EXPLANATORY STATEMENT

SELECT LEGISLATIVE INSTRUMENT NO. 168, 2014

Issued by the authority of the Minister for Small Business

Competition and Consumer Act 2010

Competition and Consumer (Industry Codes—Franchising) Regulation 2014

Section 172 of the *Competition and Consumer Act 2010* (the CCA) provides, in part, that the Governor-General may make regulations, not inconsistent with the CCA, prescribing all matters that are required or permitted by the CCA to be prescribed or are necessary or convenient to be prescribed for carrying out or giving effect to the CCA.

Regulations can be made under section 51AE of the CCA to prescribe industry codes to regulate the conduct of participants in an industry towards other participants in the industry. Under the CCA, being bound by a prescribed industry code may be on either a mandatory or a voluntary basis.

Purpose

The object of the CCA is 'to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection.'[1] One way it does this is by providing for the establishment of industry codes. An industry code is:

> …a code regulating the conduct of participants in an industry towards other participants in the industry or towards consumers in the industry.[2]

Industry codes are:

> …co-regulatory measures, designed to achieve minimum standards of conduct in an industry where there is an identifiable problem to address. Industry codes can be used as an alternative to primary legislation in instances where a market failure has been identified.[3]

The *Competition and Consumer (Industry Codes—Franchising) Regulation 2014* (the Regulation) prescribes an improved and modernised Franchising Code of Conduct (the Franchising Code), which is a mandatory code.

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[1] Section 2, *Competition and Consumer Act 2010.*
[2] Section 51ACA, *Competition and Consumer Act 2010*.
[3] *Policy guidelines on prescribing industry codes under Part IVB of the Competition and Consumer Act 2010*, May 2011, Commonwealth of Australia. See: http://archive.treasury.gov.au/documents/2035/PDF/Policy%20Guidelines%20on%20Prescribing%20Industry%20Codes.pdf.

The purpose of the Franchising Code is to 'regulate the conduct of participants in franchising towards other participants in franchising.'[4] The key aspects of the Franchising Code are to require franchisors to disclose certain information to franchisees, prescribe minimum standards in franchise agreements and to provide dispute resolution processes.

The Franchising Code:

- replaces the existing Franchising Code of Conduct established by the *Trade Practices (Industry Codes—Franchising) Regulations 1998* (the 1998 Code);
- updates provisions in the 1998 Code to reflect changes in the franchising sector and modern drafting practices; and
- gives effect to the Government's proposed reforms to franchising policy, as outlined in its *The Future of Franchising*[5] statement, which builds on the 2013 report by Mr Alan Wein of his independent review of the 1998 Code.[6]

Context

The Wein Review was tasked with inquiring into the efficacy of amendments to the 1998 Code, as well as certain issues of particular importance to the franchising sector – good faith in franchising, the rights of franchisees at the end of franchise agreements and the enforcement of the 1998 Code. The Wein Review reported on 30 April 2013.

Following his review, Mr Wein released a report titled *Review of the Franchising Code of Conduct* that made 18 substantive recommendations to Government. On 2 April 2014, the Government released its *The Future of Franchising* statement, which supported the majority of Mr Wein's recommendations. It stated:

> This Government will ensure this important industry has the support it needs to flourish. That is why, before the election, we said we would refine the national Franchising Code. We want to promote growth in the sector, reduce red tape and make sure that all participants in the industry follow best practice principles. The Government is also committed to guard against separate and additional state regulation to maintain a consistent national framework.
>
> Following the recommendations from the 2013 Wein Review and ongoing consultation with the franchising sector, the Government committed to:

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[4] Franchising Code of Conduct, clause 2.
[5] *The Future of Franchising*, April 2014, www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/Franchising-Code.
[6] *Review of the Franchising Code of Conduct*, Mr Alan Wein, 30 April 2013.

- ensuring franchisees and franchisors act in good faith in their dealings with each other;
- introducing penalties for a breach of certain provisions of the Franchising Code;
- improving the transparency of marketing funds; and
- improving disclosure including by provision for short form, easy to understand information for prospective franchisees.[7]

Application

The Regulation is a legislative instrument for the purposes of the *Legislative Instruments Act 2003* and commences on 1 January 2015.

The Franchising Code has been drafted to provide the greatest possible coverage of existing and future franchise agreements. Except as provided below, the Franchising Code applies to conduct occurring on or after 1 January 2015 (other than to discharge an outstanding obligation under the 1998 Code) in relation to a franchise agreement entered into on or after 1 October 1998.

Subclause 3(4) provides that the following provisions of the Franchising Code do not apply to certain franchise agreements:

- subclause 21(2) and clauses 22 and 23 do not apply in relation to agreements entered into on or after 1 March 2008 but before 1 January 2015; and
- paragraph 20(1)(b), subclause 21(2) and clauses 22 and 23 do not apply in relation to agreements entered into on or after 1 October 1998 but before 1 March 2008.

These clauses have been disapplied, or carved-out, to avoid possible risks of contravening section 51(xxxi) of the *Commonwealth of Australia Constitution Act 1900* (the Constitution) concerning the acquisition of property by the Commonwealth on just terms.

However, subclause 3(4) does not apply if the franchise agreement is varied or transferred on or after 1 January 2015. For example, an extension of the term of a franchise agreement on or after 1 January 2015, made with the agreement of both the franchisor and the franchisee, is a variation of the agreement.

[7] *The Future of Franchising*, April 2014, p. 3.

Details

An overview of the Regulation is set out in Attachment A, with the details of the Regulation set out in Attachment B. Attachment C outlines the transitional provisions to facilitate the introduction of the Franchising Code. Attachment D is a copy of the Regulation Impact Statement in relation to the Regulation.

Consultation

There was extensive consultation with stakeholders during the Wein Review and the subsequent drafting of the Regulation, which has been instrumental in the development of the Franchising Code.

- The Wein Review received 73 formal submissions from a wide range of stakeholders including government bodies, academics, legal and professional advisers, industry associations, and individual franchisors and franchisees. Mr Wein also held 25 face-to-face meetings with stakeholders across Australia.

- 169 responses were received from a range of stakeholders to a consultation paper released in June 2013 to seek feedback on Mr Wein's recommendations.

- 31 submissions were received from a cross-section of the franchising community in response to the exposure drafts of the Franchising Code and the Competition and Consumer Amendment Bill 2014 (later enacted as the *Competition and Consumer Amendment (Industry Code Penalties) Act 2014*), which were released for public comment in April 2014.

- There has been further targeted consultation with key industry stakeholders on changes and refinements to the Franchising Code following public feedback on the exposure draft.

REGULATION IMPACT STATEMENT

Policy objective

The Regulation achieves the Government's policy objective of refining the 1998 Code to strengthen its effectiveness, improve its responsiveness to the sector's unique commercial characteristics and guard against additional state-based regulation.

The Regulation reduces red-tape for franchisors and franchisees, estimated at around $8.6 million annually.

A copy of the Regulation Impact Statement approved by the Office of Best Practice Regulation in relation to the Regulation is at Attachment D.

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

Competition and Consumer (Industry Codes-Franchising) Regulation 2014

The *Competition and Consumer (Industry Codes-Franchising) Regulation 2014* is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the Legislative Instrument

The Regulation prescribes an improved and modernised Franchising Code of Conduct, which is a mandatory prescribed industry code for the purpose of the *Competition and Consumer Act 2010*. The purpose is to regulate the conduct of participants in franchising towards other participants in franchising.

Human rights implications

This Regulation does not engage any of the applicable rights or freedoms.

Conclusion

This Regulation is compatible with human rights as it does not raise any human rights issues.

Attachment A

An overview of the *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*

Section 1 - Name

This section provides that the title of the Regulation is the *Competition and Consumer (Industry Codes—Franchising) Regulation 2014* (the Regulation).

Section 2 - Commencement

This section provides for the Regulation to commence on 1 January 2015.

Section 3 - Authority

This section specifies that the Regulation is made under section 51AE of the *Competition and Consumer Act 2010* (the CCA).

Section 4 – Code of Conduct

This section provides that for the purposes of section 51AE of the CCA, the code set out in Schedule 1 to the Regulation is prescribed and is a mandatory industry code of conduct.

Section 5 – Transitional arrangements

This section provides transitional arrangements for when a franchisor has an existing disclosure document as at 1 January 2015 and is required to maintain it under the new Franchising Code of Conduct set out in Schedule 1 to the Regulation. Further explanation of transitional provisions is provided at Attachment C.

Section 6 – Continued appointment of mediation adviser

This section provides that the appointment of the mediation adviser under the *Trade Practices (Industry Codes—Franchising) Regulations 1998* will continue under the Franchising Code.

Schedule 1 – Franchising Code of Conduct

There are broadly six parts to the Franchising Code:

- Part 1: Introduction;
- Part 2: Disclosure requirements before entry into a franchise agreement;
- Part 3: Franchise agreements;
- Part 4: Resolving disputes;

- Annexure 1: Disclosure document for franchisee or prospective franchisee; and
- Annexure 2: Information statement for prospective franchisee.

Part 1: Introduction

This part contains provisions setting out the purpose of the Franchising Code, its application, definitions of terms used in the Code and the obligation for parties to the franchise agreement to act in good faith. In particular, a person would be participating in a franchise agreement if the business arrangement satisfies the definition of franchise agreement.

The most significant change from the 1998 Code is the introduction of an obligation on the parties to a franchise agreement to act in good faith (clause 6). This obligation applies both to franchisors and franchisees in respect of any matter arising under or in relation to the franchise agreement or the Franchising Code.

The meaning of good faith under the Franchising Code is the same as at common law. While the obligation is not defined the Franchising Code contains a non-exhaustive list of matters that the courts may have regard to when determining whether a breach of the obligation has occurred. The purpose of this list is also to provide some guidance to assist franchise participants to understand the nature of their obligation to act in good faith.

Clause 6 implements a recommendation by Mr Wein. Similar recommendations were made by a number of earlier reviews of the franchising sector, including the Parliamentary Joint Committee on Corporations and Financial Services' 2008 report *Opportunity not opportunism: improving conduct in Australian franchising*.

Part 2: Disclosure requirements before entry into a franchise agreement

Part 2 of the Franchising Code requires a franchisor to maintain a disclosure document that gives prospective franchisees information about the franchise, so that they can make an informed decision on whether to enter into the franchise agreement. The disclosure document also provides existing franchisees with information material to the operation of their business and updated information about the franchise system. Part 2 contains requirements relating to the disclosure document and procedures to be followed before a prospective franchisee enters into a franchise agreement, or before an existing franchisee renews or extends a franchise agreement or enters into a new agreement.

Building on Mr Wein's recommendations, the Government announced changes to the Franchising Code that would reduce disclosure requirements where evidence showed that it was unnecessary or burdensome, but also to strengthen disclosure requirements where evidence demonstrated that this was required. Some of the changes made to the disclosure requirements from the 1998 Code include:

- removing the requirement for master franchisors to provide disclosure to subfranchisees where there is no direct relationship between them;
- streamlining the disclosure document by removing unnecessary, duplicative provisions that required a summary of the franchise agreement to be produced;
- allowing franchisors to depart from the strict format of the disclosure document to improve readability, by moving all non-applicable items to an attachment;
- deleting the 'short form' disclosure document (Annexure 2 to the 1998 Code); and
- requiring franchisors to provide prospective franchisees with an easy to understand information statement about franchising, in the form set out in the new Annexure 2 to the Franchising Code.

Section 5 of the Regulation contains provisions facilitating transition to the Franchising Code. Effectively, section 5 allows for a grace period before existing disclosure documents are required to be updated in accordance with the Franchising Code, until 31 October 2015 (rather than being required to update at the commencement of the Franchising Code on 1 January 2015). Further, it allows a franchisor to use and rely on an existing disclosure document, being one within the meaning of the 1998 Code, until 1 November 2015.

Part 3: Franchise agreements

Part 3 sets out the obligations on the franchisor in relation to the information that must be disclosed to prospective franchisees and franchisees, end of term arrangements, and record keeping.

In particular, Part 3 specifies that certain types of clauses cannot be included in a franchise agreement, such as those:

- releasing the franchisor from liability towards the franchisee;
- specifying that 'an action or proceedings' or mediation in relation to a dispute be brought in the State or Territory outside that in which the franchised business is based or outside of Australia; and
- requiring the franchisee to pay the franchisor's costs of settling a dispute.

If a franchise agreement contains such clauses, they will have no legal effect.

Part 3 also deals with:

- restraint of trade clauses providing that they have no effect after a franchise agreement expires if certain circumstances occur;

- limitations on the franchisor to require a franchisee to undertake significant capital expenditure;
- marketing and advertising fees;
- disclosure of details of former franchisees; and
- the right of franchisees to associate.

Part 4: Resolving disputes

Part 4 of the Franchising Code deals with mediation and the procedure for resolving disputes between the parties to a franchise agreement. It makes it clear that the parties can choose to either pursue a complaint under the franchisor's internal complaint handling procedure or under the Franchising Code's specified complaint handling procedure. It provides details around what those procedures entail.

In particular, Part 4:

- requires a party to attend mediation and to approach it in a reconciliatory manner, and identifies some of the behaviours which show that this is happening;
- provides that parties are equally liable for the costs of mediation under the Franchising Code, unless they agree otherwise at the time of the mediation; and
- provides for the appointment of a mediation adviser by the Minister.

Annexure 1: Disclosure document for franchisee or prospective franchisee

Annexure 1 to the Franchising Code sets out the form and content of the disclosure document a franchisor is required to create under clause 8.

The disclosure document has been streamlined where possible, in keeping with the Government's policy of reducing red tape for franchisors and franchisees, and includes changes to make the information provided to franchisees and prospective franchisees more relevant and useful.

Annexure 1 includes new or altered disclosure requirements, including those that relate to:

- litigation involving directors of associates of the franchisor (item 4);
- master franchisors (item 7);
- sale of goods or services online (item 12);

- details of whether a prospective franchisee will have an option to renew a franchise agreement, and if not, whether it will be entitled to compensation (item 18.1(c));
- a statement of the franchisee's rights at the end of the term of the franchise agreement (item 18.3-18.5);
- the meaning of 'earnings information', if earnings information is disclosed (item 20.2); and
- financial details, including the solvency of the franchisor (item 21).

More information about each of these items can be found in Attachment B.

Annexure 2: Information statement for prospective franchisee

Annexure 2 sets out the standard information statement required by clause 11 of the Franchising Code. This is a generic statement designed to inform prospective franchisees of the risks and rewards in franchising before they make the psychological commitment to enter into a franchise agreement.

Details of the Regulation are in Attachment B.

Attachment C outlines provisions relating to transition from the 1998 Code to the Franchising Code.

Attachment D is a copy of the Regulation Impact Statement in relation to the Regulation.

Attachment B

Details of the *Competition and Consumer (Industry Codes—Franchising) Regulation 2014*

Part 1: Introduction

Clause 1: Name of code

This clause provides that the name of the code is the *Franchising Code of Conduct* (Franchising Code).

Clause 2: Purpose of code

This clause provides that the purpose of the Franchising Code is 'to regulate the conduct of participants in franchising towards other participants in franchising'.

Clause 3: Application

The Franchising Code has been drafted to provide the broadest possible coverage of existing and future franchise agreements. Except as provided below, the Franchising Code applies to conduct occurring on or after 1 January 2015 (other than to discharge an outstanding obligation under the 1998 Code) in relation to a franchise agreement entered into on or after 1 October 1998.

Clause 3 should also be read in conjunction with the *Competition and Consumer (Industry Codes—Franchising) Repeal Regulation 2014*. Item 2 of Schedule 1 of that Regulation provides that an obligation that arose under the 1998 Code that is still outstanding on 1 January 2015 continues despite the repeal of the 1998 Code. Item 3 of Schedule 1 of that Regulation provides that the repeal of the 1998 Code 'does not affect any right, privilege or liability acquired, accrued or incurred under [the 1998 Code]'.

The Franchising Code does not attempt to retrospectively penalise any act (or omission) before the commencement date. It should be noted that any conduct occurring before 1 January 2015 that breaches the 1998 Code or the Australian Consumer Law remains subject to investigation and enforcement by the Australian Competition and Consumer Commission (ACCC).

This means that, for franchisors that have obligations under the 1998 Code that run through to 1 January 2015 (and beyond), they are entitled to fulfil that obligation in accordance with the 1998 Code. The Franchising Code does not alter that existing obligation or apply civil penalties under these circumstances, despite its fulfilment taking place after 1 January 2015.

For example, if a franchisee leases premises from a franchisor on 15 December 2014, the franchisor is required to provide the franchisee with a copy of the lease within one month in accordance with clause 14 of the 1998 Code. On 15 January 2015, the franchisor is entitled to discharge that obligation under the 1998 Code. Clause 13 of the Franchising Code also requires the franchisor to provide the franchisee with a copy of the lease within one month. Additionally, it requires the franchisor to provide details of any incentives or financial benefits that the franchisor is entitled to receive as a result of the lease and is a civil penalty provision. Clause 13 of the Franchising Code does not apply under these circumstances. This approach allows for a seamless transition from the 1998 Code to the Franchising Code.

