5 April 2018

Individual submission: An inquiry into the operation and effectiveness of the Franchising Code of Conduct, 2018

Dear Sir/Madam,

My name is Dr Courtenay Atwell. I have recently completed a comparative law doctoral dissertation at UNSW Sydney on the business format franchise model. My dissertation is titled 'Early withdrawal rights in franchise contracts: A comparative study of their role and effectiveness in Australia, England and France'. In arriving at the recommendations offered here, 12 in-depth interviews were undertaken with experts in the Australian market. These Australian experts included lawyers, bankers, franchisors, franchisees, mediators, franchise consultants and a government appointed business commissioner.

In total, 10 recommendations are proposed around 6 key themes. These recommendations address section (a) in the Terms of Reference that correspond with the parliamentary inquiry into Australia's franchise sector.

1. Clarity Around Timing

There is confusion over the duration and timing of the pre-signature waiting period. The interviewed experts recognised that prospective franchisees are often led to believe that after the 14-day pre-signature waiting period they must sign and return the franchise agreement. This is not what Section 26 of the Code states, and suggests that the franchisor may have imposed their own conditions through the franchise agreement or put pressure on them to commit at day 14.

The lack of clarity in the Code is a direct cause of this confusion and can account for misinterpretation around the requirement to sign at a specific date.[1] The experts confirmed that the duration of the provision could, and frequently does, extend for a much longer period. On the actual duration of the provision, one ex-franchisee, franchisor, consultant and mediator, contended:

> I have a lot of people that come to me and think that they must sign on at the 14 day mark. The 14 days is a minimum period. I think that in the preamble on the front page of the franchise document it says that but maybe people don't interpret it that way. They talk to people and think that they only have the 14 days. They should understand that they have as many days as they want to make up their mind.

Regarding the duration of the temporal protection mechanisms, the ACCC Model Franchising Disclosure Template states:

> You are entitled to a waiting period of 14 days before you enter into this agreement. If this is a new franchise agreement (not the transfer or renewal of a franchise agreement, nor the extension of the term or the scope of a franchise agreement), you will be entitled to a 7-day "cooling off" period after signing the agreement, during which you may terminate the agreement.[2]

The use of 'entitled' suggests that the provision is available if the franchisee wishes to use it. It is not indicative of a mandatory provision that must be complied with or that 14 days is a minimum.[3] The mandatory nature of the provision has been diluted by the wording of the ACCC template and in its current form implies that it is a maximum duration rather than a minimum number of days that can be extended upon agreement between the parties.

High-pressure sales tactics that can accompany the sale of a franchise may lead the franchisee to believe that the provisions are voluntary. Further, a 'hot' emotional state may prevent them from seeking out and using the protection mechanism.

Recommendation I: The wording of the ACCC template should be changed so that prospective franchisees can understand they are entitled to the provision; and it is not provided at the discretion of the franchisor. For example, 'granted', 'allocated' or 'provided with' that can be followed by 'that must be complied with' is a better approach.

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[1] Section 9 (1)(c) of the Code stipulates:

> A copy of the franchise agreement, in the form in which it is to be executed; to a prospective franchisee at least 14 days before the prospective franchisee:
> (d) enters into a franchise agreement or an agreement to enter into a franchise agreement; or
> (e) makes a non-refundable payment (whether of money or of other valuable consideration) to the franchisor or an associate of the franchisor in connection with the proposed franchise agreement.

[2] ACCC Model Franchising Disclosure Template

[3] 'Entitled' is defined as 'to give (a person or thing) a title, right, or claim to something; furnish with grounds for laying claim'.

2. Statutory Identification of the Reciprocal Nature of the Waiting and Cooling Off Provisions

The reciprocal nature of the pre-signature waiting period and in-term withdrawal right (temporal protection mechanisms) was identified. In a general sense, both are understood to be provisions to protect the franchisee. Usually, though, where an expert could recall use of the provision, it had been at the franchisor's instigation. One franchisor lawyer said that it is common practice for franchisors to retain an unofficial in-term withdrawal right that facilitates the termination from an agreement if the franchisee underperforms during the training program. The lawyer also acknowledged that franchisors often make satisfactory completion of the in-term training program a condition of the contractual agreement, noting that:

> The thing that franchisors often do is that they require the franchisee to go through a training period before they start their store and it will often be a pre-condition to the franchise agreement that they satisfactorily complete their training or it will be a termination scenario if they fail to satisfactorily complete the training.

