Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into Franchising Code of Conduct

September 12, 2008

Submission of the National Retail Association

The National Retail Association

The National Retail Association (NRA) is Australia's largest and most representative retail organisation with over 3000 members and affiliates located across all Australian states and territories. Its membership includes a substantial number of franchisor and franchisee entities, both small and large.

Request to Present at Public Hearing

NRA is strongly of the view that should the Committee elect to receive oral submissions from individuals or organisations, then NRA should be afforded the same opportunity and respectfully requests accordingly.

Do We Need an Inquiry?

The mandatory Franchising Code of Conduct was introduced in 1998. Since then a number of reviews have been conducted. The most recent review was commissioned on 28 June 2006 and it dealt with the disclosures section of the Code. Subsequent changes to the Franchising Code came into effect earlier this year.

In NRA's view a further inquiry into the sector at this time is unnecessary. Frequent inquiries into the code inevitable cause uncertainty and contribute to a destabilising effect on the franchising sector.

The Franchising Australia 2006 Survey undertaken by Griffith University and sponsored by the Franchise Council of Australia found that (page 11 of the report):

- The level of reported disputes in the franchising sector remains low
- Patterns in changes in franchise unit ownership continue to provide evidence of stability in the sector.
- Fewer than 2 percent of franchised units ceased to operate, supporting the notion that franchising failure rates are low.
- Franchisees remain in the system for an average of 7 years, indicating that their businesses are operating profitably.

The Survey also estimated that 62,000 units are operating in business format franchises in Australia. NRA submits that the Committee should evaluate complaints about the operation of the Franchise Code in this context. For example as best as we could ascertain it, about 25 current or former franchisees made submissions to the 2008 WA Inquiry chaired by Chris Bothams viz 0.04% of all units across Australia.

NRA submits that it is important that the Committee make conclusions based on information and data that reflects, in a reasonably representative sense, on the operation of the Code. Isolated complaints, whether justified or not, do not form a legitimate basis for a review of a Code which applies to 62,000 businesses. Additionally it is important that the Committee distinguishes between change which might benefit one or a minority of operators as opposed to change which is in the best interests of the franchise sector as a whole

ACCC Report Card

An ACCC report card on franchising issues provided by John Martin, Commissioner, on 11 October 2007, in Melbourne, also does not support a view that the Franchising Code is in need of significant change or that current available remedies are not working effectively. The report card states that:

To this point, the level of reported disputes in the franchising sector remains relatively low. Substantial disputes (those referred by franchisors/franchisees to external dispute resolution methods i.e. mediation) were experienced by 35% of participating franchise systems in the past 12 months, but most were with only two franchisees. Both, the survey data and the ACCC database show that mediation is being used extensively as a means of resolving dispute.

.....

In the 12 months to 30 June, the ACCC recorded 855 contacts related to franchising (525 complaints, 330 inquiries). This represents just 1.65% of the total contacts recorded in the national database over that period

The Scope of the Inquiry

The terms of reference of the current inquiry are, in effect, limitless. The inquiry will look into "the operation of the code"; "the nature of the franchising industry"; the "rights of both franchisors and franchisees"; among other things. It is unreasonable that a sector which is generally acccepted to operating in an efficient and effective manner should be subject to such a limitless review. By implication the Committee activities are pro-regulation and the scope of the terms of reference is suggestive of a determination to find something to regulate, or to look for change for "changes sake".

Additionally the unlimited scope of the inquiry makes it extremely difficult for industry players to focus or concentrate their submission in areas of greatest concern to them. In reality we simply do not know, for the most part, what the Committee had in mind when it decided to conduct the inquiry.

We do know that the terms of reference specifically deal with good faith, the interaction of the code with the trade practices act, and dispute resolution provisions, but beyond this there is no limit to matters under consideration. This places industry as at a particular disadvantage as it goes about the task of preparing submissions and suggests that a further opportunity to comment should be afforded before the Committee arrives at its final conclusions.

Competitive Foods

The current inquiry is widely perceived as being constituted as a result of Competitive Foods displeasure with commercial outcomes affecting some of its stores in WA.

If the perception is reality, the franchise sector is confronted by an extraordinary state of affairs wherein the regulation of the sector is hostage to the self-interest requirements of a single organisation. That is not to say that other disaffected individuals or groups will not enthusiastically make use of the opportunities created by the inquiry process. Their involvement however does not diminish from widespread concern that a very large company should be able to disrupt and destabilise the operation of the franchise sector in the manner in which it apparently has.

Given the perception, we submit that it is important for reasons of probity and governance, that the Committee make some finding about the extent to which any of its recommendations will beneficially affect Competitive Foods.

The perception also requires that some comment be made on the predicament of Competitive Foods in WA. NRA's understanding of the situation is:

- The arrangement was ended in accordance with the terms of a contract entered into between Competitive Foods and [redacted] International.

- Both [redacted] International and Competitive Foods are large well resources organisations. Presumably both organisations enjoy ready access to qualified legal advice and enter into commercial arrangements with a full and comprehensive understanding of their respective rights and obligations.