The Franchising Code also does not apply:

- to a franchise agreement entered into before 1 October 1998;
- where another mandatory industry code[8] applies to the franchise agreement; or
- where the goods or services supplied under the agreement are substantially the same as those supplied by the franchisee for at least two years immediately prior to entering into the agreement, and sales of which are unlikely to account for more than 20 per cent of the franchisee's gross turnover for goods and services of that kind for the first year.

These provisions are intended to avoid regulatory overlap with other mandatory industry codes. They also avoid capturing certain pre-existing business relationships within the Franchising Code in circumstances deemed unnecessary.

Further, subclause 3(4) provides that:

- subclause 21(2), relating to jurisdiction to settle disputes, and clauses 22 and 23, relating to costs of settling disputes and restraint of trade clauses respectively, do not apply in relation to agreements entered into on or after 1 March 2008 but before 1 January 2015; and
- paragraph 20(1)(b), prohibiting a waiver of any verbal or written representation made by the franchisor, and subclause 21(2) and clauses 22 and 23 do not apply in relation to agreements entered into on or after 1 October 1998 but before 1 March 2008.

These clauses have been disapplied to avoid possible risks of contravening the Constitution, specifically in relation to section 51(xxxi) which concerns the compulsory acquisition of property on just terms. The Government has taken this approach to provide the greatest regulatory certainty for franchise participants and reduce compliance costs.

However, subclause 3(4) does not apply if the franchise agreement has been varied or transferred on or after 1 January 2015. For example, an extension of the term of a franchise

[8] For example, the Oilcode, established under the *Competition and Consumer (Industry Codes—Oilcode) Regulation 2006*.

agreement on or after 1 January 2015, made with the agreement of both the franchisor and the franchisee, is a variation of the agreement.

If a franchise agreement is varied or transferred on or after 1 January 2015, it will be brought under the Franchising Code in its entirety without carve outs. The principle underlying this provision is that parties that mutually agree to alter their agreement after the commencement of the Franchising Code, do so with the knowledge of the current regulatory environment and in effect consent to their agreement being subject to the Franchising Code in its entirety without carve outs.

Any variation, whether material or immaterial, will be sufficient to bring an agreement under the Franchising Code in its entirety.

Parties should also note that section 15A of the *Acts Interpretation Act 1901* (Cth) applies to the Franchising Code and states:

> Every Act shall be read and construed subject to the Constitution, and so as not to exceed the legislative power of the Commonwealth, to the intent that where any enactment thereof would, but for this section, have been construed as being in excess of that power, it shall nevertheless be a valid enactment to the extent to which it is not in excess of that power.

<u>Example 1</u>: Jenny's Home Help enters into a franchise agreement with Tina on 13 January 2009 for a term of five years. The franchise agreement includes a clause requiring Tina to pay Jenny Home Help's costs of attending a mediation of a dispute. This clause remains valid after 1 January 2015, as the operation of clause 22 of the Franchising Code has been disapplied by virtue of subclause 3(4).

However, on 27 February 2015, Jenny's Home Help varies the franchise agreements, so that franchisees will be required to pay a new amount into the advertising fund. This involves a change to the franchise agreement, bringing it under the Franchising Code, with the result that the clause relating to Tina paying the costs of mediation is void. Jenny's Home Help should consider amending the clause relating to the costs of mediation at the same time.

<u>Example 2</u>: Stooges Clowning enters into a franchise agreement with Moe Curley on 21 January 2015. The agreement will be subject to the Franchising Code in its entirety, as it was entered into after the commencement of the Franchising Code.

<u>Example 3</u>: DMH Bookshops, a franchisor, enters into a franchise agreement on 6 July 2013 for a period of seven years, with Liza. On 30 November 2014, DMH Bookshops acts dishonestly and not in good faith during dealings with Liza. DMH repeats the same conduct on 30 April 2015.

The first instance of this conduct is not a breach of clause 6, as the conduct occurred before the Franchising Code commenced on 1 January 2015. However, the second instance is a breach of clause 6, as the conduct occurred after 1 January 2015.

Clause 4: Definitions

Clause 4 defines terms used in the Franchising Code. A number of key terms used in franchising have been defined for the first time or redefined in the Franchising Code. These include the following definitions:

- The definition of **associate** of a franchisor has been expanded to include a person whose relationship with the franchisor is relevant to the franchise system because the person:

  > 'owns intellectual property used in the franchise system [or] is involved in market research, market testing, market development, sales promotion or management of the franchise system.'

  This extends the reach of the Franchising Code to persons integral to the operation of the franchise system who were not previously covered by the provisions of the 1998 Code.

The definitions of 'extend' and 'renew' are based on consultations with the industry and apply to two distinct situations. In particular:

- **extend**, in relation to the scope of a franchise agreement, has been defined to mean:

  > a material change to:
  >
  > (i) the terms and conditions of the agreement; or
  >
  > (ii) the rights of a person under or in relation to the agreement; or
  >
  > (iii) the liabilities that would be imposed on a person under or in relation to the agreement.

What is considered to be a material change to a franchise agreement should be determined having regard to all the circumstances of the case.

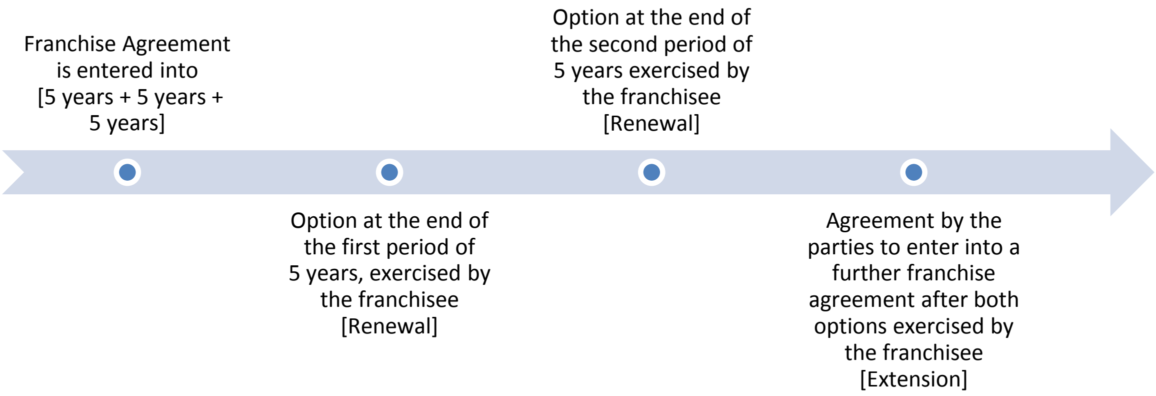
- An extension of the term of a franchise agreement, 'occurs when the period of the agreement is extended, other than because of an option exercisable by the franchisee during the term of the agreement'.

- A definition of **renew** has been introduced, so that renewal of a franchise agreement 'occurs when the franchisee exercises an option during the term of the agreement to renew the agreement'.

Whether or not an extension or a renewal has taken place, depends on whether or not the franchisee has exercised an option. The definition of renewal does not exclude a conditional renewal or some level of negotiation between the franchisor and franchisee. Further, the agreement entered into by the parties does not have to be identical to the agreement that already exists. The franchise agreement may contain provisions that place conditions, such as sales targets or licensing requirements, on the franchisee's right to exercise its option to renew the agreement.

> <u>Example</u>
>
> A franchisor, McCroskey Air Services, enters into a franchise agreement with Ms Teddi Striker that gives her an initial period of 5 years, plus an option she can exercise to continue for a further 5 years. A condition of the agreement is that Ms Striker must have a professional pilot's licence during the term of the agreement.
>
> <u>Situation 1</u>: At the end of the first 5 years, Ms Striker has maintained her pilot's licence and so is able to exercise her option to continue the agreement for a further 5 years. This is a renewal for the purposes of the Franchising Code.
>
> <u>Situation 2</u>: Ms Striker advises McCroskey Air Services that she will not be renewing her professional pilot's licence because of a medical condition. Instead she proposes to hire a licensed pilot, Rodger Murdoch, to fulfil those functions. McCroskey Air Services is satisfied with that arrangement. The parties agree to a variation of the franchise agreement to allow a person employed by the franchisee and approved by the franchisor to hold the pilot's licence. McCroskey Air Services also agrees to continue the agreement for a further 5 years, with Teddi Striker remaining the franchisee.
>
> This is an extension of the franchise agreement for the purposes of the Franchising Code, as Ms Striker has not exercised her option to renew because she was unable to meet the pre-condition for renewal under the agreement.

The difference between an extension and a renewal can also be explained by the following diagram:



- **financial year** now means 'a period of 12 months in respect of which financial statements relating to the franchise are prepared for the franchisor'. That is, the financial year is that which applies to the franchisor, as some franchisors do not operate on a standard Australian financial year of 1 July to 30 June.

- **transfer** is defined to include where:

  (a) the agreement is terminated on the basis that a new franchise agreement is entered into between the franchisor and prospective transferee; or

  (b) the franchisee's rights and obligations under the agreement are assigned to a prospective transferee; or

  (c) the agreement contemplates a transfer in specified circumstances and those circumstances happen.

The definition of novation contained in the 1998 Code has been deleted, as this has been subsumed under the definition of transfer.

<u>Example</u>

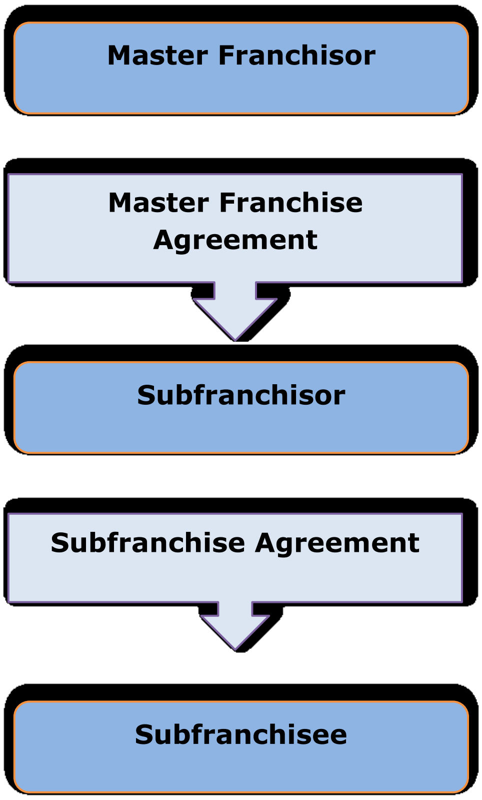
The franchise agreement between the franchisor, George Jones Liquor Stores, and the franchisee, Patty Lovelace, requires Ms Lovelace to hold a certain licence. George Jones Liquor Stores and Ms Lovelace anticipate that at some point before the agreement expires, Ms Lovelace may no longer hold that licence, however, George Jones Liquor Stores is happy to have Ms Lovelace continue in some role within the franchised business.

Accordingly, the parties include a clause in the franchise agreement that provides that if Ms Lovelace no longer holds that licence, control of the franchised business should pass to Dwight Lovelace, her son, who also holds the required licence.

If Ms Lovelace ceases to hold the required licence, the change in control of the franchised business to Dwight is deemed a transfer and not a new franchise agreement.

The terms **master franchise** and **subfranchisor**[9] have been defined. The terms **master franchisor**, **subfranchisee** and **subfranchise agreement** have not been defined. It is considered that the meanings of those terms can be determined from the context in which they are used and from their use in the definitions of franchisor and franchisee.

To assist in understanding these terms, the typical structure of a franchising arrangement involving a master franchisor, subfranchisor and subfranchisee is set out in the diagram below:



Clause 5: Meaning of franchise agreement

This clause sets out what is meant by the term 'franchise agreement' and is largely unchanged from the provision of the 1998 Code.

Clause 6: Obligation to act in good faith

This clause provides that the parties to a franchise agreement 'must act towards another party with good faith'. A franchise agreement cannot limit or exclude the obligation to act in

[9] The position of 'subfranchisor' is referred to as 'master franchisee' in the Regulation Impact Statement.

good faith (subclauses 6(4) and 6(5)). A party may be liable for a civil penalty if it breaches the obligation to act in good faith.[10]

Clause 6(1) provides that the obligation to act in good faith refers to ‘good faith, within the meaning of the unwritten law from time to time’. That is, the meaning of good faith under the Franchising Code takes on the same meaning that exists at common law, as it continues to develop and evolve in Australia over time. The clause aims to ensure that consistency is maintained in relation to the interpretation of good faith under the Franchising Code as at common law.

The obligation has not been defined, however, subclause 6(3) provides that, without limiting the matters it may consider in determining whether a party has contravened the obligation,

> … the court may have regard to:
>
> (a) whether the party acted honestly and not arbitrarily; and
>
> (b) whether the party cooperated to achieve the purposes of the agreement.

These matters are broadly indicative of the doctrine of good faith at common law. One of the purposes of subclause 6(3) is to provide some guidance to assist franchise participants to understand the typical behaviours that the courts will likely consider are required under this obligation. They are not intended as a definitive statement of the common law obligation to act in good faith.

This is a broad obligation that aims to strengthen the commercial dealings between the parties, particularly given the unique, interdependent relationship and imbalance in bargaining power that typically exists in franchising. The obligation to act in good faith will apply to all parties to the franchise agreement, as well as prospective franchisees, during all aspects of the franchise relationship. This includes during negotiation, execution of the franchise agreement, renewal or extension of the agreement, dispute resolution and in relation to obligations arising under the Franchising Code.

A party will not be in breach of the obligation to act in good faith merely by acting in its own legitimate commercial interests (subclause 6(6)). The Franchising Code also provides that if the franchise agreement does not give the franchisee an option to renew the agreement or allow an extension of an agreement, this does not mean that the franchisor has not acted in good faith in negotiating or giving effect to the agreement (subclause 6(7)). Whether or not a party has breached the obligation should be considered having regard to all the circumstances of the case.

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[10] Breach of a civil penalty provision of the Franchising Code may expose the contravener to a civil penalty imposed by a Court or the issue of an infringement notice by the ACCC. The prescribed penalty for a breach of a civil penalty provision is a maximum of 300 penalty units. An infringement notice may be issued for 50 penalty units for a body corporate and 10 penalty units in any other case.

The obligation to act in good faith is not intended as a panacea for all potential misconduct in the franchising relationship. Further, it does not replace or amend the prohibitions contained in the Australian Consumer Law, such as those relating to unconscionable conduct[11], or other prohibitions in the CCA more generally. Rather, it is intended to provide a flexible mechanism for addressing opportunistic and unfair conduct in franchising that may fall below the threshold of more serious misconduct provisions within the Australian Consumer Law or the CCA.

In summary, clause 6 provides certainty to franchise participants that the duty to act in good faith applies to franchise agreements, in accordance with its meaning at common law, and is extended to apply to all aspects of the franchising relationship, including during initial pre-contractual stages.

Part 2: Disclosure requirements before entry into a franchise agreement

Clause 7: Application of Part—master franchisors

Clause 7 exempts a master franchisor from compliance with this Part in relation to a subfranchisee.

The effect of this clause is to remove the requirement in the 1998 Code for master franchisors to provide a disclosure document to subfranchisees unless the master franchisor is a party to the franchise agreement. Such disclosure was generally found to be of little benefit to the subfranchisees and often regarded as irrelevant and unnecessary. Clause 7 aims to significantly reduce compliance and administrative costs for master franchisors and subfranchisees alike, compared to the 1998 Code. This will also reduce the burden on foreign franchisors where they operate in Australia as master franchisors and have a direct franchising relationship with a subfranchisor only.

A master franchisor will still be required to fully comply with the Franchising Code and provide disclosure to subfranchisors.

Clause 8: Franchisor must maintain a disclosure document

This clause requires a franchisor to create a disclosure document, which must provide the information set out in Annexure 1 to the Franchising Code. A failure to create a disclosure document may leave the franchisor liable to a civil penalty.

By providing only for a disclosure document in accordance with Annexure 1, the clause has the effect of abolishing the short form disclosure document, as set out in Annexure 2 of the 1998 Code.

[11] Australian Consumer Law, section 20.

Subclause 8(1) requires a franchisor to create a disclosure document that complies with subclauses 8(3), (4) and (5). However, subsection 5(1) of the Regulation provides that subclause 8(1) does not apply if the franchisor has an existing disclosure document. An 'existing disclosure document' is defined as a disclosure document within the meaning of the 1998 Code that exists on 1 January 2015.

Subclause 8(2) specifies that the purpose of a disclosure document is to provide a prospective franchisee or existing franchisee with:

> … information from the franchisor to help the franchisee to make a reasonably informed decision about the franchise [and to] give a franchisee current information from the franchisor that is material to the running of the franchised business.