It was concluded that the provisions can act as safeguards for the franchisor's brand where a new franchisee is identified to be a 'lemon' in the early contractual stages.[4]

The in-term withdrawal right also has value for franchisors who, during the term of the withdrawal period, identify a new franchisee to be an unsuitable fit for their brand or lacking the skills to run an operation independently. Competent franchisees are essential to the success of the whole franchise system, and from this perspective, the withdrawal right could be construed as a reciprocal mechanism.

This proposal is a departure from the commonly held belief that pre-contractual protection mechanisms are included exclusively for the franchisee's benefit.[5] The search for a 'good' franchisee becomes an embodiment of the 'lemon' dilemma, whereby the franchisor cannot accurately predict whether a new franchisee will become an asset to or burden on their system. The in-term provisions are clearly beneficial to franchisors in situations where a new franchisee may become a liability to the brand.

Recommendation II: A statutory reference to the reciprocal nature of the provisions in Section 26 of the Code. Explicitly extend the waiting and cooling off rights to both franchisor and franchisee. This change would ensure the policy objective 'to reduce the risk and generate growth in the sector by increasing the level of certainty for all participants' is achieved.

3. Increased Levels of Advice Seeking

The provision of advice in the pre- and early-contractual stage that is unconnected to that which is provided by the franchisor is an essential component of a prospective franchisee's due diligence. The Australian experts recognised the importance of advice and the reality that many franchisees do not seek out and receive adequate advice. There is scope for improvement in the current Code. To one franchise consultant:

> The provision of the certificates by the advising professionals is integral. None of my clients would be allowed to admit a franchisee into their business without their solicitor's certificate.

However, as another franchisor and franchise consultant observed:

> My gut feeling is that about 30-40 percent of franchisees don't take legal advice and more than 50 percent don't take business and/or accounting advice.

The sector lobbyist group, the Franchise Council of Australia (FCA), has previously indicated that expert advice from a third party is an area for improvement in the Code:

> [T]he Code process is designed to give extensive information, and is fool proof if a franchisee follows the recommended process. Arguably the only deficiency with the Code is the fact that franchisees are encouraged, but not obliged, to seek legal advice. The vast majority of complaints by aggrieved franchisees feature one common element - a failure to obtain advice in accordance with the Code recommendations.[6]

Here, five recommendations on the procurement of expert advice in the pre- and early contractual stages are proposed.

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[4] George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *The Quarterly Journal of Economics* 488.

[5] That franchisees may change their mind and should be allowed to withdraw from a contract that was made in the heat of the moment.

[6] Franchise Council of Australia, 'Submission in relation to the Treasury Legislative Amendment (Small Business and Unfair Contract Terms) Exposure Draft ' 2015) 7.

Recommendation III: Each state and territory law society and all professional accounting bodies in Australia to establish an accredited specialist status that recognises members who have a requisite level of expertise in the franchise business model.

Recommendation IV: Section 10 of the Franchising Code of Conduct establishes compulsory advisory provisions that require franchisees to consult with legal practitioners or accountants who are accredited specialists in the business model.

Recommendation V: An additional sub-clause ought to be added to Section 10 of the Franchising Code of Conduct requiring new franchisees to speak to existing franchisees. An alternative may be for the in-term withdrawal period to be tied to the successful completion of a training program, after the completion of which both parties are given an opportunity to terminate the franchise agreement. This sub-section should state, or have the effect of stating:

> During the in-term cooling off period, the prospective franchisee is required to consult with, or visit in-person for better information transfer, existing franchisees currently operating a franchise in the proposed system.

Recommendation VI: A caveat to the effectiveness of Recommendation V to occur in instances where existing franchisees may have engaged in a mediation or dispute hearing with the franchisor and be prevented from recounting this experience to prospective franchisees by a confidentiality agreement. To overcome this, it is suggested that a high-level history of mediation hearings, that lists the franchisee, store name and location, date and outcome, is to be included as a compulsory disclosure item in disclosure documents.

The interviewed experts argued that an exception to the advice-seeking requirement should be made for unsophisticated investors who purchase low-cost franchises. These experts suggested that it is not fair to force the cost of conducting due diligence and receiving professional advice on undertakings when the value of the investment is comparatively low.

