTIONS

Which regulatory and non regulatory options (including quasi-regulation) for dealing with the problem are being considered?

The Government agreed to a mandatory Franchising Code of Conduct underpinned by the *Trade Practices Act 1974* and an education campaign-regarding compliance with the code. [More detail of the options considered by the Government is contained in the Regulation Impact Statement at **Attachment 1**].

A number of options were considered by the Government in its *New Deal: Fair Deal* package with regard to regulating the franchising sector including:

- not taking action, that is, maintaining the status quo;
- relying on educating franchisees (and increasing their awareness levels) to achieve a long term resolution of problems caused by a lack of information;
- industry self-regulation (including the industry based Franchising Code of Practice);
- enacting substantial legislation dealing with the problems of the franchising sector;

relying on a prohibition of harsh, oppressive or unconscionable conduct in the *Trade Practices Act 1974*;

supporting industry self-regulation by requiring those who have joined a prescribed industry code to abide by the obligations to which they have agreed; and

a mandatory code.

IMPACT ANALYSIS (COSTS AND BENEFITS)

Who is affected by the problem and who is likely to be affected by its proposed solutions?

The code will regulate behaviour between franchisors, subfranchisors and franchisees.

What are the costs and benefits of each provision in the code? What are the data sources used in making these assessments?

There are four main parts to the mandatory code as follows:

- Definitions and coverage of the code.
- Disclosure
- Conditions of franchise agreement
- Resolving disputes

Discussion of the costs and benefits of each part of the code, including the provisions in each part is at **Attachment 2**.

Data sources for making an assessment on each provision of the code include, but are not limited to, submissions provided on the September 1997 and April 1998 Exposure Drafts of the code, consultations with key industry stakeholders, reports commissioned by the Department of Workplace Relations and Small Business on the cost of compliance with the code and into the scope of coverage of the code, and legal advice.

CONSULTATION

Who are the main affected parties? What are the views of those parties?

The proposed code follows consultation with industry associations, franchisor and franchisee organisations, representatives from the legal sector, relevant State and Territory Government Departments, the Australian Competition and Consumer Commission (ACCC) and the Office of Legislative Drafting. A list of persons/organisations who made submissions on the September 1997 Exposure Draft and the April 1998 Exposure Draft is at **Attachment 3**.

The views of industry participants on particular aspects of the code varied significantly between franchisors and franchisees. These views have been outlined in the section of this Regulation Impact Statement relevant to each clause of the code.

CONCLUSION

What is the preferred option? Briefly outline the main assumptions that the conclusion rests upon. Why is this option preferred and others rejected?

The Code deals with the major issues of concern raised by industry participants and represents the median road between the views of franchisors and franchisees. It is "light touch" regulation as it focuses on disclosure rather than prohibition.

The ACCC will be responsible for enforcing the provisions of the code. This means the ACCC may take action at any time against a franchisor for non-compliance with the code.

The ACCC will be the first point of contact for reporting serious non-compliance by franchisors. The ACCC has a range of enforcement options open to it. When choosing which option to take the ACCC will assess how blatant the breach is, the public detriment, the educative effect and if it will create new law or a new market issue. Should the noncompliance result in a dispute between franchisee and franchisor, dispute resolution processes outlined in the code may provide an appropriate means of resolving the dispute.

Where practicable, franchisees are encouraged to raise breaches of the code with that franchisor, in the first instance with a view to resolving a breach within the franchise system. Private individuals as well as the ACCC can take court proceedings for breaches of the Trade Practices Act and the code. In practice, most breaches should not be resolved in court. The threat of legal action can be sufficient to make wayward businesses play by the rules.

Part 4 of the code provides a process for the resolution of disputes between a franchisor and a franchisee. If a franchise agreement already contains a dispute resolution process, that internal process should be used in the event of a dispute. Should there not be a dispute resolution process contained in the franchise agreement, then this Part of the code will apply. All new franchise agreements entered into on or after 1 October 1998 must contain a dispute resolution process. If the parties are unable to agree to a resolution of the dispute, either party may refer the dispute to a Mediation Adviser to be appointed by the Government. The Mediation Adviser will then refer the parties to an appropriate mediator for resolution of the dispute.