To improve the readability of the disclosure document, the franchisor may depart from the strict format requirement in subclause 8(3) and include in the disclosure document only information and headings that are applicable to the franchised business. However, so that the prospective franchisee or franchisee is aware what information has not been provided, the franchisor must list the headings of items for which no applicable information exists in an attachment to the disclosure document.

For example, if the franchisee may not make goods of the sort sold in the franchised business available online and the franchisor has no intention of making those goods available online itself, the franchisor can omit the heading for item 12 from the main body of the disclosure document but it must list item 12 in an attachment.

Subclause 8(6) states that a franchisor after entering into a franchise agreement 'must update the disclosure document within 4 months after the end of each financial year.' This subclause is also relevant to the operation of subclause 9(1), which sets out the obligation on the franchisor to provide a disclosure document to a prospective franchisee and a franchisee in certain circumstances. A failure to update a disclosure document in accordance with subclause 8(6) may leave the franchisor liable to a civil penalty.

Subclause 8(7) provides an exception to the requirement to update each year where:

> (a) the franchisor did not enter into a franchise agreement, or only entered into 1 franchise agreement, during the year; and
>
> (b) the franchisor does not intend, or if the franchisor is a company, its directors do not intend, to enter into another franchise agreement in the following financial year.

While a franchisor does not have to update its disclosure document each year if it qualifies for the exception in subclause 8(7), there is nothing preventing it from doing so. For example, an existing franchisee may decide to retire suddenly, or the franchisor may come under new administration whose business plan calls for quick expansion of the company. If the franchisor has not updated its disclosure document for some years, the process of doing so may be made more time consuming and difficult and the opportunity to enter into the new agreement may be delayed or lost entirely.

Subclause 8(8) provides that, despite subclause 8(7), where a franchisee requests a disclosure document under subclause 16(1):

> … the franchisor must update the disclosure document so that it reflects the position of the franchise as at the end of the financial year before the financial year in which the request is made.

A failure to provide an updated disclosure document may leave the franchisor liable to a civil penalty.

These provisions should be read in conjunction with section 5 of the Regulation. Paragraph 5(2)(a) provides that an existing disclosure document may be given under the new Code up until 1 November 2015. Paragraph 5(2)(b) provides that a franchisor has to update the existing disclosure document on or before 31 October 2015, in accordance with the new Franchising Code. Paragraph 5(2)(c) provides that, thereafter, the franchisor must update its disclosure document within four months of the end of its financial year.

Section 5 of the Regulation aims to create certainty within the sector about the timing and scope of the obligation to update disclosure documents taking into account the fact that, under the Franchising Code, franchisors may choose to adopt a financial year that ends on a date other than 30 June. This provision aims to allow a franchisor sufficient time to transition and update its disclosure document to comply with the Franchising Code.

This does not mean that a franchisor cannot update the disclosure document at any time before 1 November 2015. Once a disclosure document has been updated in accordance with paragraph 5(2)(b) it is no longer an existing disclosure document and does not have to be updated again before 1 November 2015. Once the disclosure document has been updated, the other provisions of the Franchising Code apply, so that a franchisor is required to comply with subclause 8(6) or subclause 8(7), as the case may be.

It should be noted that ‘an existing disclosure document’ for the purposes of section 5 of the Regulation means a valid disclosure document created in accordance with the 1998 Code. Section 5 does not operate to remedy any defects in the existing disclosure document.

Where a franchisor creates a disclosure document on or after 1 January 2015, it is required to update that disclosure document within four months of the end of the financial year, in accordance with subclause 8(6).

> Example 1: A franchisor, Gitani Skip Bins, operates on a 1 July – 30 June financial year. Gitani Skip Bins must update its existing disclosure document to comply with the Franchising Code by 31 October 2015.
>
> Example 2: A subfranchisor, Cameron Trivia Quizzes, operates on the same 1 October to 30 September financial year as its master franchisor, an American company.
>
> In accordance with paragraph 5(2)(b), Cameron Trivia Quizzes must update its disclosure document to comply with the Franchising Code by 31 October 2015. Thereafter, subclause 8(6) applies to the next financial year that begins on or after 1 January 2015, which would be the year from 1 October 2015 to 30 September 2016. This means that Cameron Trivia Quizzes would be required to next update its disclosure document by 31 January 2017.

Clause 9: Franchisor to give documents to a franchisee or prospective franchisee

Clause 9 outlines the documents a franchisor must give a prospective franchisee before the prospective franchisee enters into a franchise agreement or makes a non-refundable payment in connection with the proposed franchise agreement, and the timing for the provision of these documents.

The documents a franchisor must provide to a prospective franchisee and the time frame for doing so are set out in subclause 9(1). A failure to provide the documents required by subclause 9(1) in the time frame specified may leave the franchisor liable to a civil penalty.

The disclosure document must be the disclosure document updated to comply with subclause 8(6). However, subparagraph 9(1)(b)(ii) provides that, if subclause 8(7) applies, the disclosure document must be updated so that it reflects 'the position of the franchise as at the end of the financial year before the financial year in which the request is made.'

The requirement in the 1998 Code to provide a 'current' disclosure document has not been replicated in this subclause, however, as stated in subclause 8(2), 'the purpose of a disclosure document is to … give a franchisee current information from the franchisor that is material to the running of the franchised business'. The disclosure document that must be provided is the latest version that has been updated in accordance with subclauses 8(6) or (7), as the case may be.

This avoids conflicting interpretations of the term ‘current’ disclosure document, highlighted in *SPAR Licensing Pty Ltd v Mis QLD Pty Ltd,*[12] which favoured a view that the disclosure document must be current and updated at the time the franchisee agreement is entered into. That interpretation differs from general industry practice and could impose significant compliance burden on franchisors. Subclauses 8(6) and (7) do not require continuous disclosure by the franchisor.

Subclause 9(2) provides that, in relation to a renewal or extension of a franchise agreement, the documents referred to in subclause 9(1) are to be given to the person to whom a franchise is granted. A failure to provide the documents in the time frame required by subclause 9(2) may leave the franchisor liable to a civil penalty

Subclause 9(2) reflects the intention that a franchisor is not required to provide documents beyond what is reasonable and necessary to comply with the purpose of the Franchising Code. It will avoid any broader interpretations that may extend the obligation to provide documents to other third parties that participate in a franchise or have an interest in the franchised business, such as the shareholders in a company to which the franchise is granted. Once the franchisor has complied with subclause 9(1) or 9(2), as the case may be, it is a matter for the recipient of the documents to determine who else has sufficient interest in the franchise to warrant being provided with the documents, as it is in the best position to make that judgment.

In some cases, a franchisor may not have updated its disclosure document because it falls within the exception in subclause 8(7). However, where a franchisor decides to enter into a franchise agreement with a new franchisee it is subject to subclause 9(1) and must update the disclosure document in accordance with subclause 8(6). If the decision to enter into an agreement with a new franchisee is made more than four months after the end of the financial year, the franchisor will not be able to comply with the timing to update the disclosure document set out in subclause 8(6). In that situation, subparagraph 9(1)(b)(ii) provides that, where subclause 8(7) applied, the franchisor must update the disclosure document to the end of the last financial year before the financial year in which it enters into the new agreement.

As noted above, nothing in clause 8 prevents a franchisor from updating its disclosure document on a regular basis to cover the eventuality that it decides to enter into another franchise agreement.

<u>Example 1:</u> On 31 April 2015, a franchisor, Annie’s Pet Set, provides a prospective franchisee, John, with a copy of the Franchising Code, a disclosure document in accordance with clause 8 and a copy of the franchise agreement.

[12] *SPAR Licensing Pty Ltd v Mis QLD Pty Ltd* [2014] FCAFC 50 (1 May 2014).

During the negotiation of the franchise agreement, John requests the following changes to the agreement:

- the franchisee should be his new company, Grandson Enterprises Pty Ltd;
- the company's address for service is his accountant's office;
- the term of the agreement be for five years, not four years; and
- the territory in the agreement be described more clearly.

Annie's Pet Set agrees on all points and changes the agreement accordingly.

In those circumstances, Annie's Pet Set should provide Grandson Enterprises with a new franchise agreement containing the updated provisions, however, this does not restart the 14 day period in subclause 9(1), as the changes to the agreement were made at Grandson Enterprises' request.

Example 2: A master franchisor, Marcello's Trattoria Napoletena, has only one subfranchisor, Georgina, and no franchisees. Georgina has a number of subfranchisees, all in New South Wales. Marcello's Trattoria Napoletena operates on a 1 July – 30 June financial year.

In 2014, Danni, who lives in Queensland, visits one of Georgina's subfranchisee restaurants and thinks she would like to open a franchise in Queensland.

Georgina has no interest in offering subfranchises in Queensland, so it tells Danni to discuss becoming a subfranchisor for Queensland with Marcello's Trattoria Napoletena.

Danni approaches Marcello's Trattoria Napoletena which decides, in February 2015, after conducting due diligence on Danni, to make her the subfranchisor for Queensland.

Clause 9 does not apply in this situation. Marcello's Trattoria Napoletena can provide Danni with its existing disclosure document, as section 5 of the Regulation has the effect of deeming its existing disclosure document valid for the purposes of the Franchising Code.

Clause 10: Franchisee or prospective franchisee to give advice to franchisor before entering into franchise agreement

Subclause 10(1) provides that, before a franchisor can enter into, renew, transfer or extend the term or the scope of a franchise agreement, it has to receive a written statement from the franchisee, prospective franchisee or prospective transferee stating that it has ‘received, read and had a reasonable opportunity to understand the disclosure document and this code’.

Paragraph 10(2)(a) provides that a franchisor cannot enter into a franchise agreement until it receives a written statement from an independent legal adviser, business adviser or accountant that that person has provided advice to the prospective franchisee or the prospective transferee. Subclause 10(2) does not require the prospective franchisee or prospective transferee to receive that advice. If the prospective franchisee or prospective transferee does not receive advice from any of those persons, or from one of them, paragraph 10(2)(b) states that it must provide a signed statement indicating that it was told it should seek that advice but decided not to do so.

Subclause 10(2) does not apply to a renewal or extension of a franchise agreement, however, the franchisor can still require the franchisee to obtain one of the statements referred to in paragraph 10(2)(a).

Clause 11: Franchisor to give information statement to prospective franchisee

Clause 11 provides that a franchisor must give a prospective franchisee a copy of the information statement set out in Annexure 2 to the Franchising Code, ‘as soon as practicable after the prospective franchisee formally applies or expresses an interest in acquiring a franchised business.’

The purpose of the information statement is to provide simple, easy to understand information to a prospective franchisee of the risks and rewards in franchising before it makes the psychological commitment to the relevant franchised business.

The timing for providing an information statement is not fixed, however, a franchisor should not allow delays once a formal application or an expression of interest has been received. For example, many franchise system require a prospective franchisee to complete an online application form and provide details if interested in acquiring a franchise. This would be considered a formal expression of interest by a prospective franchisee. If the franchisor does not have an application form, it must exercise its best judgment about what is a formal expression of interest in acquiring a franchised business.

Example 1: Vinh’s Hot Cars receives an unsolicited phone call from Karen asking general questions about its franchise system. After Vinh’s Hot Cars has answered those questions, Karen says that she would like to think about it.

In this situation Vinh’s Hot Cars would not be expected to provide Karen with an Information Statement.

Example 2: Niew Homewares receives an unsolicited phone call from Chloe who asks questions about its franchise system, including about competing businesses, qualifications she might need to run the franchise and financing.

In this situation Niew Homewares would not be expected to provide Chloe with an Information Statement, though it might be advisable.

Example 3: The manager of the RMK Bakehouse franchise system receives a phone call from Julia, who she previously met at a trade fair. Julia asks detailed questions about the RMK Bakehouse franchise system, the price of a franchise and the next steps in obtaining more information on the system. RMK Bakehouse directs Julia to the application form on its website, which Julia completes.

In this situation RMK Bakehouse must provide Julia with an Information Statement as soon as practicable after it receives the completed application form.

Part 3: Franchise agreements

Clause 12: Application of Part—master franchisors

Clause 12 exempts a ‘master franchisor’ from compliance with this Part in relation to a ‘subfranchisee’ , unless the master franchisor is a party to the franchise agreement (see above chart in relation to clause 4).

Similar to clause 7, the effect of this clause is to limit the disclosure a master franchisor is required to provide to a subfranchisee. This provides for a significant reduction in compliance and administrative costs for both master franchisors and subfranchisees.

A master franchisor is still required to comply with the Franchising Code in relation to a subfranchisor.

Clause 13: Copy of lease etc.

Clause 13 requires a franchisor to provide a franchisee with documents (copy of lease or agreement to lease) and information where the franchisee leases premises from the franchisor or an associate of the franchisor. This includes the provision of details on any incentives or financial benefits that the franchisor or associate is entitled to receive as a result of the lease or agreement to lease. A failure to provide a franchisee with a copy of documents and information may leave the franchisor liable to a civil penalty.

The franchisor must also provide those documents within one month of the lease or agreement being signed by the parties. A failure to provide required documents within that time period may also leave the franchisor liable to a civil penalty.

A franchisor has a similar obligation where the franchisee occupies premises that are leased by the franchisor or an associate of the franchisor, without a lease. A failure to provide required documents or to provide them within the time period specified may leave the franchisor liable to a civil penalty.

By virtue of the application provision in subclause 3(1), clause 13 applies when a lease of premises is entered into on or after 1 January 2015, or when the commencement of the occupation, without a lease, occurs on or after 1 January 2015.

It should be noted that section 2 of the *Competition and Consumer (Industry Codes—Franchising) Repeal Regulation 2014* provides that an obligation that arose under the 1998 Code that remains outstanding after 1 January 2015 continues despite the repeal of that Code. In other words, a party would not be liable for a breach of the Franchising Code where the obligation in question arose in relation to a comparable obligation under the 1998 Code and fulfilled accordingly.

<u>Example 1</u>

On 1 April 2015, a franchisor, Blood and Chocolate Pty Ltd, negotiates a lease with Costello Shopping Town for premises for a franchised business. It signs the lease on 1 April 2015 and sends it to Costello Shopping Town for it to sign on the same day.

Blood and Chocolate enters into a franchise agreement with Declan McManus for the Costello Shopping Town site on 2 April 2015.

Blood and Chocolate is required to provide Mr McManus with a copy of the lease by 2 May 2015 (and information on any incentives it received as a result of the lease) or it may be liable for a civil penalty.

<u>Example 2</u>

On 10 December 2014, a franchisor, Dr Hackenbush Vitamins, enters into a lease for a shop at Dumont Shoppingworld's Fredonia Shopping Village, in anticipation of it entering into a franchise agreement with a franchisee. After signing the lease on 10 December, Dr Hackenbush Vitamins sends the lease to Dumont Shoppingworld's head office for its signature.

On 15 December 2014, Dr Hackenbush Vitamins enters into a franchise agreement with Chico Ravelli. Mr Ravelli occupies the premises at Fredonia Shopping Village, without entering into a sublease with Dr Hackenbush Vitamins.

Subclause 14(3) of the 1998 Franchising Code requires Dr Hackenbush Vitamins to provide Mr Ravelli with a copy of the lease it has with Dumont Shoppingworld within one month of it being signed by both it and Dumont Shoppingworld. Aware of its obligations under the

1998 Code, before entering into the franchise agreement and allowing Mr Ravelli to occupy the premises, Dr Hackenbush Vitamins makes inquiries with Dumont Shoppingworld's about the lease. Dumont Shoppingworld advises Dr Hackenbush Vitamins that it signed the lease on 14 December 2014 and will send it as soon as possible.

Dr Hackenbush Vitamins has still not received the signed lease by 15 January 2015.

Dr Hackenbush Vitamins is in breach of subclause 14(3) of the 1998 Code, however, because of the operation of item 2 of Schedule 1 to the *Competition and Consumer (Industry Codes—Franchising) Repeal Regulation 2014*, this is an outstanding obligation that arose under the repealed 1998 Code. Therefore, it is not liable for a civil penalty under the new Franchising Code.

Clause 14: Copy of other agreements

Subclause 14(1) provides that where a franchise agreement requires the franchisee to enter into other agreements, as set out in subclause 14(2), the franchisor must give the franchisee a copy of those other agreements within the time frame provided for in subclause 14(3). A failure to provide the required agreements in accordance with subclause 14(1) may leave the franchisor liable to a civil penalty.

Subclause 14(3) provides that the document referred to in subclause (2) must be given at least 14 days before the franchise agreement is signed or, if it is not available, as soon as it becomes available.

By virtue of the application provision in subclause 3(1), clause 14 applies to franchise agreements entered into on or after 1 January 2015.

Clause 15: Copy of financial statements

Clause 15 concerns the administration of a marketing or other cooperative fund, including requirements to prepare an audited financial statement about the fund. It relates only to funds into which franchisees are required to pay money and only where the franchisor or an associate of the franchisor has control over the fund. In conjunction with clause 31, clause 15 seeks to strengthen the management of marketing and other cooperative funds. A failure to provide copies of financial statements in accordance with this subclause may leave the franchisor liable to a civil penalty.