Recommendation VII: Section 10 (3) to be amended to read:

> Where the total upfront cost of establishing the franchise (including franchise fee, purchase of plant and equipment, and training) does not exceed $30,000, the prospective franchisee is not required to seek expert advice.

4. Sophisticated Investor Exemptions

The experts drew attention to the value of a separate code for sophisticated business investors and multi-unit operators. There was a consensus that experienced franchisees should not be granted protection-oriented pre-contractual protections or in-term withdrawal rights, nor should franchisors selling to these sophisticated franchisees be burdened by having to ensure that all the right boxes have been ticked. When single-unit franchisees become multi-unit franchisees, under current law, often they must go through the same pre-contractual process as a new, inexperienced buyer. This is frustrating for all parties to an agreement for a subsequent store offering and offers no real protection, unless there have been significant system changes that have resulted in the need for updated disclosure; the only disclosure of real value is the location-specific information about the new offering.

Clarity is needed on whether franchisee expansion from a single-unit to a multi-unit operation is encompassed under the exception for changes in 'the scope of a franchise agreement'. At present, it is uncertain whether franchisees acquiring new stores are entitled to both the pre-contractual and in-term protections for each new store offering. Further, this matter presents another point of contention; whether owning one outlet can be sufficient evidence to guarantee that the franchisee is now an 'expert'. Of concern is that some franchisees who are successfully operating 2 franchise outlets are then coerced/flattered by their franchisor into taking on a third 'lame duck' outlet that another franchisee has not been able to turn a profit in. Great caution should be exercised in excusing a franchisor from making full disclosure in this situation.

Perhaps sophisticated investor status should be awarded based on other criteria. Several US states have enacted different categories of franchisee exemptions.

Recommendation VIII: An additional subclause to be added to Section 9 of the Code that advises when an exemption from disclosure requirements can be afforded to 'sophisticated multi-unit investors' with a specified number of existing store offerings or range of other criteria. However, location-specific information about the

proposed new store offering should not, in any circumstance, be exempted from disclosure. Section 7 of Ontario's *Arthur Wishart Act (Franchise Disclosure)* provides a best practices guide.[7]

5. The Recognition of Franchisees as Consumers

Franchisees as consumers is an alignment that has been argued by Professor Jenny Buchan,[8] and more recently was brought back into the spotlight through the unfair contract term provisions and the review of the Australian Consumer Law.[9] In a general business sense, the significance of the pre-contractual period has been recognised by the courts and treated as a distinct contract formation process.[10]

The Australian Consumer Law (ACL) lists multiple definitions of a 'consumer' depending on the issue or provision in question. In the context of consumer guarantees, a consumer is anyone who has goods or services that were 'ordinarily acquired for personal, domestic or household use or consumption', or where the cost of these goods and services 'did not exceed $40,000'.[11] The latter condition meaning that some small and medium-sized businesses are also able to rely on the protections provided through the ACL. The ACL also uses the term 'business consumer',[12] an alignment that in many respects befits the characteristics of a prospective franchisee. The six operational objectives that were acknowledged during the drafting process of the ACL are analogous with the intentions of the Franchising Code of Conduct.[13]

A Government appointed business commissioner, who I interviewed was open-minded on the consumer alignment:

> There is always a sort of blurring there, you might be aware that there is unfair contracts legislation being prepared to extend the protection of unfair contract provisions to small businesses.[14] The view I will take with that is, what is the difference between someone being a consumer and someone being a small business having the benefit of those protections? I probably don't have any problem with how it is characterised and I wouldn't necessarily say that you have to regulate differently in certain areas, because someone happens to be behaving in a business fashion compared with someone behaving in a consumer fashion. Because they are close, why make a differentiation? In any event, what's achieved by being technical and saying that doesn't apply to you because at the moment you're acting as a consumer and that thing you just consumed was for your own individual purpose not for your business. So, the next day can you keep saying, that was for your business?

In opposition, some experts argued franchisees did not deserve consumer-derived protections. A franchisee and area representative, insisted:

> Potential franchisees do not buy a franchise with a flip of coin. A franchise may or may not be as expensive as a house, but the information disclosed is a lot more comprehensive and quantified.