An extensive information dissemination and education campaign is to be implemented including widely advertising the availability of the code through national and regional newspapers,

brochures and seminars involving the ACCC, the Department of Workplace Relations and Small Business (DWRSB) and industry associations.

IMPLEMENTATION AND REVIEW

How will the preferred option be implemented?

The Franchising Code of Conduct is to become mandatory under the *Trade Practices Act 1974* on 1 July 1998.

The intent is that:

- for "franchise agreements" made before 1 October 1998:
 - clauses 14 (Copy of lease), 15 (Association of franchisees) and 17 (Marketing and other cooperative funds) of the Franchising Code of Conduct are to apply on and after 1 July 1998; and
 - the rest of the code applies on and after 1 October 1998;
- for all new, renewed, extended or materially changed "franchise agreements" made on or after 1 October 1998, the Franchising Code of Conduct is to apply on and after 1 October 1998.

The Government gave a commitment in its *New Deal: Fair Deal* reform package to introduce a Franchising Code of Conduct. Due to an extensive consultation process regarding the form of the code, the implementation of the code was delayed. The Franchise Council of Australia advised that industry would require a minimum of 6-8 weeks to comply with the provisions of the code. The Government has provided a transitional period of 3 months within which industry can comply with the provisions of the code. Franchisors will be required to comply from 1 July 1998 with those provisions in the code which can be complied with immediately without adversely impacting on the operation of the business.

An amount of \$160,000 has been allocated over two years to implement an extensive information dissemination and education campaign including widely advertising the availability of the code through national and regional newspapers, brochures and seminars.

In order to assist franchisors in implementing the provisions of the Code, a compliance manual will be produced and will be available in July. Up to \$100,000 has been allocated to implement a compliance program, including the compliance manual. The compliance manual will assist small to medium franchisors to establish systems to comply with the code. The manual will provide guidance on the minimum standards-necessary and a best practice model for those franchisors who wish to adopt it.

Is the preferred option clear, consistent, comprehensible and accessible to users? Is it sufficiently flexible to adapt to various situations and circumstances?

The code has been drafted by the Office of Legislative Drafting in accordance with accepted drafting principles including plain English.

What is the impact on business, including small business, and how will compliance and paper burden costs be minimised?

A study commissioned by the Department of Workplace Relations and Small Business indicates that the likely incremental cost of complying with the annual disclosure requirements in the code are as follows:

- where the franchisor already complies with the disclosure requirements under the former voluntary code requirements - \$1,000 during the year of changeover to the code. Ongoing disclosure costs in subsequent years could range from \$500 - \$1,000 for a small franchisor to \$1,000 - \$1,500 for a large franchisor;
- where the franchisor's current disclosure is nominal or non-existent - from \$4,000 - \$6,000 for a small franchisor to \$6,000 - \$9,000 for a large franchisor during the year of changeover to the proposed code. Ongoing disclosure costs in subsequent years could range from \$1,500 - \$3,500 for a small franchisor to \$3,500 - \$5,500 for a large franchisor;
- the likely cost of providing an audited annual statement of disbursements from a compulsory marketing fund could be \$2,000 - \$3,000 for small franchisors to \$6,000 - \$10,000 for large franchisors. This cost may be avoided through the provision allowing the audit to be waived if 75% of franchisees agree.

Costs for franchisors may be passed to franchisees. Analysis on the proposed costs shows that the costs to be passed on to franchisees could, on average, range from \$10 - \$100 for each franchisee depending on the number of franchises, where the franchisor was already complying with the former voluntary code. Where the franchisor's disclosure is nominal or non-existent, costs passed on to franchisees could be, on average, from \$35 - \$500 for each franchisee, depending on the number of franchises. These figures are based on the average numbers of franchisees for small, medium and large systems.

Additional costs incurred by franchisors must be balanced with decreased disputes and litigation, increased certainty in the industry and better sharing of information. Overall, it is unlikely that the growth of the franchising sector will be affected.

The ACCC will provide an advisory and enforcement role. Small business case officers will be located in each State and Territory to advise on the code. The ACCC will also take on a codes enforcement function.

How will the effectiveness of the preferred option be assessed? How frequently?

