REGULATORY IMPACT STATEMENT

Franchising policy reforms and the Government response to the Joint Committee on Corporations and Financial Services' report on franchising

Overview

This Regulatory Impact Statement (RIS) is a consideration of three broad policy issues identified in the Parliamentary Joint Committee on Corporations and Financial Services (Joint Committee) report on franchising:

- End of term arrangements (Recommendation 5).
- Establishment of a registration system for franchise businesses and collection of data on the franchising sector (Recommendation 2 and Recommendation 7).
- Insertion of a good faith clause into the Franchising Code (Recommendation 8).

The analysis is set out in three main parts. The first part provides an overview of the Franchising Code of Conduct (Franchising Code), the recommendations by the Joint Committee, the Government's policy and regulatory objectives in relation to the Franchising Code and suggests a framework for addressing the Joint Committee's recommendation. The second part provides an overview of the costing methodology for assessing business compliance costs within this analysis, a summary of the preferred regulatory option and the basis for further consultation with business on the compliance costs posed by the regulatory options. It also provides an overview of the other recommendations by the Joint Committee which were not considered within the analysis (Recommendations 1, 3, 4, 9-11).

Finally, the third part is a detailed analysis of each of the three broad policy concerns identified above. The detailed analysis sets out the background to the problem, outlines the problem, the Government's objective in relation to each problem, the options that could be considered by the Government to address the problem, the impacts of the options, and further business consultation that was undertaken to refine the cost-benefit analysis of each regulatory proposal and a conclusion on the preferred option.

PART I

The Franchising Code of Conduct

The Franchising Code of Conduct (Franchising Code) is a mandatory code under the *Trade Practices Act 1974* (Trade Practices Act). The objective of the Trade Practices Act is to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection. The Franchising Code contributes to the overall objective of the Trade Practices Act by ensuring transparency in dealings between franchisees and franchisors. Informed decision making by businesses furthers competition in the Australian market, which contributes to consumer welfare.

Under the Franchising Code, franchisors are required to disclose specific facts to franchisees about the franchise business and to follow set procedures in their dealings with franchisees. While the Franchising Code provides for minimum standards of disclosure and conduct, it is not intended to replace the need for franchisees to seek independent legal, business or other advice before entering into a franchise agreement. The need for franchisees to be sufficiently informed about their disclosure documentation, their rights and obligations under the Franchising Code and the need for them to seek advice on their franchise agreement prior to entering into a franchise agreement is specifically recognised under the Franchising Code (clause 11).

The Joint Committee noted that the time during which a prospective franchisee is considering entering into a franchise agreement represents the best opportunity for both the franchisee and the franchisor to make an accurate and informed assessment about whether this is the right agreement for them.

As the Joint Committee notes, franchising is an ongoing relationship between two separate commercial parties, a franchisee and franchisor. The franchising relationship is based on a prescribed business model which is offered by the franchisor and carried out under their guidance and oversight by franchisees. While recognising the interdependent nature of franchise agreements, the Joint Committee noted:

- the scope for differing expectations about the obligations of each party as the franchising relationship evolves over time; and
- the asymmetry of bargaining power which could potentially be abused by the stronger party (the franchisor).

The Franchising Code was introduced, in part, in recognition of the imbalance in bargaining power between franchisors and franchisees. Nevertheless, as the Joint Committee noted, franchising is a relationship between two separate commercial parties. The Franchising Code does not prohibit both parties from pursing their own individual interests nor does it prohibit normal hard commercial dealings which may be perceived as 'unfair' by one party. This approach recognises that while franchisees may benefit from minimum disclosure and procedures that must be followed by franchisors in their dealings with them, the Code provisions should not unreasonably constrain franchisors from making business decisions in not only their own interests but also for the benefit of the entire franchise system.

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

According to a Griffith University survey of franchising in 2008[1], the Australian franchising sector: consists of approximately 1,100 business format franchisors; has 63,500 business format franchised units and 7,900 company owned units (total of 71,400 units); employs over 400,000 people; and in 2007 had a sales turnover of $130 billion. Broadly, a franchise unit is a franchise business operated by a franchisee within a franchise system. The May 2009 IBIS World industry report on franchising indicates that despite the current economic downturn, high performance businesses within the sector expect revenue growth. The Report notes that demand for new franchise businesses will stem from rising unemployment and redundancies. The Government has indicated that it would not support any regulatory changes which would damage the existing franchising business model that has provided employment to thousands of people.

The Joint Committee's recommendations

The Joint Committee considered that by making the improvements to the Franchising Code that are recommended in its report and by allowing time for the 1 March 2008 amendments to the Code to have an impact, the existing regulatory framework is developing into the most appropriate mechanism for fostering franchising in Australia. However, it made 11 recommendations to improve the operation of the Franchising Code which can be broadly grouped into five categories:

- the need for better indicators of stability of the franchising sector (in particular, data on disputes within the sector) (Recommendations 2 and 7);
- improved disclosure and due diligence, in particular in relation to risks of franchisor failure and end of term arrangements (Recommendations 1, 4 and 5);
- the need for 'good faith' conduct between franchisees-franchisors including in dispute resolution and changing the name of the Office of the Mediation Adviser (OMA) (Recommendations 6 and 8);
- greater enforcement powers for the Australian Competition and Consumer Commission (ACCC) (Recommendations 9-11); and
- the need for an adequate review of the 1 March 2008 amendments to ascertain their efficacy (Recommendation 3).

At the core of the majority of franchisee stakeholder submissions to the Joint Committee are concerns about the inherent imbalance of bargaining power that exists in a franchising relationship; franchisees' dissatisfaction with the quality of the advice received prior to entering into the franchise agreement and that some franchisees feel overwhelmed by the amount of information they receive as part of their pre-contractual disclosure.

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

Policy and regulatory objectives

While the Franchising Code exists to provide a minimum 'safety net' for franchisees, any further regulatory options must have due regard to the need for franchisors (some submissions to the Joint Committee suggested that many franchisors are small businesses) to grow and expand. Any further regulatory proposals should not impose undue compliance burdens on the sector.

Business failure, early exit from the business for personal reasons, non-renewal of contracts (for instance, lease arrangements), disputes between businesses and their customers or suppliers are a feature of the Australian business environment. These issues are often exacerbated during periods of economic downturn. Franchise failure can be particularly devastating. Submissions to the Joint Committee noted that where the franchisee has invested substantial resources and spent the larger part of their working life in operating the franchise business, they have likened the end of the franchise relationship to the experience of personal relationship breakdown or even death. Other franchisees in the network may also suffer as a consequence of the negative publicity associated with disputes (brand damage). Given these risks, regulators and policy makers should remain vigilant to systemic concerns and problems that could be indicative of a broader policy concern that needs to be addressed by regulatory or other intervention. The benefit of any regulatory intervention needs to outweigh the costs of such intervention.

The Government policy guidelines on making industry codes of conduct enforceable under the *Trade Practices Act 1974* state that Code requirements should be drafted to address specific problems. Codes should be drafted in terms of requirements and obligations, not aims and ideals. Enforceable provisions within codes of conduct under the Trade Practices Act must be drafted in clear, unambiguous language that can be clearly interpreted by industry participants, consumers, investigators and by the Court. Ultimately, the provisions of the Franchising Code should be in line with the overall objective underpinning the Trade Practices Act. That is, to further competition and fair trading for the benefit of the consumers.

This RIS focuses on possible options in relation to the recommendations by the Joint Committee that potentially have regulatory impacts stemming from amendments to the Franchising Code. These recommendations broadly deal with pre-contractual disclosure in relation to end of term arrangements (**Recommendation 5**); the insertion of a good faith clause into the Franchising Code (**Recommendation 8**) and the establishment of a registration system for franchise businesses, which could enable the collection of data on the franchising sector (**Recommendation 2 and Recommendation 7**).

A way forward

Imbalance of power and unilateral variation of contractual terms

Broader provisions in relation to the unconscionable conduct under the Trade Practices Act are relevant to franchisees' concerns about the imbalance in bargaining

power in a franchise relationship and unilateral variation of contractual terms by franchisors.

Under the Government's *Trade Practices Amendment (Australian Consumer Law) Bill 2009* (Australian Consumer Law Bill), 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.

On 3 December 2008, the Senate Committee on Economics released its report – *the need, scope and content of a definition of unconscionable conduct for the purposes of Part IVA of the Trade Practices Act 1974*. The Senate Committee's report comments extensively on franchising and the recommendations are aimed at clarifying the law in relation to unconscionable conduct.

Amendments specific to the Franchising Code to address identified problems

Where a specific problem has been identified in the Joint Committee's report, the preferred option identified in relation to each recommendation is guided by the broad policy and regulatory objectives identified above. It is suggested that the preferred option, on balance, is likely to:

- minimise any anti-competitive effects for businesses;
- ensure clarity in rights and obligations between franchisors and franchisees; and
- provide a net benefit for franchise businesses and the public.

The preferred options favour 'light touch' regulatory changes addressing better pre-contractual disclosure, augmented by improved pre-contractual education for franchise sector participants. The proposed regulatory changes, by themselves, will not address franchisees' core concerns about poor quality of advice they may have received prior to entering into the franchise agreement and lack of guidance when contemplating entering into a franchise agreement. A regulatory response to these issues, such as mandating pre-contractual education for franchisees or nationally recognised qualifications for advisers within the franchise sector, risks encroaching into commercial matters which are best determined by the individuals themselves and could impose significant costs on the industry and the stifle growth of the sector.

The ACCC is responsible for enforcing the Trade Practices Act and the Franchising Code. The ACCC's role is to ensure compliance with the Trade Practices Act and the Code through education, liaison and, where necessary, enforcement action. To do this, the ACCC assists franchisors and franchisees to understand their rights and obligations under the Franchising Code and the Trade Practices Act by developing educational and compliance materials such as guidelines, articles and fact sheets, as well as giving presentations by outreach staff in each state and territory.

Currently, public information and links to the ACCC education material is available to franchise businesses on the ACCC's website at www.accc.gov.au and at www.business.gov.au. Submissions from both franchisee and franchisor sector stakeholders to the Joint Committee recognised the benefit of quality pre-franchise

education for franchisees. Key stakeholders, such as the ACCC, noted their improved communication strategies in this area. Other submissions noted the need for franchisee education to emphasise the potential risks of entering into a franchise business model.

The Government could review the existing public information on www.business.gov.au to ensure that persons considering entering into a franchise system are directed to pertinent pre-contractual education material such as the ACCC franchisee and franchisor manual and other state based agencies. This would complement the important role of private industry bodies, such as the Franchise Council of Australia and advisers in educating the franchising sector on common risks and limitations of entering into a franchise agreement. The www.business.gov.au website is the seventh most visited Australian Government website and is the main portal for businesses accessing Government information and services.

Regulatory Offsets

As part of the RIS analysis, consideration was given to the requirement for regulatory offsets, however none were identified. According to the Department of Finance and Deregulation's guidelines, an agency meets the intent of the 'one-in one-out' principle by considering opportunities, even when it cannot identify any offsets. However, a review of the public information on franchising, in particular information available on www.business.gov.au may improve industry access and understanding of the obligations under the existing regulatory framework.

In addition, if adopted, under the preferred option (Option 3) for Recommendation 5, franchisors would be required to clearly stipulate what the end of term arrangements will be before a prospective franchisee enters into a franchise agreement. The disclosure of this information may assist in mitigating disputes where one party has an expectation not shared by the other party that the franchise agreement will be renewed.

It is also possible that clarification of the types of behaviours expected by parties to franchise mediation (as noted as part of the preferred option for Recommendation 8) may result in a regulatory offset. This option may reduce ambiguity surrounding what 'trying to a resolve a dispute' means.

PART II

Business Compliance Costs

The Business Cost Calculator (BCC) has been used to estimate the compliance costs for businesses in relation to each regulatory option where it was possible to identify and quantify costs or benefits. The estimated cost to businesses of the proposed regulatory options has been informed by industry consultation.

The following assumptions were factored into the analysis as part of the BCC:

- Employee costs that may be incurred by a franchisee or a franchisor were based on the most recent Australian Bureau of Statistics (ABS) estimates of employee earnings and hours (Employee Earnings and Hours, Australia, Catalogue 6306.0). The labour costs involved in a business operator undertaking the business activities identified within the regulatory proposals is around $35 per hour.
- The costs of seeking specialist legal, accounting or other business advice in relation to the proposed regulatory reforms is estimated to cost around $300 per hour.
- The costs of mediation for each party to a dispute of $1675 were based on the Government appointed OMA estimates of average costs for parties to attend mediation and estimated labour costs involved in preparing for the mediation.
- All costs are inclusive of GST where applicable.
- The costs of preparing for mediation would vary depending on the nature of the dispute and the complexity of the issues to be addressed at the mediation.

Other information on the numbers of franchise units and franchisors in operation, the types of businesses, exits of businesses from a franchise system, turnover and disputes was drawn from the biennial survey undertaken by the Asia-Pacific Centre for Franchising Excellence within Griffith University (Griffith University Franchising Survey) or submissions to the Joint Committee (on franchisor failures for instance). The results of the Griffith University Franchising survey were based on responses from around 285 franchisors.

Any regulatory amendments to the Franchising Code and the disclosure provisions proposed as part of the Government response to the Joint Committee report would apply prospectively. The franchisor has an existing obligation to maintain and provide a disclosure document to franchisees before entering into a franchise agreement or provide such a document within four months after the end of the financial year after entering into a franchise agreement. Any regulatory amendments to the Franchising Code that necessitate a change to the disclosure document provided by the franchisor would be part of existing compliance activities undertaken the franchisor.

Regulatory options and consultation

In brief, the following are identified as **preferred regulatory options** for Recommendations 2, 7, 5, 4 and 8 has been informed by industry consultation. Consultation assisted in the confirmation of the estimated business compliance costs and activities in relation to the preferred options identified below.

End of term arrangements (Recommendation 5)

The preferred option is to amend the Franchising Code to require franchisors to disclose to franchisees before they enter into a franchising agreement what, if any, renewal options or exit payments exist for franchisees when the agreement expires (Option 3).

Option 3 would assist in limiting the personal and professional upheaval suffered by franchisees due to unanticipated non-renewal of franchise agreements by franchisors.

Given the concerns noted in the Joint Committee and during DIISR's consultation, there may be merit in implementing option 2 in addition to Option 3. On its own, a pre-expiry notice period (Option 2) may not achieve the stated objective if franchisees nevertheless wish to challenge the franchisor's right not to renew the franchise agreement upon its expiry. However, a pre-expiry notice could give franchisees an opportunity to sell the franchise business at market value; which may help the franchisee recoup their investments in the business.

Establishment of a registration system for franchise businesses and collection of data on the franchising sector (Recommendation 2 and Recommendation 7)

The preferred option is to explore wider dissemination of information from existing avenues for data collection on the franchising sector, which does not involve the establishment of a separate registration system for franchises (Option 3).

Registration of franchise businesses in itself is unlikely to meet the stated objective and will pose business compliance costs. As part of the preferred option, the Government could explore the potential for wider circulation of ACCC data on trends of inquiries and complaints from small businesses and also franchised businesses. This could be an indicator of concerns within the franchising sector as compared with small business more generally. The ACCC and ARC sponsored Griffith University study on franchising disputation would add to the Government's understanding of disputation within the franchising sector.

Insertion of a good faith clause into the Franchising Code (Recommendation 8)

The preferred option is to identify the specific opportunistic conduct/behaviours or issues that impact on the franchising sector and implement specific measures to discourage these behaviours (Option 3).

The insertion of a broad good faith obligation by way of an aspirational goal for the franchise sector (Option 2) is likely to create regulatory uncertainty, resulting in compliance costs for business.

This preferred option is the most effective way of addressing specific opportunistic conduct in the franchise sector which could impede the successful operation of franchising agreements.

Under Option 3, specific measures could be introduced to discourage opportunistic conduct in areas of primary concern that were identified in the Joint Committee report and through DIISR's consultations. Where specific measures or behaviours could not be identified to discourage opportunistic conduct in an identified area of concern, the issue could be referred for further investigation. The implementation of specific measures under this option could improve the behaviour between parties to a franchise agreement, which could reduce the number of disputes in the sector, and in turn better balance the rights between franchisees and franchisors.