It is relevant to note that the recommendations of the WA Inquiry did not accommodate Competitive Foods preferences in terms of "end of agreement arrangements". The Inquiry made the following recommendations:

Recommendation 3.1:
The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to explicitly specify, in the disclosure document, what end of agreement arrangements are in place under the franchise agreement.

Recommendation 3.2:
The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to explicitly specify, in the disclosure document, what the position is in relation to the franchisee's entitlement or lack of entitlement to goodwill or other compensation if the agreement is not renewed.

Recommendation 3.3:
The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to conduct a pre-expiry review with the franchisee at least one year prior to the expiry of the franchise agreement. The purpose of the review is to inform the franchisee of any variations between the existing and new agreement and any conditions that need to be met in order for agreement renewal.

Recommendation 3.4:
The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to specify, in the disclosure document, a reasonable period of notification in which to inform the franchisee of their intention not to renew the agreement.

It is inappropriate in NRA's view for any Government to contemplate altering the Franchise Code or related legislation in order to protect an individual operator, large or small, who has explicitly agreed to certain commercial terms, but who at some later stage becomes dissatisfied with the agreed terms, and sets out to effect some form of retrospective amendment to these arrangements. Such an outcome would also set a dangerous precedent.

Australia's franchising sector is predominantly made up of small business owners. These small businesses typically work very hard and commonly work long hours. However a disagreement between two of Australia's largest franchise players should not be characterised as a contest which is about the defence of the interests of small business operators.

Good Will

NRA is concerned that any change to the law dealing with the concept of good will may inevitably result in increased costs for both franchisors and franchisees. That is, if franchisees have a right to claim goodwill upon the termination of the franchise agreement, then the anticipated cost of these claims will be factored into franchise negotiations and inevitably lead to higher costs of entry and/or operation for franchisees. Higher costs could be incurred in the form of higher initial or renewal fees, higher royalties, higher costs recovery for training and support services, and/or a reduction in the level or scope of resources provided by the franchisor to the franchisee network.

The consequences of this may include lower investment leading to fewer overall franchises and fewer jobs.

NRA is also concerned that a change in the legal approach to good will in the franchise sector could also impose serious burdens on failing franchises. For example if franchisees have a right to claim payment for good will in defined circumstances, it follows that an underperforming franchise may be deemed to have undermined the franchise brand and negatively impacted the performance of other franchisees, thus rendering the failed franchisee liable to pay compensation arising from the negative good will generated.

The traditional concept of goodwill is not easily translatable to the franchisee sector.

In general terms franchisees businesses are not businesses whose formation is based on concepts of innovation or creativity and where success is attributable to products or services which have differentiating characteristics and which can be distinguished from other products or services currently on the market. To the converse the franchise model is built on the concept of stringent replication. Not only replication in physical structure, appearance and layout but also in terms of employee training, uniforming, job standards and procedures, and across all areas of operation of the business. In this context it is exceptionally difficult to measure goodwill and to determine how much good will should be attributed to the brand, the system, etc and how much should be attributed to the contributions of the franchisee.

Current Australian law holds that a franchisee has no general right, on termination or expiration of the franchise term, to payment for any contribution it has made to goodwill. Consequently franchise contracts typically provide for an up-front assignment to the franchisor of any goodwill generated incidental to the operation of the franchise.

The 1986 Federal Review of Franchise Regulation noted that:

- The initial fee and subsequent franchise fees should reflect a discount factor for the goodwill that is built up y the franchisee's efforts;

- By entering into the agreement, the franchisee acknowledges that it is not entitled to be compensated at the end of the term for the franchisor receiving the benefits of any such goodwill; and

- The franchisee's implied acknowledgement of this fact is particularly clear if it had agreed to post-term competition restrictions, as the fees paid over the course of the agreement effectively incorporate a discount on what the fees would have been in the absence of those restrictive covenants.

The 1986 Review also noted the difficulties in attempting to measure the respective contributions to goodwill of a franchisee and a franchisor in a single context let alone across different contexts and industries:

"...it is not desirable (even possible) to make provision by legislation for an apportionment of goodwill on termination of the franchise agreement ..... and the franchisee should be cognizant from entering an agreement of the possibility/likelihood that they will not be compensated upon termination for goodwill built up by them"

Why More Regulation?