The effectiveness of the code will be reviewed by the Council within 3 years.

If the preferred option takes the form of regulation, is there a built-in provision to review or revoke the Act after it has been in place for a certain length of time?

There is no built-in provision to review or revoke the code after it has been in place for a certain length of time. However, the terms of reference for the Franchising Policy Council require that the Council members will review the effectiveness of the code within 3 years.

REGULATION IMPACT STATEMENT:

PRESCRIBING THE FRANCHISING CODE OF CONDUCT

PROBLEM IDENTIFICATION AND SPECIFICATION OF REGULATORY OBJECTIVES

Problem to be addressed/rationale for Government action

There have been increasing calls for stronger regulation in the franchising sector in response to continuing high levels of disputation and litigation (13 per cent of franchisors are in litigation and a further 12 per cent have major disputes with franchisees, which amounts to one in four franchisors, having either disputes, major disagreements or litigation in Courts). The sector has been unregulated since the collapse of the voluntary Franchising Code of Practice in December 1996.

2. The operation of the franchising sector has been of concern for Government for many years. In 1991 a Task Force was established to examine the problems experienced in the sector. As a result of the Task Force recommendations, the Franchising Code of Practice was introduced on 1 February 1993, for a two year trial period. The Code was administered by the then Franchising Code Administration Council (FCAC). The FCAC was established with seed funding from the Commonwealth and was to become fully funded by industry within 2 years (by 1995).

3. In early 1994, a review of the Code was conducted in response to continued complaints by industry participants about its effectiveness, the lack of coverage of the Code and the poor performance of the FCAC in reducing the high levels of litigation in the sector. The FCAC received additional resources to expand its operations. It developed a new strategic plan, changed its name to the Franchising Code Council (FCC), and succeeded in increasing coverage of the Code to around 65 per cent of industry participants. However, after the Budget decision to cease funding after 1996/97, internal disputes in the FCC led to the decision to cease trading in December 1996.

4. The franchising sector is characterised by high dispute levels generally arising out of the imbalance of power between franchisors and franchisees. Major problems include: inadequate levels of disclosure in franchise agreements; clauses in agreements that allow franchisors to unilaterally vary terms; misrepresentation by franchisors; hidden commissions and fees; the high cost of actions under the TPA; difficulties experienced by franchisees in obtaining redress from infringing franchisors; Churning of franchises; encroachment of company stores on franchisees' areas; lack of appreciation by business advisers of the pitfalls associated with franchising; and franchisees' lack of understanding of the skills, experience and capital necessary to succeed.

5. In June 1996, the then Minister for Small Business and Consumer Affairs, the Hon Geoff Prosser MP, referred a range of business conduct issues to the House of Representatives Standing Committee on Industry, Science and Technology. The Committee reported on 26 May 1996, recommending the introduction of specific franchising legislation and compulsory registration of franchisors. In response to the Committee's recommendations, the Government has accepted the need for regulatory intervention.

Regulatory objective

6. The Government's objectives are to provide a protective safety net for franchisees by:
- ensuring minimum standards of disclosure are adhered to throughout the sector, allowing franchisees to have sufficient information to make rational commercial decisions;
 - reducing the incidence of unfair commercial conduct by franchisors;
 - providing an environment of certainty for all sector participants;
 - ensuring the sector has a strong role in the development and maintenance of its regulatory environment;
 - ensuring that suitable remedies and sanctions are available for breaches of the code;
 - reducing the incidence of disputes and litigation in the sector; and
 - bringing about a cultural change in the sector that results in higher standards of commercial behaviour.

Current regulation

7. The franchising sector was, until December 1996, regulated by a voluntary Franchising Code of Practice (FCP). High levels of disputation and litigation in the sector indicate that the voluntary system was not entirely effective in reducing poor business practices. Major impediments to the effectiveness of the voluntary code included:

- limited coverage of franchisors (approximately 35 per cent of franchisors remained outside the code);
- the inability of the administering body to name those that breached the code for fear of defamation action;
- a lack of sanctions for breaches of the code; and
- the high cost of bringing an action under the *Trade Practices Act 1974* (TPA) (the average cost of investigating an action under s52 (misleading and deceptive conduct) is \$100,000).