Implementation and Review

A review of the 1 March 2008 amendments to the disclosure provisions of the Franchising Code of Conduct is the subject of **Recommendation 3** by the Joint Committee.

Any regulatory options that are proposed as part of the Government's consideration of franchising policy issues, including the Government's response to the Joint Committee report, would be implemented through amendments to the *Trade Practices (Industry Codes – Franchising) Regulations 1998.*

The Best Practice Regulation Handbook (August 2007) suggests that new regulations should be reviewed within five years. Franchise agreements generally operate for 5-10 years.

It is proposed that any new Franchising Code regulations (resulting from the Government's consideration of the regulatory options within this RIS) along with the 1 March 2008 amendments be reviewed in 2013. This would allow for a review after an adequately sized pool of contracts (established since the amendments took effect) have run their course.

Current ramifications of breaches of regulatory provisions under the Franchising Code

When a code is prescribed under the Trade Practices Act, this will have the effect of making the code law. Section 51AD of the Trade Practices Act provides that a corporation must not contravene an 'applicable industry code'. An 'applicable industry code' is either a mandatory industry code, or a voluntary code to which the corporation has subscribed, that has been prescribed under the Trade Practices Act. The Franchising Code is a mandatory industry code.

Breaches of any new regulatory provisions of the Franchising Code (and as contemplated as part of a Government response) would constitute a breach of section 51AD. The ACCC is responsible for enforcing prescribed codes of conduct under section 51AD. Complaints about non-compliance with a prescribed code, that cannot be resolved through the dispute mechanisms in the code scheme, can be directed to the ACCC.

Of course, it is also possible for aggrieved persons to take private actions under section 51AD. Consumers, small business customers or competitors can take action against a company that contravenes an industry code of conduct.

Businesses that breach section 51AD (by failing to comply with a prescribed code of conduct, such as the Franchising Code) are liable to a range of remedies under the Trade Practices Act. The Court may impose remedies including:

- damages to consumers or business customers that have been hurt;
- injunctions to restrain companies from engaging in conduct in breach of a code;
- Court orders requiring corrective advertising or the disclosure of information;

- Court orders declaring a contract to be void or varying the terms of a contract; and/or
- Court orders requiring money to be refunded.

Recommendations 9-11 of the Joint Committee report suggest new penalties for breaches of industry codes and additional investigative powers for the ACCC. As noted below, this RIS does not consider these recommendations.

Other recommendations by the Joint Committee not considered within this RIS

Recommendations 9 – 11 deal with penalties for breaches of industry codes and other provisions of the Trade Practices Act and additional investigative powers for the ACCC. These issues have wider implications for the Trade Practices Act (beyond the Franchising Code) and, therefore, are for separate consideration by the Government.

Recommendation 6 (changing the name of the OMA) deals with an administrative issue and does not involve regulatory changes.

Recommendation 4 requires that the Government further consider options to better balance the rights and obligations of franchisees upon their franchisor's failure. One option to address Recommendation 4 would be to amend the Franchising Code to require that franchisor disclosure documents include a clear statement by franchisors of the liabilities and consequences applying to franchisees in the event of franchisor failure (as suggested in **Recommendation 1**). The Government's proposed action in relation to Recommendations 1 and 4 are likely to have a nil-low regulatory impact.

Recommendations 1, 4, 6 and **9-11** are, therefore, not considered within this RIS.

RECOMMENDATION 5: END OF TERM ARRANGEMENTS

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.

BACKGROUND TO THIS RECOMMENDATION

Chapter 6 of the Joint Committee's report outlines the circumstances in which franchise agreements can end, be it through early termination or through expiry and non-renewal of an agreement. The Committee noted that it received many submissions which expressed concerns regarding lack of clarity and/or lack of fairness in relation to the end of agreements.

The Committee's inquiry focussed on whether existing arrangements for non-renewal are sufficient, the notion of goodwill in franchising and canvassed whether franchisees should have any right to an exit entitlement that recognises the contribution they have made to building the reputation and success of the franchise. After considering these matters, the Committee recommended that the Code 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.

In discussing the insertion of a good faith obligation within the Franchising Code, stakeholder submissions in Chapter 8 noted that inserting a 'good faith' obligation in the Code will assist franchisees in situations where a franchisor does not renew a franchise agreement. However, as further discussed at Part III of this RIS, at the analysis in relation to Recommendation 8, the insertion of a broad good faith obligation within the Franchising Code is unlikely to provide any rights in relation to renewal of franchise agreements beyond what is agreed in the franchise agreement.

The Franchising Code recognises that termination of a franchise agreement can occur where there has been a breach by one party or regardless of a breach. For example, Clause 22 applies where there is no breach by the franchisee. Clause 22 permits termination after the franchisor has given reasonable written notice of the proposed termination and reasons for it to the franchisee. In the case of non-renewal, an agreement ends at the conclusion of the period originally agreed, with no new franchise agreement being agreed between both parties.

The main concerns over end of agreement arrangements raised during the inquiry were:

- Non-renewal of franchise agreements at the expiration of the first term, whether there should be an automatic right of renewal or whether non-renewal by a franchisor should only be permitted where 'good cause' can be shown.
- The circumstances in which a franchisor should be able to terminate an agreement, including potential abuses of current termination provisions within the Code.

- Whether a payment for the franchisee's contributed value to the business should be mandated if the agreement is terminated or not renewed for any reason.
- What happens when a franchisor fails.
- Transferability of equity in the value of the business as a going concern.

While provisions within the Franchising Code deal with situations involving termination of franchise agreements (clauses 21, 22 and 23 of the Franchising Code), the Joint Committee was concerned about ‘churning’ of franchisees (alternatively referred to as opportunistic termination by the Joint Committee). The Committee noted that although most franchisors succeed on the basis of mutually beneficial relationships with their franchisees, evidence from the inquiry suggests a small element of franchisors seek financial gain through opportunistic termination. The Committee recognised that franchisors need the ability to protect the value of their brand across the network by being able to terminate agreements that are not deriving benefit for the network. The Committee was of the opinion that it would be sensible to allow the 1 March 2008 amendments, which allow prospective franchisees to access information about the history of the franchise site (including former franchisees’ contact details), to have effect. The amendments were, in part, designed to alert franchisees to the possibility that ‘churning’ is taking place and would assist with alerting franchisees to unscrupulous conduct by franchisors.

The Committee was of the view that franchisors should be entitled to decline to renew franchise agreements on expiration if that is their choice. The Committee therefore did not support an automatic right to renewal or the requirement for good cause to be shown for not renewing a franchise agreement. The Committee recognised that it is not the role of the law to force unwilling parties to enter into any commercial arrangement, including new franchise agreements. However, the Committee noted that a franchisee should receive reasonable notice from a franchisor of any decision not to renew. Furthermore, a decision by a franchisor not to renew should not be designed to extract extra payments from a franchisee, nor to generate a windfall gain for the franchisor.

The Committee was concerned that a franchisee’s contribution to a business may not be recognised by the franchisor when the agreement comes to an end. The Committee was of the view that pre-agreement disclosure documentation should give due regard to the potential transferability of equity in the value of the business at the time the agreement ends. The Committee suggested that market valuation of a franchise business may be one way of measuring “equity in the value of the business as a going concern”. Accordingly, exit payments between franchisors and franchisees, as a starting point, could recognise the market value of a business if a franchisor wished to take over from the franchisee in operating that business.

While statistics indicate that the rates of termination and non-renewal of franchise agreements are low, the OMA has identified terms of termination/exit arrangements as the most common issues considered in mediation. Terms of termination/exit arrangements have arisen on 55 occasions in cases successfully mediated by the OMA over January 2005 to June 2008. The Griffith University Franchising Survey also notes that although franchise agreements are typically for a 5 year term, franchisees remain in the system for a median of 7 years. The Department of Innovation, Industry Science and Research’s (DIISR) consultation with the sector confirmed that a typical

term for a franchise agreement is approximately 5 years. This would appear to indicate that franchisees generally remain within the franchise system for another term after the end of the first and choose to renew their contract. The Committee considered that it is possible that the rate of non-renewal, either as a result of a decision by a franchisee or a franchisor, over the longer term (at the end of 7 years) could be high. The Committee also noted evidence by an industry representative that 7 years also equates to the amount of time it takes to recoup a franchisee's initial investment.

The Griffith University Franchising Survey estimates that across the entire population of franchise businesses, around 190 businesses (less than one per cent of franchised units) considered non-renewal during a 12 month period. The most common reasons cited for exiting or transferring the franchise business were that the franchisee had attained personal goals (around 29 per cent); personal or family reasons (around 18 per cent); lack of suitability to franchising (around 17 per cent). Other reasons include unprofitable operations (around 12 per cent) and conflict with franchisor (4 per cent). For the purposes of this analysis it is presumed that in these cases, the franchisor decided against renewing the franchise agreement. If 35 per cent of these cases involved a decision by franchisors, around 65 franchisees could be affected by non-renewal of a franchise agreement by a franchisor.

The previous review of the disclosure provisions of the Franchising Code by the Australian Government in 2006 (the Matthews Review) also identified the need for clarity in relation to termination, expiry or non-renewal of a franchise agreement (Recommendation 20). The previous Government agreed in-principle to Recommendation 20 and in its response asked the ACCC to refer to the risks to the franchisee on termination, expiry or non-renewal of the franchise agreement in its educational material.

PROBLEM

Submissions from key industry stakeholders to the Joint Committee indicates that there is a common belief among franchisees, even when their agreements are for a fixed term, that they would be entitled to renew their agreement when it expires. However, franchising by definition involves a franchisor granting a franchisee a right to carry on the business under a franchise business model offered and controlled by the franchisor for a specified period of time. The franchisee pays the franchisor a fee in exchange for the use of the franchisor's brand and systems. There is neither an automatic right of renewal of franchise agreements nor a right to compensation (via an exit payment) for franchisees if a franchisor decides not to renew a franchise agreement.

It is unclear to what extent franchisors 'over-selling' the benefits of entering into a franchise business may have contributed to franchisees' belief that they have bought a 'job for life'. During DIISR consultation with the sector, a variety of views were expressed by stakeholders as to the reasons why franchisees overestimate the terms of an agreement. Some stakeholders noted that such an overestimation on the franchisee's part is due to the optimistic nature of a prospective franchisee or a result of a misunderstanding, while other stakeholders claimed that it was due to franchisors overselling the franchise agreement. The Joint Committee noted evidence, by way of

example, that when franchisees are told that they have a five year term with the possibility of renewal for two further consecutive five year terms, franchisees believe that they have signed up to a 15 year agreement. It is unclear whether franchisees contemplate the alternative scenario. That is, the agreement may not be renewed after 5 years.

Franchise agreements can be in place for as long as 30 years in some cases and both franchisees and franchisors often invest substantial time and resources into the relationship. Given this passage of time, one or both parties may have expectations about renewal of the franchise agreement when it comes to an end. Franchisees in particular have indicated that they make a substantial personal investment in the franchise business which can result in devastating consequences where non-renewal of the franchise agreement is not anticipated. Non-renewal often not only has direct consequences for the franchisee but may also impact on employees of the franchise business and their families if those employees lose their job as a consequence of the non-renewal of the franchise agreement, for example, if the franchisor decides to cease the operation of that business.

During consultations with the sector, the majority of stakeholders consulted indicated that most franchise agreements are explicit on the rights of the franchisor and the obligations of a franchisee, but are not explicit on the rights of the franchisee and obligations of the franchisor at the end of the term. In one of the Joint Committee's public hearings, the ACCC gave evidence indicating that often disclosure documents do state exactly what the position will be at the end of the term but is in complex legalistic language making the information fairly obscure and hard to digest. Legalistic terminology in relation to end of term arrangements may reduce the transparency of disclosure documents where the franchisee does not have the necessary skills to understand the terminology. A franchisor may consider that he/she is acting in accordance with the franchise agreement when they do not renew the franchise agreement when it expires, however, the franchisee may have an expectation that they have a right of renewal, particularly if they have operated the franchise business for a substantial period of time. While not specifically canvassed in the Joint Committee's report, DIISR's consultation with the sector noted that, in some mature franchise systems or well functioning franchise relationships the franchisors provide feedback on the franchisees' performance at regular intervals and clearly articulate their intention in relation to renewal of franchise agreements prior to the franchise agreement expiring. However, there is no data on the extent to how much this happens in the sector. In these cases, the franchisor's feedback would assist manage franchisees' expectations about the renewal of the franchise agreement when it expires. This may limit the upheaval that may be suffered by franchisees in the event of unexpected non-renewal of franchise agreements. Nevertheless, at this stage, the franchisee would generally have limited scope to negotiate alternative arrangements (such as exit payments) when the franchise agreement expires.

The Joint Committee did not support automatic rights of renewal for franchisees. DIISR's consultation with the sector noted franchisors' concerns that such a right of renewal would limit business ability to innovate and could result in less efficient market outcomes. Franchisors should be able to retain the ability to decide not to renew agreements that are not deriving benefit for their network. The Committee

considered that exit arrangements between franchisors and franchisees, as a starting point, could recognise the market value of a business as a going concern.

The Joint Committee's discussion of Recommendation 5 indicates that franchisees' expectations about renewal need to be better managed, and the financial implications of non-renewal better understood, before fixed term franchise agreements are initially signed. Franchisees' expectations could be better managed if franchise agreements expressly stipulate what, if any, renewal options or exit payments exist for franchisees when an agreement expires. An explicit statement by franchisors may serve to direct franchisees' attention to the prospect of non-renewal of a franchise agreement at the pre-contractual stage.

In cases where franchise agreements are not renewed, franchisees may seek guidance and advice from a third party to negotiate alternatives such as a new franchise agreement, an exit payment (where such a payment is not provided for under the franchise agreement) or a higher exit payment to what may be stipulated under the franchise agreement. One avenue for third party guidance on negotiating alternatives is the mediation service provided by the OMA.

The OMA has identified terms of termination/exit arrangements as the most common issues considered in mediation (on average around 15 times per year). While the issues covered in mediation cover all exit arrangements (whether termination or non-renewal), for the purposes of this analysis it is assumed that all cases relate to non-renewal since a further breakdown on these results is not possible. Therefore, out of the 65 franchisees that may face non-renewal of a franchise agreement each year, it is assumed that 15 of these seek guidance from the OMA. These mediations could involve 15 franchisors (assuming that each franchisee is part of a separate franchise system). Accordingly 15 franchisees and 15 franchisors could be resorting to OMA mediation to address non-renewal issues.

There are a number of alternatives to the OMA, including state based mediation services, the dispute resolution systems internal to a franchise system and direct negotiations between franchisees and their franchisors. DIISR's consultation with the sector notes that some franchisees and franchisors already have established relationships with lawyers and rely on mediation and dispute resolution services provided by lawyers rather than the OMA services. Given that there is no data available on the number of franchisees and franchisors that use alternate mediators such as lawyers or state based services, it is not possible to quantify the proportion of franchisees and franchisors that use alternative mediation nor would it be possible to quantify the costs that could be incurred by parties in pursuing these alternatives.

OBJECTIVES

What are the objectives of government action?

The objective of Government action is to better balance the rights of franchisees and franchisors by reducing the differing expectations that franchisees and franchisors have over the rights and obligations at the end of the franchise agreement. These differing expectations can result in disputes between the parties to a franchise agreement. The Joint Committee noted in its report that end of term arrangements are

one of the largest areas of disputes in the franchising sector. Drawing franchisees' attention to end of term conditions and increasing transparency in which details are disclosed, would improve the conduct and mitigate disputes between franchising sector participants in relation to non-renewal of franchise agreements.

The Government also has an interest in reducing disputes between sector participants not only to support its previous initiative of providing mediation services to the franchising sector, but by directing resources into productive activities and away from non productive activities that would result if parties engaged in a dispute.

As noted by the Joint Committee, franchisors should be entitled to decline to renew franchise agreements on expiration if that is their choice. It is not the role of the law to force unwilling parties to enter into any commercial arrangement, including new franchise agreements.

OPTIONS

1. Status quo

Under this option, the ACCC could continue its educative efforts to draw franchise sector participants' attention to what, if any, renewal options or exit payments exist for franchisees when an agreement expires.