The scope of the current inquiry appears to invite or encourage the possibility of new regulation. An outcome which NRA belives is inconsistent with the Governments own "Deregulation Agenda" which is defined in the following terms:

> *The Government has committed to reducing the regulatory burden on Australian businesses, non-profit organisations and consumers. This is consistent with larger commitments to address impediments to Australia's long-term productivity growth.*
>
> .....
>
> *Key elements of the deregulation agenda include:*
>
> - *the Financial Services Working Group that is tackling the complexity associated with financial services advice and disclosure. The simplification of financial product disclosure documents will reduce the lengthy, complex and unreadable disclosure documentation in financial services and will reduce costs for business, investors and consumers;*
>
> - *a strengthening of procedures that means new or amended regulation will only be enacted where necessary and at a minimum cost to business, non-profit organisations and consumers. This includes maintaining and improving the best practice regulation requirements. As well, a one-in-one-out principle has been introduced that requires that in bringing forward new regulatory proposals, Ministers identify other areas where regulation can be modified or removed to reduce compliance costs for business, thereby addressing the cumulative burden of regulation;*

- *the Council of Australian Governments (COAG) Business Regulation and Competition Working Group (BRCWG), co-chaired by Ministers Tanner and Emerson that is addressing ways to reduce the regulatory burden on business and enhance productivity and workforce mobility in areas of shared Commonwealth and State responsibility. In March 2008 COAG endorsed Implementation Plans for 27 areas of regulatory reform giving priority to establishing nationally consistent occupational health and safety laws. Other areas on the BRCWG agenda include trade measurement, rail safety regulation, product safety, trade licensing, further payroll tax harmonisation, mine safety and regulation of financial service delivery; and*

- *the introduction of a culture of continuous improvement in regulatory activity that will be demonstrated by the Government continually looking for opportunities to streamline regulatory processes.*

In a speech to the Sydney Institute on Tuesday 26 February 2008 titled "Relieving the burden on business - Labor's deregulation agenda", the The Hon Lindsay Tanner MP, Minister for Finance and Deregulation stated that:

We have already started to review and reform existing regulation, adopting practical measures to relieve the regulatory burden.

Procedures will be strengthened to ensure new regulation is enacted only where absolutely necessary and at minimum cost to consumers and business.

.....

Focus on Deregulation

The cost of regulation is notoriously difficult to estimate. Spread across a large number of businesses it often goes unnoticed, even though the aggregate burden may be substantial.

The Productivity Commission's best estimate is that the total cost of compliance associated with all Federal, state, territory and local government regulations could be at least as high as four per cent of GDP per year. That is more than $40 billion.

As well as imposing specific compliance costs, regulation can also have a choking effect on entrepreneurship, risk-taking and innovation.

These costs ultimately affect all of us through higher prices and restricted choice of goods and services.

Deregulation will improve the capacity of Australian businesses to compete internationally. Not by engaging in a race to the bottom, but by catching up to other OECD countries that have already put in place advanced regulatory reform programs to assist business.

.....

Reforming Existing Regulation

We are working with states and territories through the Council of Australian Governments (COAG) to address areas of regulatory duplication or inconsistency between different levels of government.

Our Business Regulation and Competition Working Group has been meeting to progress an accelerated program of reform which will be presented to COAG in late March.

These measures will be targeted at reducing the cost of regulation to business.

.....

A systematic process to identify and reform regulations across other areas of government has commenced. Over the coming months I will be working in partnership with Commonwealth portfolio ministers to identify and address areas where the regulatory burden on business can be eased.

I will initiate proposals for regulatory reform, and conduct joint reform projects with individual Ministers.

The first instalment of this is the comprehensive reform of the Financial Services Reform Act disclosure regime which Kevin Rudd promised before the election.

We have all heard the stories about 50 and 80 page product disclosure statements. The Business Council of Australia even cited an example in their submission to the Banks Review of 227 pages of documentation being given to a customer wishing to open a simple cheque account with overdraft limit and home loan.

This benefits neither the business nor the customer. It increases costs which the customer ultimately bears.

Reducing the burden of new regulation

Prior to the election we committed to a one-in one-out principle for new regulation. When Ministers bring forward new regulatory proposals, they will be required to also identify other areas where regulation can be modified or removed to reduce compliance costs for business.

This form of regulatory budgeting will address the cumulative burden of regulation.

In NRA's view, and in broad terms, the conduct of the current inquiry is inconsistment with the Government's stated objectives and/or policy in terms of deregulation.

In addition, the recent state activity around the franchise sector is also inconsistent with these objectives or policies. Already two States, nothwithstanding acknowledgements around the desirability of the maintenance of a national code, have conducted inquiries into the franchise sector. In varying degrees these inquiries are disruptive to the franchise sector, they cause uncertaininty about the future shape of the regulatory framework, they raise the spectre of the emergence of multiple jurisdictions in the regulation of the franchise sector, they may unfavourably influence investment decisions, and for those who need to monitor and review the work of these inquiries and/or involve themselves in the inquiry process, they are costly and an unwelcome distraction of resources.

Good Faith

NRA does not support any explicit inclusion in the code of provisions dealing with good faith. An implied duty of good faith may already exist in the common law and the concept continues to evolve as courts decide relevant matters. The Auto Masters case found, for example, that the precise nature of any good faith obligation depends on the circumstances of the case and the context of the contract as a whole. NRA doubts whether much benefit will accrue from the introduction of a statutory concept of "good faith" and suggests that the more sensible course would be to allow the current legal processes to continue to resolve argument around the concept.

Filed by:

Gary Black
Executive Director
National Retail Association
395 St Pauls Terrace
Fortitude Valley
Queensland 4006

Phone: 07 3251 3000
Fax: 07 3251 3030
Email: g.black@nra.net.au