However, subclause 15(2) provides that a franchisor is not required to have the statement audited if 75 per cent of the franchisees in Australia that contribute to the fund have voted to allow the franchisor to avoid this obligation in respect of a financial year. This vote must take place within three months after the end of the financial year.

The Franchising Code does not prescribe a process for conducting franchisee votes required by subclause 15(2). This recognises the diverse nature and structure of franchise systems and provides flexibility for voting to be conducted in a way that best suits the franchise system. The underpinning objective is to allow franchisees to collectively determine, in an equitable manner, whether further scrutiny is warranted for marketing and cooperative funds for a particular financial year.

Subclause 15(3) allows the reasonable costs of administering and auditing the fund to be paid from the fund, if a franchisee is required to pay into it by the franchise agreement.

> Example: Kate's Fashions has 50 franchisees within its system. It operates another 10 franchise units itself. All franchisees contribute to the system's marketing fund. The size of contributions is calculated based on the size of the franchisee's territory. In accordance with clause 31 of the Franchising Code, the units Kate's Fashions operates contribute to the marketing fund on the same basis as the other units.
>
> Kate's Fashions feels it is too costly to audit the financial statements for the marketing fund each year. In accordance with subclause 15(2), on 20 August 2015, it holds a vote of its franchisees to approve that decision. Kate's Fashions may vote on behalf of the units it operates, as it would be considered 'a person who otherwise participates in a franchise' under the definition of franchisee in clause 4.
>
> Of the 60 franchises entitled to vote, 43 vote in favour of the proposal not to have audits conducted, 14 vote against the proposal and 3 do not vote at all.
>
> This does not allow Kate's Fashions to avoid having to audit the marketing fund. This is because clause 15 requires 75 per cent of franchisees in Australia who contribute to the fund (that is, 45 franchisees), to vote for the proposal for it to succeed.

Clause 16: Disclosure document

Subclause 16(1) allows a franchisee to request a franchisor to provide it with a disclosure document. Subclause 16(2) provides that a franchisee that makes a request of this sort cannot do so again for twelve months after making that request.

This clause is designed to assist a franchisee to make an informed decision on whether or not to renew or agree to an extension of the franchise agreement. A failure to provide a disclosure document within the time period stated in the clause may leave the franchisor liable to a civil penalty.

Where a franchisor is required, by subclause 8(6), to update its disclosure document each year, the franchisee is entitled to receive the franchisor's most recently updated disclosure document.

However, where the franchisor comes within the exception in subclause 8(7), the franchisor may not have a recently updated disclosure document. In that case, subclause 8(8) requires that the franchisor must provide a disclosure document updated to the end of its previous financial year. It has two months to do so. While this two month period is less than the four months allowed to update a disclosure document under subclause 8(6), it should be noted that the franchisor has had the convenience of not updating its disclosure document for some time before the request is made. As noted above, the Franchising Code does not prevent a franchisor that comes within subclause 8(7) from updating its document on a regular basis.

Franchisors should also be mindful of the obligation to act in good faith in clause 6 of the Franchising Code and the provisions of the Australian Consumer Law relating to misleading or deceptive conduct, which may be relevant to the obligation to provide a disclosure document under clause 16.

Clause 17: Disclosure of materially relevant facts

Clause 17 sets out obligations on the franchisor to provide a franchisee or prospective franchisee with 'materially relevant facts' that are not included in the disclosure document.

Subclause 17(1) provides that if updated financial documents (being those documents referred to in item 21 of Annexure 1) become available between when the prospective franchisee receives the disclosure document and when it intends to enter into the franchise agreement, then at least one of those financial documents must be given to the prospective franchisee as soon as reasonably practicable, but in any event before the franchise agreement is entered into. A franchisor may be liable for a civil penalty if it fails to provide a prospective franchisee with a copy of the updated financial documents in accordance with subclause 17(1).

The franchisor has the choice of which financial document to provide where more than one is available at the required time and providing that document satisfies the obligation in clause 17.

This provision seeks to address an issue highlighted by the decision in *SPAR Licensing Pty Ltd v Mis QLD Pty Ltd*[13] in relation to providing a prospective franchisee with a current disclosure document. In that case, the franchisor, SPAR Licensing, provided a disclosure document to the prospective franchisee, Mis QLD, in July 2010, but the franchise agreement was not entered into until February 2011. In the interim, financial reports had become available which showed that the financial position of the franchisor had deteriorated considerably, however, those reports were not provided to the prospective franchisee.

[13] *SPAR Licensing Pty Ltd v Mis QLD Pty Ltd* [2014] FCAFC 50 (1 May 2014).

Financial details, such as the franchisor's solvency statement and financial reports, are often critical to the prospective franchisee's ability to make a reasonably informed decision about the franchise. This is particularly the case if those updated financial details reveal a significant downturn in the franchisor's financial position that is not reflected in the disclosure document which was given to the franchisee.

This provision does not oblige the franchisor to create any new documents, it only requires that the relevant documents be provided to the prospective franchisee if they become available before the prospective franchisee enters into the franchise agreement. It does not prevent a prospective franchisee from requesting from the franchisor the most recently updated disclosure document or updated financial statements prior to entering into the franchise agreement.

Subclause 17(2) requires a franchisor to provide a franchisee with the additional information set out in subclause 17(3). Failure to disclose any of the additional information required by clause 17 may leave the franchisor liable to a civil penalty.

Clause 17 must be read in conjunction with item 22 of Annexure 1 to the Franchising Code. Item 22 requires a franchisor to update any information given under clause 17 if this has changed between the date of preparation of the disclosure document and the date when this was provided under the Franchising Code.

Example: A franchisor, Schartz-Metterklume Education, provides a prospective franchisee, Hector Munro, with a disclosure document in December 2016. At the time it is provided, the document is up-to-date to the financial year ending 30 June 2016. For various reasons, Mr Munro does not enter into the franchise agreement until August 2017.

Between December 2016 and August 2017, new financial statements have been prepared for the franchisor.

Clause 17 requires Schartz-Metterklume Education to provide Mr Munro with the new financial statements before it enters the franchise agreement, regardless of whether they indicate an improvement or a deterioration in Schartz-Metterklume Education's financial position.

Clause 18: End of term arrangements

Clause 18(1) provides for a franchisor to give a franchisee notice, in writing, whether it intends to extend a franchise agreement or enter into a new agreement.

In the case of a franchisee agreement for a period of six months, subclause 18(2) effectively requires a franchisor to provide advice whether it intends to renew at the time it enters into the agreement.

Under subclause 18(3), if the franchisor intends to extend the agreement, it must advise the franchisee that it can request a disclosure document, subject to subclause 16(2).

Not providing notice of the franchisor's intentions (subclause 18(2)) or not advising the franchisee it can request a disclosure document, if the agreement is to be extended (subclause 18(3)), may leave the franchisor liable to a civil penalty.

Clause 19: Keeping certain information and documents

Under section 51ADD of the CCA, if a corporation is required to keep, to generate or to publish information or a document under an applicable industry code, then the ACCC may require that such information be provided to it for investigation and auditing purposes.

Clause 19 specifies that a franchisor must keep:

- each document, or a copy of each document, that it receives from a franchisee or prospective franchisee under the Franchising Code; and
- any document that supports a statement made in the franchisor's disclosure document.

Documents must be kept for a period of at least six years. This is in keeping with the limitation period on an action for a breach of the Franchising Code of six years.[14] Clause 19 does not affect a provision in any other legislation that requires a franchisor to keep a document for a longer.

The *Electronic Transactions Act 1999* (Cth) applies to any requirement to provide a document under the Franchising Code. Under clause 19, where a franchisee provides a document electronically, the franchisor is required to keep the document, but it is up to the franchisor whether it keeps an electronic or a hard copy. If the franchisor is required to provide a document to the ACCC that it has received electronically, it may do so in electronic form.

The purpose of these provisions is to allow the ACCC to access necessary documents to conduct its audit and enforcement functions in relation to the Franchising Code, under section 51ADD of the CCA. This strengthens the ACCC's ability to regulate the franchising sector, however, it does not require a franchisor to create a new document, and so should not significantly increase the administrative burden placed on franchisors by the extension of the audit power.

[14] See subsections 82(2) and 87(1CA) of the CCA.

Clause 20: Prohibition on release from liability etc

Clause 20 prohibits a franchise agreement from requiring a franchisee to sign a general release from liability or a waiver of any representations made by the franchisor. Any such clause in a franchise agreement is of no effect. This clause is disapplied for certain pre-commencement agreements to avoid raising constitutional issues (see subclauses 3(4) and 3(5)).

Clauses 21 and 22 are aimed at removing two potential barriers to franchisees pursuing their rights under the franchise agreement. The aim of these provisions is to reduce the barriers and costs to a franchisee in seeking access to justice and resolving disputes, as it is typically not as well-resourced as a franchisor.

Clause 21: Jurisdiction for settling disputes

Clause 21 provides that the franchise agreement must not contain a clause that requires a party to bring proceedings or seek mediation of a dispute in any jurisdiction, other than that in which the franchised business is based. If such a clause is included in the franchise agreement, it has no effect. This clause is disapplied for certain pre-commencement agreements to avoid raising constitutional issues (see subclauses 3(4) and 3(5)).

Clause 22: Costs of settling disputes

Clause 22 specifies that a franchise agreement must not contain a clause requiring the franchisee to pay the franchisor's costs in settling a dispute. Any such clause in an agreement will have no effect.

This provision is intended to capture clauses in franchise agreements that require the franchisee to pay for costs associated with settling a dispute, such as the franchisor's legal costs, travel costs, mediator fees and venue hire. It is not intended to prevent the parties entering into an agreement in relation to the franchisor's costs at any time after the franchise agreement has been entered into.

This clause is disapplied for certain pre-commencement agreements to avoid raising constitutional issues (see subclauses 3(4) and (5)).

Clause 23: Effect of restraint of trade clause if franchise agreement not extended

In the context of franchising, a restraint of trade clause seeks to impose a restriction on a franchisee's ability to open a business similar to the one conducted under the franchise agreement once the franchise arrangement has ended. As a general principle, in Australian law the test of the validity of a restraint of trade clause is whether it is 'justified as reasonable in the interests of both the parties.'[15]

The purpose of clause 23 is to limit the enforceability of a valid restraint of trade clause in a franchise agreement, or an ancillary document, if a narrow set of conditions can be met by the franchisee. Clause 23 applies only to restraint of trade clauses designed to prevent competition by a former franchisee. It does not apply to other restraint clauses, such as those that prevent a former franchisee approaching staff of the franchisor or using the franchise's intellectual property. For the clause to apply, <u>all</u> the conditions set out in subclause 23(1) must apply, though some conditions have options within them.

Paragraph 23(1)(a) provides that a franchisee must indicate, in writing, that it wants to 'extend the agreement on substantially the same terms' as the franchisor's then current franchise agreement (not necessarily the agreement the franchisee is on at the time the agreement ends).

At the same time, paragraph 23(1)(a) is intended to ensure the franchisor cannot offer the franchisee a substantially different agreement to that offered to other franchisees or prospective franchisees. In this regard the parties are reminded that their conduct in relation to the franchise agreement is still subject to the obligation to act in good faith in clause 6, even though the agreement has ended.

Whether or not a former franchisee is in breach of the agreement should, for the purposes of paragraph 23(1)(b), be assessed at the time the agreement expires.

Paragraph 23(1)(e) requires that the former franchisee has not received genuine compensation for goodwill at the expiry of the agreement. For example, compensation does not include compensation for goods returned or a rebate on moneys paid by the franchisee to the franchisor under the agreement. Subparagraph 23(1)(e)(i) <u>does not</u> mean that a franchisee will be assumed to have contributed to the goodwill in the franchised business and does not create a right to be compensated for any such contribution. In some cases the franchise agreement will not allow the franchisee to claim compensation for goodwill, in which case subparagraph 23(1)(e)(ii) will apply.

Where it can be shown that the former franchisee has contributed to the growth of the franchised business and has thereby generated goodwill in the franchised business, it is considered reasonable that the former franchisee be compensated for that, if it is to be

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[15] Russell V Miller, *Miller's Australian Competition and Consumer Law Annotated*, 36^{th} Edition 2014, p.648. See: *Nordenfelt v Maxim Nordenfelt Guns & Ammunition Co Ltd* [1894] AC 535; *Buckley v Tutty* (1971) 125 CLR 353, 46 ALJR 23, [1972] ALR 370; *Amoco Australia Pty Ltd v Rocca Bros Motor Co Engineering Pty Ltd* (1973) 133 CLR 288, 1 ALR 385, ATPR 40-001; *Peters American Delicacy Co Ltd v Patricia's Chocolates & Candies Pty Ltd* (1947) 77 CLR 574, 21 ALJR 281.

limited by a restraint of trade clause. Whether the compensation offered is genuine should be decided having regard to the circumstances of the case.

Clause 23 is intended to provide relief in special circumstances where a franchisee, through no fault of its own, has not had its franchise agreement extended by the franchisor. Preventing a former franchisee from continuing a similar business in an area, when it has materially contributed to the goodwill in the franchised business, would allow the franchisor to make a windfall gain in the value of the franchised business, with no opportunity for the former franchisee to leverage customer relationships it formed and local knowledge it gained while a franchisee.

The provision does not prevent a franchisor taking action where it believes a former franchisee has breached a restraint of trade clause. The onus will be on the former franchisee to show that it comes within the exception contained in clause 23. It is strongly recommended that a former franchisee seek legal advice on the applicability of clause 23 before acting contrary to a restraint of trade clause.

This clause is disapplied for certain pre-commencement agreements to avoid raising constitutional issues (see subclauses 3(4) and (5)).

Example: Capital Lunchvans is a mobile lunch vans franchise system, offering pre-prepared food, drinks and snacks. The lunch vans it uses are standard mobile food vans and do not contain any specialised equipment. The business model Capital Lunchvans uses is not innovative or unique. Its franchise agreement does contain a restraint of trade clause purporting to prevent a franchisee opening a competing lunch van or similar business within 5 kilometres of its original territory for a period of two years.

Glen was one of the first franchisees in the Capital Lunchvans system. He trained his staff and has a large number of regular customers who visit his van each day. He believes he has an excellent rapport with his customers.

In February 2015, seven months before the expiry of the franchising term Capital Lunchvans advises Glen that it will not be extending his franchise agreement. Glen is not in breach of the franchise agreement at that time, though he has been in breach in the past, but always remedied the breach. He emails Capital Lunchvans advising that he wants to extend the agreement on the terms Capital Lunchvans is offering other franchisees, or if that is not possible then to at least be compensated for the goodwill he believes he has created in the business.

Capital Lunchvans declines to pay Glen goodwill, arguing that it has provided him with the business, training and advertising and that it is largely responsible for any success of the business.

In March 2016, Glen purchases a café in a building within his old Capital Lunchvans territory. He also delivers lunches to offices in the building in which his café is located.

Capital Lunchvans believes Glen's new business competes with the franchisee who has taken over Glen's old territory, however, on these facts it is unlikely that it would be able to enforce its restraint of trade clause against Glen. While Glen's new business is likely to be considered a similar business to a lunch van, he appears to have satisfied the conditions of clause 23.

Clause 24: Request for franchisor's consent to transfer

Clause 24 relates to a request to a franchisor to agree to a transfer of a franchise agreement.

Clause 25: Franchisor's consent to transfer

Clause 25 relates to a franchisor's decision whether or not to consent to a transfer and sets out some of the circumstances in which consent may reasonably be withheld or revoked. The clause also provides that the franchisor cannot unreasonably withhold or revoke its consent.

Clauses 26 to 30 address how the parties should deal with the termination of a franchise agreement.

Clause 26 – Termination – cooling off period

Clause 26 provides for a seven day cooling-off period, after the franchisee enters into the franchise agreement or makes any payment under the agreement, during which a franchisee may terminate an agreement or an agreement to enter into a franchise agreement.

Failure by the franchisor to repay all payments made by the franchisee, less reasonable expenses if the agreement is terminated, may attract a civil penalty.

Clause 27: Termination – breach by franchisee

Clause 27 sets out the procedure for termination of an agreement by the franchisor where the franchisee is in breach of the agreement and the franchisor proposes to terminate the agreement because of that breach. The franchisor must give the franchisee written notice that it proposes to terminate the agreement, advise it what must be done to remedy the breach and give the franchisee reasonable time to remedy the breach.

Failure by the franchisor to give the required notice may attract a civil penalty.

Clause 28: Termination – no breach by franchisee

Clause 28 sets out the procedure for termination of an agreement where there is no breach by the franchisee. This clause applies where the franchisor terminates the franchise agreement in accordance with the agreement, before it expires and without the consent of the franchisee.