The ACCC's pre-contractual educative efforts could support industry stakeholder efforts in this area to make franchisees aware of some of the limitations of entering into a franchise business model – notably, that a franchise agreement commonly operates for a fixed term with no right of renewal.

2. Option 2 – Amend the Franchising Code to require franchisors to inform franchisees, at least six months prior to the end of the franchise agreement, of their decision to either renew or not to renew a franchise agreement.

Under this option, franchisors would have to write to each franchisee at least six months prior to the end of the franchise agreement, notifying the franchisee of their decision to either renew or not to renew the agreement. This requirement would not apply to franchise agreements that were for a term less than six months. Where franchise agreements were for a term less than six months, franchisors would be required to inform franchisees at least one month prior to the end of the franchise agreement of their decision to renew or not to renew a franchise agreement.

Franchisors failing to notify their franchisees of their decision to renew or not to renew the agreement within the mandated timeframe would be in breach of section 51AD of the Trade Practices Act; however, failure to comply with this requirement would not mean automatic renewal of a franchise agreement.

As this option would create a clear expectation for franchisees of what will happen at the end of the agreement there would need to be flexibility in the way any new provision would apply to franchisors to take account of any unforeseen or exceptional circumstances for the franchisor that could alter their decision to renew or not to renew a franchise agreement. For example:

i. If a franchisor intended to renew an agreement they would be required to notify the franchisee of their intention to renew at least six months (or one month) prior to the end of the agreement. However, if, after notifying a franchisee of their intention to renew the agreement, the franchisor's circumstances changed such that they were no longer in a position to renew the agreement they could be in breach of the Trade Practices Act. Therefore a provision would need to be included in the Franchising Code that would allow for exceptional and/or unforeseen circumstances; this could include a provision for the franchisor to notify the franchisee of the unforeseen circumstances, such as change in majority ownership and control of the franchisor, and how the unforeseen circumstances impacted on their decision to renew or not to renew the agreement, within a reasonable timeframe (but not more than 14 days) of the franchisor becoming aware of these circumstances.
ii. Alternatively a franchisor intending not to renew an agreement would be required to notify the franchisee of their intention not to renew at least six months (or one month) prior to the end of the term. However, if after advising the franchisee of their decision not to renew, the circumstances behind the franchisor's decision to terminate the agreement changed, the franchisor may want the option to renew the franchise agreement.

3. Option 3 – Amend the Franchising Code to require franchisors to disclose to franchisees before they enter into a franchising agreement what, if any, renewal options or exit payments exist for franchisees when the agreement expires.

Under this option, the Franchising Code would be amended to require franchisors to disclose to franchisees before they enter into a franchising agreement what, if any, renewal options or exit payments exist for franchisees when the agreement expires. This would include disclosure of how exit payments, if applicable, will be determined for franchisees. Under this option, the franchise agreement cannot be silent as to what happens upon the expiry of a franchise agreement. Where it is intended that there would be no option for renewal of a franchise agreement, this must be explicitly stated within the disclosure documentation.

Without limiting the items that would need to be disclosed when developing end of term arrangements, under this option the following issues could be considered by a franchisor when determining what processes will apply at the end of the term:

- 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?

Under this option, franchisors failing to comply with these disclosure requirements would be in breach of section 51AD of the Trade Practices Act.

ACCC education material would need to be updated to reflect the regulatory change.

IMPACT ANALYSIS

1. Option 1 – Status quo

Under Option 1, there would be no regulatory changes to the Franchising Code.

The ACCC's educational material for franchisees refers to the risks and prospects of non-renewal of franchise agreements. The ACCC *Franchisee Manual* notes that the term of the franchise agreement is limited and franchisees may have little input on renewal options. In addition, the ACCC *Franchisee start-up checklist* specifically directs franchisees to consider the following issues in relation to renewal, termination or transfer of franchise agreements:

- Is the franchise granted for a specified period of time? What is your position at the conclusion of the franchise period? Are you able to negotiate an extension? Who will own the goodwill in the business?
- Ensure you have an exit strategy should the franchise agreement not be renewed.
- Check clauses regarding termination, renewal and transfer of the franchise, and make sure you are willing to accept them.
- If the deal is not acceptable, try to negotiate a better offer or find a better deal.

<u>Benefits</u>

The benefit of Option 1 is that there would be no regulatory changes to the Franchising Code. Therefore, there would be no compliance burdens imposed on either franchisees or franchisors since they will not have to understand and comply with any new regulatory changes to the Franchising Code.

The recent focus on the franchising sector may further the impetus for industry bodies, such as the Franchise Council of Australia, to educate franchisees about the risks they could face, including non-renewal of franchise agreements.

Drawing franchise sector participants' attention to the need to consider the possibility of non-renewal of a franchise agreement may act as a trigger for franchisees to seek further clarification from the franchisor, legal or other business advice on agreements that are either silent or ambiguous as to what, if any, renewal options or exit payments exist for franchisees when an agreement expires.

A greater understanding by both parties of the possibility of non-renewal of a franchise agreement may assist manage parties' expectations and mitigate disputes where one party has an expectation (not shared by the other party) that the franchise agreement will be renewed.

<u>Costs</u>

According to the Griffith University 2008 franchising survey, there is currently an estimated 63,500 business format franchised units and 7900 company-owned units of the total of (71,400 units) operating in franchise systems in Australia.

Due to the limited statistics in relation to non-renewal of franchise agreements, it is not possible to accurately quantify the potential compliance costs faced by the entire franchising sector in relation to Option 1. Therefore, the following are only estimates of possible costs. Costs have been broadly identified where those costs cannot be quantified.

Costs faced by franchisees and their dependants

Based on submissions to the Joint Committee, it appears that franchisees more often than not do not contemplate non-renewal of franchise agreements. This is despite the availability of pre-contractual education in relation to non-renewal issues. It is unclear as to the reasons why pre-contractual education is not working; some stakeholders have suggested that is because of the optimistic nature of franchisees, others indicate that franchisees may be unaware where to seek advice or may not understand the legalistic terms in their disclosure document. Under Option 1, franchisees who have made a substantial personal investment in the franchise business would continue to face personal and professional upheaval when the non-renewal of the franchise agreement is not anticipated. Submissions to the Joint Committee noted that this upheaval could impact on the franchisee's health and their family often suffers. Apart from the immediate impact on the franchisee, employees of the franchise business could face unemployment if, for instance, that franchise business is closed by the franchisor.

Mediation or other costs faced by franchisees

In relation to mediation costs, the OMA has identified terms of termination/exit arrangements as the most common issues considered in mediation (on average around 15 times per year). As noted previously there are a number of alternatives to the OMA; however, given there is no data available on the number of franchisees and franchisors that use alternate mediators, it is not possible to quantify the proportion of franchisees and franchisors that use alternative mediation nor would it be possible to quantify the costs that could be incurred by parties in pursuing these alternatives.

Based on OMA data, around 15 franchisees and 15 franchisors (30 businesses) of the total 71,400 franchise units could be resorting to OMA mediation to address non-renewal issues per year. While the issues covered in mediation cover all exit arrangements (whether termination or non-renewal), for the purposes of this analysis it is assumed that all cases relate to non-renewal since a further breakdown on these results is not possible.

On average, the OMA's mediation costs are approximately $1,500 per party (exclusive of costs of preparation for the mediation).

Based on the assumptions outlined above, it is possible that around 30 businesses (franchisors and franchisees) could be resorting to the OMA to address issues in relation to non-renewal of franchise agreements.

Based on OMA estimates and the labour costs involved in preparing for mediation, the mediation costs incurred by each business may be around $1,675.

There are a number of alternatives to the OMA, including state based mediation services, the dispute resolution systems internal to a franchise system and direct negotiations between franchisees and their franchisors. The costs that could be incurred by parties in pursuing these alternatives cannot be quantified.

2. **Amend the Franchising Code to require franchisors to inform franchisees, at least six months prior to the end of the franchise agreement, of their decision to either renew or not to renew a franchise agreement.**

There could be a one-off education cost for businesses and their advisers to keep abreast of the changing regulations. However, clearly defined obligations under the Franchising Code and guidance by way of ACCC education should limit the need for complex legal or other advice to ensure that the franchisors are meeting their obligations under the Code. It is estimated that franchisors would need to allocate around 15 minutes of their time to familiarise themselves with the regulatory changes proposed which may involve labour costs of $10.

Under Option 2, there would be a regulatory change to the Franchising Code to require franchisors to provide at least six months notice to franchisees notifying them of the franchisors' decision to either renew or not to renew the franchise agreement (pre-expiry notice). Where franchise agreements were for a term less than six months, franchisors would be required to inform franchisees at least one month prior to the end of the franchise agreement of their decision to renew or not to renew a franchise agreement. The onus and compliance costs would fall on franchisors.

Under this option, the franchise agreement could remain silent as to what, if any, renewal options or exit payments exist for franchisees when the agreement expires. If the franchise agreement was silent as to renewal options and exit payments, and the franchisor decided against renewing a franchise agreement, the franchisee would at least receive six months notice of the franchisor's intention. DIISR's consultation with the sector noted that a pre-expiry notice would in some cases provide a franchisee with the opportunity to sell their franchise at market value. Selling the business as opposed to handing it back to the franchisor would enable a franchisee to recoup some of the goodwill built into the business or recoup the investment a franchisee may have made in the business. The benefits and limitation of selling the franchisee business are detailed below.

DIISR consultation with the franchising sector indicated that some franchisors do notify their franchisees a number of months before the franchise agreement ends of their intent to renew or not to renew the agreement. Stakeholders in DIISR's consultation noted that this practice is more common in mature franchise systems or systems in which franchisees and franchisors have a well functioning relationship, and as such, represents industry best practice.

The Joint Committee quoted from the Griffith University Franchising Australia survey report, 2008, that 'overall franchise agreement renewal was standard practice

in the sector' and therefore only a small percentage of the franchisee population are faced with a non renewal. Out of the percentage of franchisees that are not renewed, DIISR's consultation indicates that under industry best practice a number of franchisees facing non renewal would be given adequate time to make alternative arrangements. This then leaves the remaining franchisees with inadequate time to make alternative arrangements. Therefore those franchisees that are faced with short notice of non renewal represent only a small proportion of the franchise sector as a whole.

While the problems of inadequate notice of non renewal of a franchise agreement only affects a small percentage of the franchise market, it needs to be recognised that the franchisees that are subject to this short notice have legitimate concerns, as such an event would create significant financial and personal upheaval to the franchisee. This option therefore could mitigate some of the upheaval experienced by the franchisee by the franchisor being required to give adequate notice of non renewal. This option is aimed at setting a standard of behaviour that would be in line with existing industry best practice.

During DIISR's consultation with the sector many stakeholders expressed views on the appropriate timeframe for a pre-expiry notice, noting that the timing of a pre-expiry notice should be in accordance with the length of the original terms of the agreement and the type of business. Stakeholders favouring a longer pre-expiry notice argued that a longer notice period would enable the franchisee to get the business accounts in order and ready for sale, but noted that a 6 month pre-expiry notice would provide adequate time to sell a business. Franchisees that have undertaken adequate due diligence before entering a franchise agreement should be aware of the possibility of an agreement not being renewed, and as such should be preparing their business accounts for the possibility of such an event. While some stakeholders argued for shorter pre-expiry notice periods and others longer, six months on the whole was generally agreed a reasonable notice to either sell the franchised business or make alternative arrangements.

<u>Benefits</u>

Option 2 may assist manage franchisees' expectations in relation to the renewal of their franchise agreements by mandating early notice by franchisors of their intention to renew or not to renew the franchise agreement.

In the event that franchisors decide against renewing the agreement when it expires, this pre-expiry notice would provide an opportunity for franchisees to plan for their financial and personal affairs once the agreement expires thus somewhat limiting the upheaval that non-renewal may cause for franchisees.

DIISR's consultation with the sector noted that a pre-expiry notice would in some cases provide a franchisee with the opportunity to sell their franchise at market value, enabling the franchisee to recoup some of the investment made into the business. A franchisee's ability to sell their business would depend on the franchisor's intention for the business, that is, if the franchisor intends to take over the business themselves or instate another franchisee. Only in cases where a franchisor intended to instate another franchisee would the current franchisee have an opportunity to sell the

business. The ability to sell the business would depend on the franchisee finding a suitable buyer and getting the franchisor's approval. A pre-expiry notice may, in some cases, also give the franchisee the opportunity to sell equipment and stock that the franchisee has acquired. The ability to sell equipment and stock may depend again on finding a suitable buyer and terms in the franchise agreement. A 6 month pre-expiry notice would also assist employees and franchisees to find alternative employment. Thus Option 2 may serve to limit the acrimony franchisees may feel towards franchisors who choose not to renew a franchise agreement without any prior notice. As noted above, franchisees generally have an expectation that the franchise agreement would be renewed upon expiry even though the franchise model is predicated on the franchisor retaining control of the franchise business.

As noted above, the OMA statistics may provide one indicator of the costs faced by parties to a franchising dispute (where they seek mediation services from that Office to clarify their rights and obligations upon the expiration of a franchise agreement). There could be less need for the services of the OMA if, as it is proposed under Option 2, it was mandatory for franchisors to provide franchisees with notice of their intention not to renew the franchise agreement when it expires. The notice period may provide the opportunity for better communication between both parties such that any misunderstandings do not escalate into disputes requiring third party intervention, such as mediation or legal advice. The mediation cost savings for each affected business may be around $1,675 per business.

Costs

Option 2 may only partly meet the stated objective since it provides franchisees with early notice of a franchisor's intention not to renew a franchise agreement. However, it does not provide franchisees with an opportunity to negotiate mutually acceptable terms with their franchisor prior to entering into a franchise agreement.

DIISR's consultation with the sector supports the view, that there would be a risk that some franchisees, who may be dissatisfied with a franchisor's decision not to renew a franchise agreement, could use the pre-expiry notice as an opportunity to damage the franchise brand by either providing substandard services or goods or by instigating negative media coverage. Stakeholders used this argument to support a short pre-expiry notice period. However, DIISR notes that activities to damage the franchise brand could trigger termination clauses within the franchise agreement. Clause 21 of the Franchising Code outlines the processes that a franchisor must follow in the event of termination resulting from a breach by a franchisee. If the franchisee triggered a termination clause and the franchisee was unable to rectify the breach, the franchisor would have the right to terminate the agreement before the six month pre-expiry notice.

The franchisee would also have a commercial interest not to damage the brand or provide substandard goods or services. The franchisee's commercial interest should be to ensure a continuing specified income from the franchise business during the pre-expiry period and to ensure the terms of the franchise agreement are honoured during this period. Franchisees also may have an interest in preserving the goodwill so the franchise business can be sold.

As discussed above in relation to costs posed by Option 1, there may be costs for franchise sector participants who may be resorting to dispute resolution providers, dispute resolution mechanisms internal to a franchise system or legal advice on avenues that may be open to them when their franchise agreement ends. There would be at least an element of the franchisee population that would seek to challenge the franchisor's right not to renew the franchise agreement upon its expiry. The disputes in these cases could escalate with franchisees contesting the franchisor's decision through various avenues (dispute resolution providers or legal advice). Option 2 would not result in any cost savings in such cases. The mediation costs to parties, as identified above (around $1,675 per business) would continue to be incurred.

This option would impose compliance burdens on franchisors rather than franchisees. The onus would be on franchisors to contact their franchisees via writing and convey their intentions as to whether or not they wish to renew a franchise agreement. Franchisors may wish to keep records of this process in order to document/evidence of the pre-expiry procedure. For example, records of emails, and letters. However, record keeping costs associated with the pre-expiry notification would constitute normal business practice and would be unlikely to incur any additional administrative costs.

According to the Griffith University Franchising Survey there are around 1,100 franchisors in existence in 2008. Any regulatory amendments would apply prospectively and to new franchise agreements (following the expiry of the current agreements between existing franchisees and franchisors). It is assumed that the average length of a franchise agreement is 5 years. It is also assumed each franchisor would enter at least one new franchise agreement after the changes take effect. This means all 1,100 franchisors would send at least one letter in 4.5 years. In these cases, under Option 2, the franchisor would have to write to the franchisees to provide them a notice of his/her intention to either renew or not renew a franchise agreement.

