

Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into the Operation and Effectiveness of the Franchising Code of Conduct

Submission of:

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1. My credentials in franchising are well established and are built on research, writing, teaching and consulting on/to the Australian and regional franchise sectors over four decades. I am a Professor of Business Regulation in the Discipline of Business Law at the University of Sydney Business School and am Honorary Dean of the Franchise Management School of Beijing Normal University on the Zhuhai campus. I have been inducted as an inaugural member of the Australian Franchising Hall of Fame (for my contribution to franchising education) and am currently a member of the ACCC's Small Business and Franchising Consultative Committee. I have written/presented about 400 articles/papers on legal, regulatory, commercial, business development issues in franchising. I drafted Vietnam's Franchise Law (on an AusAid project) and have recently completed a PSLP project on Franchising Development in ASEAN. For many years I was Head of the Judging Panel for the National Franchising Awards. I have been an expert witness in a number of franchising cases and was for 10 years Special Counsel to the law firm that is now Norton Rose Fulbright working within the franchising practice within the firm. I am the co-author of the Australian franchising service *Franchising Law and Practice* first published in 1998 and the co-editor of *Handbook on Research in Franchising* published in London in 2017.

I have made submissions to previous franchise inquiries and indeed my words in oral testimony to the House of Representatives Standing Committee on Industry, Science and Technology *Inquiry into Fair Trading* in 1996 which led to the introduction of the *Franchising Code of Conduct* prefaced the franchising chapter of the Committee's Report:

Good franchising is very good. It is so much better than independent business operation. But bad franchising is so much worse.

This is a proposition to which I still strongly subscribe and which informs this submission. Franchising, properly and responsibly executed, is a proven business model which has repeatedly and consistently been acknowledged as having an important, positive and beneficial effect on the Australian economy.

2. Previous franchising inquiries have led to the development of a regulatory regime for the Australian franchising sector which is undoubtedly the most robust and comprehensive in the world. The specific protection of the *Franchising Code of Conduct* (in relation to both prior disclosure to address the information imbalance and relationship regulation to address aspects of the power imbalance) in combination with the broad and general good faith obligation under the *Code*, the prohibition of misleading and unconscionable conduct, and, subject to the monetary threshold, the prohibition of unfair contract terms, under the *Australian Consumer Law*, provides a significant reservoir of protection for franchisees unmatched by any other country.
3. That the concerns and events that have led to this inquiry have occurred in the context of the world's most comprehensive regulatory regime suggest a number of issues:
 - i. that external factors are having an impact on franchisee profitability
 - ii. that the regulatory regime itself is inadequate
 - iii. that the franchises are not exercising appropriate and rigorous due diligence

- iv. that dispute resolution mechanisms are not adequate
- v. that the increasing trend to private equity investors and ASX listed franchisors is impacting adversely on the traditional franchise model

I will address each of these.

4. External factors

There are of course a range of commercial factors external to the franchisor/franchisee relationship which have impacted on the profitability of franchisees – in particular high rents and high wages which impact particularly significantly on franchisees in particular sectors. Franchisees in labour intensive sectors and those operating under shopping centre leases are particularly vulnerable. These matters are not addressed in this submission but should be the subject of further inquiry.

5. The current regulatory regime: the *Franchising Code of Conduct*

Disclosure generally

Prior disclosure is the primary regulatory strategy for franchisee protection and is the most common regulatory mechanism in those countries which specifically regulate their franchising sector – only about a third of those in which franchising is a substantial business activity. It has nevertheless been argued that “mandated disclosure may be the most common and least successful regulatory technique in American law” (Ben-Shahar and Schneider, *More than you wanted to know. The failure of mandated disclosure*, Princeton University Press 2014 p3). Prior disclosure addresses information imbalance and is not necessarily the most effective regulatory strategy to address power imbalance issues which may be better dealt with by specific relationship and conduct regulation. To the extent that the Committee identifies issues that need to be addressed in the franchisor/franchisee relationship the convenient strategy of mandating further disclosure is highly unlikely to be the most effective. The phenomenon of information overload can limit the effectiveness of prior disclosure and there is increasing evidence – albeit largely anecdotal – that this is a current reality. Increasingly complex, wordy and voluminous disclosure documentation is a real concern. Reference could be made to Terry and Zhang, “The power and information imbalance in franchising: the role of prior disclosure under the Franchising Code of Conduct” (2011) 39 ABLR 245.