Subclause 28(2) provides that 'a condition of a franchise agreement that a franchisor can terminate the franchise agreement without the consent of franchisee is not taken to be consent'. The effect of this provision is that a franchisor must comply with clause 28 and give notice, even if there is a provision in the franchise agreement that states that the franchisee consents to termination where it has not breached the agreement.

Subclause 28(3) provides that the franchisor is required to give the franchisee 'reasonable written notice [of the decision to terminate the agreement] … and the reasons for it'. What is 'reasonable' should be considered in all the circumstances of the case. Failing to give the franchisee notice of the termination and reasons for the decision may attract a civil penalty.

Clause 29: Termination – special circumstances

Clause 29 <u>does not</u> create a substantive right for the franchisor to terminate an agreement. It sets out circumstances in which a franchisor does not have to follow the procedures set out in clauses 28 and 29 when terminating a franchise agreement.

Subclause 29(1) exempts the franchisor from compliance with clauses 27 and 28, where the franchise agreement already contains a provision allowing a franchisor to terminate for one of the reasons outlined in subclause 29(1). The terms of the franchise agreement are a matter for negotiation between the parties. The reference in paragraph 29(1)(a) to 'licence' is aimed at covering a broad range of requirements, including any qualification, authority, permit or other requirement the franchisee is required to hold to carry on the business.

Subclause 29(2) provides an exception to the procedures set out in clauses 27 or 28, where the parties mutually agree to terminate the agreement 'at the time of termination'. This provision protects a franchisee from potentially waiving its right to receive 'reasonable notice' before termination at the outset of the agreement, at a time when there may be an imbalance in bargaining power or an overly optimistic view of the future franchise relationship.

If the franchisor seeks to terminate the agreement on grounds other than those in subclause 29(1), it must still comply with either clause 27 or 28, as the case may be.

<u>Example:</u> Chicago Steve's Speakeasy is a franchisor of American style restaurants. Its franchise agreement contains clauses setting out procedures for terminating the agreement

if the franchisor becomes insolvent, if a franchisee becomes insolvent or if a franchisee abandons the business.

Situation 1: Chicago Steve's Speakeasy's St Kilda franchisee breaches the agreement. If Chicago Steve's Speakeasy decides to terminate the agreement before it expires, it must follow the procedure set out in clause 27 of the Franchising Code. If the franchisee does not remedy the breach, Chicago Steve's Speakeasy can terminate in accordance with the agreement.

Situation 2: Chicago Steve's Speakeasy has been in dispute with its Bondi franchisee about a number of issues but the franchisee has not breached the agreement. If Chicago Steve's Speakeasy decides to terminate the agreement before it expires, it must give reasonable notice and reasons for the decision to terminate the agreement, in accordance with clause 28 of the Franchising Code.

Situation 3: Chicago Steve's Speakeasy's Gold Coast franchisee, without notice, closes the doors of the restaurant and leaves Australia. After it has established that the franchisee has abandoned the business voluntarily, Chicago Steve's Speakeasy may terminate the agreement in accordance with the procedure set out in the agreement. However, under clause 29, it does not have to comply with clauses 27 or 28 in doing so, as this situation is covered in the franchise agreement.

Clause 30: Capital Expenditure

Subclause 30(1) prohibits a franchisor from requiring a franchisee to undertake significant capital expenditure in relation to the franchised business.

Subclause 30(2) sets out the circumstances in which a franchisor can require a franchisee to undertake capital expenditure. It seeks to address concerns that a franchisor can demand significant capital expenditure from a franchisee without forewarning and without providing any commercial or economic justification for the demand. At the same time, the clause recognises that a franchisor has responsibility for the management of the franchise system as a whole and should maintain reasonable flexibility to respond to changing laws, market dynamics and economic pressures, which may require significant capital expenditure by the franchisee to benefit the franchise system as a whole.

Paragraph 30(2)(a) does not require the franchisor to state the exact amount of the capital expenditure in the disclosure document. The statement justifying the capital expenditure in paragraph 30(2)(e) is intended to provide an objective justification for the expenditure. This statement should be in writing and should be provided to each of the franchisees that are being required to undertake the significant capital expenditure.

The objective of clause 30 is to improve transparency and provide reasonable justification to franchisees in respect of capital expenditure in the franchised business.

The exemption in subclause 30(2)(b) from the general prohibition in subclause 30(1) refers to a 'majority of franchisees' that will incur the capital expenditure. The Franchising Code does not prescribe a method for how this majority should be determined, to allow flexibility for franchise systems to make this determination in an appropriate and equitable manner.

The clause aims to foster cooperation between the parties in relation to significant capital expenditure by ensuring there is communication and explanation about the need for expenditure, either before the agreement is entered into or when the need arises.

Franchisors are reminded that a statement justifying the expenditure must not breach the obligation to act in good faith or be misleading or deceptive, whether by act or omission, in breach of the Australian Consumer Law.

Example: A franchise system, David Andrew Sportswear, has found that over the five years since it began operation, the core business of the franchise system has changed such that its name is no longer descriptive of much of its business, its e-commerce platform has grown considerably and its accounting systems are out of date and slow.

David Andrew Sportswear decides, after obtaining professional advice and in consultation with the franchisee representative council, to change its name to DA Gear, refit its shopfronts and upgrade its computer systems. It advises all franchisees of its decision and that each of them will be liable for a capital expenditure payment of $45,000 for the fit out and upgrade.

In the above circumstances, David Andrew Sportswear's options for requiring franchisees to undertake the significant capital expenditure include:

- providing existing franchisees with a statement setting out the rationale for the investment being proposed, the amount involved, the anticipated outcomes, benefits and expected risks of the proposed investment; or
- obtaining the approval of a majority of franchisees for the proposed investment.

Clause 31: Marketing and advertising fees

Clause 31 sets out procedures relating to the management of marketing and advertising fees paid by franchisees. It requires the franchisor to maintain a separate account for these fees and, in relation to franchisor operated franchise units, pay fees on the same basis as other franchisees.

In conjunction with clause 15, clause 31 seeks to maintain a high-level of transparency about the management of marketing and advertising funds. Subclause 31(3) provides that marketing or advertising fees may only be used to meet expenses that have been disclosed in the disclosure document, are ‘legitimate marketing or advertising expenses’ or ‘have been agreed to by a majority of franchisees’ or to pay the reasonable costs of administering or auditing the fund.

Legitimate marketing and advertising expenses are not defined by the Franchising Code. This is a matter for the parties to determine, however, it is noted that during the course of Mr Wein’s Review examples were cited of marketing funds being used for expenses such as attendance at a franchising convention, as distinct from a trade fair, repainting head office and the registration and maintenance of existing or new trademarks. Careful consideration should be given to whether these activities could be considered legitimate marketing expenses.

The Franchising Code does not prescribe a method for how a ‘majority of franchisees’ should be determined. This allows flexibility for franchise systems to make this determination in the most appropriate and equitable manner considering the circumstances of the franchise system.

Clause 32: Disclosure of former franchisee details

Item 6 of Annexure 1 requires a franchisor to include details of former franchisees in its disclosure document. Clause 32 allows a former franchisee to request, in writing, that its details not be disclosed to a prospective franchisee and prohibits a franchisor from disclosing those details.

A franchisor may be liable for a civil penalty if it does something with the intention of inducing a former franchisee to make or not to make a request that its details not be disclosed.

The clause aims to assist a prospective franchisee in conducting its due diligence before entering into an agreement, by ensuring, as far as possible, that the prospective franchisee can speak to as many former franchisees about the system as it wishes, while reducing the potential for former franchisees to be hassled by a franchisor when they do not wish to be contacted by prospective franchisees.

Clause 33: Association of franchisees or prospective franchisees

Clause 33 prevents a franchisor from engaging in conduct that would restrict franchisees or prospective franchisees from forming an association for a lawful purpose. A franchisor may be liable for a civil penalty if it breaches this requirement.

Part 4: Resolving disputes

An essential feature of the Franchising Code is the establishment of a dispute resolution framework under Part 4 to allow franchisors and franchisees to resolve disputes in a cost effective and timely manner, without the need for litigation.

Part 4 of the Franchising Code allows the franchise system to devise and operate its own internal dispute resolution procedure, provided it meets certain minimum standards, as set out in the Franchising Code. In other words, the parties may follow a complaints handling procedure of their own devising (a procedure under the franchise agreement), or they can utilise the Code complaints handling procedure set out in Division 3 of Part 4 of the Franchising Code.

This provides flexibility to allow the parties to adopt the franchisor's internal complaint handling procedure. For example, a complaint handling procedure may include additional steps the parties are to take during mediation or specify details that have been agreed to in relation to handling complaints, such as the preferred mediator or timeframes for mediation. Alternatively a franchise system may adopt the Franchising Code's basic dispute resolution procedure. It should be noted that the Franchising Code's basic dispute resolution procedure adopts the same minimum requirements provided for the internal complaint handling procedure, however it includes further provisions in relation to the termination and cost of mediation.

Clause 34: Internal complaint handling procedure

Clause 34 requires a franchise agreement to include a complaint handling procedure, which contains the obligations set out in Division 2 of Part 4 of the Code (clauses 38 and 39). These are the minimum standards which must apply to the franchisor's internal complaint handling procedure.

Clause 35: Resolving disputes

Clause 35 allows a party to an agreement to commence a dispute resolution procedure, either under the procedure set out in the agreement or under the procedure set out in Division 3 of Part 4 of the Franchising Code (clauses 40 to 43).

This means that a party to the franchise agreement may choose not to follow the complaints handling procedure set out in the agreement, but rather utilise the procedure in the Franchising Code.

Clause 36: When a party is taken to be trying to resolve a dispute

Clause 36 sets out examples of the behaviours a party should exhibit if it is to be taken to be trying to resolve the dispute in a reconciliatory manner.

Clause 37: Right to bring proceedings unaffected

Clause 37 specifies that Part 4 of the Franchising Code does not affect a party's right to bring legal action under the agreement or otherwise.

Clauses 38 and 39 set out the minimum standards for a franchise system's internal complaint handling procedure.

Clause 38: Notification of dispute

Where the parties to a franchise agreement decide to pursue the internal complaint handling procedure in the agreement, clause 38 requires that procedure to provide for the complainant in a dispute to give the respondent written notice in relation to the dispute. That procedure must provide that, if the parties cannot reach an agreement on how to resolve the dispute within three weeks, either party may refer the matter to a mediator for mediation. Subclause 38(3) states that this can be either under the franchisor's internal complaint handling procedure or under the Franchising Code's complaints handling procedure.

Clause 39: Mediation

Subclauses 39(1) and (2) provide that the mediator may decide the time and place for mediation, which must be conducted in Australia. Subclause 39(3) requires the parties to attend the mediation.

Subclause 39(5) requires the parties to try to resolve the dispute. This provision should be read in conjunction with clause 36 which sets out circumstances in which a party is taken to be trying to resolve a dispute.

An internal complaints handling procedure must provide the rights and obligations set out in clauses 38 and 39. A breach of a provision in an internal complaints handling procedure that is required by the Franchising Code is also a breach of the Franchising Code, and in the case of subclause 39(3), a breach may result in a civil penalty.

Division 3 of Part 4 of the Franchising Code (clauses 40 to 43) sets out the basic standards for a complaint handling procedure under the Code. Clauses 40 and 41 of Division 3 are identical to clauses 38 and 39 in Division 2, making it clear that certain minimum standards apply to both dispute resolution procedures under an agreement and the Code.

Clause 40: Notification of dispute

Where the parties to a franchise agreement decide to pursue the complaints handling procedure set out in Division 3 of Part 4, clause 40 provides for the complainant in a dispute to give the respondent written notice in relation to the dispute. If the parties cannot reach an agreement on how to resolve the dispute within three weeks, either party may refer the matter to a mediator for mediation. Subclause 40(3) states that this can be either under the franchisor's internal complaint handling procedure or under the Franchising Code's complaints handling procedure.

Clause 41: Mediation

Subclauses 41(1) and (2) provide that the mediator may decide the time and place for mediation, which must be conducted in Australia. Subclause 41(3) requires the parties to attend mediation. A party may be liable for a civil penalty for failing to attend mediation.

Subclause 41(5) requires the parties to try to resolve the dispute. This provision should be read in conjunction with clause 36 which sets out circumstances in which a party is taken to be trying to resolve a dispute.

Clause 42: Termination of mediation

Clause 42 provides for termination of mediation by the mediator and the process to be followed when the mediator makes that decision.

Clause 43: Cost of mediation

Clause 43 provides that the parties are equally liable for the costs of mediation, unless they agree otherwise, and that they must pay their own costs of attending the mediation.

Clause 44: Mediation adviser

Clause 44 requires the Minister to appoint a mediation adviser for the purposes of Part 4 of the Franchising Code. Section 6 of the Regulation specifies that the appointment of the mediation adviser under the repealed *Trade Practices (Industry Codes—Franchising) Regulations 1998* continues despite the repeal of those Regulations.

Clause 45: Mediator

Clause 45 requires the mediation adviser to appoint a mediator for a dispute within 14 days of the referral or request by the parties of the dispute under clauses 38 or 40.

Annexure 1: Disclosure document for franchisee or prospective franchisee

Annexure 1 to the Franchising Code sets out the form and content of the disclosure document a franchisor is required to create under clause 8 and provide to franchisees and prospective franchisees under clauses 9 and 16. A disclosure document must include:

Item 1: First page

On page 1, certain information and a prescribed statement about the disclosure document and the franchising relationship.

Item 2 – Franchisor details

Details of the franchisor's business, including the names of associates of the franchisor and its relationship with those associates.

Item 3: Business experience

Details of the business experience of the franchisor and each person mentioned in item 2, over the previous ten years.

Item 4: Litigation

Details of litigation involving the franchisor, a director of the franchisor or an associate of the franchisor.

Item 5: Payments to agents

Details of payments by the franchisor 'in connection with the introduction or recruitment of a franchisee'.

Item 6: Existing franchises

The names and contact details of franchisees, and details of franchised businesses which were transferred or ceased to operate during the previous three years.

Item 7: Master franchises

Where the franchisor is also a subfranchisor, information about the master franchisor and the master franchise agreement.

Item 8: Intellectual property

Details of intellectual property, which includes 'any trade mark … patent, design or copyright that is material to, the franchise system'.

Item 9: Franchise site or territory

Where the franchise is for an 'exclusive or non-exclusive territory [or is] limited to a particular site', details of the relevant site or territory.

Item 10: Supply of goods or services to a franchisee

Details of ‘the franchisor’s requirements for supply of goods or services to a franchisee’, including the franchisor’s obligations to supply goods and services.

Item 11: Supply of goods or services by a franchisee

Details of ‘the franchisor’s requirements for the supply of goods or services by a franchisee’.

Item 12: Supply of goods or services – online sales

Details of online sales of goods and services by the franchisor or an associate of the franchisor and franchisees.

Online sales, and e-commerce in general, are now an important part of the operations of many franchise systems. However, until now there was no specific obligation on the part of a franchisor to include information about online sales in the disclosure document.

Item 12 sets out the information the franchisor must disclose to a prospective franchisee or franchisee if the franchisee may make goods or services available online, if the franchisor or an associate of the franchisor may do so and if the franchisor may or is expected to make goods or services available online in the future.

Item 12.5 requires a franchisor to provide details of arrangements that would affect the franchisee, directly or indirectly, including agreements with third parties and other franchisees.

This item seeks to promote transparency in this growing part of the franchising sector. The parties to the franchise agreement should approach disclosure under this item with the obligation on parties to act in good faith in mind.

<u>Example:</u> Time Peace is a franchisor of shops that sell and repair watches and clocks. In response to increased traffic and comments on its website, Time Peace begins to sell watches, clocks and related paraphernalia, such as watch bands and chains, and personalised time pieces, online, from a website it controls.

The personalised time pieces are made to order by the creator of Time Peace in his own workshop. This is time consuming and expensive and sales are relatively small. For those reasons they are not sold in franchised shops; they are only available online. Time Peace also offers personalised timepieces on sites such as eBay, GraysOnline and Gumtree. It has found most sales are word of mouth, so Time Peace shares some of the profit from sales with people that refer sales of personalised timepieces.

Time Peace's disclosure document states that it may sell watches, clocks and related paraphernalia online, and that it will share the profit from any sales with the franchisee within whose territory the purchaser of the goods lives. The disclosure document does not refer to the sale of personalised timepieces.

Even though personalised timepieces are only available from the Time Peace website, it is likely they would be considered 'goods of the same type' as those being sold by Time Peace franchisees, as they are in competition with clocks and watches sold in franchised businesses. Time Peace should, therefore, disclose that it sells them on other websites. However, it would not be required to include the details of the terms and conditions of sale of websites it does not control, such as eBay. If it is unsure about this point, Time Peace should obtain legal advice.

In relation to its profit sharing arrangements with third parties, Time Peace need only disclose arrangements that would affect the franchisee.

One of Time Peace's franchisees decides to sell its own range of personalised watches and clocks online. It uses eBay, as well as a site it sets up itself. As Time Peace's disclosure document does not refer to the sale of personalised clocks and watches, the franchisee is not in breach of its agreement.