In terms of compliance activities, it is presumed that the franchisor would adopt a template letter for renewals and non renewals to comply with this regulation. This would involve a one-off cost for franchisors to drafting template letters and ongoing costs as follows:

- If labour costs are $35 per hour requiring 30 minutes of the franchisor's time, the one-off costs of setting up template letters are around $17.50 ($35 in total) per franchisor per template letter. (Two letters would need to be prepared). Franchisors may wish to keep records of this process in order to document/evidence of the pre-expiry procedure. However, these record keeping costs would constitute normal business practice and would be unlikely to incur any additional administrative costs.
- These template letters may need to be updated by franchisors on an annual basis where franchise agreements terms were coming to end in future years. The time taken to draft using templates is estimated to be around 15 minutes. If labour costs are $35 per hour requiring 15 minutes of the franchisor's time, there may be an ongoing annual cost to each business of around $10.

3. **Amend the Franchising Code to require franchisors to disclose to franchisees before they enter into a franchising agreement what, if any, renewal options or exit payments exist for franchisees when the agreement expires.**

An explicit statement by a franchisor, as part of their pre-contractual disclosure, that the franchisee does or does not have an option to renew their franchise agreement; and/or will or will not receive exit payments, would enable franchisees to make a more fully informed decision on entering into that franchise business. For instance, if the franchisor's disclosure statement indicates that the franchisee does not have an option to renew nor will they receive exit payments upon the expiry of the agreement, this may act as a trigger for franchisees to negotiate a more favourable arrangement or alternatively seek another business opportunity.

Under Option 3, there would be a regulatory change to the Franchising Code to mandate pre-contractual disclosure between franchisors and franchisees what, if any, renewal options or exit payments exist for franchisees when the agreement expires. Under this option, franchisors and franchisees would be free to negotiate the arrangements best suited to their circumstances. If parties contemplate exit arrangements, these arrangements should be clearly articulated in the franchisor disclosure document and the franchise agreement. Submissions to the Joint Committee indicate that parties could consider methods involving the market value of the business or a predetermined formula that takes into account the amount of investment the franchisee has made in the franchise business. It would be open to the parties to the franchise agreement to stipulate the methods by which exit arrangements will be determined when the agreement comes to an end.

The regulatory changes under Option 3 could be supported by ongoing educative efforts by the ACCC reiterating the need for franchise sector participants to pay particular attention to the rights and obligations of parties when a franchise agreement comes to an end.

Benefits

An explicit statement by a franchisor, as part of their pre-contractual disclosure, that the franchisee does not have an option to renew nor will they receive exit payments upon the expiry of the agreement may act as a trigger for franchisees to negotiate a more favourable arrangement or alternatively seek another business opportunity. This would contribute to one of the key objectives of the Franchising Code – to address imbalances in power between franchisees and franchisors by assisting franchisees with their due diligence prior to entering into a franchise agreement. It may also serve to mitigate disputes where one party has an expectation (not shared by the other party) that the franchising agreement will be renewed.

Improved due diligence by franchisees in relation to non-renewal issues would ensure that franchisees are aware of when their franchise agreement is due to expire and what rights or exit payments are available to them upon expiry. Franchisees would then be able to have a strategy in place for exiting the franchise business. This should limit the personal and professional upheaval franchisees face when their franchise agreement is not renewed by a franchisor.

It is possible that the franchisor may close a franchise business if, as agreed in the franchise agreement, the franchisee does not meet the conditions of renewal of the franchise agreement. In these instances, under Option 3, franchisees would be in a

position to inform employees within the franchise business of the prospect of non-renewal of a franchise agreement. These employees would then be able to seek out alternative employment in instances where they face unemployment.

Consultation with the sector supports DIISR's view that with Option 2, above, there could be cost savings for businesses if pre-contractual disclosure by franchisors mitigates the need for franchisees to seek mediation and other services to ascertain their position when a franchise agreement is not renewed. The mediation cost savings for each affected business may be around $1,675 per business.

<u>Costs</u>

Franchisors would not need to incur costs in relation to this regulatory proposal until they renew or enter into new franchise agreements since any regulatory changes would apply prospectively.

There could be a one-off education cost for businesses and their advisers to keep abreast of the changing regulations. However, clearly defined obligations under the Code and guidance by way of ACCC education should limit the need for complex legal or other advice to ensure that the franchisors are meeting their obligations under the Code. It is estimated that franchisors would need to allocate around 15 minutes of their time to familiarise themselves with the regulatory changes proposed which may involve labour costs of $10.

Submissions to the Joint Committee and DIISR's consultation with the sector stakeholders indicates that some franchise agreements already contain terms relating to end of term arrangements. There is no data on the number of franchise agreements that already detail end of term arrangements. The parties to these agreements would not face any additional compliance costs.

Where franchisors and franchisees do not already stipulate end of term arrangements and where they are entering into new agreements, they would need to seek legal or other advice to ensure that they have terms in place determining end of term arrangements. Currently, franchisors are required to update the disclosure documents they provide to their franchisees. Therefore, any costs posed by Option 3 would be one component of the total costs already incurred by franchisees and franchisors in negotiating their franchise agreements; these costs would be a one off rather than an ongoing cost.

The hourly rate charged by an adviser with franchise specific industry knowledge is in the order of $300 per hour. It is assumed that advisers could allocate around 30 minutes of their time in providing guidance and drafting provisions for franchisors or franchisees to explicitly articulate what, if any, renewal options or exit payments would be available to franchisees when a franchise agreement comes to an end. The average cost per franchisor in seeking professional advice on drafting these terms may be in the order of $150. This is likely to be a one-off cost to franchisors. Franchisors could adopt any number of methods to stipulate any conditions of renewal or they may wish to explicitly stipulate that no right of renewal exists for franchisees. For franchisors who receive advice and choose to alter the drafting provisions provided by their advisor by, for example, incorporating only select provisions into the disclosure

document/franchise agreement; there could be additional labour costs involved. The amount of labour costs would be dependent on the extent to which franchisors incorporated the advice into their disclosure document. That is, if they adopt all provisions drafted there would be nil to low labour costs, if a franchisor made minor changes to the provisions before incorporating them into the disclosure document, there may be low to medium labour costs involved. If labour costs are $35 per hour requiring 30 minutes of the franchisor's time, the one-off costs of the franchisor drafting renewal options or exit payments terms into the franchising agreement would be $17.50 (per franchise agreement). If a franchisor made more complex changes to the provisions, before incorporating them into the disclosure document, there again would be higher labour costs involved, but these costs would vary depending on the complexity of that change, and would be difficult to quantify.

Any regulatory amendments to the Franchising Code and the disclosure provisions proposed as part of the Government response to the Joint Committee report would apply prospectively.

Support and guidance would be provided to franchise sector participants and their advisers through ACCC education materials to assist parties to the franchise agreement understand their obligations under the new regulatory changes. This would also assist in keeping additional compliance costs low.

CONSULTATION

DIISR is the lead department responsible for preparing the Governments' response to the Joint Committee's Inquiry. To ensure a whole-of-Government response to the Joint Committee's inquiry into Franchising, DIISR convened an inter-departmental committee (IDC) in May 2008 consisting of the following Government departments and agencies: Treasury; Finance and Deregulation; Prime Minister and Cabinet; and the ACCC. In addition to regularly consulting with IDC members, DIISR has liaised with a number of other Government agencies as needed.

The Joint Committee's inquiry was one of four inquiries conducted into the sector over a period of three years (commencing with the Commonwealth Matthews review in 2006 and concluding with the Joint Committee's report in December 2008). All four inquiries consulted extensively with the sector, holding public hearings and calling for written submissions. Given the extensive public consultation already undertaken, DIISR conducted targeted consultation consisting of a number of one-on-one consultations with franchisees, franchisors, industry groups and advisers and invited the public to make written comments to the Government's consultation paper which was released on 21 June 2009. The consultation paper was posted on the DIISR website for 3 weeks and a link to the paper appeared on the consultation portal administered through www.business.gov.au. The paper contained specific questions aimed at ascertaining the potential business compliance activities and costs in relation to each regulatory proposal. The purpose of DIISR's targeted consultation was to further inform the Government response by building on previous consultation and seeking comments to those already expressed as part of the Joint Committee's inquiry.

In DIISR's consultation with the sector and in submissions to the Joint Committee, some stakeholders noted that while the ACCC's educational material refers to the

risks of non-renewal of a franchise agreement for franchisees, a large proportion of franchisees do not contemplate the issue of non-renewal when they enter into a franchise agreement. DIISR's consultation with the sector has indicated that this may be because of the optimistic nature of franchisees or that the terms of the agreement is oversold to the franchisor.

In submissions to the Joint Committee and in DIISR's consultation with the sector, stakeholders indicated that some franchise agreements already contain terms relating to end of agreement arrangements. For example in the Joint Committee's report, Australia Post indicated that they made clear up front that the term of the agreement is for a specified period and that there will be an exit payment (based on a predetermined formula). McDonald's Australia Ltd referred to reviews it conducts of its 17 and 20 year franchise agreements. Subject to certain criteria being met, McDonald's Australia Ltd indicated that it approaches the review 'with an open mind'.

During DIISR's consultation with the sector, there was support from franchisees and franchisors for a pre-expiry notice to be given to the franchisee six months before the end of the agreement, advising the franchisees if the agreement will be renewed or not renewed. A similar proposal was made and received franchisees' support in the 2008 Western Australian Government Inquiry into the Operation of Franchise Business in Western Australia. The Western Australian Inquiry recommended a pre-expiry review, in which the franchisor would have to inform the franchisee, at least one year prior to the expiry of the franchise agreement, of any variations between the existing and new agreement and any conditions that need to be met in order for agreement renewal. This option received some support including from the Franchise Council of Australia and franchisees. The Western Australian Government referred the findings of its franchising inquiry to the Commonwealth Government since franchising is regulated at the Commonwealth level. Option 2 adopts the broad principle underpinning the pre-expiry review contemplated in the Western Australia Inquiry.

During DIISR consultation with the sector, Option 3 had support from both franchisor and franchisee representative groups. The Franchise Council of Australia and franchisees in their submissions to the Joint Committee supported regulatory changes to the Franchising Code to ensure that pre-contractual disclosure documentation explicitly articulates the rights and obligations of parties when a franchise agreement ends. The ACCC in its submission to the Joint Committee also supported regulatory changes to the Franchising Code that would require franchisors to provide an explicit statement to franchisees of their rights to renew the franchise agreement, or any payments that may accrue to franchisees when the franchise agreement expires.

CONCLUSION AND PREFERRED OPTION

Maintaining the status quo, as proposed in Option 1, may mean that there would be ongoing costs for franchise sector participants who may be resorting to dispute resolution providers, dispute resolution mechanisms internal to a franchise system or legal advice on avenues that may be open to them when their franchise agreement ends. These costs may be avoided by parties as a result of a pre-expiry notice period by the franchisor, as proposed in Option 2, if it provides franchisors and franchisees

with an opportunity to address expectation gaps and misunderstandings before they escalate into major disputes.

On its own, a pre-expiry notice period may not achieve the stated objective if franchisees nevertheless wish to challenge the franchisor's right not to renew the franchise agreement upon its expiry. There is also a risk that some franchisees may use the pre-expiry notice period to inflict 'brand' damage for instance through providing substandard goods and services or instigating negative media attention. However, a pre-expiry notice could give franchisees an opportunity to sell the franchise business at market value; which may help the franchisee recoup their investments in the business. A pre-expiry notice could also provide franchisees with the opportunity to reassess the business opportunity prior to renewing a franchise agreement.

There is a common belief amongst franchisees, even when their agreements are for a fixed term, that they would be entitled to renew their agreement when it expires. Managing franchisees' expectations as to renewal of franchise agreements appears to be a major challenge for industry bodies and professionals involved in pre-contractual education of franchisees. This has resulted in calls for regulatory changes to the Franchising Code to ensure that disclosure documentation explicitly articulate rights and obligations of parties when a franchise agreement ends.

Drawing franchisees' attention to their rights and obligations in relation to conditions of renewal of franchise agreements or exit payments as part of their pre-contractual due diligence will provide franchisees with the capacity to negotiate with their franchisors on these issues. A pre-expiry notice, while it might provide franchisees with early notice of a franchisor's intention not to renew a franchise agreement, does not provide franchisees with an opportunity to negotiate mutually acceptable terms with their franchisor prior to entering into a franchise agreement.

DIISR's consultation noted some franchise agreements already state end of term arrangements. Despite this information there still appears to be a problem associated with franchisees not understanding the implications of these end of term arrangements. Therefore DIISR's preferred option is to implement Option 2 in addition to Option 3. Implementing both options would assist prospective franchisees in making an informed decision prior to entering into a franchise agreement, while a pre-expiry notice will enable a franchisee to make alternative arrangements in the event of a non-renewal. In recommending both options, DIISR notes that amendments to the Franchising Code would need to reflect that a pre-expiry notice would need to be consistent with any end of term arrangements or processes outlined in the franchise agreement.

Option 3 involves amending the Franchising Code to require an explicit statement by a franchisor to franchisees before they enter into a franchising agreement what, if any, renewal options or exit payments exist for franchisees when the agreement expires. The one-off costs for franchisors in familiarising themselves with the regulatory change and updating their disclosure documents could be around $150 per business.

Option 3 may serve to mitigate disputes where one party has an expectation (not shared by the other party) that the franchise agreement will be renewed. It would also

contribute to one of the key objectives of the Franchising Code – to address imbalances in power between franchisees and franchisors by assisting franchisees undertake their due diligence, particularly in relation to what, if any, renewal options or exit payments exist for franchisees when the agreement expires. It would provide franchisees with the opportunity to have greater input on their rights and obligations upon the expiry of the franchise agreement. It would assist in limiting the personal and professional upheaval suffered by franchisees due to unanticipated non-renewal of franchise agreements by franchisors.

RECOMMENDATIONS 2 AND 7: REGISTRATION AND STATISTICS

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*.

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.

BACKGROUND TO RECOMMENDATION 2 AND RECOMMENDATION 7

Recommendation 2 was discussed in Chapter 4 of the Joint Committee report which deals with pre-contractual arrangements. The Committee saw merit in a simple annual online registration system for franchisors, requiring them to identify the nature and size of their franchising system and, through the act of registering, to provide a guarantee that they are operating their system in compliance with the Franchising Code. The Committee suggested that the ACCC could administer this system. The Committee also considered that a system of registration would ensure that a central government agency would have useful data on how many franchisee businesses are operating in Australia.

Recommendation 7 was discussed in Chapter 7 of the Joint Committee report which deals with franchising disputes. The Joint Committee noted that the OMA is only one avenue for dispute resolution. Since statistics relating to disputes resolved through internal processes, before an agreed mediator or through an alternative path (including recourse to state or territory based processes) are not centrally captured, the Committee considered that it is not possible to form an accurate picture of the number of disputants pursuing mediation in the sector. The Committee noted that data on the extent of disputes where no mediation action is taken, is also not available.

The Committee considered that it is difficult to assess the efficacy of current mediation provisions in the Code in the absence of a reliable understanding of the true extent of disputation in the sector. The 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, with a focus on franchise disputation and dispute-related franchisee turnover, using information collected from both franchisees and franchisors. The Committee suggested this may be appropriately undertaken as part of existing business surveys, or as a new survey directed at the sector only.

Any survey of the entire franchising sector as suggested in Recommendation 7 would necessitate identifying the businesses within the sector. Identification of franchise businesses would most likely involve registration of franchise businesses, which is the subject of Recommendation 2. Since Recommendations 2 and 7 of the Joint

Committee are closely related, the following regulatory impact analysis is a joint consideration of both recommendations.

Franchising disputes and existing surveys

The Griffith University collates a biennial Franchising Australia Survey which estimates the size, structure and growth of the franchising sector. The survey also includes some information on the disputes within the franchising sector. Private companies may also provide industry research on a user pays basis, one of which is IBIS World which produces a report on franchising in Australia. This report includes industry statistics such as revenue growth, employment and wages.