Disclosure of Earnings Information

Item 20 of the Disclosure Document addressing Earnings Information is the only disclosure item which is not compulsory – provided of course that the required statement is included. Given that earnings information is probably the single most important and influential factor for a prospective franchisee it is unfortunate that relevant information is not required to be given. Of course, in the words of the Item 20.3 statement, “Earnings may vary between franchises” (should this be between “franchisees”?) and “The franchisor cannot estimate earnings for a particular franchise”. But Item 20 allows historical, comparative and other earnings information to be provided (as well as earnings forecasts and projections provided

that the details which underlie the forecast are set out). Many franchisors of course provide the former – historical/comparative earnings information. Consideration should be given to requiring historical and/or comparative information to be provided. This would facilitate due diligence and enable more meaningful advice to be provided by advisors. Provided that the earnings information is factual, and that any particular factors that may adversely impact on it are disclosed, the franchisor should not be liable, absent misleading conduct, if a particular franchisee does not achieve particular earnings.

Disclosure of supplier rebates

Disclosure of supplier rebates (Item 10 (j), (k)) is a highly contentious issue. The *Code* properly requires the franchisor's receipt and application of supplier rebates to be disclosed but commercial-in-confidence considerations have limited rebate disclosure to these matters and issues of quantum/percentage, and the extent to which product/service supply cost is inflated to accommodate the rebate, are not addressed. This is a particularly difficult issue but one which should be addressed given its impact in particular systems where identical or equivalent products/services may be sourced more cost effectively.

Franchisee communications

Clause 33 prohibits a franchisor from restricting or impairing franchisees from associating. There is anecdotal evidence that some franchisors are relying on contractual or extra-contractual means to prevent, restrict or impair the ability of franchisees to talk to the media. Whether or not this is the case the *Code* should be amended to clarify the situation and to allow franchisees to participate in a wider public debate. As whistleblowing receives greater prominence – and more expansive legislation is of course currently before the Senate – this issue assumes greater importance. Action to protect confidential information or in respect of defamation or injurious falsehood would remain available to the franchisor.

Termination

The termination provisions should be reviewed to facilitate franchisor termination of a franchisee in cases of serious non-compliance with obligations beyond the narrowly contractual – for example, in the circumstances of franchisee underpayment of employees which gave rise to protracted litigation in *Chalal Group Pty Ltd v 7-Eleven Stores Pty Ltd* [2018] NSWCA 58. Franchisor termination without notice and opportunity to cure should also be available in respect of repeated breaches of the same kind.

Consideration should also be given to granting franchisees a termination right commensurate with that granted to franchisors under cl29 in cases of insolvency and administration. And, in cases of serious system change – for example by significant franchisor ownership change on sale to private equity investors or significant change in the strategic direction of the system – franchisees should be given the right to terminate. Franchise agreements rarely, if ever, give franchisees rights in such circumstances but there are few, if any, limitations on the franchisor's rights and powers in these circumstances. Amendments to the *Code* would be required to protect the franchisee's position if a

termination right was given – in the insolvency situation to de-badge and trade independently or with another group, and in the strategic change situation to transfer the franchise or be bought out by the franchisor on fair terms.

Marketing funds

Clause 31 should be amended to provide greater clarity as to the purposes for which advertising/marketing fees can be used.

6. Franchisee Due Diligence

The submission of COSBOA in relation to the 1986 draft of a later abandoned Franchise Agreements Bill noted that :

Entrepreneurship and business creation in a free enterprise society such as ours necessarily includes an element of risk and it should certainly not be the role of Government to remove risk. Nevertheless in the particular circumstances of franchising there are elements quite different to normal business development because of the control of the franchisor which can be an overriding risk for other than purely business or commercial reasons. Those special additional risks arising in part because of the balance of power in the franchising relationship should be minimised while leaving the commercial risks and decisions to be handled by the parties concerned.

Research suggests that franchisees are “unrealistically optimistic about risks of setting up their businesses even after those risks have been disclosed to them” (Buchan, The Conversation 14 November 2016). My experience is consistent with these research findings. It is an unfortunate reality that prospective franchisees do not always exercise due diligence in relation to both legal and commercial risks despite the combined efforts of the ACCC through its publications and educational initiatives, the educational programs, the commentators, and the endeavours of the FCA. The *Code* itself which of course must be provided to prospective franchisees at least 14 days before the agreement or non-refundable payment requires on its first page a strong statement of advice to prospective franchisees and the latest iteration of the *Code* requires a “Risk and Reward” statement to be provided “as soon as practicable after the prospective franchisee formally applies or expresses an interest in acquiring a franchised business” (cl 11). I imagine that most prospective franchisees would be surprised by the admission of YUM, the then franchisor of Pizza Hut, in the recent, and unsuccessful, class action litigation brought by franchisees – that it's implied duties under the franchise agreement did not “extend to requiring Yum to do all things necessary to enable the Franchisees actually to make a profit in the conduct of their business”. In the words of Bennett J, “Yum maintains that the Franchisees’ profit is not a contractual object or benefit of the [franchise agreement]” (in *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd* [2016] FCA 43 at [234]). The harsh reality acknowledged in such an admission is likely to focus the prospective franchisee’s mind to a greater extent than the “vanilla” wording of the “Risk and Reward” statement and be a lot more effective in encouraging due diligence.