IDENTIFICATION OF ALTERNATIVES

8. To address the problems in the franchising sector, the following alternatives for Government action were considered:

- *allow market forces to establish industry standards* - this option assumes that the problems which have been identified in this high growth sector do not constitute a market failure that should be addressed through regulatory intervention. It is arguable that there are already sufficient avenues through which disputes can be resolved (and further such disputes may act as a signal to prospective franchisees to take greater care in entering franchises). Franchisees can presently allege contraventions of various provisions of the TPA (including sections 46, 51AA, 52) or base actions in common law for breach of contract or tort (eg. negligence). Resolution of disputes can also be sought outside the judicial processes, through non-judicial mechanisms such as mediation and arbitration. This option does not address the recommendations of the Committee or the expectations of the small business community.
- *re-introduce a voluntary code of conduct* - a voluntary code is unlikely to capture all franchisors. Market pressure can be brought to significantly increase coverage by strengthening the code, improving its administration, particularly the ability to name infringing franchisors, and by ensuring subscription by high-profile, respected franchisors. A voluntary code has advantages over regulation in that it can be owned, maintained and administered by the industry. In doing so, the sector itself can quickly and simply modify the code in response to changing market conditions. Sufficient safeguards can be built into an industry system to attempt to ensure that all interests are protected. Despite these advantages, it is unlikely that a voluntary model would meet the current expectations of the small business sector, that is, that franchisors provide fuller greater disclosure and franchisees will have access to remedies for wrongdoing. Past experience of the Franchising Code of Practice provides clear evidence of the difficulties associated with a self-regulatory approach.
- *prescribe the Franchising Code of Practice as a voluntary code of conduct under amendments to the TPA* - this option would address the balance of power between franchisors and franchisees, making it simpler and less expensive for franchisees to enforce adherence to the code and address some of the problems of the Franchising Code of Practice. An aggrieved franchisee would have a clear cause of action in the Federal Court to pursue breaches of the code and access to a wide range of remedies under the TPA. Franchisees would have access to enforcement mechanisms through the ACCC. Prescribing a voluntary code encourages prospective franchisees to deal only with franchisors that subscribe to the code. However, the code would apply only to those franchisors who registered. This approach would, therefore, not adequately address the issue of market failure of the previous voluntary code..

- *prescribe a mandatory code of practice under amendments to the TPA* - the Committee concluded that any form of voluntary code would be ineffective and that the market power held by franchisors was open to abuse in a way that normal competition could not effectively control. The Committee also concluded this abuse of market power was widespread. This conclusion is supported by the high level of disputation and the long history of calls for Government intervention. As a result, the Committee recommended legislative action in the form of a specific franchising act. An effective alternative to legislation is the prescription of the mandatory code under the proposed amendment to the TPA. This option has similar outcomes to legislation, yet combines the benefits of an industry code, with the complete industry coverage that can be achieved through regulation. It would meet the expectations of the Committee and the small business community. It would lead to resources being better targeted to industry education and code enforcement, instead of marketing and soliciting for membership of the code.

- *enact specific franchising legislation* - the Committee recommended the enactment of specific franchising legislation in order to provide protection to all franchisees. This option was previously considered in 1986-87 when a draft *Franchise Agreements Bill* was issued for consultation. However, broad business support for the proposal was not forthcoming. This option lacks the flexibility of a mandatory code as the barriers to amending or repealing legislation reduce its ability to respond to changing market conditions.

9. All proposed strategies have been evaluated against their ability to create an environment of certainty for those in the sector, without imposing a regulatory burden and additional costs on franchisors and franchisees. A balance must be achieved between protecting franchisees from unfair practices and the freedom to conduct business in a competitive manner.

IMPACT ANALYSIS

10. In order to evaluate the impact of the various options proposed on the sector, the following criteria were considered:

- regulatory impact of the strategy;
- level of protection that will be provided to franchisees;
- franchisee's ability to access justice;
- degree of coverage likely to be achieved amongst franchisors;
- costs that will be imposed on franchisors;
- ease of amendment to ensure market responsiveness;
- regulatory complexity; and
- ongoing cost to the government.