The ABS survey of business characteristics (*Selected Characteristics of Australian Businesses*, 2006-07) has limited information on franchising. The information identifies the proportion of small businesses which are identified as involved in franchising as either a franchisor or franchisee.

The franchising sector, and more specifically some disputes, often receive media attention. As such, the franchising sector and the Franchising Code have been reviewed at both the State and Commonwealth levels. The most recent inquiry into franchising was by the Joint Committee - one of the four inquiries into the sector conducted over a short period of three years (commencing with the Commonwealth Matthews review in 2006 and concluding with the Joint Committee's report in December 2008). It is worth noting that some of the contentious issues raised in the most recent federal inquiry (in 2008) are the same issues that were raised as long as 30 years ago when a broad inquiry into the Trade Practices Act touched on problems in the franchising sector. Debate in relation to the franchising sector has polarised stakeholders' views, with some noting that the sector is functioning well and others expressing concerns that the sector is characterised by systemic problems. It is against this framework of regular inquiry and debate that a need has been expressed for more reliable indicators of the extent of stability (more particularly disputation) within the sector.

It should be noted that the number of dispute enquiries received by the OMA each year is generally stable, averaging around 365 enquiries each year since 2002 (based on data to the end of June 2008). In addition, the ACCC in its submission to the Joint Committee noted that an examination of franchising-related complaints received by the ACCC indicates that few franchise systems receive complaints from more than one or two franchisees. The ACCC considered that this suggests that there is no widespread misconduct regarding the Franchising Code or the Trade Practices Act by most franchisors. However, the Joint Committee considered that these statistics on franchising by themselves were not indicative of what could be a broader problem within the sector. That is, even if franchising related inquiries or mediations were low relative to the number of franchise agreements in operation, there could be many more franchisees facing disputes in the sector that may not be captured by this data.

Disputes are an inherent part of operating any type of business, including a franchise business. It is not the role, nor would it be viable, for the Government to monitor all disputes faced by Australian businesses. Franchise businesses are a subset of the wider business community. However, the Government has a role in ensuring the

effective operation of the Franchising Code and that the sector does not face burdens over and beyond those faced by Australian businesses more generally. Therefore, any indicator of stability (including disputes) within the sector must be viewed in the context of similar problems faced by other Australian businesses (particularly small businesses). The ABS does not currently undertake any surveys of business to business disputes.

PROBLEM

The Joint Committee's analysis in relation to Recommendation 2 focuses on two elements:

- The first element of the online registration system 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. This is related to the broader problem of inadequate statistics on the franchising sector as discussed in Recommendation 7.
- The second element of the online registration system was aimed at improving franchisors' compliance with the Franchising Code. The 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 of Conduct and the *Trade Practices Act 1974*.

At Recommendation 7, the Joint Committee considered that a lack of data on franchise disputation and dispute-related turnover has meant that it is difficult to assess the stability of the sector and the effectiveness of the mediation provisions under the Code. The Joint Committee also considered that while the Griffith University Franchising Survey was a survey of franchisors' experiences, an independent survey of the sector was needed covering both franchisees and franchisors.

OBJECTIVES

What are the objectives of Government action?

The objective of Government action would be to gain a better understanding of the stability of the franchising sector (particularly disputation), without unduly increasing the regulatory or compliance burden for businesses.

Any indicator of disputation within the sector must include a measure of similar problems faced by other Australian businesses (particularly small businesses). This comparison is necessary to ascertain whether the sector is facing any burdens or concerns over and beyond those faced by Australian businesses more generally over the same period of time.

Trends and patterns of disputation within the franchising sector as compared with small business more generally, may assist prospective franchisees to gain a better understanding of the operation of the sector. It would also allow prospective and

current franchisees to consider the disputes which receive negative media focus against the context of disputes faced by small businesses more generally.

Wider release of data on indicators of stability within the franchising sector would assist franchisees in undertaking their pre-contractual due diligence.

While this analysis considers the five options to address the Joint Committee's recommendations, only three options were considered feasible and were subject to further regulatory impact analysis.

OPTIONS

1. Option 1 – Status quo.

Under this option, franchising sector participants would continue to rely on the biennial Franchising Australia Survey collated by the Asia-Pacific Centre for Franchising Excellence, Griffith University or private industry reports such as the industry report on Franchising produced by IBIS World.

2. Option 2 – The Government establishes a simple online registration system for franchise businesses.

Option 2 considers the first element of Recommendation 2, where the registration system was simply to act as a research tool and assisting with data collection on the sector.

Under Option 2 the Government would set up an online registration system for franchise businesses for the purpose of collecting data on the franchise sector. Franchisors would need to annually register their name; identify the nature of their business (for example, motor vehicle retailer) and the size of their franchising system.

There would be an obligation to reregister annually to verify whether or not the franchise system had undergone any changes since registration in the prior year.

The implementation of this option would require further analysis of where this online system of registration would be located, who would administer the system and how such a system could be designed. Since this impact analysis is undertaken for the purposes of informing the Government's consideration of the policy basis for Option 2, the implementation aspects of Option 2 are not considered within this RIS.

The second element of Recommendation 2 (improving franchisors' compliance with the Franchising Code) is considered at Option 4.

3. Option 3 – Explore existing avenues for data collection on the franchising sector, which do not involve the establishment of a separate registration system for franchises.

Under Option 3, the Government would explore existing avenues whereby Australian Government agencies collect data on franchise sector participants. The ACCC collects information on the inquiries and complaints it receives from small businesses and franchise businesses. Currently, the ACCC makes this information available to a limited number of key franchising stakeholders.

Under this Option, the Government would explore the possibility of the ACCC making this information available to the wider public. This information may then be used as a possible indicator of trends and patterns of disputation within the franchising sector and enable comparison with small business more generally.

4. **Option 4 – The Government establish 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 of Conduct and the *Trade Practices Act 1974*.**

Option 4 considers the second element of Recommendation 2 (improving franchisors' compliance with the Franchising Code).

Option 4 would require Australian franchisors to lodge statements, on an annual basis, providing a guarantee that they are meeting their obligations under the Franchising Code of Conduct and the *Trade Practices Act 1974*.

In discussing Recommendation 2, the Joint Committee noted 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 Committee noted that Government resources are better directed to educational and enforcement responsibilities. In accordance with the Joint Committee's comments, the Government would not be involved in verifying the accuracy of any statements of guarantee provided by a franchisor as contemplated under Option 4. A system of registration of guarantees is unlikely to provide franchisees with any extra benefit since they would need to undertake their own due diligence in any case to make sure that the information on the register is accurate.

Such a system of registration would not only impose compliance costs for business but it could create an expectation that the franchise has received the endorsement of the regulator. Consultation with the sector supports DIISR's view that the perceived endorsement may result in a franchisee not undertaking their proper due diligence before entering a franchising agreement. The Joint Committee noted that currently there is an 'expectation gap' in the franchising sector about the capacity for the Government to intervene in contractual disputes. A system of registration of guarantees by franchisors could serve to increase this expectation gap.

During DIISR's consultation, one stakeholder noted that a franchisor can merely attempt to comply but it cannot guarantee compliance with the Code and the Trade Practices Act, as the Code and the Trade Practices Act are the subject of interpretation and are often interpreted differently by different Courts. Such a requirement would dramatically increase the compliance costs to franchisors, as a guarantee would require franchisors to engage in professional advice to determine compliance. The same stakeholder also noted that legally such a requirement may reverse the onus of

proof by requiring franchisors to prove that they have not breached the Code or the Trade Practices Act. Such a reversal of the onus of proof would signify a significant change to a fundamental principle of Australia law.

Accordingly, given all of these concerns this aspect of Recommendation 2 is not considered desirable, does not meet the Government's objective and is not considered further in this RIS.

5. Option 5 – The Government to support a survey of the franchising sector, with a focus on franchise disputation and dispute-related franchisee turnover, using information collected from both franchisees and franchisors.

The Joint Committee recommended that the Government require the ABS to conduct a survey of the franchising sector, with a focus on franchise disputation and dispute-related franchisee turnover.

The ABS is an independent statutory agency which determines its own priorities in consultation with stakeholders. The ABS has indicated that while its work programs are currently fully committed, a user pay collection or analysis may be possible. Regardless of which funding model is used, the ABS needs to ensure that any new project meets the ABS assessment criteria of: validity of statistical need; justified use of ABS resources (including issues in relation to cost and impact on existing priority work); confidentiality must be assured; and acceptable data quality.

There is currently no way of readily identifying the franchise sector from the broader business community in current data sources. Before any direct survey of the sector could be undertaken, a system of registration would need to be established to identify franchise businesses. A system of registration for franchise businesses is considered under Option 2. While the establishment of a registration system may produce more detailed data on the franchising sector, such data would only be as good as the information provided by those parties that register. For a registration system to produce improved data on the franchising sector, the Government would need to make registration mandatory as well as policing registration to ensure that registration is representative of the whole sector. Such a system of registration would be costly to administer and police and would impose compliance burdens on the sector.

An alternative option for collecting data on the franchising sector is to conduct a survey of Australian businesses. Given the 'law of averages', a percentage of those business surveyed could reasonably be expected to be from the franchising sector. This is the approach the ABS undertook when conducting its Business Characteristics Survey. The Business Characteristics Survey produces limited data on the franchising sector, namely the proportion of Australian businesses that identify as either a franchisee or franchisor and what industry they operate in. Given the small sample of franchisees and franchisors that participate in the Business Characteristics Survey, the ABS is unable to use this collection to publish more detailed data on the sector. The ABS has noted that a survey resulting in a small sample size would result in unreliable data that could either overstate or understate the true degree of the characteristics being measured. Thus, the data could be rendered misleading and unusable for statistical purposes and would not meet the ABS standard of acceptable data quality. Furthermore, any survey estimates based on a small sample size would need to be

suppressed or confidentialised to prevent business and individuals being identified, in accordance with the ABS policy of only releasing data where confidentiality can be assured.

To ensure that data produced on the franchising sector is an accurate representation of the franchising sector, a larger sample needs to be taken of the sector. This could be achieved through conducting a larger survey of Australian business. Such a survey would impose considerable compliance burdens on the broad business community. The Government would 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.

In addition to the issue of identifying the franchising sector from the broader business community, the collection of data on disputes may raise other concerns. The ABS does not currently undertake a survey of business to business disputes in Australian firms. Business disputes are subjective in nature and hard to define. A survey on disputes may be costly and difficult to conduct as Australian businesses do not share a common understanding of what constitutes a business dispute.

The Government considers that to gain a better understanding of the issues facing the franchising sector, comparative data on other Australian businesses would need to be produced as a means to benchmark the franchising sector to the broader business community. Comparative data on disputes would provide a means to determine whether the franchising sector is facing burdens over and beyond those faced by Australian business more generally. DIISR's consultation with the sector suggests varying views on what constitutes a dispute. Given the difficulty of defining disputes, a survey of franchising business and non-franchising business would both be costly to run and timely to complete as survey participants would need to take the time to understand the definition of dispute used in the survey and then complete the survey. The lack of a common understanding of what constitutes a business dispute may result in a poor response rate to the survey or inaccurate responses being recorded.

Given that a registration option is not being recommended in this RIS, and that a larger business survey would impose significant burdens on the wider business community, Option 5 is not considered further in this RIS.

IMPACT ANALYSIS

1. Option 1 – Status quo

Under this Option, franchising sector stakeholders would continue to rely on the existing data on the franchising sector contained in the biennial Franchising Australia survey collated by the Asia-Pacific Centre for Franchising Excellence, Griffith University or use private industry research such as the IBIS World report on franchising. While the Griffith University survey contains some information on the disputes within the franchising sector, it is based largely on franchisors' experiences. There is a concern that the survey does not sufficiently capture franchisees' experiences of disputes.

<u>Benefits</u>

The benefit of Option 1 is that there would be no regulatory changes and, therefore, there would be no compliance burdens imposed on the franchise sector.

Costs

This option would not address the stated objective of the Government releasing data on indicators of stability, such as disputes, within the franchising sectors so that prospective franchisees gain a better understanding of the operation of the sector.

Without better indicators of stability (and the extent of disputation) within the franchising sector, the stability of the sector will continue to be the subject of speculation.

Media focus on negative complaints relating to one franchise system can result in "brand damage" and have an adverse impact on other franchisees in the franchise system. This may, in turn, result in excessive negative focus on the franchising sector even though, as the ACCC noted in its submission, few franchise systems receive complaints from more than one or two franchisees and there is no widespread misconduct regarding the Code or the Trade Practices Act by most franchisors.

2. Option 2 – The Government establish a simple online registration system for franchise businesses.

Under Option 2 franchisors would need to annually register their name; identify the nature of their business (for example, motor vehicle retailer) and the size of their franchising system.

If registration was voluntary the information on the register would only represent those who had voluntarily registered and not necessarily the whole of the franchising sector. In addition the information on the register may not contain current information; these factors may result in potentially misleading information. Therefore, to ensure accuracy and currency of the information on the register, annual registration would need to be mandated via a regulatory change.

Benefits

A system of mandatory registration for the franchise sector would provide an independent measure of the numbers of franchise systems in operation, along with the number of franchisees and franchisors. This may serve to bolster existing statistics on the franchising sector as provided by the Griffith University Franchising Survey and would cover both franchisees and franchisors (as supported by the Joint Committee).

Information on the register may provide a means to monitor entry and exits from a franchise system (which would be one indicator of stability within the sector).

Costs

Government objective

A system of mandatory registration of franchise businesses would be viewed as contrary to the Government's objective of reducing regulatory burdens on business. It imposes compliance costs on businesses as detailed below.

<u>*Business compliance costs*</u>

The *Australian Government Cost Recovery Guidelines* requires agencies to consider charges to recover the costs of products or services where it is efficient and effective to do so, where the beneficiaries are a narrow and identifiable group and where charging is consistent with Australian Government policy objectives. In this particular case, since the beneficiaries of a system of registration under Option 2 would essentially be franchisees, the Government would need to consider cost recovery from the franchise sector. The cost associated with the registration system would depend on the type of registration (online or other) and the information that would be captured. This cost to the Government of establishing this system would be covered by a fee which would apply across the entire franchise sector.

To cover the costs to the Government in setting up an annual registration system, it is proposed that all businesses across the sector would need to pay around $10 each for initial registration. The cost of renewal would be around $5 and the cost of deregistering by a franchisor would be $5.

Even a simple online registration system requiring the lodgement of a trading name, the nature of the business and the number of franchise units within the system would require a franchisor to allocate around 30 minutes to that activity. A business owner/employee would need to read through instructions to fill in the relevant information and allocate time away from the franchise business to lodge these details. The labour costs involved would be around $17.50.

Option 2 would impose significant burdens on the sector while the data collected as part of this process (names, types and numbers of franchise businesses) is unlikely to be a significant improvement over the information that is available through existing sources.

During DIISR consultation with the sector, most stakeholders said they would not be prepared to pay for a registration system and only a small number said that they would consider the cost of registration as part of the cost of doing business. In addition, a small number of stakeholders noted that a simple registration system would only duplicate what is already supplied to prospective franchisees.

3. Option 3 – Explore existing avenues for data collection on the franchising sector, which do not involve the establishment of a separate registration system for franchises.

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 then 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 and the ACCC has commissioned the Griffith University to research conflict in the franchising sector. The research project is to be conducted over two years and commenced in 2008. The research is to produce an analysis of the most effective methods for anticipating and avoiding conflict. The ACCC is to use the results of this survey to assist it with its education efforts in relation to the sector.

Benefits

This would involve no compliance costs for the sector. This information is currently made available to a limited number of franchise sector stakeholders including main industry bodies. Making this information available more widely would assist existing and prospective franchisees to gain a better understanding of the operation of the franchising sector. This information would be one indicator of trends in complaints and disputes within the sector relative to other small businesses.

It would also allow prospective and current franchisees to consider the disputes which receive negative media focus against the context of disputes faced by small businesses more generally.

Wider release of data on indicators of stability within the franchising sector would be in line with the objective of the Franchising Code to assist franchisees undertake their pre-contractual due diligence.

Costs

Any inferences drawn from the ACCC enquiries data would be limited as the ACCC would be unable to guarantee that all enquiries are legitimate and are indicative of genuine disputes. Given these limitations, if the ACCC was able to make such information available more widely, a list of caveats would need to accompany the data.