The *Code* of course also requires franchisors to be satisfied – by a signed statement – that they have received or been given the opportunity to receive independent legal, business and accounting advice (cl 10). That not all prospective franchisees take due diligence as seriously as they should is a very real concern – but one that is difficult to address. COSBOA’s words nevertheless continue to resonate over 30 years later. The Government cannot remove all risk.

There are nevertheless several initiatives that may facilitate more diligent due diligence. Because franchising presents particular challenges the *Code* should be amended to require that advice be provided from an advisor with particular expertise in franchising. This would require an accreditation protocol that is not unreasonable to expect. But the unfortunate reality is that with a disclosure protocol that does not mandate any information about earnings information albeit historical, local, comparative the capacity for meaningful financial advice is compromised. And, the utility of legal advice is compromised by the existence of broad discretionary powers in the franchise agreement which limit the advising lawyer’s ability to advise other than in unhelpfully general terms. The words of the Full Federal Court in *Virk Pty Ltd (in liq) v YUM Restaurants Australia Pty Ltd* [2017] FCAFC 190 at [263] provide little comfort to either the prospective franchisee or the advising lawyer:

... regard must be had to the entrepreneurial nature of the decisions capable of being made by Yum as the Franchisor under the International Franchise Agreement. The franchise structure established by that agreement gave Yum broad discretionary powers. Ultimately, Yum pays a commercial price if it makes poor business decisions, as returns from Franchisees will fall and fewer people will want to be franchisees.

As unfolding events so dramatically demonstrated the “price” paid by the failed Pizza Hut franchisees in terms of social and financial and emotional cost was so much greater than that any “commercial price” to the franchisor. In the face of such “broad discretionary powers” there is little the advising lawyer can do apart from advising prospective franchisees that there are broad discretionary powers which the franchisor may exercise. Whether these powers will be exercised wisely or unwisely is beyond the jurisdiction of the lawyer.

A particular initiative which would assist franchisees in exercising due diligence is for the *Code* to be amended to require Disclosure Documents to be lodged – I suggest with the ACCC which is the franchise sector regulator and has the power in any event to conduct *Code* compliance checks/random audits – and be publicly available to enable prospective franchisees to make meaningful comparisons. I am not suggesting an audit or approval regime as exists in several US states – although the ACCC’s *Code* compliance check/audit powers may be seen as going some way towards this – and I am not suggesting that lodgment implies or suggests or confers regulatory approval of the franchise offered. I envisage simply a requirement that Disclosure Documents – that under the *Code* have to be prepared each year – be available to other than those who are in negotiations to acquire a particular franchise and to whom a Disclosure Document must be provided, albeit possibly as late as only 14 days before the contract is entered into or non-refundable money transferred. At this stage the time for mature consideration of alternative investment opportunities has probably passed.

A lodgment scheme would provide a range of other advantages. Franchise sector researchers, as well as governments and indeed the sector itself, is disadvantaged by the

lack of empirical data. The current gold standard, the biennial Griffith University *Franchising Australia Survey*, which provides the most authoritative source of franchise sector statistics relies on responses to a survey. Crucial sector data is extrapolated from the replies received – with a usual response rate of about 11%. This data is no doubt statistically valid but not always convincing – at least to this non-statistician. Even the most basic statistic – how many franchise systems in Australia – is a best estimate based on a range of sources when the most authoritative source is not available because Disclosure Documents do not have to be lodged with an appropriate authority. Every franchisor is required by the *Code* to create a Disclosure Document and it is not a big step to require lodgment of these. This would not only facilitate ACCC enforcement, academic research, government decision making, informed media commentary and franchise sector planning but would, and perhaps most importantly, facilitate better informed decision-making by prospective franchisees.