Impact group identification

11. The following groups are relevant to the proposal:

- franchisors;
- franchisees with existing franchise agreements;
- prospective franchisees;

- Government bodies that may be required to administer and enforce the regulation;
- parties with commercial relationships with franchisees and franchisors;
- legal and business advisers; and
- consumers that may bear the costs of regulation and high levels of business failure.

Impact on existing regulations and existing regulatory authorities

12. Currently there is no existing franchising specific regulation. The voluntary Franchising Code of Practice has not been in operation since the FCC was wound up in December 1996. The relationship between franchisors and franchisees is, however, subject to the protections contained in the TPA.

Cost/Benefit analysis

Option 1 - Allow market forces to establish industry standards

13. The costs and benefits of allowing market forces to establish industry standards are:

Costs:

- The trend of increasing business failure, particularly in the retail sector, suggests that maintaining the status quo would result in increased costs of business failure that would be borne by business, Government and ultimately the public.
- The option is likely to be viewed as contrary to the Government's commitment to improve the environment for small business and does not address the Committee's recommendations.
- The option is likely to result in continuing pressure for Government action from aggrieved interest groups.

Benefits:

- This option will reinforce the emerging recognition that the Government's policies seek to avoid unnecessary regulatory intervention and thereby avoid distortion of the investment climate.
- There will be an avoidance of any 'flow on' to other industry sectors which might seek Government regulation to address conduct issues.

Option 2 -Re-introduce a voluntary code of conduct

14. The costs and benefits of a voluntary code of conduct are:

Costs:

- The option requires ongoing Government expenditure to get self-regulation working, as the sector has proven reluctant to adequately fund self-regulation.
- Coverage of the code would not be complete and it has been demonstrated that market forces are not sufficient to achieve better than 60-70 per cent coverage.

- An administering body may have difficulties in de-registering participants for breaches of the code due to possible defamation actions, although this can be addressed through provision of qualified privilege or contract based systems that remove or limit liability.
- There are no real sanctions for breaches of the previous Franchising Code of Practice or of Oi1 Code, which restricts the effectiveness of such codes in addressing the problems identified by the Committee.

Benefits: This option puts responsibility for regulating the industry with industry itself.

- Successful industry self-regulation will result in a reduction of calls from the community for Government intervention.
- Mechanisms are largely self-enforcing and promote avoidance of the costs involved in accessing the legal system by improving the attractiveness of mediation as a means of avoiding costly court action.
- Voluntary codes allow the market to operate and adapt to changes in the market structure.

Option 3 - Prescribe the Franchising Code of Practice as a voluntary code of conduct under the amendments to the TPA

15. The costs and benefits of an underpinned voluntary code of conduct are:

Costs:

- Because the provision imposes no obligations on those who do not accept the industry standards laid down in the code, it may not be fully effective in addressing industry problems identified by the Committee.
- Compliance costs would be incurred by industry as a whole, whether or not individual participants in the industry have joined the franchising code.
- Some industry participants may wish not to be associated with a prescribed code, because of a perceived increase in risk exposure.
- Unless the code can establish a sufficient market signal, its compliance cost implications could place subscribers at a competitive disadvantage in relation to non-subscribers.
- The sector may respond to prescription by lowering standards of conduct contained in the prescribed codes.
- Administrative arrangements would involve ongoing cost to Government (\$1.477 million over four years).

Benefits:

- As the obligations imposed by the provision bind only those who choose to be bound, the provision is significantly less likely than other more regulatory options to distort the investment market.
- Franchisees would have access to the Federal Court (and TPA remedies) to enforce obligations under the code.

- Voluntary codes allow the market to operate freely and be adapted to changes in the market structure.

Option 4 - Prescribe a mandatory code of practice under the amendment to the TPA

16. The costs and benefits of a mandatory code of practice are:

Costs:

- Compliance costs would be incurred by industry.
- The sector may respond to prescription by seeking to lower standards of conduct contained in prescribed codes.
- Administration and enforcement will involve ongoing cost to Government.
- Mandatory codes are not able to adapt to market changes as effectively as voluntary codes of conduct. They are, however, more flexible than primary legislation.