Consultation

DIISR is the lead department responsible for preparing the Governments' response to the Joint Committee's Inquiry. To ensure a whole-of-Government response to the Joint Committee's inquiry into Franchising, DIISR convened an inter-departmental committee (IDC) in May 2008 consisting of the following Government departments and Agencies: Treasury; Finance and Deregulation; Prime Minister and Cabinet; and the ACCC. In addition to regularly consulting with IDC members, DIISR has liaised with a number of other Government agencies, in particular the ABS, on the options proposed within this RIS which deal with Recommendation 2 and 7.

The Joint Committee's inquiry was one of four inquiries conducted into the sector over a period of three years (commencing with the Commonwealth Matthews review in 2006 and concluding with the Joint Committee's report in December 2008). All four inquiries consulted extensively with the sector, holding public hearings and calling for written submissions. Given the extensive public consultation already undertaken, DIISR conducted targeted consultation consisting of a number of one-on-one consultations with franchisees, franchisors, industry groups and advisers and

invited the public to make written comments to the Government's consultation paper which was released on 21 June 2009. The consultation paper was posted on DIISR website for 3 weeks and a link to the paper appeared on the consultation portal administered through www.business.gov.au. The paper contained specific questions aimed at ascertaining the potential business compliance activities and costs in relation to each regulatory proposal. The purpose of DIISR's targeted consultation was to further inform the Government response by building on previous consultation and seeking comments additional to those already expressed as part of the Joint Committee's inquiry.

In its submission to the Joint Committee the ACCC supported the need for more statistics on the franchising sector to both inform prospective franchisees and to better inform public debate about franchising. That is, to place the ACCC complaints data in context and more accurately understand the issues facing the sector.

While some industry stakeholders supported registration of franchise systems with a central body as a checking and validation system for franchisees, others expressed concerns that registration of disclosure documents, be it with the ACCC or another body, might somehow imply endorsement of the system and discourage franchisees from seeking adequate advice on their franchise agreement

An overwhelming theme expressed during DIISR consultation with the sector, was that while better data on the sector, particularly disputes, may be desirable, more data on the sector might not be utilised by prospective franchisees to make more informed decisions. Stakeholders expressed the view that prospective franchisees on the whole are more interested in a business type or industry rather than franchising per se. Franchisees for example, might want to enter into a particular industry and recognise they need help with establishing and running a business and that is why they turn to franchising. As such, prospective franchisees are more likely to be interested in the performance of a particular franchising system rather than the performance of the franchising sector as a whole.

Additionally, a number of stakeholders noted that they would not support more data on the sector noting that, better data on the sector would only assist prospective franchisees and not current franchisees.

The ABS has been consulted on the options proposed within this RIS in relation to Recommendations 2 and 7 by the Joint Committee. The ABS supports the conclusion that the costs of a registration system, combined with the probable data quality issues that would be encountered in trying to measure and analyse disputation within the franchise sector, present a strong case for not proceeding with the development of a register of franchise businesses or a survey on franchising disputes.

Conclusion and recommendation

Out of the five options considered, Options 1-3 were subject to a regulatory impact analysis. Options 4 and 5 were not considered feasible.

Options 4 and 5

Option 4, would require Australian franchisors to lodge statements, on an annual basis, providing a guarantee that they are meeting their obligations under the Franchising Code of Conduct and the *Trade Practices Act 1974*. Such a system of registration would not only impose compliance costs for business but it could create an expectation that the franchise has received the endorsement of the regulator. Such a system of registration is likely to contribute to an 'expectation gap' within the sector about the capacity for the Government to intervene in contractual disputes. It may also detract from the franchisee's need to undertake their due diligence before entering into a franchising agreement. Option 4 is not supported since it potentially has an undesirable outcome.

Option 5 would firstly require a registration of franchise businesses, after which a survey of small business, including franchising, disputes could be contemplated. Even if a system of registration of franchise businesses was to be adopted, a comparative analysis of franchising disputes against disputes faced by other small businesses would not be possible. Australian Government agencies, such as the ABS, do not conduct surveys on small business disputes. If similar data were to be collected for all small businesses and not just franchises, this would add substantially to the administrative costs and compliance burdens of this option.

While the Government could ask the ABS to undertake statistical analysis of the information gathered by a survey of small business and franchise disputes, the ABS is an independent statutory agency which determines its own priorities. The ABS supports the conclusion that the costs of a registration system and the probable data quality issues that would be encountered trying to measure and analyse disputation within the franchisee sector, present a strong case for not proceeding with Option 5.

Options 1, 2 and 3

In summary, maintaining the status quo and continuing to rely on the existing data published on the franchising sector (Option 1) would not address the Government's objective to gain a better understanding of the stability of the franchising sector (particularly disputation).

Any indicator of disputation within the sector must include a measure of similar problems faced by other Australian businesses (particularly small businesses). This comparison is necessary to ascertain whether the sector is facing any burdens or concerns over and beyond those faced by Australian businesses more generally over the same period of time.

While a simple system of registration as considered under Option 2 may provide limited data on the franchising sector, notably entry and exits, compulsory registration would result in substantial compliance costs for businesses. It would not be in line with the Government's objective of reducing compliance burdens on businesses. In addition, any cost of establishing a registration system or the cost associated with maintaining the register would be borne by the sector according to the *Government's Cost Recovery Guidelines*.

Option 2 would impose significant costs on franchise businesses but would result in a limited improvement over the current information that is available on the franchise sector. The cost of implementing this option would not outweigh the benefits.

DIISR consultation with the sector has confirmed that option 3 is the preferred and recommended option. It addresses the identified problem of lack of data on the franchising sector, particularly indicators of disputation within the sector. Wider circulation of ACCC data on trends of inquiries and complaints from small businesses and franchising businesses could be 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.

RECOMMENDATION 8 – GOOD FAITH

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.

BACKGROUND TO THIS RECOMMENDATION

Part of the Joint Committee's terms of reference required it to consider the need for the inclusion of a good faith obligation within the Franchising Code. In particular, the Joint Committee considered 'whether an obligation for franchisors, franchisees and prospective franchisees to act in good faith should be explicitly incorporated into the Code (having regard to its presence as an element in paragraph 51AC(4)(k) of the *Trade Practices Act 1974*)'. Broadly section 51AC prohibits unconscionable conduct by a business in the supply or acquisition of goods or services. One of the factors to which a Court may have regard in determining unconscionable conduct by a business is the extent to which the supplier and the business consumer acted in good faith (paragraph 51AC(4)(k)).

It should be noted that the Joint Committee's Recommendation 8 was for a stand-alone good faith obligation to be inserted into the Franchising Code. A stand-alone good faith obligation can be differentiated from the current reference to good faith within the unconscionable conduct provisions of the Trade Practices Act where good faith is only one of the many factors the Court may have regard to in assessing unconscionable conduct.

While there is no clear definition of 'good faith', the Joint Committee considered that it is generally understood to mean acting fairly, reasonably and honestly, encapsulating the concept of 'a fair go'.

At Chapter 2 of its report, the Joint Committee notes that the interdependent nature of the franchise relationship leaves the parties to the agreement vulnerable to opportunistic conduct by either franchisors or franchisees. The Joint Committee considered that there is an inherent and necessary imbalance of power in franchise agreements in favour of the franchisor, but abuse of this power can lead to opportunistic practices. Submissions to the Joint Committee and DIISR's consultations suggest that parties to a franchise agreement may engage in opportunistic practices in the following areas: end of term arrangements (including non-renewal), dispute resolution, unforeseen capital expenditure, unilateral contract variations, attribution of legal costs, confidentiality arrangements and changes to franchise agreements when a franchisee is trying to sell the business.

The Joint Committee was of the opinion that the optimal way to provide a deterrent against opportunistic conduct in the franchising sector is to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith.

The rationale underpinning the Joint Committee's Recommendation 8 appears to be that the insertion of a good faith obligation within the Franchising Code would act as a deterrent for parties to a franchise agreement to engage in opportunistic practices. At the crux of these specific concerns is the capacity for an imbalance in power in favour of franchisors within a franchise relationship.

The need for good faith conduct in a working relationship between the franchisee and franchisor is discussed at Chapter 5 (issues arising during franchise agreements) and the need for a good faith obligation in the context of mediation is discussed at Chapter 7 (dispute resolution in franchising).

The Joint Committee noted that the majority of the issues identified in Chapter 5 that may arise in a working relationship between the franchisee and franchisor could be addressed by existing Trade Practices Act provisions. There are specific provisions in the Franchising Code dealing with rights of franchisees in the event of termination by a franchisor and options to address concerns about non-renewal of franchise agreements are discussed at as part of the analysis of Recommendation 5 by the Joint Committee.

The following analysis will focus on specific options that could be contemplated by the Government to address specific opportunistic behaviours in which parties to a franchise agreement may engage.

PROBLEM

In its report, the Joint Committee noted that there is an inherent and necessary imbalance of power in franchise agreements in favour of the franchisor, but abuse of this power can lead to opportunistic conduct.

The franchising model is necessarily predicated on strict franchisor control over the use of their brand, allowing them to impose strict terms and conditions on the way franchisees operate their franchise business. Because the franchisor's model needs to be implemented uniformly across the franchise network, franchise agreements are typically underpinned by standard form contracts drafted by the franchisor. These may be presented to franchisees on a 'take it or leave it' basis: the franchisee can either agree to establish a franchising relationship on the franchisor's terms or not proceed at all.

The Joint Committee noted that the main difference between franchise agreements and most other commercial relationships is that the nature of franchising dictates that each party's contractual obligations are ongoing and variable—forming a contract that is fundamentally based on an ongoing relationship. These are not discrete, one-off exchanges between parties on clearly defined terms that characterise ordinary contractual agreements.

In practice, franchisors are able to dictate business operations and procedures to franchisees, and are able to change these at will. Franchisors can impose rigorous obligations on the way the franchisee operates, which are subject to change at the discretion of the franchisor. These obligations may be strictly enforced: failure by the

franchisee to meet their obligations, as interpreted by the franchisor, can trigger termination of the contract. This control allows franchisors to prevent franchisees from exploiting their intellectual property to the detriment of the overall franchise network but can also lead to the potential for abuse of power.

The nature of the franchising model creates an asymmetrical distribution of power within the franchise agreement. The interdependent nature of the franchise relationship can leave the parties to the agreement vulnerable to opportunistic conduct by either franchisors or franchisees.

DIISR's consultation with the sector, and submissions to the Joint Committee, suggest that opportunistic conduct can be associated with issues relating to end of term arrangements (including non-renewal), dispute resolution, unforeseen capital expenditure, unilateral contract variations, attribution of legal costs, confidentiality arrangements and changes to franchise agreements when a franchisee is trying to sell the business. However, the statistical data on the extent to which parties to a franchise agreement engage in these opportunistic practices is limited and, therefore, the extent of the problem is not entirely clear.

Existing arrangements for opportunistic conduct

Where one party (for example the franchisee) to a franchise agreement was of the view that the other party (for example the franchisor) had engaged in opportunistic conduct, the franchisee could seek recourse to the proposed opportunistic conduct under the unconscionable conduct provisions within the Trade Practices Act.

Parties to a franchise agreement could also access the existing dispute resolution procedures under the Franchising Code to attempt to resolve disputes that may have arisen from opportunistic conduct. The Franchising Code obliges parties to a franchise relationship to attempt to resolve disputes through direct negotiations. Where parties fail to reach an agreement through direct negotiation, either party may refer the matter to mediation with a mediator of their choice or request that the Government funded OMA appoint a mediator. Once the mediation is requested by either party, it is mandatory for both parties to attend the mediation and try to resolve the dispute.

The Joint Committee noted that the Franchising Code's current mediation provisions provide franchisees and franchisors wanting to constructively resolve their dispute with a less costly resolution option than litigation. Existing provisions within the Franchising Code stipulate specific obligations that must be met by the parties to engage in constructive and fair dispute resolution (clause 29). Clause 29(2) states that parties must try to agree about how to resolve the dispute and clause 29(6) notes that parties must attend mediation and try to resolve the dispute.

Limitations of existing arrangements

The determine of whether or not a party had engaged in unconscionable conduct may require the party(ies) to take the matter to the Court. Such litigations would be expensive and many franchisees would be unable to afford the costs and even where

franchisees could afford the litigation costs, there is no guarantee of the outcome as it would be a decision for the Courts.

While parties to a franchising dispute can access the dispute resolution processes in the Franchising Code, submissions to the Joint Committee and DIISR's consultation with the sector 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. Such action would reduce the effectiveness of the dispute resolution processes; even where parties to a franchise dispute approach their dispute in a reconciliatory manner, there is no guarantee that the outcome of mediation will resolve or address the proposed opportunistic conduct.

The Joint Committee noted that opportunistic conduct can have negative impacts on the sector including personal hardship and negative ramifications for individual franchise systems and the franchising sector as a whole.

The Joint Committee was of the view that the imbalance of power in franchise agreements is not something that should be changed, but what does need to be checked is any abuse of this power.

Submissions to, and, public hearings held by the Joint Committee suggested that there are no effective measures available to parties to a franchising agreement to address or constrain opportunistic conduct resulting from abuse of power in the franchising sector.

OBJECTIVES

What are the objectives of government action?

The objective of Government action is to increase transparency in dealings and, in turn, improve the conduct between franchising sector participants.

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. Accordingly, any regulatory changes to the Franchising Code in relation to good faith dealings would need to be defined clearly so that they do not create uncertainty in business dealings nor unduly increase regulatory or compliance burdens for businesses. The need for clearly defined obligations under the Franchising Code is also in line with the Government's policy guidelines on making industry codes of conduct enforceable under the *Trade Practices Act 1974* (policy guidelines on industry codes).

The Government policy guidelines on industry codes state that Code requirements should be drafted to address specific problems. Codes should be drafted in terms of requirements and obligations, not aims and ideals. Enforceable provisions within codes of conduct under the Trade Practices Act must be drafted in clear, unambiguous language that can be clearly interpreted by industry participants, consumers, investigators and by the Court. Ultimately, the provisions of the Franchising Code

should be in line with the overall objective underpinning the Trade Practices Act. That is, to further competition and fair trading for the benefit of the consumers.

The implementation of measures to discourage opportunistic conduct in franchising could: improve the transparency of franchise agreements, improve conduct between parties to a franchise agreement and in turn may reduce disputes within the franchising sector.

OPTIONS

1. Status quo.

Under Option 1, parties to the franchise agreement would continue to rely on existing unconscionable conduct (Section 51AC) and the misleading or deceptive conduct (Section 52) provisions within the Trade Practices Act to seek redress for opportunistic conduct.

Under this option, prospective franchisees would continue to have access to the educative material made available by the ACCC, as part of their due diligence, prior to entering into a franchise agreement.

Parties to the franchise agreement could also seek a Court determination as to whether a party has acted in good faith.

In addition, under this option, where disputes have arisen as a result of possible opportunistic conduct, parties to the franchising dispute would continue to rely on existing dispute resolution procedures under the Franchising Code.

2. Broad good faith obligations stipulated within the Franchising Code.

Submissions and public hearings to the Joint Committee suggested that opportunism in the franchising sector may be addressed through constraining the behaviour of franchisors and empowering franchisees. The introduction of a statutory obligation of good faith within the Franchising Code was suggested as one possible mechanism for regulating the conduct of franchising parties and, in particular, for preventing franchisor opportunism.

Under this option, a stand alone obligation could be inserted into the Franchising Code to stipulate that both franchisees and franchisors must act in good faith in relation to all aspects of their franchise agreement. This reference to good faith would be undefined.

This option would mean that behaving contrary to good faith would constitute a breach of the Franchising Code, which could be a premise for legal action.

3. Identify the specific opportunistic conduct/behaviours or issues that impact on the franchising sector and implement specific measures to discourage these behaviours.

Under this option, amendments could be made to the Franchising Code to promote specific behaviours to address or discourage certain types of conduct in primary areas of concern where parties to a franchising agreement may engage in opportunistic conduct. This option would not include a broad good faith obligation.