Item 13: Sites or territories

The franchisor's policy for selection of the site or territory of the franchised business, including information about a franchised business for that site that ceased to operate.

Item 14: Other payments

Details of any payments required from a franchisee, such as payments before the franchise agreement is entered into, start-up costs for the franchised business and payments by a franchisee to the franchisor or an associate of the franchisor. This includes details of 'why the money is required, how the money is to be applied and who will hold the money.'

Item 15: Marketing or other cooperative funds

Details of marketing and cooperative funds 'controlled or administered by or for the franchisor, to which the franchisee may be required to contribute'.

Item 16: Financing

The 'material conditions' of any financing arrangement offered to the franchisee by the franchisor 'for the establishment or operation of the franchised business'.

Item 17: Unilateral variation of franchise agreement

The circumstances 'in which the franchisor has unilaterally varied a franchise agreement in the last 3 financial years' and the circumstances in which it may unilaterally vary an agreement in the future.

This provision does not relate to operations manuals, unless they are considered part of the franchise agreement. Whether or not this is the case will depend on the terms of the agreement.

Item 18: Arrangements to apply at the end of the franchise agreement

'(T)he process that will apply in determining arrangements to apply at the end of the franchise agreement', including whether the franchisor has, in the previous three years, considered significant capital expenditure by franchisees in determining end of term arrangements.

The item includes statements that must be included in the franchise agreement that set out for a franchisee the arrangements that apply at the end of the agreement.

The reference to 'an option' in item 18.1(a) includes a reference to a legal right.

Item 19: Amendment of franchise agreement on transfer of franchise

Whether the franchisor will amend the franchise agreement on transfer of the franchise.

Item 20: Earnings information

If earning information for a franchise business is given, historical earnings data, the assumptions on which any projected earnings are based and any other information from which financial details of the franchised business can be assessed. This clause does not require earnings information to be included in the disclosure document.

Item 21: Financial details

A statement reflecting the franchisor's solvency and financial records for the previous two completed financial years.

Item 22: Updates

Any materially relevant facts, as required under clause 17 of the Franchising Code, that have changed between the date of the disclosure document and the date it is given to the franchisee.

Item 23: Receipt

A statement that the prospective franchisee can keep the disclosure document and a form on which it can acknowledge it has received the disclosure document.

Annexure 2: Information statement for prospective franchisee

Annexure 2 sets out the information statement required by clause 11 of the Franchising Code.

The information statement sets out general information that should be considered by a prospective franchisee before entering into a franchise agreement including an explanation of what franchising is and what the franchising relationship involves, the risks of franchising, information on where to obtain more information and online education courses on franchising.

Attachment C

Transition from the 1998 Code to the Franchising Code

Provisions relating to the transition from the 1998 Code to the Franchising Code are found in section 5 of the Regulation, clauses 3 and 8 of the Franchising Code and item 2 of Schedule 1 of the *Competition and Consumer (Industry Codes—Franchising) Repeal Regulation 2014.*

Subclause 3(1) states:

> Subject to subclause (4), this Code applies to conduct occurring on or after 1 January 2015 (other than to discharge an outstanding obligation that arose under the old Code) in relation to a franchise agreement entered into on or after 1 October 1998.

Conduct, in this instance, should be given a broad meaning, including requirements and obligations arising under the Franchising Code after 1 January 2015. This is in accordance with the policy principle that the Franchising Code should apply as widely as possible and to as many franchise agreements as legally permissible.

Subclause 3(4) provides that provisions of the Franchising Code do not apply to certain franchise agreements.

- Subclause 21(2) and clauses 22 and 23 do not apply in relation to agreements entered into on or after 1 March 2008 but before 1 January 2015.

- Paragraph 20(1)(b), subclause 21(2) and clauses 22 and 23 do not apply in relation to agreements entered into on or after 1 October 1998 but before 1 March 2008.

However, subclause 3(4) does not apply if the franchise agreement has been varied or transferred on or after 1 January 2015 (subclause 3(5)). For example, an extension of the term of a franchise agreement on or after 1 January 2015, made with the agreement of both the franchisor and the franchisee, is a variation of the agreement.

Subclause 8(1) requires a franchisor to create a disclosure document that complies with subclauses 8(3), (4) and (5). This is conditioned by subsection 5(1) of the Regulation, which provides that subclause 8(1) does not apply if the franchisor has an existing disclosure document. An 'existing disclosure document' is defined as a disclosure document within the meaning of the 1998 Code that exists on 1 January 2015.

Subsection 5(2) states that where a franchisor has an existing disclosure document:

> (a) the existing disclosure document may be given under the new code before 1 November 2015;

(b) the franchisor must update the existing disclosure document so that it complies with subclauses 8(3), (4) and (5) of the new code by 31 October 2015; and

(c) the requirements of subclause 8(6) of the new code apply to a financial year that begins on or after 1 January 2015.

The effect of paragraph 5(2)(c) is that, once a franchisor has updated its existing disclosure document, its schedule for updating the disclosure document reverts to its normal financial year.

The aim of these provisions is to create certainty within the sector about the timing and scope of the obligation to update disclosure documents taking into account the fact that under the Franchising Code franchisors may choose to adopt a financial year that ends on a date other than 30 June. It allows a franchisor sufficient time to transition and update its disclosure document to comply with the Franchising Code.

The table below sets out a sample of possible financial years.

Financial year	**End of financial year beginning after 1 January 2015**	**Next update after 31 October 2015 by**
1 January – 31 December	31 December 2015	1 May 2016
1 April – 31 March	31 March 2016	1 August 2016
1 July – 30 June	30 June 2016	1 November 2016
1 October – 30 September	30 September 2016	1 February 2017

A franchisor whose financial year means it does not have to update its disclosure document for more than 12 months after 31 October 2015 should bear in mind the obligations in clause 6 relating to good faith and clause 17 to provide materially relevant facts, as well as the requirements of the Australian Consumer Law not to engage in misleading or deceptive conduct.

This does not mean that a franchisor cannot update the disclosure document at any time before 1 November 2015. It is open to a franchisor to choose to update the document earlier. Once a disclosure document has been updated in accordance with paragraph 5(2)(b), the other provisions of the Franchising Code apply, so that a franchisor is required to comply with subclause 8(6) or subclause 8(7), as the case may be.

Item 2 of Schedule 1 of the *Competition and Consumer (Industry Codes—Franchising) Repeal Regulation 2014* provides that an obligation that arose under the 1998 Code that is still outstanding on 1 January 2015 continues despite the repeal of the 1998 Code.

Attachment D

Australian Government

The Treasury

Regulation Impact Statement

Proposed changes to franchising regulation

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1. Executive summary

The franchising sector is primarily regulated by the *Competition and Consumer Act 2010* (CCA). The Franchising Code of Conduct (Franchising Code) is a mandatory industry code prescribed by regulation under the CCA. The Australian Competition and Consumer Commission (ACCC) is responsible for taking enforcement action under the CCA and/or the Franchising Code in appropriate cases.

Amendments to the Franchising Code and the CCA are prepared by the Office of Parliamentary Counsel (OPC) on instructions from the Treasury. Treasury advises the Minister for Small Business, who is primarily responsible for provisions of the CCA relating to industry codes, including the Franchising Code.

The purpose of this Regulation Impact Statement (RIS) is to inform the Australian Government's decision with regard to amending the CCA and the Franchising Code to:

- Provide the ACCC with additional enforcement tools, to deter parties from breaching the Franchising Code and allow the ACCC more flexibility in pursuing breaches; and
- Implement the Government's commitment to refine the Franchising Code, including by acting on recommendations made following an independent review conducted in early 2013, and pursuing other opportunities to reduce compliance costs and remove unnecessary regulation.

These amendments will have the effect of strengthening national franchising regulation.

This RIS provides a detailed analysis of the regulatory impacts of proposed changes that underpin the policy development process. It is the culmination of a multi-stage consultation process which considered a range of policy options. This RIS is a single stage impact analysis and is intended to be read in conjunction with exposure drafts of legislation showing the detail of changes to:

- The CCA; and
- The Franchising Code.

These documents are included at **Attachments A** and **B** respectively.

2. Background

2.1. The Franchising Sector

The franchising sector is an important component of Australia's small business sector, with approximately 73 000 franchises and approximately 1180 franchisors in Australia, and an annual turnover in the order of $131 billion.[16]

An important underpinning of the franchise sector is the relationship between franchisors and franchisees. The interdependent nature of a franchise arrangement makes it a unique business relationship. The success of a franchisor relies on that of a franchisee and vice versa.

A number of laws support participants in the franchising sector. In particular, the CCA includes a number of requirements aimed at promoting competition and fair dealing, and protecting consumers. Part IVB of the CCA provides an additional framework to promote fair dealing where there may be a need for additional measures to improve the functioning of an industry, for example, due to unequal bargaining power. Part IVB allows the Government to make industry codes which are legislative in nature and may be either voluntary or mandatory.

2.2. The Franchising Code of Conduct

To address particular concerns in the franchising industry, in 1998 the *Trade Practices (Industry Codes — Franchising) Regulations 1998* came into effect. These regulations prescribe the Franchising Code as a mandatory industry code of conduct under the CCA.

The purpose of the Franchising Code is 'to regulate the conduct of participants in franchising towards other participants in franchising'.[17] When the Franchising Code commenced in 1998, the Explanatory Statement stated that its objectives were to:

- 'address the imbalance of power between franchisors and franchisees;
- raise the standards of conduct in the franchising sector without endangering the vitality and growth of franchising;
- reduce the cost of resolving disputes in the sector; and
- reduce the risk and generate growth in the sector by increasing the level of certainty for all participants.'[18]

Broadly, it seeks to achieve this by prescribing certain rules with respect to the interaction between franchisors and franchisees, requiring franchisors to disclose specific information to franchisees to assist them in conducting due diligence prior to entering into a franchise agreement, and setting out

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[16] Griffith University, Asia-Pacific Centre for Franchising Excellence, *Franchising Australia 2012* pages 9-12.

[17] *Trade Practices (Industry Codes – Franchising) Regulation 1998*, clause 2.

[18] Explanatory Statement, *Trade Practices (Industry Codes – Franchising) Regulation 1998*.

a procedure for dispute resolution which can include invoking the assistance of a Government-appointed mediation adviser.[19]

The ACCC enforces compliance with the Franchising Code.

2.3. Review of the Franchising Code

During early 2013, an independent review of the Franchising Code was undertaken by Mr Alan Wein (the Review). The terms of reference for the review focused on 2008 and 2010 amendments to the Code, in addition to:

- good faith in franchising;
- the rights of franchisees at the end of the term of their franchise agreements; and
- provisions for enforcement of the code.

Mr Wein presented his report, *Review of the Franchising Code of Conduct* (the report) on 30 April 2013. The report was made publicly available on 17 May 2013 and can be accessed via the Department of Industry website.[20]

Subsequent to the Review, small business policy officials, formerly in the then Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education and now located within the Treasury, have been engaged in ongoing consultation with the sector on the issues raised by the report recommendations. This consultation has been comprehensive and is outlined in further detail in part 6 of this RIS.

2.4. Commitment to refine franchising regulation and reduce red tape

The Government has committed to refine the Franchising Code with a view to strengthening its effectiveness, improving its responsiveness to the sector's unique commercial characteristics and tensions, and guarding against additional state-based regulation.

As part of this, the Government has said it is looking for opportunities to reduce red tape imposts, while improving knowledge about commercial expectations and risks, rights and responsibilities under agreements governed by the Franchising Code.[21]

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[19] The Australian Government funded Office of the Franchising Mediation Adviser (OFMA) assists franchisors and franchisees resolve disputes. It does this by providing information and advice free of charge by telephone and email about dispute resolution. In appropriate cases, this may extend to facilitating contact between a franchisor and franchisee to assist in resolving the dispute. OFMA also facilitates formal, low cost mediation for parties in dispute.

[20] http://www.innovation.gov.au/smallbusiness/codesofconduct/Pages/Library%20Card/ReviewoftheFranchisingCodeofConduct.aspx. On 18 September 2013, small business policy functions transferred to the Department of The Treasury. The Treasury website will be updated to reflect Machinery of Government Changes in due course.

[21] The Coalition's Policy for Small Business, August 2013.

3. What is the problem being solved?

The Franchising Code has previously been identified as addressing a range of problems. Regular reviews of regulation such as the Franchising Code can reveal whether they are still addressing the problems they were originally brought in to address, and to identify whether new problems have emerged and warrant action.

In absolute terms, franchisees and franchisors total 74,180 businesses[22], out of a total number of 2,016,800 businesses in operation in Australia.[23] This means that franchise businesses account for 3.6 per cent of the Australian business community. The problems identified as requiring changes to the Franchising Code of Conduct examined in this RIS must be viewed in this context.

The Review made 18 recommendations for changes to the Code. Mr Wein noted that 'the recommendations are not overly conservative, nor do they advocate an unduly interventionist approach from the government.'[24]

It is not possible to identify the extent of the prevalence of any single problem within the franchising sector with certainty. However, statistics relating to the number of disputes and enquires to the ACCC support the belief that problems in the franchising sector are moderate to low. For example, in 2013, the ACCC received 595 complaints and 189 enquiries relating to franchising.[25] Similarly, the Office of the Franchising Mediation Adviser reported 504 enquiries from 1 July 2012 to 30 June 2013. Some examples of these include:

: 60 related to exit;

: 50 related to misrepresentation/deception;

: 43 related to monies owed by franchisor;

: 40 related to termination/renewal; and

: 32 related to inadequate support.[26]

These statistics show that while there are complaints and disputation in the franchising sector, they are not of a level that indicates a large problem. As Mr Wein observed, 'We have a good franchise industry model in Australia and I have sought to improve upon that model with the recommendations put forward in this review. Generally, the Code operates effectively within a very dynamic and difficult economic environment. However, like most industries, there are changes that could be made to improve upon which is already a robust model.'[27]

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[22] This is an addition of the number of franchisors and franchisees from the Griffith University publication, *Franchising Australia 2012*, page 2.

[23] Counts of Australian business operators, 2011-2012, Australian Bureau of Statistics.

[24] Mr Alan Wein, *Review of the Franchising Code of Conduct* (April 2013), p. vii.

[25] ACCC, *Small business in focus*. It is important to note that the information reported here reflects complaints and enquiries received by the ACCC from various sources and are provided as general guidance only. On further investigation, the reported conduct may not amount to a legislative breach. Therefore, care should be taken when drawing conclusions based on this data.

[26] Office of the Franchising Mediation Adviser, Annual Report: 1 July 2012 – 30 June 2013.

[27] Letter presenting the review report to the then Minister for Small Business and the then Parliamentary Secretary for Small Business Minister from Mr Alan Wein dated 30 April 2013, *Review of the Franchising Code of Conduct* (April 2013).

One problem which has emerged in prominence since the Franchising Code was introduced in 1998 is the problem of 'red tape' and the cumulative compliance burden which emerges because businesses are required to comply with such a wide range of laws.

Set out below is a discussion of this evolving problem and of the key problems the Franchising Code was introduced to address. Against these broader contexts, specific issues which have emerged in the franchising sector are identified.

3.1. Red tape and unnecessary complexity in regulation

The Franchising Code was first introduced in 1998. Since 1998 significant amounts of new regulation and law has been introduced. Often characterised as 'red tape', this growth of regulation and law can be damaging and costly to business – particularly small businesses.

A recent inquiry by the Productivity Commission noted that small businesses feel the burden of regulation more strongly than other businesses, and that almost universally, their lack of staff, time and resources present challenges in understanding and fulfilling compliance obligations.[28] Most franchisees are small businesses. A significant number of franchisors may also be classified as small businesses on the basis that they employ less than 20 people.[29]

The Franchising Code is accepted by the sector as a necessary piece of regulation, the costs of which are outweighed by the benefits. It is also part of a regulatory environment including tax laws, occupational health and safety regulations and laws relating to intellectual property. The regulatory burden of the Franchising Code on the franchising sector should be viewed as part of a broader regulatory framework. Reviews of regulation such as the Franchising Code may identify areas which can be simplified or removed and it is important to act on such findings to ensure minimum effective regulation. With a total of 15 years' experience with the Franchising Code (and a voluntary code before that), the sector is in a position to provide feedback on what works and what does not.

One of the major problems that has been identified in this respect is over-disclosure in franchise systems with multiple tiers. In such systems, the Franchising Code currently requires all entities in the position of franchisor to provide disclosure to all entities in the position of franchisee – which is burdensome for franchisors and leads to franchisees receiving multiple, or very complex, disclosure documents. The result is that the important information required to be disclosed may not be prominent and could be overlooked among the large body of paperwork the franchisee receives. This over-disclosure also exacerbates a problem identified during the Review – not all franchisees fully read or understand the disclosure documents. Given that there is very little benefit for franchisees in receiving multiple disclosure documents, this has been identified as an unjustified compliance cost. This is particularly the case for master and foreign franchisors that do not have a practice of regularly granting franchises in Australia, instead putting in place subfranchisors that enter into franchise agreements with subfranchisees.