One difference between buying a property and a franchise, however, is that the purchaser of a property is often able to inspect their final purchase and/or seek a financier's approval on the valuation to secure a mortgage. Another franchisor and franchise consultant, who I interviewed argued against consumer protections in franchise law was made with reference to the purchase of stocks:

> You can buy shares tomorrow from BHP Billiton, with relatively blissful ignorance, because nobody checks. But has BHP updated you today about your investment decision. Nobody protects you if you buy a milk bar or any other independent business. I think it's about as protected as it is reasonable to do. I don't want to sound like I am an anti-code person. I think we have just gone far enough.

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[7] Arthur Wishart Act (Franchise Disclosure), 2000.
[8] Buchan, Jenny, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences* (Springer Science & Business Media, 2012)
[9] In 2015, the Unfair Contract Terms (UCT) legislation was passed affording small business people the same protections as consumers. Commonwealth of Australia, *Australian Consumer Law Review – Issues Paper* (2016) <http://consumerlaw.gov.au/files/2016/03/ACLreview_issues_paper.pdf>.
[10] See for example DW McLauchlan, 'Contract Formation, Contract Interpretation, and Subsequent Conduct' (2006) 25 *University of Queensland Law Journal* 77.
[11] The $40000 threshold limit has not changed since 1985.
[12] Section 22(2) of the *Australian Consumer Law* 'Unconscionable Conduct in Business Transactions' refers to the concept of a business consumer.
[13] The operational objectives are as follows: 1. to ensure that consumers are sufficiently well-informed to benefit from and stimulate effective competition; 2. to ensure that goods and services are safe and fit for the purposes for which they were sold; 3. to prevent practices that are unfair; 4. to meet the needs of those consumers who are most vulnerable or are at the greatest disadvantage; 5. to provide accessible and timely redress where consumer detriment has occurred; and 6. to promote proportionate, risk-based enforcement.
[14] From 12 November 2016, unfair contract terms, included in the *Australian Consumer Law*, were extended to cover small business standard form contracts.

A franchisor lawyer interviewee was riled by the issue and argued that the provision of the consumer-derived pre-contractual protections was a ransom situation, whereby state governments can threaten the enactment of state-based legislations if the federal government does not continue to extend the specific franchise provisions in the Code of Conduct:

> … there have been some state-based moves by independent MP's who are consumer focused and screaming about franchisee rights and they're having to be quieted down by things like this new [2014] Code, which introduces things like good faith. If you're cutting back on the so-called consumer rights, I think that sort of background noise would arise again and the downside to it is, you may end up with a fractured state-based regulatory system in Australia.

I believe temporal protection mechanisms are paternalist policies. The theoretical underpinning of these policies suggests that where consumer choice is not welfare enhancing, governments ought to impose restrictions on their ability to make decisions.[15] Not all the problems with the franchising should be attributed to franchisor behaviour and that, in some situations, prospective franchisees need to be protected from their own poor decision-making. This is the basis of Recommendation IX.

Recommendation IX: Statutory recognition that franchisees who do not qualify for sophisticated franchisee exemptions are to be treated as consumers in the pre-contractual stage.

6. Recognition that Temporal Protection Mechanisms are Measured in Calendar Days

To add to the confusion franchisees may experience in the pre-contractual stage, the Code provides 14-days (Section 9) for the pre-contractual period and 7 days (Section 26) for the in-term cooling off period. It would have been prudent for the policymakers to stipulate whether these are calendar or business days in the legislation and not assume the franchisee understands that they also need to read the *Acts Interpretation Act* 1901 (Cth) to know that these are calendar days. While, automatically assumed to be calendar days by those working with the Code, it is not clarified statutorily in the specific industry statute nor obvious to lay persons or prospective franchisee's inexperienced in the law. This contrasts with Section 15 (1) of the now repealed *Petroleum Retail Marketing Franchise Act* (1980) (Cth) No. 139, 1980 that specifically stipulated that the pre-signature waiting period was to be observed in business days.

Recommendation X: Recognition that the days are measured in calendar days in Section 9 of the Code.

The above is a summary of the findings from my doctoral dissertation that are relevant to this inquiry. For a complete justification with more supporting evidence and anecdotal accounts from the interviewed experts, I would be happy to supply a copy of my dissertation to the Committee.

Kind regards,
Dr Courtenay Atwell

[15] Anthony T Kronman, 'Paternalism and the Law of Contracts' (1983) 92(5) *The Yale Law Journal* 763.