Based on DIISR's consultations, and submissions to the Joint Committee, there are a number of primary areas where parties may engage in opportunistic conduct[2]:

- 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.

Under this option the Government could implement specific measures (via amendments to the Franchising Code) to address or discourage certain types of conduct or franchising behaviours.

IMPACT ANALYSIS

1. Option 1 – Status quo.

Under this option, parties to the franchise agreement would continue to rely on current Trade Practices Act provisions, including unconscionable conduct (Section 51AC) and misleading or deceptive conduct (Section 52), to seek redress for opportunistic conduct.

Section 51AC of the Trade Practices Act provides a list of matters which the Court may have regard to for the purposes of determining if a party has engaged in unconscionable conduct. Section 51AC does not attempt to define good faith but lists it among a range of factors the Courts may consider in determining whether a party had engaged in unconscionable conduct (section 51AC(4)(k)). Section 52 of the Trade Practices Act also provides protection in relation conduct that is misleading or deceptive.

In its report, the Joint Committee noted that the time during which a prospective franchisee is considering entering into a franchise agreement represents the best opportunity for both the franchisee and the franchisor to make an accurate and informed assessment about whether this is the right agreement for them. This information may assist prospective franchisees to undertake their due diligence prior to entering into a franchise agreement. ACCC educative material currently available to educate franchisees and franchisors about their rights and obligations under the Franchising Code and Trade Practices Act includes:

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[2] These primary areas of concern were identified in submissions to the Joint Committee and during consultation. This list is not intended to be an exhaustive list nor is it intended to suggest that opportunistic conduct does not take place in other areas in franchising.

- Franchising Code of Conduct compliance manual for franchisors and master franchisees, book with CD;
- The franchisee manual;
- Franchisee start-up, checklist;
- Resolving franchising disputes, fact sheet;
- Disclosure under the Franchising Code of Conduct, fact sheet;
- Being smart about your new franchise: checklist before signing a lease agreement;
- Being smart about your new franchise and your retail lease, fact sheet; and
- Overview of the Franchising Code of Conduct, fact sheet.

Under this option, prospective franchisees and franchisors would continue to have access to these documents to assist them in undertaking their due diligence prior to entering the franchise agreement.

Under this option, parties to franchising disputes resulting from potentially opportunistic conduct could continue to access the existing dispute resolution procedures under the Franchising Code.

The ACCC education material also provides guidance to parties on their rights and obligations in mediation, as under the Franchising Code. The ACCC's educational material notes that it is mandatory for parties to attend mediation and genuinely try to resolve their dispute. Currently, what constitutes a genuine attempt to resolve a dispute is a matter of subjective assessment by parties to a dispute.

Benefits

The benefit of Option 1 is that there would be no additional regulatory changes to the Franchising Code. Therefore, there would be no additional compliance burdens imposed on either franchisees or franchisors since they will not have to understand any new regulatory changes to the Franchising Code.

Costs

Option 1 would not address the identified problem of some parties to a franchising agreement engaging in opportunistic conduct.

DIISR's consultation with the sector, and submissions to the Joint Committee, suggest that opportunistic conduct can be associated with the following issues: end of term arrangements (including non-renewal), dispute resolution, unforeseen capital expenditure, unilateral contract variations, attribution of legal costs, confidentiality arrangements and changes to franchise agreements when a franchisee is trying to sell the business. However, there is limited data on the extent to which parties to a franchise agreement engage in opportunistic conduct.

Anecdotal evidence from submissions to the Joint Committee and comments made during DIISR's consultation indicated the costs of opportunistic conduct may take the following forms: cost to each party of litigation; loss of income or reduced profits; strain on personal relationships and cost of mediation. Without evidence on how wide

spread the problem is, the compliance costs of adopting Option 1 cannot be quantified.

2. Broad good faith obligations stipulated within the Franchising Code.

‘Good faith’ would be undefined under Option 2. There is not a single 'definition' or a standard set of 'behaviours' that constitute good faith. In most contexts in which it is used, what constitutes 'good faith' is usually largely dependent on the particular factual situation in which the issue arises. What constitutes good faith in one situation may not be considered good faith in another situation. Case law in this area has not sought to codify the meaning of good faith or its practical requirements. Therefore, whether or not parties to a franchise agreement have acted in good faith would be likely to be addressed on a case by case basis.

Under Option 2, franchising sector participants would have to examine situations they could face during the life of the franchise agreement, including when pursuing dispute resolution under the Franchising Code, to ascertain whether an obligation to behave in good faith could apply in that instance.

The extent to which a party has acted in good faith is already a factor to be taken into account by Courts in determining whether conduct is considered to be unconscionable under section 51AC of the Trade Practices Act. Section 51AC does not attempt to define good faith but lists it among a range of factors the Courts may consider in determining whether a party had engaged in unconscionable conduct (section 51AC(4)(k)).

Submissions to the Joint Committee noted that there is lack of an authoritative High Court decision on the application of a good faith principle in commercial dealings. However, the Joint Committee considered that ‘good faith’ is generally understood to mean acting fairly, reasonably and honestly, encapsulating the concept of ‘a fair go’.

Some franchisee representatives in submission to the Joint Committee have suggested that the concept of good faith in the Franchising Code would recognise that parties to a franchise relationship cannot act in the pursuit of their individual interests because of the interdependent nature of the franchising relationship. However, submissions to the Joint Committee from the Law Council of Australia and others recognise that the requirement to act in good faith does not require franchising parties to act against their legitimate interests consistent with the terms of the franchise agreement.

There is not single ‘definition’ or a standard set of ‘behaviours’ that constitute good faith. In most contexts in which it is used, what constitutes ‘good faith’ is usually largely dependent on the particular factual situation in which the issue arises. By way of example, in *ACCC v Simply No-Knead (Franchising) Pty Ltd* (a case involving a franchising arrangement) [2000] FCR 253 the Court had regard to the particular circumstances of the relationship between the franchisor and franchisee in determining that the franchisor had demonstrated a lack of good faith within section 51AC(4)(k). The Court noted that the franchisor had engaged in the conduct in question despite knowing its conduct would damage the franchised businesses (for

instance, by producing advertising material which failed to display the details of franchisees).

On one hand, proponents of the need for a reference to good faith within the Franchising Code argue that it could serve as an aspirational goal for franchise sector participants, would recognise the interdependent nature of the franchising relationship and would recognise a principle which is being tested in the Courts. In contrast, other stakeholder submissions to the Joint Committee noted that there is wide disagreement in both the Courts and academia as to the suitability and applicability of the good faith principle in commercial arrangements. Furthermore DIISR's consultation with the sector noted that there is a lack of a universally accepted specific definition of good faith and there is wide disagreement on the implications of inserting a reference to good faith within the Franchising Code.

Benefits

Irrespective of the regulatory change proposed by Option 2, the concept of 'good faith' in commercial dealings continues to be tested in the Courts.

The benefit of this approach is that the codification of an aspirational goal for franchise sector participants may improve conduct in the franchising sector by serving as a moral and educative influence. During DIISR's consultation with the sector, some stakeholders indicated that the benefits of this option would include providing a minimum standard of behaviour to be adhered to by sector participants while others saw benefits in bringing honesty, integrity and professionalism back to the industry.

In submissions to the Joint Committee and in DIISR's consultation with the sector, some stakeholders indicated that a good faith provision in the Franchising Code would assist with some specific problems, including:

- Requiring franchisees to conduct a refurbishment or requiring them to purchase equipment that was not foreseen or detailed in the franchise agreement;
- Varying the franchise contract unilaterally to the detriment of the franchisee;
- Making changes to franchise agreements when a franchisee is trying to sell the business, thereby making it less attractive to sell; and
- Issues associated with non-renewal and end of term arrangements.

While the introduction of a reference to good faith would not remove the uncertainty surrounding its meaning, it may enable the concept to continue to develop incrementally through case law pursued through the Courts. However, it is difficult to identify and quantify the benefits in a tangible way or identify the degree to which this option would improve outcomes for franchise sector participants.

Costs

Since the application of a broad good faith obligation would depend on the circumstances faced by the parties in each case and would be situational; it is not possible to quantify the potential compliance costs faced by the franchising sector. However, the following potential impacts on business, which would involve cost to businesses, have been identified in relation to Option 2.

Increased ambiguity of rights and obligations and disputation

A broad reference to 'good faith' could result in ambiguity for franchise sector participants, enforcers and the Courts.

DIISR's consultation with the sector supported concerns the ACCC made in its submission to the Joint Committee. The ACCC stated that since the meaning of good faith could to be considered separately in each case depending on its particular facts, it may introduce ambiguity and confusion about the rights and responsibilities of franchisors and franchisees, and potentially increase disputes and conflict among franchising participants. That is, since a reference to good faith would involve subjective notions of fairness and honesty, there could be increased allegations of lack of good faith behaviour by either franchisees or franchisors. It is possible to envisage common business decisions made by either franchisors or franchisees which may be perceived as lack of good faith behaviour by one party.

Consider the example of the renewal of franchise agreements. Evidence to the Joint Committee indicates that while franchise agreements usually operate for around five years, most franchisees operate within a franchise system for seven years. That is, it is suggested that franchise agreements are usually renewed after the first term. A franchisor or franchisee is not obliged to renew a franchise agreement when it expires unless otherwise agreed to by both parties. A franchisee may decide against renewing a franchise agreement when that franchise agreement expires due to personal reasons such as early retirement. In this context, the decision may be perceived as unfair or unreasonable by the franchisor if they had an expectation, based on common industry practice, that the franchisee would renew their franchise agreement for another term. This could lead to the franchisor alleging lack of good faith behaviour on the part of the franchisee. On the other hand, the franchisee may believe that they are acting in good faith since they have acted in accordance with the express terms of the franchise agreement. This is one example of the potential confusion and ambiguity about the rights and responsibilities of franchisors and franchisees that could result from the inclusion of a broad good faith obligation within the Franchising Code. This may ultimately increase disputes and conflict among franchising participants. There would be related costs to business where they need to seek legal or other guidance in resolving their disputes. Some businesses could pursue litigation which would also involve costs to business.

Irrespective of such disputes, more generally, some businesses would be faced with situations during the life of the franchise agreement where they would need to ascertain whether a good faith obligation could apply in that instance. In these cases, businesses would need to seek legal advice and guidance. As part of DIISR's consultation, some stakeholders expressed concerns about the costs of this option. Stakeholders suggested that the cost of legal advice could be particularly onerous and highlighted that there would be additional costs to keep meticulous records to refute any allegations of not acting in good faith. Stakeholders noted that due to a lack of a common definition of what constitutes good faith, sector participants would need to obtain legal advice to ascertain if they are conducting themselves in good faith. However, due to a lack of a definition, and that a definition would change and evolve over time, legal advice would be unlikely to help clarify sector participants concerns.

As such, according to some stakeholders, without a clear or agreed definition of what constitutes good faith, such an inclusion would make no difference to the behaviour of sector participants.

While stakeholders in DIISR's consultation detailed an extensive list of behaviours and problems that could be remedied with good faith provisions, few had detailed insight into how such a provision would work. Stakeholders noted that such a provision would not help the average small business; and that a general good faith obligation would only help parties that could afford to take their matter before the Courts.

Administration and enforcement issues

During DIISR consultations, concerns were raised that an explicit good faith clause in the Franchising Code may add to the expectation gap in franchise relationships. The Joint Committee report also noted the ACCC's concerns that on top of the prescriptive requirements of the Franchising Code and of the relatively low threshold of misleading and deceptive conduct, an additional layer of a somewhat hazy, woolly concept of good faith would end up having an increased expectation gap in franchise relationships, potentially creating more legal uncertainty. The ACCC also noted that the insertion of a good faith obligation may contribute to the already existing expectation gap in the franchise sector that the ACCC would have a capacity to intervene in contractual disputes where there are allegations of lack of good faith by one party.

In the mediation sense, DIISR consultations also noted that good faith could introduce complications for mediators with them being called to testify whether a good faith obligation has been met in mediation by the parties to the dispute. This may compromise the confidentiality, and accordingly the success, of the mediation process under the Franchising Code.

Furthermore, the insertion of a good faith obligation into the Franchising Code is unlikely to provide any rights in relation to franchise agreements beyond what is expressly negotiated in the franchise agreement. The Franchising Code recognises that franchisees and franchisors are commercial parties operating at arms length. The rights and obligations of franchisees and franchisors are predominantly determined by the franchise agreement. Therefore, there would be little scope for the ACCC to intervene in contractual disputes merely by virtue of the insertion of a good faith obligation in the Franchising Code.

Government's objectives

In 2007, 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. A reference to 'good faith' within the Franchising Code without enumerating what this obligation practically entails, as contemplated under Option 2, would be contrary to the key premise of the Government's election commitment. In addition, Option 2 would be contrary to Government policy guidelines on industry codes which require code provisions to be drafted in terms of requirements and obligations, not aims and ideals.

3. **Identify the specific opportunistic conduct or issues that impact on the franchising sector and implement specific measures to discourage these behaviours.**

Under this option, amendments could be made to the Franchising Code to promote specific behaviours to discourage specific types of conduct. This option could improve the behaviour between parties to a franchise agreement, which could reduce the number of disputes in the sector, and in turn better balance the rights between franchisees and franchisors.

The Joint Committee noted that the interdependent nature of the franchising relationship leaves the parties to the agreement vulnerable to opportunistic conduct by either franchisors or franchisees. Opportunistic conduct canvassed in the Joint Committee's report and identified during DIISR's consultation include: end of term arrangements (including non-renewal), dispute resolution, unforeseen capital expenditure, unilateral contract variations, attribution of legal costs, confidentiality arrangements and changes to franchise agreements when a franchisee is trying to sell the business. Submissions (and public hearings) to the Joint Committee suggest that:

- the opportunism in the franchising sector could be addressed through constraining the behaviour of franchisors and empowering franchisees; and
- the introduction of a statutory obligation of good faith within the Franchising Code could be one possible mechanism for preventing opportunism.

During DIISR's consultation with the sector, several concerns were raised regarding the insertion of a general good faith clause in the Franchising Code[3]. These concerns included:

- Accessibility for small business. The determination of whether parties to an agreement have acted in good faith is likely to require a Court ruling – these costs could prohibit access for small business;
- Greater uncertainty for business – businesses would second guess business decisions;
- Increased legal costs – franchisors and franchisees would need to seek legal advice to check their conduct, this could introduce another layer of uncertainty that could lead to increases in disputes;
- There is no clear definition of good faith;
- Unless there is a clear definition, the insertion of a good faith clause into the Franchising Code will not change the behaviour of franchisees or franchisors; and
- The insertion of a good faith clause could be used against small business.

The call for the insertion of a general good faith provision in the Franchising Code appears to have been (at least partially) motivated by a desire to limit or prevent opportunistic conduct by parties to a franchising agreement. Given the concerns raised above, under this option specific measures could be implemented to discourage opportunistic conduct directly.

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[3] See Option 2 for a full discussion on the issues associated with the insertion of general good faith clause.

Outlined below are two primary areas where opportunistic conduct may potentially take place, that were identified in DIISR's consultations and in submissions to the Joint Committee. Other areas where opportunistic conduct may take place were identified (through DIISR's consultations and submissions to the Joint Committee) including: 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. However, it is unclear the extent to which opportunistic conduct in these areas is a problem for the franchising sector. Due to the limited data, these issues are not discussed here; however, they are discussed in more detail under the section on consultation.

End of Term Arrangements
The Joint Committee noted that end of term arrangements is one of the largest areas of dispute in the franchising sector. This issue was also the subject of one of the Joint Committee's recommendations (Recommendation 5) and is discussed in detail under Part III of the RIS.

A specific measure to address this issue would be to amend the Franchising Code to require an explicit statement by a franchisor to prospective franchisees before they enter into a franchising agreement what, if any, renewal options or exit payments exist for franchisees when the agreement expires (Option 3 under Part III). As discussed in Part III of the RIS, there may also be benefits in making amendments to the Franchising Code to require franchisors to inform franchisees, six months prior to the end of the franchise agreement, of their decision to either renew or not to renew a franchise agreement.

The costs and benefits of these measures (Options 2 and 3 under Recommendation 5) are discussed in under Part III of the RIS; as such they are not discussed here.