: To address this problem, it was recommended that the disclosure obligations be reduced to ensure that master and foreign franchisors are not subjected to

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[28] Productivity Commission Research Report, *Regulator Engagement with Small Business,* September 2013, page 2.

[29] Griffith University, *Franchising Australia 2012*, page 37.

unjustified disclosure burdens, and franchisees are not overwhelmed by information of only marginal relevance to their decision whether to enter into the franchised business.

Additionally, some parts of the Franchising Code have been identified as redundant. Redundant regulation which remains in force can cause confusion for participants in the sector. This can contribute to the regulatory burden.

: Currently, the Franchising Code sets out two different formats for disclosure documents. The first is the commonly used 'long-form' disclosure document. The second is a 'short-form' disclosure document which is a truncated version of the long-form disclosure document designed to be used in systems where the expected annual turnover for the franchised business is less than $50,000.[30] The Review could not find any evidence that the 'short-form' disclosure document (Annexure 2 of the Code) is used in practice, and the sector felt that it was redundant.

Consultation following the Review has also identified other provisions of the Code where the regulatory burden does not appear to be justified by the benefit conferred on prospective franchisees.

: The disclosure document requires franchisors to provide franchisees with a summary of certain provisions of the franchise agreement.[31] The disclosure document is essentially summarising and cross referencing another document (the franchise agreement) that must be given in conjunction with the disclosure document. However, reading the disclosure document and its description of the franchise agreement should not be a replacement for reading, understanding and receiving advice in relation to the franchise agreement itself. Accordingly, in the context of concern about the growth and complexity of disclosure documents, this summary of provisions in the franchise agreement would appear to be an unnecessary aspect of disclosure.

Additionally, it has been noted that the policy intent of the Franchising Code is not always clear from the language used, and the uncertainty this produces can lead to increased legal costs, and inconsistency of practice among the industry.

: To address this, it was recommended that the Franchising Code be amended to clarify the policy intent of its provisions and remove ambiguities, where necessary. It was also recommended that the requirements in relation to transfer and novation be clarified to reflect industry practice, which is that franchisees wishing to sell or transfer the franchised business to a new franchisee must provide franchisors with the information required under the franchise agreement to allow the franchisor to evaluate their request. There is a concern that franchisors might be deemed to have consented to a transfer or novation without sufficient information regarding the incoming franchisee in the absence of this amendment.

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[30] See Clause 6 of the Franchising Code.

[31] See Items 15, 16, 17, and 17B of the disclosure document (Annexure 1 to the Franchising Code).

Another compliance problem identified with the Franchising Code is that it has been regularly amended since first being introduced in 1998. Since 1998, four rounds of amendments have been made to the Franchising Code (1999, 2001, 2007 and 2010). These amendments have typically responded to reviews, and there have been eight reviews at federal and state levels since 2006. While such reviews are necessary to identify whether the Franchising Code is working effectively, they can also be disruptive and costly as the sector's participants incur one-off costs in engaging with review processes and understanding the implications of subsequent legislative changes. This can contribute to the red tape and sense of compliance burden felt by industry, as well as a level of 'review fatigue', identified by stakeholders during the review.

: The Review recommended a moratorium on further reviews of the Franchising Code for a period of five years from when the current review process is concluded and any subsequent legislative changes take effect.

3.2. Information asymmetries

Franchisors possess a range of information that is relevant to franchisees in deciding whether or not to enter into an agreement to operate a franchised business. Some of this information may be positive and encourage prospective franchisees, however there is also likely to be information which may present the business in a negative light. Where the information is positive, there is an incentive for the franchisor to provide it to the franchisee because this will make the franchisee more likely to enter into the franchise agreement which will in turn create financial reward for the franchisor and help them grow their business. However, where the information is negative, the incentive for the franchisor to provide the information is reduced and in some circumstances they may withhold relevant information from the franchisee. This is particularly problematic where the information cannot be gathered independently by the franchisee.

This is known as 'information asymmetry' and it is a recognised type of market failure where one party (in this case the franchisor) knows more about the product than the other (in this case the franchisee). It is a problem because it may result in an inefficient pricing and allocation of resources – if franchisors can conceal negative information, they may be able to inflate the price at which they sell franchises since the true value will not be apparent to the prospective franchisee. For their part, franchisees may waste resources by purchasing franchise businesses that are not viable or not suited to them.

The Franchising Code already addresses this particular problem to a large extent. One of the main functions of the Franchising Code is to require franchisors to provide a 'disclosure document' to prospective franchisees. The disclosure document is required to contain a range of information which is relevant to the prospective franchisee's decision regarding whether to enter into the franchise agreement, and which the franchisee may not otherwise have access to.

: For example, low turnover in the ownership of franchised businesses in the system is a positive thing, and something the franchisor may voluntarily disclose to the franchisee. On the other hand, high levels of turnover within the system may not reflect well on the franchisor, the franchise system or the particular franchised business and would be unlikely to be voluntarily disclosed by the franchisor. As this is not something the franchisee can easily discover independently, it is appropriate for the law to respond to this market failure by requiring franchisors to provide information about franchisee turnover to prospective franchisees.[32]

The Franchising Code also provides mechanisms for ongoing, or continuous, disclosure to be provided to franchisees, where it is important that the franchisee has access to particular information which is materially relevant to their relationship with the franchisor and the franchised business but was not available at the time the disclosure document was prepared. The failure to provide certain types of information to franchisees throughout the life of the franchise agreement can generate distrust. Further, transparency in relation to certain key information increases the incentives for the franchisor to operate the franchise system according to best practice and ensures franchisees are engaged and informed regarding the broader franchise system.

: For example, franchisors are required to disclose to franchisees any change in majority ownership or control of the franchisor, and various types of legal proceedings against the franchisor such as civil proceedings commenced against the franchisor by a group of its franchisees.[33] Franchisors are also required to provide basic information regarding the use of marketing and other cooperative funds to franchisees annually. This ensures the franchisor is accountable to the franchisee for monies collected from franchisees for a specific purpose.[34]

The Review of the Franchising Code identified areas in which refinements can be made to address new or emerging problems caused by information asymmetry. The Review received evidence of concern and disputation within the sector based on a lack of information being available to franchisees. The fact that franchisees and their representatives raised this during the Review indicates the information is not always being voluntarily provided by franchisors.

: It was recommended that there be further disclosure and transparency in relation to marketing funds. For example, the Review suggested that there needs to be additional disclosure around the types of expenses marketing funds are being used for, due to evidence that franchisors may be using these funds for expenses which are not traditionally considered to be 'marketing' expenses. The Review has also recommended improved audit requirements and that franchisors separate marketing funds from other monies of the franchisor.

Additionally, over time, there are changes in the economy and business environment which may mean that new types of information are relevant to franchisees which were not originally envisaged when the Franchising Code was introduced, or during previous reviews.

: It was recommended that the Franchising Code be amended to require franchisors to disclose details of the respective rights of the franchisor and franchisee to conduct and benefit from online sales. Evidence was presented to the Review that in some cases franchisors are conducting sales online and in this sense are competing with their franchisee. This is relevant to a franchisee's assessment of the

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[32] See, for example, *Trade Practices (Industry Codes – Franchising) Regulations 1998,* Schedule 1 (the Franchising Code), Annexure 1, items 6 and 11.

[33] See *Trade Practices (Industry Codes – Franchising) Regulations 1998,* Schedule 1 (the Franchising Code), clause 18.

[34] See *Trade Practices (Industry Codes – Franchising) Regulations 1998,* Schedule 1 (the Franchising Code), clause 17.

viability of the business they are proposing to operate, and so it is problematic where the franchisee was not aware of this prior to entering into the franchise agreement. A change to the Franchising Code is proposed to address this problem by requiring the disclosure documents prepared by franchisors to include information about the respective rights of the franchisor and franchisee to conduct and benefit from online sales.

Franchisor failure was identified as part of the Review as an area where the information and rights of franchisees could be improved.

: The Review recommended measures to address the potential for inequitable outcomes between the parties in the event of franchisor failure or insolvency, which can often lead to the interests of the franchisee being compromised. It was recommended that the Franchising Code be amended to confer a specific right for the franchisor and franchisee to terminate the franchise agreement in the event of the other party's insolvency. It was further recommended that the franchisee be given unsecured creditor status by allowing their franchise fees to be notionally apportioned across the term of the agreement instead of being paid up front.

Accordingly, information asymmetry and lack of transparency are ongoing problems in franchising. Although addressed largely by the existing provisions of the Franchising Code, evidence of those problems has been brought forward relating to gaps in current disclosure requirements relating to marketing funds and online sales. As discussed above, while the Franchising Code largely deals with information asymmetry through the provision of the disclosure document, the recommendations that were made deal with issues remaining in the franchising sector which result from the problem of information asymmetry.

3.3. Inability to understand documents and lack of adequate due diligence

During the Review, there was consistent evidence suggesting that franchisees do not read all the information presented to them in a disclosure document. This limits the ability of the disclosure document to facilitate due diligence so that the franchisee may make an informed decision about whether to enter into a franchise agreement. Further, despite the benefits of seeking professional advice as an important aspect of due diligence (e.g. from lawyers and accountants), there was evidence suggesting many franchisees do not obtain such advice before entering into a franchise agreement. Alternatively, even if they do obtain advice, they may not follow that advice.

The insights of behavioural economics are relevant in this respect and suggest that individuals do not always make decisions in their best interests based on all the information provided. Given a large number of franchisees operate as individuals or partnerships (such as a husband and wife team), these small businesses often make decisions in the same manner as individuals. This is sometimes termed 'bounded rationality', which is a concept that recognises that decision making is affected by the amount of time available to make a decision, and the limited capacity of the human mind to evaluate and process information that is available. Franchisees may not appreciate the relevance of information in a disclosure document until after they are operating the business.

Further, individuals may have a bias towards taking an optimistic view of the chances of success, particularly when this affirms the emotional and psychological commitment they have made to an opportunity. For example, even though they may have received professional advice suggesting they do not enter into the franchise agreement, they might be persuaded by other sources of information such as the franchisor to think *'it won't happen to me – I am willing to work hard and that will mean I succeed'.* There may also be other factors which persuade a prospective franchisee to conduct limited due diligence; for example, they may have been made redundant from their previous employment and be desperate to secure an income stream. This might cloud their judgment and ability to objectively evaluate a franchise opportunity.

Accordingly, one problem identified during the Review is the common failure of franchisees to conduct adequate due diligence and obtain and follow professional advice in order that they appreciate the risks involved in franchising – such as the risk of franchisor failure – and have realistic expectations prior to entering into a franchise agreement.

: To encourage franchisees to conduct better due diligence, it was recommended that franchisees should be provided with a short, high level, generic statement which detailed some of the key risks of franchising and explained the benefits of a thorough approach to due diligence. This was recommended in preference to more burdensome options such as mandating professional advice or creating onerous obligations around education prior to entering into a franchise agreement. It was recommended that the summary should be provided to a franchisee before formal disclosure – at the earliest practicable opportunity when discussions between a franchisor and franchisee begin.

Information can also be a problem for franchisees whose franchise agreements are due to expire, and they are considering whether or not to seek to renew the franchise agreement so they can continue to operate the business. Franchisors are required to provide franchisees with formal disclosure at least 14 days before the renewal or extension of a franchise agreement. In reality, however, most franchisees will have already made up their mind at this point about whether or not to continue as a franchisee. Accordingly, evidence to the Review indicated a problem that franchisees may be making decisions regarding renewal without the benefits of disclosure.

: To address this, it was recommended that disclosure to franchisees be provided at least six months before the actual need to renew the franchise agreement arises – at the same time the franchisor is required by other provisions in the Franchising Code to state whether the franchisor is willing to renew the franchise agreement.[35]

Similar to the recommendations for changes to address information asymmetry, the concerns relating to franchisees not undertaking due diligence have largely been addressed through free education[36], educational material developed by the ACCC and a requirement for franchisees to certify they have received legal advice. As such, the problem is relatively small. The recommendations discussed above deal with relatively minor issues remaining which can be caused by a lack of due diligence undertaken by a franchisee. To some extent, there will always be a minority of business operators who make poor decisions. The effect of a competitive market is that often these business operators will not be successful and their businesses will fail. This in itself is not

[35] See *Trade Practices (Industry Codes – Franchising) Regulations 1998,* Schedule 1 (the Franchising Code), clause 20A.
[36] Griffith University offers a free, pre-entry franchise education course sponsored by the ACCC. See: http://www.franchise.edu.au/home/education/for-franchisees/pre-entry-franchise-education.

market failure and there should be some reluctance to suggest that the failure of some franchisees based on poor decisions relating to due diligence and lack of business judgment reflects a 'problem' within the franchising sector. It is important to distinguish between the specific problem identified during the course of the Review, and this feature of any competitive market. That is, even if the recommendation, or any reasonable alternative, is adopted, failures or disappointments may continue to be experienced by some franchisees due to inadequate due diligence.

3.4. Onerous contractual requirements

Effective information disclosure alone may not be sufficient to address imbalances of bargaining power. In some cases, franchise contracts may be offered on a 'take it or leave it' basis, with no or minimal scope for negotiation of the terms of the agreement. In such cases, even if a franchisee is well advised and understands the agreement, they may lack the capacity to effectively advocate in their own interests. Although prospective franchisees have the option to not go ahead with the transaction, this may not be a realistic reaction, particularly if most franchisors are offering similar terms. Alternatively, if the problematic term is not one of the key terms such as the price or length of the agreement a franchisee may be less inclined to walk away from the deal.

Many commercial transactions contain some degree of imbalance of bargaining power. However, this can become a problem in a sector such as franchising where the stronger party may use this imbalance of bargaining power to the detriment of the efficient functioning of the sector by distorting incentives to manage risk, or extracting concessions which go beyond their reasonable business interests. Where this problem arises in franchising, the costs can be significant due to the long term relationship between a franchisor and franchisee.

Specific contractual terms that have been identified as problematic follow.

Contractual terms relating to the end of the franchise relationship

: Imbalance of bargaining power is problematic in the context of end of term arrangements. Franchise agreements are generally offered as fixed term agreements and their average duration is 5 years.[37] If the franchisee wishes to continue operating the business after its term expires, and the franchisor is satisfied with their performance, it is usual practice for franchisees to be offered a renewal of the franchise agreement, whether this was contemplated in the original agreement as a contractual right or not.[38] If a franchise agreement is not renewed, franchisees are not usually offered any form of compensation or exit payment for the 'goodwill' they may have generated in the business. This is despite the fact that the franchisor may be able to sell the franchise at a higher price to a new franchisee because it is an established business and may have a positive reputation. Further, a franchisee is

[37] Research by Griffith University, presented in the Franchising Australia 2012 report, indicates that the average term of a franchise agreement is 5 years (see page 46). An electronic copy of the report is available from the Griffith University website.

[38] Research by Griffith University, presented in the *Franchising Australia 2012* report indicates that only three per cent of agreements are terminated, not renewed or repurchased by franchisors annually, indicating that the sector is actually quite stable in this respect (see page 69). An electronic copy of the report is available from the Griffith University website.

usually restrained by the franchise agreement from operating a similar business nearby for a period of time. These circumstances reflect the contractual bargain which the parties have struck.

However, problems can arise where the franchisee is effectively managing the franchised business and wishes to renew the franchisee agreement, but the franchisor wishes to end the relationship and enforce a restraint of trade. The commercial success of the franchise system benefits from strong incentives for the franchisee to invest in developing their expertise to run the business efficiently. In such circumstances, the franchisee is unable to benefit directly from the goodwill they have generated in the business by continuing to operate it or being compensated for it. They are also unable to benefit indirectly by drawing on the experiences and skills they have gained to operate a similar business. Accordingly, in this specific circumstance, clauses which restrain the franchisee from operating a similar business may be considered imbalanced. The restraint of the franchisee also limits the franchisor's exposure to competition, and competition is an accepted driver of efficiency and innovation among businesses.

To address this, it was recommended that a restraint of trade clause should not be enforceable if certain, well defined conditions are met and the franchise agreement does not allow a franchisee to make a claim for compensation in the event that the franchise is not renewed.

Imposition of unreasonable capital expenditure

: Another area in which imbalance of bargaining power has been identified to be a problem in franchising is in relation to franchisors requiring franchisees to incur significant capital expenditure. If a franchisee does not anticipate a large capital expense – such as an upgrade to a point of sale system or a refurbishment of retail premises – then this could have a significant impact on the expected income from the business. The Review also received evidence that, in some instances, the term of the franchise agreement did not give franchisees sufficient time to recoup capital expenditure.