Benefits:

- Provides complete coverage of the sector.
- Will provide all franchisees with enforceable rights to minimum disclosure and fairness which addresses the Committee's primary concerns for the sector.
- This option is more flexible and responsive to industry needs than primary legislation and provides a greater role for industry in the development and maintenance of the regulatory environment.
- The ACCC will take a advisory and enforcement role that will ensure the effective administration of the code without the risk of defamation action.
- Gives sector participants access to the sanctions and remedies contained in the TPA.
- Reduces the impediments to franchisees' ability to access justice.
- Will be subject to the in-built review and sunseting provisions contained in the Legislative Instruments Bill 1996 (when enacted).

Option 5 - Enact specific franchising legislation.

17. The costs and benefits of specific franchising legislation are:

Costs:

- Primary legislation is generally inflexible and non-responsive to market changes.
- The involved process for amendment of primary legislation lends itself to outdated regulation which may result in the stultification of an important growth sector of the economy.
- The option has ongoing budgetary implications for Government.
- The option carries considerable compliance costs for industry.

- Enacting a specific Franchising Act is likely to distort community expectations on the Government's regulatory policy and result in calls for similar intervention in other areas.
- Would require either the establishment of a new statutory body to administer the legislation or amendments to the TPA to allow the ACCC to take on an administrative role.
- Barriers to repeal of Acts may retard the eventual transition to more market-driven regulation.

Benefits:

- Franchising legislation could be used to specifically target problems which exist.
- Franchising legislation could provide a more certain environment in which businesses can operate.
- The existence of franchising legislation can be used to resist calls for further protection.

PREFERRED OPTION

18. Prescribing a Franchising Code of Practice is the preferred option as it combines the advantages of industry self regulation with the certainty and complete coverage that can be achieved through legislation. While the enactment of primary legislation would meet the expectations of the sector, its inflexibility and potential to distort the market would outweigh its advantages.

19. A mandatory code will provide protection for all franchisees through the establishment of minimum standards of disclosure and conduct. It has the flexibility to respond to market changes and offers the greatest opportunity for industry involvement and management. Franchisees would have access to the remedies and sanctions under the TPA and the ACCC Codes Enforcement Unit would reduce the costs of dealing with complaints.

OTHER REQUIREMENTS

Consultation

20. A number of reviews, involving extensive public consultation, have examined problems in the franchising sector have been undertaken over the past ten years, including:

- the Beddall Inquiry into Small Business in Australia 1990;
- the 1991 Franchising Task Force Inquiry;
- the 1994 Review of the Franchising Code of Practice; and
- the 1997 House of Representatives Standing Committee on Industry, Science and Technology Inquiry into Fair Trading.

21. Each of these reviews have involved extensive public consultation. Each has recommended Government intervention in the franchising sector to address continuing problems created by the imbalance of bargaining power between franchisors and franchisees. The most recent inquiry, the Fair Trading Inquiry, received over 200 submissions from business groups and individuals and evidence from over 50 groups in public hearings.

Administrative simplicity, economy and flexibility

22. The preferred option to prescribe the Franchising Code of Practice as a mandatory code under the TPA addresses the concerns of the Committee to improve protection for all franchisees while retaining the flexibility and industry responsiveness of codes of practice. It provides an opportunity to review the regulatory framework within a specified time-frame and, if significant cultural change has occurred in the sector, the code can be moved towards a more voluntary approach.

23. The model utilises the established enforcement mechanisms provided by the TPA through the ACCC. Franchisees will have access to the remedies and sanctions available under the TPA. These procedures provide a considerable degree of flexibility in enforcement to ensure regulatory aims can be met.

24. The strategy also involves the establishment of a Franchising Policy Council (FPC) to provide industry input into the code and the appointment of a Disputes Resolution Adviser (DRA) for the franchising sector. The DRA will advise or select the most appropriate form of alternative dispute resolution process in the circumstances. The appointment of a DRA will overcome concerns about possible difficulties faced by franchisees, through inexperience or coercion by franchisors, in coming to an agreement on an appropriate mediator.