Dispute Resolution
Submissions to the Joint Committee and DIISR's consultation with the sector 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.

There is limited data on what types of behaviour, by one party to a franchise dispute are typically viewed as indicators of a genuine attempt by that party in resolving their dispute. Similarly, there is limited data on the numbers of franchise sector participants that may be subject to unconstructive or unscrupulous conduct during dispute resolution.

While the OMA collects statistics on mediations it conducts, franchise sector participants facing disputes may be using other dispute resolution processes (such as internal dispute resolution mechanisms established within the franchise systems). Some stakeholders in DIISR's consultation noted a preference to conduct mediation with lawyers which they have had prior dealings rather than rely on the OMA services. Therefore, OMA data may not be indicative of the true extent of the problem within the sector.

A specific measure to address this issue would be to define a set of practical behaviours that parties to a franchising dispute could exhibit to indicate that they are

engaging in dispute resolution in a constructive manner. This would involve introducing amendments to the Franchising Code to include a non-exhaustive list of behaviours that could indicate whether parties to a dispute are engaging in dispute resolution in a constructive manner.

This measure would provide clarification in relation to existing obligations within the Franchising Code which encourages parties to work constructively in resolving their dispute (clause 29). However, the list of 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 could cover a number of different aspects of dispute resolution and mediation and would be aimed at discouraging behaviour which is impeding the effectiveness of the dispute resolution process under the Franchising Code.

The list of behaviours has been informed by DIISR's consultation with the sector and includes behaviours to be exhibited by both franchisees and franchisors prior to and during mediation as follows:

- 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 or publicising the dispute.

A non-exhaustive list of behaviours inserted into the Franchising Code would serve as a guide to minimum conduct, behaviours and procedures that could be followed by parties to a franchise dispute to demonstrate that they are engaging in dispute resolution in a constructive manner.

This list would only be indicative of the type of conduct expected by parties rather than conduct that *must* be exhibited. Since it is a non-exhaustive list, other behaviour by parties could also indicate the intention of parties to a franchise agreement to engage in constructive dispute resolution. For example, franchisees and franchisors may be able to provide evidence that they were prepared to make concessions in order to achieve a mutually acceptable outcome in mediation. This would also indicate that parties are engaging in constructive dispute resolution.

Benefits

Clarity of rights and obligations and disputation

This measure is likely to provide more certainty for businesses. It does not seek to impose additional compliance burdens on businesses since it provides clarification in relation to existing obligations under the Franchising Code.

A non-exhaustive list of behaviours expected of parties approaching dispute resolution under the Franchising Code would serve to discourage unconstructive and unscrupulous behaviour which impedes the effective operation of the dispute resolution process under the Franchising Code. In DIISR consultation stakeholders responded positively to a list of behaviours to be exhibited in mediation, noting that such a list would provide parties with a general indicator as to what to expect in mediation. This option would be a targeted solution to the identified problem.

Clarification of the types of conduct expected of parties during dispute resolution may result in cost savings for all businesses, including small businesses, where they are currently facing unconstructive conduct by the other party in dispute resolution. The minimum set of behaviours described in this measure could guide the conduct of parties such that they work towards a meaningful solution to their dispute.

Government's objectives

This measure would support the current success of the mediation service provided by the OMA. More meaningful and mutually acceptable solutions would be encouraged if parties demonstrate the above behaviours.

Costs

Administration and enforcement issues

Since this measure provides clarification of existing obligations under the Franchising Code, this regulatory proposal should not raise significant additional compliance or enforcement issues for the ACCC.

Stakeholders in DIISR consultation raised some concerns that there could be a risk that mediators and the ACCC would be called on to assess whether parties to a franchise dispute are demonstrating the conduct expected of them in the list contemplated under this measure. Since this measure is a clarification of existing provisions under the Franchising Code, this measure should not add to this risk. In addition, DIISR has developed the list in consultation with stakeholders and the clearly enumerated list should mitigate the need for mediators to get involved in testifying whether or not a party behaved in accordance with their obligations under the Franchising Code during mediation. Requiring mediators to get involved in such assessments would not be in accordance with the policy underpinning the dispute resolution process under the Franchising Code which requires both parties to observe confidentiality when attempting mediation.

While the list of behaviours is designed for use by the parties themselves as a guide to their behaviour, there is a risk that parties may perceive the list as an exhaustive guide of what is expected in mediation. That is, if one party does not exhibit all or most of the behaviours outlined above, the other party may point to this as evidence of non-compliance with the Franchising Code. There could be increased conflict and calls for the ACCC and mediators to intervene in these cases to make assessments on whether one party has behaved in 'good faith' in mediation. This risk could be

mitigated through the clear drafting of obligations and supporting material (education and explanatory material to accompany the regulations) to clarify how this provision is intended to operate in practice. That is, it is a non-exhaustive list and that parties may be able to demonstrate their intention to resolve their dispute with other behaviours not necessarily captured by this measure.

Business compliance costs

There could be a one-off education cost for businesses and their advisers to keep abreast of the changing regulations to the Franchising Code. However, clearly defined obligations and guidance by way of ACCC education should limit the need for complex legal or other advice for parties to understand the Franchising Code provisions. It is estimated that franchisors and franchisees would need to allocate around 15 minutes of their time to familiarise themselves with the regulatory changes proposed which may involve labour costs of $10.

Franchisors and franchisees may wish to keep records of the dispute resolution process in order to document/evidence their intention to engage in constructive dispute resolution. For example, records of emails, telephone calls and preparation of a strategy for the mediation process would indicate that the parties pursued the mediation in a constructive manner. However, record keeping, including during dispute resolution, would constitute normal business practice and would be unlikely to incur any additional administrative costs.

Benefits of Option 3

Option 3 is likely to be the most effective way of discouraging opportunistic conduct.

Option 3 would implement measures to specifically address some of the opportunistic behaviours (or conduct) in which parties to a franchise agreement might engage. Measures to address specific issues would discourage opportunistic conduct and would be a targeted solution to the identified problem. (The individual benefits of measures to address end of term arrangements and dispute resolution are discussed in detail earlier in the RIS).

Unlike a general reference to good faith which is likely to create uncertainty as to the rights and obligations of franchisees and franchisors, Option 3 is likely to provide more certainty for businesses as it proposes specific measures to address specific conduct.

Option 3 is also consistent with one of the policy intentions of the Franchising Code to address the imbalance of power between franchisors and franchisees and raise the standards of conduct in the franchising sector without endangering the vitality and growth of franchising.

Costs of Option 3

Option 3 would involve costs under the measures for end of term arrangements and dispute resolution – these costs have been outlined in detail above.

CONSULTATION

DIISR is the lead Department responsible for preparing the Government's response to the Joint Committee Report. To ensure a whole-of-Government approach to the Report, DIISR convened an inter-departmental committee (IDC) in May 2008 consisting of Government departments and agencies: Treasury; Finance and Deregulation; Prime Minister and Cabinet; and the ACCC. In addition to regularly consulting with IDC members, DIISR has liaised with a number of other Government agencies, as needed.

The Joint Committee inquiry was one of four inquiries conducted into the sector over a period of three years (commencing with the Commonwealth Matthews review in 2006 and concluding with the Joint Committee's Report in December 2008). All four inquiries consulted extensively with the sector, holding public hearings and calling for written submissions. Given the extensive public consultation already undertaken, DIISR conducted targeted consultation consisting of a number of one-on-one consultations with franchisees, franchisors, industry groups and advisers and invited the public to make written comments to the Government's consultation paper which was released on 21 June 2009. The consultation paper was posted on the DIISR website for three weeks and a link to the paper appeared on the consultation portal administered through www.business.gov.au. The paper contained specific questions aimed at ascertaining the potential business compliance activities and costs in relation to each regulatory proposal. The purpose of DIISR's targeted consultation was to further inform the Government's response by building on previous consultation and seeking comments to those already expressed as part of the Joint Committee's inquiry.

During DIISR's consultations with the sector, a number of distinct views were expressed by stakeholders in relation to incorporating a broad good faith obligation into the Franchising Code. Some franchise interest group submissions supported the insertion of a good faith obligation within the Franchising Code to address specific concerns that may arise during a term of a franchise agreement such as: 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. These submissions appeared to suggest that the insertion of a broad good faith obligation within the Franchising Code would provide them with 'protections' beyond what was negotiated and agreed between the parties to the franchise agreement. It was suggested that the duty to act in good faith in the context of franchising would recognise that parties to a franchise agreement are interdependent and could not act in pursuit of their individual interests.

In Submissions to the Joint Committee, stakeholders including the Law Council of Australia also recognised that the requirement to act in good faith does not require franchising parties to act against their legitimate interests consistent with the terms of the franchise agreement.

In submission made to the Joint Committee franchisees views were divided on how good faith provisions could be drafted and to what extent the insertion of a broad good faith obligation would improve outcomes for franchise sector participants. In its submission to the Joint Committee, the Motor Trades Association of New South Wales suggested that the insertion of a broad good faith obligation may import a subjective element in the assessment of conduct by franchisors and franchisees which may result in more disputes and, therefore, suggested underpinning the concept with an objective proscription of categories of conduct which are regarded as inappropriate.

Yum! Restaurants Australia Group (YRA's) submission to the Joint Committee considered that a general statutory duty to act in good faith could confirm that good faith is imported into franchise agreements but it would not remove the uncertainty surrounding its meaning – arguing that its meaning would have to develop organically and incrementally through case law. Alternatively, YRA suggested that achieving greater certainty via a specified set of factors would depend on the factors chosen and on whether they were proscriptive or allowed for discretionary decision making. Accordingly, a specified set of factors envisaged under Option 3 (which allow for discretionary decision making) would meet the YRA's suggested need for certainty in the drafting of regulations dealing with 'good faith' obligations.

The ACCC's submission to the Joint Committee also raised concerns about what a broad good faith obligation within the Franchising Code would mean for it as the administrator of the Franchising Code. That is, an ambiguous reference to a good faith requirement may result in the ACCC being called to testify in Courts or provide its opinion on a subjective element.

There was widespread support from both franchisees and franchisors for parties to a franchise agreement to work constructively in resolving their disputes. The Joint Committee's report at Chapter 7 (Dispute resolution in franchising) specifically considered the need for the inclusion of a good faith obligation in the context of dispute resolution. Franchisees suggested that the insertion of a broad good faith obligation in the Franchising Code would also encourage parties to a franchise dispute to approach their dispute in a reconciliatory manner. One franchisor, Competitive Foods Australia Pty Ltd, noted that having standards of conduct stipulated under the Franchising Code (such as good faith) would hold franchisors accountable and mediated results may be achieved more quickly and easily.

Based on submissions to the Joint Committee, franchisees, franchisors, academics and practitioners are divided about how a good faith provision could be drafted to ensure certainty for businesses and to limit the disputes that may arise in relation to a concept that involves subjective assessments. Therefore, Option 2 may raise concerns for franchisees, franchisors, practitioners and administrators in its operation.

During DIISR consultations with the sector, a variety of views were expressed by stakeholders in relation to a list of behaviours, as outlined in the consultation paper, to be exhibited in mediation. Some stakeholders noted that a number of behaviours identified from the initial list of good faith behaviours in mediation, may be difficult to prove in practice. The updated list of behaviours below has been informed by

DIISR's consultation with the sector and includes behaviours to be exhibited by both franchisees and franchisors prior to, and during, mediation as follows:

- 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 or publicising the dispute.

DIISR's consultation with the sector, and submissions to the Joint Committee, noted several areas where parties to a franchise agreement may engage in opportunistic conduct, including: 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. Concerns on these issues are outlined below.

Unforeseen capital expenditure
During DIISR's franchising consultations, concerns were raised that the terms of a franchise agreement may not be long enough for a franchisee 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.

Clause 13 of Annexure 1 of the Franchising Code requires a franchisor to provide details of payments that franchisees will be required to pay to the franchisor – this includes information on recurring or isolated payments payable by the franchisee to the franchisor or an associate of the franchisor or to be collected by the franchisor or an associate of the franchisor for another person (clause 13.6). During DIISR consultations, a concern was raised that a franchisee may be required to make a payment to an unrelated third party (such as a construction company) at the request of the franchisor and that such a payment would not appear to be covered by the requirements of clause 13.6 of Annexure 1 of the Franchising Code.

Unilateral variation
Submissions to the Joint Committee expressed concern that the Franchising Code does not prohibit unilateral variation of contracts. The Joint 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.

During DIISR's consultations, some stakeholders suggested that if a franchisor changes the agreement or the procedure manual then the franchisees should be consulted. Concerns were also raised during consultations that changes to an

agreement may change the viability of the franchise and could result in franchisees reversing their decision to invest in the franchise system.

Attribution of legal costs
During DIISR's 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.

The inclusion of a clause in a franchise agreement requiring a franchisee to pay for the franchisor's 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.

Confidentiality agreements
During DIISR's 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 (Item 6.4 to 6.6, Annexure 1 of the Franchising Code).

While confidentiality agreements may be necessary to protect a franchisor's intellectual property, the information provided by current and past franchisees could aid the decision-making process of prospective franchisees.

Changes to franchise agreements when a franchisee is trying to sell the business
During DIISR's franchising consultations, concerns were raised that when franchisees try to sell the business, franchisors can change the terms of the franchise agreement, thus potentially reducing the viability of the business and making it harder for the franchisee to sell.

Neither DIISR's consultation with sector nor the submissions to the Joint Committee provided clear details on the extent to which opportunistic conduct in these areas is a problem for the franchising sector or the potential implications changes to address conduct in these areas could have on the franchise model. The Joint Committee noted that the diverse nature of the franchising sector presents the potential problem that a specific change, while beneficial for one system, may have unintended consequences for another. Therefore DIISR is unable to recommend a specific measure(s) to address these issues. DIISR considers that, if warranted, the Government could further investigate these issues.

CONCLUSION AND PREFERRED OPTION

Maintaining the status quo, as proposed by Option 1, may mean that parties to a franchising agreement could be exposed to litigation costs in response to allegations

of opportunistic conduct exhibited during the term of a franchise agreement. Under Option 1 there could also be mediation costs for those parties seeking to addresses opportunistic conduct using the Franchising Codes dispute resolution processes. Option 1 would not address the problem of opportunistic conduct in the franchising sector.

Option 2 proposes to insert a new standard of conduct into the Franchising Code requiring franchisors, franchisees and prospective franchisees to act in good faith in relation to all aspects of a franchise agreement (Recommendation 8).

There is no single definition or standard set of ‘behaviours’ that constitutes good faith. In most contexts in which an obligation of good faith arises, what constitutes ‘good faith’ is largely dependent on the particular factual situation in which the issue arises and may take into consideration the commercial activity and nature of the relationship between the parties.

If any obligation to act in 'good faith' is going to be imposed, a clear definition of what is considered to be ‘good faith’ behaviour is crucial for the parties to an agreement to understand what is expected of each other, and to avoid ambiguity and uncertainty in the commercial environment. Without a clear definition, the inclusion of a requirement to 'act in good faith' could make the requirements and obligations of the parties to a franchising agreement unclear. In addition, if the obligation to act in good faith is expressed in very general and high-level terms, it may provide little practical protection to the parties.

During the consultation process, concerns were expressed that a general notion of acting in ‘good faith’ would be subject to interpretation by the Courts and this may have the effect of increasing risk and increasing business costs.

The recommendation for a good faith clause in the Franchising Code appears to have been generally motivated by specific opportunistic conduct that arises during the term of a franchise agreement, including issues with end of term arrangements, dispute resolution, unforeseen capital expenditure, unilateral contract variations, attribution of legal costs, confidentiality arrangements and changes to franchise agreements when a franchisee is trying to sell the business.

Under Option 3 specific measures could be introduced to discourage opportunistic conduct in areas of primary concern that were identified in the Joint Committee report and through DIISR’s consultations. Where specific measures or behaviours could not be identified to discourage opportunistic conduct in an identified area of concern, if warranted the issue could be referred for further investigation. The implementation of specific measures under this option would improve the behaviour between parties to a franchise agreement, which could reduce the number of disputes in the sector, and would better balance the rights between franchisees and franchisors.

Option 3 is the preferred option.