7. Dispute Resolution

Although the compulsory mediation requirement of the *Code* is a sensible and appropriate provision delivering an impressive settlement rate (about 80%) at a low cost (about \$1000 per party) in a short time (less than a day) the high settlement rate I believe disguises the reality that many settlements are reluctantly entered into by the franchisee because of the impracticality of formal dispute resolution through the courts if a settlement is not reached. The Office of the Franchising Mediation Advisor does not provide – and probably cannot provide – the percentage of “reluctant” mediation settlements but anecdotal evidence and media reports suggest that this is high enough to be a concern and that it is necessary to consider whether a “halfway” house between mediation and Federal Court action is necessary or possible. In the words of the Productivity Commission, “in order to deliver access to justice it is necessary to provide mechanisms that deal with issues in a proportional manner” (*Access to Justice Arrangements*, 2014, p315).

I have suggested above that Australia has the world’s most comprehensive regulatory regime for the protection of franchisees but, if it is case of, in the words of the 1970 British Consumer Council report, “Justice out of reach”, then alternative dispute resolution strategies must be considered. This report concluded that although consumers were provided with substantial legal rights they rarely invoked those rights as for the average consumer justice was out of reach for a number of reasons including expense, delay, formality and unfamiliarity with the system. The report led to the introduction of small claims courts in the UK and was influential in the later introduction of the Consumer Claims Tribunal in NSW in 1974 which has since been absorbed, with greater jurisdiction, into the NSW Civil and Administrative Tribunal.

There is an increasing regulatory awareness that the small business faces many of the same problems that have traditionally been regarded as “consumer” problems. For example over recent years the unconscionability and unfair contract terms law have been expanded from exclusively consumer protection laws to laws protecting small business – and, in the case of the unconscionability laws, big business as well. Consideration should be given to whether dispute resolution processes should similarly be reconsidered for the franchising sector – at least for “small business” franchisees however that threshold is defined. Two obvious mechanisms are a dedicated *Franchising Tribunal* and a dedicated *Franchising Ombudsman*.

A *Franchising Tribunal* would offer the advantages that a tribunal offers over a court for franchising disputes whether arising under the *Code* or the general law – a less formal, quicker and cheaper dispute resolution process. Tribunals can provide “active case management and employ alternative dispute resolution techniques, thus limiting the need for legal representation and costs awards” (*Final Report. Review of the financial system external dispute resolution and complaints framework*, April 2017, p27). There are nevertheless constitutional impediments to the creation of judicial tribunals in relation to Commonwealth laws and, absent underlying constitutional arrangements pursuant to federal, state and territory arrangements, such tribunals would be limited to administrative functions and cannot exercise judicial powers which are reserved for the courts.

A *Franchising Ombudsman* has a number of precedents which the Joint Committee could consider. Although the Productivity Commission’s 2014 *Access to Justice Arrangements* report notes that while “Tribunals...have the power to conduct an investigation and have the power to resolve disputes through rulings” most Ombudsmen “cannot make binding decisions” there are examples of industry ombudsman schemes which do have such powers.

The Financial Ombudsman Service (FOS) provides an example. The *Financial Services Reform Act 2001* enacted in response to the 1996 Wallis Committee Report required as a condition of a financial services licence an adequate internal dispute resolution procedure and membership of an external dispute resolution scheme approved by ASIC. The FOS is an independent industry ombudsman dispute resolution scheme which is a not-for-profit organisation established as a private company limited by guarantee. It can provide a wide range of remedies including payment of money, compensation for financial or non-financial loss, and in some cases variation of contract terms. Determinations are binding.

The Telecommunications Industry Ombudsman (TIO) Scheme provides another example. Section 128 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999* requires carriers to enter into a scheme providing for a TIO to investigate, make determinations in relation to complaints about telephone and internet services. The TIO operates under a company – TIO Ltd – a not-for-profit company limited by guarantee governed by a Board of Directors including industry, consumer and independent directors. It is funded by telecommunications providers who are required by law to be members. The TIO can determine complaints from consumers and from small businesses with less than 20 employees and \$3 million annual turnover.

8. Private Equity and ASX listing

It is a matter of record that, despite the comprehensiveness of the regulatory regime, a series of well publicised disputes has led to the current inquiry. But whereas in earlier inquiries the underlying issue was the need to impose/improve a regulatory regime directed primarily at the inexperienced, novice, small franchisor the catalyst for the current inquiry is the practices of large, prominent, experienced franchisors. The nature of franchising is changing with the increasing trend to private equity investors and ASX listing which expose tensions between the interests of franchisees and the interests of investors. This submission does not suggest a solution to the challenges that flow from the changing nature of the franchise model, the issues around the ownership of the franchisor, or the

tensions that can arise in multi-system/multi-brand franchising – all of which give rise to increasingly complex stakeholder inter-relationships – but it does raise these as issues which the franchising sector and those responsible for its regulation will need to address.