IMPLEMENTATION AND REVIEW

Explanatory Material

25. The Codes of Conduct Unit in the ACCC will provide educational and explanatory material. Provision has been made to subsidise initial publication of the code to ensure its wide distribution. The ACCC will produce a guide on operation of the code and its role in its enforcement. 26. The Code will be developed in consultation with an industry advisory body, the Franchise Policy Council, and industry associations such as the Franchise Association of Australia and New Zealand and the Australian Franchisees Association. It is expected that industry associations will also take a significant role in disseminating information on the code.

Implementation

27. At the time of the announcement of the Government's response to the Inquiry, the Minister for Workplace Relations and Small Business will announce the establishment of the Franchising Policy Council (FPC). The FPC will be an advisory body. The Minister will provide to the FPC a draft of the new Franchising Code of Practice. The FPC will release the code for public consultation.

28. The enabling provision to allow the prescription of codes will be introduced into Parliament prior to November 1997. When the enabling provision is enacted, the revised Code will be brought forward for prescription.

Review

29. The FPC will establish a Memorandum of Understanding with the ACCC to obtain statistical information on the operation of the code. The FPC will meet bi-annually to monitor and review the operation of the code and make recommendations on its operation. Any amendments to the code will be submitted to the Minister for Customs and Consumer Affairs for consideration.

30. All codes prescribed under the TPA amendment will require the preparation of a Legislative Instrument Proposal (LIP), ensuring that a rigorous cost-benefit analysis is undertaken before a code is prescribed. As an additional safeguard, the LIP for an industry code will require Cabinet approval before being brought forward.

31. Codes prescribed through this mechanism will be subject to ongoing and searching evaluation. The Franchising Code of Practice will undergo a formal review after three years.

SUMMARY

32. Allowing market forces to establish industry standards has not addressed the problems of the franchising sector, nor would it meet the expectations of the sector for Government intervention. There is a high level of business failure in the franchising sector and the imbalance of power between franchisors and franchisees is a factor in this. Business calls for intervention have remained consistent for the past decade and there is little evidence that behaviour in the sector has improved.

33. The voluntary Franchising Code of Practice was unable to achieve complete coverage of the sector due to the lack of sanctions against infringing franchisors. While education campaigns lifted awareness of the problems in the sector, a significant proportion of franchisors were able to operate outside the industry standards. This option would not meet the Committee's recommendations.

34. Prescribing the Franchising Code of Practice as a voluntary code under the TPA would improve franchisees of registered systems with improved enforcement mechanisms and access to justice. However, there would always be a number of systems operating outside the system that would continue to impact on the growth potential of the sector as a whole. Some industry participants would avoid a prescribed code, given the option, for fear of increased risk exposure.

35. The enactment of primary legislation would meet the expectations of the sector. However, the lack of flexibility and responsiveness of this option would outweigh many of its advantages. The difficulty in amending and repealing such legislation limits its ability to change to respond to a particularly dynamic and fast growing business sector.

36. Prescribing the Franchising Code of Practice as a mandatory code provides protection for all franchisees through the establishment of minimum standards of disclosure and conduct. It provides the flexibility to respond to market changes and offers the greatest opportunity for industry involvement and management. Franchisees would have access to the remedies and sanctions under the TPA and the Codes Enforcement Unit would reduce the costs of dealing with complaints.

37. The establishment of the FPC will ensure industry ownership and participation in the development and maintenance of the code. The DRA will provide an independent body that will facilitate dispute resolution.

38. This option, combined with an education and awareness campaign, will accelerate cultural change in the sector. The code will be reviewed within three years. If significant improvement in business conduct in the sector has been achieved, Government and industry may consider the option of prescribing the code as a voluntary code, and eventually transferring responsibility for the regulatory environment to the sector in its entirety.

DRAFT FRANCHISING CODE OF PRACTICE (SEPTEMBER 1997)

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Accord Group, Australia

Angus & Robertson Bookworld Pty Ltd

Australian Competition and Consumer Commission

Australian Institute of Petroleum Ltd

Australian Petroleum Agents and Distributors Association

Australian Society of CPAs

Bargain Box Fabrics

Cabinet Office, New South Wales

Chamber of Commerce and Industry, Western Australia

Corrs, Chambers, Westgarth - Lawyers

Cutler, Hughes & Harris - Lawyers [David Meagher]

Cutler, Hughes & Harris - Lawyers [Jenny Buchan]

Dang International

(Trading as Roger David Knox City)

Department of Industry, Science & Tourism [Antony Brugger]

Department of Industry, Science & Tourism [Philip Noonan]

Dobson, Mitchell & Allport - Barristers, Solicitors & Notaries

Dollars, Curtains & Blinds

Dymocks Booksellers

Farm Machinery Dealers Association of Western Australia

Federal Chamber of Automotive Industries

Franchise Council of Australia

Franchisees Association of South Australia

Law Institute of Victoria

Magna-Dry

Mediate Today Pty Ltd

Mitsubishi Motors Australia

Motor Trades Association of Australia [Submission 1]

Motor Trades Association of Australia [Submission 2]

Mr Rodney Hackett - McDonald's Licensee

MT Bennett

National Real Estate Franchise Association

Network Security Services

NSW Young Lawyers

Pharmacy Guild of Australia

Post Office Agents Association Ltd

Retail Food Group (Australia)

Russell Kennedy, Solicitors

SA Department of Industry and Trade

Skegg Management Group

Small Business Development Corporation, Western Australia

Small Retailers Association of South Australia Inc

Sportscene

Supa Valu Belmont

Tolhurst, Druce & Emmerson - Solicitors

Tractor and Machinery Association of Australia

Vister Australia Pty Ltd (Trading as Roger David Eastland)

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Allpower Industries Australia Pty Ltd

Angus & Robertson Bookworld

Australia Post

Australian Association of Permanent Building Societies

Australian Automotive Aftermarket Association Ltd

Australian Competition and Consumer Commission (ACCC)

Australian Institute of Petroleum (AIP)

Australian Petroleum Agents and Distributors Association (APADA)

Australian Society of Certified Practising Accountants (ASCPA)

Baker and McKenzie

Bargain Box Fabrics

Barwicks Wisewoulds Lawyers

Berri Limited

Blake Dawson Waldron Lawyers (for SOCOG)

Bob Jane T-Marts

Bruce Reid, Federal Member for Bendigo

Cabinet Office NSW State Government

Chamber of Commerce and Industry (Western Australia)

Corrs Chambers Westgarth Lawyers (for Burger King)

Council of Small Business Organisations of Australia Ltd (COSBOA)

D'Aloia Consulting

DANG International Pty Ltd

Dept of Asian Relations, Trade and Industry (Northern Territory)

Dept of Industry, Science and Tourism

Dept of Industry & Trade (SA)

Dept of Tourism, Small Business and Industry (QLD)

Diana Trenery

Entimos Business Services

Fastway Couriers

Federal Chamber of Automotive Industries

Franchise Council of Australia

Haarsmas Lawyers

Hertz Licensee Committee

Indcorp Franchisees Association of Australia

Institute of Legal Executives (Victoria)

International Franchise Association

J. R. Gibb & Co

Jenny Buchan

Law Council of Australia

Law Institute of Victoria

Macquarie Franchise Systems

Magna-Dry

Mallesons Stephen Jaques Solicitors

Master Builders Australia

Motor Trades Association of Australia

Mr Lyn Pereira

Muffin Break

National Alternative Dispute Resolution Advisory Council

National Real Estate Franchise Association (NREFA)

Office Force Pty Ltd

Office of Small Business Advocate

Outdoor Power Equipment Association

Perisherables International

Post Office Agents Association Limited

Queensland Investment Corporation

Queensland Retail Traders and Shopkeepers Association (QRTSA)

Small Business Development Corporation (Western Australia)

Sneddon Hall & Gallop

Retailers Association of Queensland (RAQ)

Rigby Cooke Lawyers

Roussety & Co and Bob Jane T-Marts Pty Ltd

The Cheesecake Shop - Baulkham Hills

The Law Society of New South Wales

The Law Society of Tasmania

The Retail Traders' Association of New South Wales

The University of Southern Queensland

Thomson Playford (for MMAL)

Tractor & Machinery Association of Australia

V.1.P. Australia

Vister Australia Pty Ltd

Ward Keller Lawyers

Wendy's (Centrepont Sydney)

Wendy's (Myer Centre Adelaide)