For any business, it is essential to invest where it is productive and warranted by commercial considerations. However in a franchise relationship problems can arise if the franchise agreement provides the franchisor with a very broad discretion to require the franchisee to undertake capital expenditure, without guidance as to the amount, frequency, or purpose for which the expenditure might be required. This makes it very difficult for the franchisee, before entering into the franchise agreement, to assess the costs and likely benefits of operating the business. In deciding whether to undertake capital expenditure, an independent business would usually consider whether the costs of the expenditure outweighs the likely benefits by generating increased profits. As it is not the franchisor making the investment, it may not always be subject to the same considerations.

It was recommended that the Franchising Code be amended to prohibit franchisors from imposing unreasonable and significant capital expenditure where such expenditure was not explicitly disclosed prior to the franchisee entering into the business, and there is no business case for the franchisee incurring the expense.

Dispute resolution

: Another area where onerous contractual terms and imbalance of bargaining power is problematic is dispute resolution. The Review identified two practices in the franchising sector relating to dispute resolution which are problematic.

The first is franchisors using the franchise agreement to require the franchisee to resolve any dispute in the state where the franchisor's headquarters are based (even when the franchisee may be based in another state). This may act as a disincentive to franchisees raising genuine disputes, since they will disproportionately bear the costs of resolving the matter. This is problematic given that, even without this advantage being conferred on the franchisor by the franchise agreement, franchisees are likely to be less well-resourced for dispute resolution than franchisors.

The second is franchisors using the franchise agreement to require franchisees to cover all costs of dispute resolution – including paying the franchisor's costs. Again, this is likely to act as a disincentive to franchisees raising genuine concerns with franchisors, since they will disproportionately bear the costs of resolving the matter. Additionally, this may remove the natural incentive for franchisors to incur the minimum necessary costs since they will not be paying, which may result in an inefficient allocation of resources.

It was recommended that both these practices be prohibited.

For the issues identified above, it is important to distinguish between the scope and the impacts of the problem. Although the scope of the problems are not widespread, as Mr Wein observed 'we have a good franchise industry model in Australia and I have sought to improve upon that model with the recommendations'[39], the impact of some of the problems outlined above can be significant on some parts of the industry.

3.5. Concerns about conduct within the franchising sector

Consultation during the Review presented consistent anecdotal evidence of questionable behaviours in franchising. Franchisors are usually in a more powerful economic and contractual position than the franchisee, and poor conduct by franchisors can have a disproportionate effect on franchisees. On the other hand, due to the network nature of franchising, poor conduct by isolated franchisees can affect the reputation of the system as a whole.

The Franchising Code sets out a number of prescriptive and clear rules to guide parties to a franchising relationship, however it does not provide parties with guidance as to the general

[39] Letter presenting the review report to the then Minister for Small Business and the then Parliamentary Secretary for Small Business Minister from Mr Alan Wein dated 30 April 2013, *Review of the Franchising Code of Conduct* (April 2013).

standard of conduct required of them in the relationship.[40] This role has largely been left to the unwritten law, and the generic protections in the Australian Consumer Law, such as prohibitions on misleading, deceptive or unconscionable conduct.[41] However, these protections are considered insufficient because poor conduct may not necessarily amount to 'unconscionable conduct', and may not necessarily be misleading or deceptive. It is usually accepted that, under the general, unwritten law, parties to a franchise agreement are under an implied contractual obligation to act in good faith toward one another. However, there is still some uncertainty regarding this.

The Review stated that 'In considering the need for an obligation to act in good faith, the review cited a number of "examples of anecdotal concerns or possible problematic conduct". Examples included problematic behaviour by both franchisors and franchisees. These included:

: the franchisor imposing unsafe practices for workers or customers;

- forcing franchisees to promote the franchisor's products in a way that diminishes the sale of other products sold by the franchisee;
- representations inconsistent with the terms of the franchise agreement;
- extreme pressure to meet sales targets with repercussions for not meeting them;
- collecting marketing budgets based on prices at which goods are never sold – that is, reducing the advertised price of goods after invoicing for marketing;
- franchisees leaving franchise systems, de-branding their businesses and then using the franchisor's intellectual property to compete with the franchisor;
- franchisors setting unrealistic standards for work without regard to the franchisee's expertise (for example, a small regional franchisee who does not see as much of a particular kind of work may take longer than a city franchisee who regularly performs the same work but has to meet the same work or time standards);
- cost shifting to the franchisee or not maintaining the franchisee's margin;
- franchisees using social media to post negative comments about their franchisor or their dispute with their franchisor; and
- franchisees indicating they have received advice as required under clause 11(2) of the Code (giving comfort to the franchisor) only to later allege that no such advice was obtained.

[40] Clause 23A of the Code provides that nothing in the Code limits any obligation imposed by the common law on parties to franchising agreements to act in good faith. However, the parties to a franchise agreement may contract out of this obligation. Clause 23A was inserted into the Franchising Code in 2010. Key concerns with clause 23A, as identified in the review report at page 68 are: it does not prevent arguments that there is no duty to act in good faith; it can be contracted out of; it is not enforceable by the ACCC; and it can result in costly legal advice needing to be sought.

[41] See *Competition and Consumer Act 2010* (Cth), Schedule 2 (The Australian Consumer Law), Chapter 2 (General Protections).

Further to this, in their submission to the Review, the South Australian Law Society cited examples of conduct where it would be difficult to prove misleading, deceptive or unconscionable conduct which indicates a need for a good faith obligation:

- differential treatment of a franchisee, which while isolated to that franchisee, could be justified under contract law but is taking place because a franchisee has raised matters of potential embarrassment to a franchisor;
- cases of bullying where numerous minor and immaterial breaches are constantly raised in an aggressive and intimidatory manner designed to extract concessions of various kinds, or cessation of complaint;
- responding to complaints in a dilatory manner and not within reasonable time frames; and
- when participating in mediations not providing any or only bare reasons in refusing proposals to settle a dispute. This response in mediations most often stifles and reduces mediations to a waste of time and money.'[42]

As with the issues identified under 'onerous contractual obligations', the conduct that causes concern in the franchising industry can be isolated to a small number of people but can have a significant impact. For example, if a franchisee makes negative comments about a franchise brand on social media before a dispute resolution process has been finalised, this could have a negative impact not only on their franchisor but on the brand as a whole, including other franchisees.

To address this problem, it was recommended that a broad and explicit statutory obligation to act in good faith be introduced into the Franchising Code. This obligation would apply to both franchisees and franchisors. This is consistent with previous recommendations made to Government in relation to the Franchising Code.[43] Mr Wein noted 'seven out of nine processes and legislative attempts [to address the issue of good faith in franchising] appear to support action in relation to good faith'.[44]

In addition to the need to address poor conduct in a general way through the introduction of an obligation to act in good faith, the Review identified some particular forms of poor conduct which warranted being specifically addressed.

Circumventing disclosure of contact details of ex-franchisees

: The disclosure document requires disclosure of the contact details of franchisees (including ex-franchisees). The only exception to this is if the franchisee or ex-franchisee has stated that they do not wish for their details to be disclosed.[45] The specific problem identified in the course of the Review was franchisors circumventing this requirement by procuring from franchisees a request that their

[42] Law Society of South Australia, submission to the review of the Franchising Code of Conduct, p 4.
[43] For example, see recommendation 8 of the *Parliamentary Joint Committee on Corporations and Financial Services "Opportunity not opportunism: improving conduct in Australian franchising" 2008.*
[44] Review of the Franchising Code of Conduct, Mr Alan Wein, 2013, p. 66.

[45] See *Trade Practices (Industry Codes – Franchising) Regulations 1998,* Schedule 1 (the Franchising Code), Annexure 1, item 6.6.

contact details be withheld from incoming franchisees. It was recommended that the Franchising Code be amended to ensure that a written request from a franchisee that its details not be disclosed to prospective franchisees has in fact been initiated by the franchisee, for example by prohibiting a franchisor from initiating, procuring or encouraging such a request from a franchisee.

Allowing franchisees to bear the costs of marketing corporate owned stores

: Among a number of concerning practices relating to marketing funds was a concern that a franchisor's corporate owned units are not necessarily contributing to marketing funds on the same basis as franchised units, or at all. Because of this, a franchisor's own store or unit could be benefiting from outlays from the marketing fund even though they are not contributing on a fair basis with other stores. It was recommended that a franchisor with corporate owned stores should ensure that those stores contribute on the same basis as franchisees to any marketing fund for the franchise system.

3.6. Overall effectiveness of the Franchising Code

At present, there are a range of possible consequences for a breach of the Franchising Code. It is possible for the ACCC and private parties (principally franchisees) to take action in the courts. Generally, however, the types of orders that a court can make are limited to providing a remedy to address a harm that has been suffered. This can mean that, in practice, there may not be a realistic threat of consequences in many instances where the Franchising Code is breached. This has been identified as a problem by many participants in the sector, and by the ACCC, in recent years. It may encourage a less diligent approach to compliance with the Franchising Code – the flipside of this being that introducing more punitive consequences for breaches would be likely to act as a deterrent.

As discussed above, conduct that causes concern in the franchising industry can be isolated to a small number of people but have a significant impact in those isolated circumstances. A respondent to the consultation process made the point that just because poor conduct is uncommon; it doesn't mean there should not be a consequence of engaging in poor behaviour. Stakeholders have argued that additional powers for the ACCC will ensure the policy intent of the Code is adhered to.

The need to improve compliance and enforcement outcomes through a range of flexible tools for use by the regulator is also consistent with more general findings in relation to the relationship between regulators and small businesses. The Productivity Commission's recent research report, *Regulator Engagement with Small Business*, noted that:

> … better outcomes for small businesses and the community are achieved when regulators have a range of tools that enable them to tailor their responses to breaches (or potential breaches) of regulation in a proportionate way, rather than having to rely solely on combative approaches such as initiating legal proceedings. Some 30 per cent of regulators reported to the Commission that they have an insufficient range of enforcement tools. For the most part, these regulators saw the need for more tools in the mid-range of sanctions, such as improvement notices and enforceable undertakings.

> Accordingly, the Commission recommends that governments ensure their regulators have a sufficient range of enforcement tools available for their activities.[46]

Accordingly, there have been calls for additional enforcement tools in relation to the Franchising Code, including allowing the ACCC to address breaches without having to initiate court proceedings.

: Among other enforcement measures, it was recommended that the ACCC be given new powers to seek pecuniary penalties from a court for breaches of the Franchising Code, and also that the ACCC should be able to issue infringement notices for breaches of the Franchising Code. Infringement notices allow parties who have breached the Code to make payment of a small amount (relative to the amount of a pecuniary penalty that could be awarded by a court), in return for immunity from court proceedings. It was also recommended that the ACCC be able to use its audit powers to assess a franchisor's compliance with all aspects of the Franchising Code. The ACCC already has access to these tools when enforcing other provisions of the CCA.

[46] Productivity Commission Research Report, *Regulator Engagement with Small Business,* September 2013, pages 6 – 7.

4. What is the objective of franchising regulation?

The purpose of the Franchising Code is to regulate the conduct of participants in franchising towards other participants in franchising.[47] The Explanatory Memorandum for the Bill introducing the power to prescribe industry codes stated that the regulatory objective of industry codes generally was to address, or ameliorate, the effect on small business of:

- information asymmetries in negotiation of contracts;
- inability to understand documents;
- unfair contract terms;
- unfair conduct within commercial relationships; and
- difficulties in resolving disputes in a time and cost-efficient manner.[48]

It is intended to achieve these objectives in a way which interferes minimally with freedom to contract. All of these objectives apply to the Franchising Code, which was the first industry code to be prescribed under these provisions.

The Franchising Code is intended to enhance the productivity and success of the franchising sector by ensuring efficient dealings, and minimal loss of productivity because of avoidable disputes or dissatisfaction in business relationships. Addressing information asymmetry is also intended to facilitate competitiveness in the sector. This is important because the businesses that participate in this sector are an important contributor to the economy and our communities.

Against this background, there are two immediate objectives relating to the current examination of the Franchising Code:

- Ensure that the Franchising Code is effectively responding to the original objectives it was brought in to address; and
- Ensure that the Franchising Code is not placing an unjustified compliance impost on business by identifying improvements which can be made to streamline the Franchising Code.

An overarching objective of the Franchising Code is to provide a single, nationally consistent framework for franchising regulation. In recent years, there has been discussion regarding state regulation of franchising. It is important to respond to the issues which have been raised in the states in order to ensure a single, national framework for franchising regulation.

5. What are the options for solving the problem?

In any reform process, it is important to consider alternative courses of action when deciding how to tackle the problem at hand. This section of the Regulation Impact Statement assesses the relative merits of three options:

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[47] See Clause 2 of the Franchising Code itself.

[48] Explanatory Memorandum, *Trade Practices Amendments (Fair Trading) Bill 1997*, page 3.

- Option 1 – the status quo. No Government action is taken.
- Option 2 – reform and refine the Franchising Code.
- Option 3 – light touch or non-regulatory responses, principally education and awareness measures.

It is important to analyse the impact of each of these options according to their costs and benefits. These costs and benefits may be both qualitative and quantitative, and both are considered below.

The business community –in particular the efficiency of the small business community – is the intended beneficiary of the proposed reforms. Improving the relationships between franchisees and franchisors can help lift productivity and incomes in this important sector. Accordingly, the impact analysis under each option is focussed on the business community.

5.1. Option 1: Status quo/take no action

5.1.1. What does this option involve?

Under this option, there would be no changes to the Franchising Code or the enforcement framework in the CCA, and no other action would be taken in response to the Review recommendations or to implement the Government's commitments in relation to franchising.

The Franchising Code is due to sunset on 1 April 2019.[49] At some point in the future, the Government would need to decide whether to conduct a further review prior to that date to assess whether the Franchising Code should be allowed to sunset.

5.1.2. What are the qualitative costs and benefits of this option?

Costs of this option include:

- The Franchising Code will not respond optimally to the problems identified in Part 3 of this RIS. As a result, franchisees and franchisors will be making economically inefficient decisions and complying with unnecessary regulation.

- Not addressing known problems (for example the failure to provide disclosure in relation to online trading activities) may mean higher than necessary levels of disputation. If parties are not fully aware of their respective rights and obligations before entering a franchise agreement, and do not consider themselves obliged to act in good faith, this may result in unacceptable levels of disputation. Resources devoted to dispute resolution cannot then be deployed to more productive outcomes within the businesses of franchisors and franchisees.

- Due to lack of action at the Commonwealth level, it is possible that duplicative franchising regulation may emerge in the states, noting that this possibility has already been explored

[49] See the *Legislative Instruments Act 2003* (Cth), section 50.

in some states.[50] This would increase compliance burdens for the sector as they contended with separate regimes for franchising regulation.

- Compliance burden will be higher for participants in the franchising sector due to the non-progression of a number of reforms relating to simplifying and streamlining the Franchising Code to reduce 'red tape'.

Benefits of this option include:

- Regulatory stability and development of case law is promoted by infrequent changes to the law. The Franchising Code was introduced in 1998 and since then has been amended 5 times, in 1999, 2001, 2007, 2008 and most recently in 2010. However, it is noted that regulatory stability will not necessarily be promoted by maintaining the current Franchising Code due to the possible emergence of state-based franchising regulation.

- This option would allow time for other regulatory reforms to be progressed which are relevant to franchising. For example, the Government has committed to an independent review of competition laws and policy, and has further stated its preference that unfair contract terms protection be available for small business. Any regulatory changes which flow from these Government policies may be relevant to decisions regarding the Franchising Code. For example, if a franchise agreement was covered by a general rule voiding unfair contract terms, some of the specific changes to the Franchising Code proposed in Option 2 (below) may not be necessary.

5.2. Option 2: Reform and refine franchising regulation (preferred)

5.2.1. What does this option involve?

In summary, this option would involve:

- making a number of refinements to the Franchising Code to respond to the recommendations made by Mr Alan Wein, and to implement the Government's commitment to reduce red tape imposts on business;

- remaking the *Trade Practices (Industry Codes – Franchising) Regulation 1998*. This will promote regulatory stability by ensuring that the Franchising Code does not need to be reviewed before 1 April 2019 merely to respond to the sunsetting provisions of the *Legislative Instruments Act 2003*. As part of this process, the regulation will be renamed the *Competition and Consumer (Industry Codes – Franchising) Regulation 2014,* to reflect changes to the name of the enabling legislation; and

- amending the CCA to improve the enforcement regime for the Franchising Code by making civil pecuniary penalties and infringement notices available to the courts and the regulator respectively in the case of breaches of industry codes.

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[50] See, for example, the Franchising Bill 2010 (WA), Franchising Agreements Bill 2011 (WA), Franchising (South Australia) Bill 2009 (SA).

Consultation exploring the practical impact of the recommendations made by Mr Wein in the Review report indicated the costs of some recommended changes may outweigh the benefits. The following examples reveal some of the considerations that have been weighed up in coming to a preferred policy position on reforming and refining franchising regulation.

Franchisor failure

- It was recommended that franchisees be given additional protections in the event of franchisor failure, including the right to terminate a franchise agreement if the franchisor fails and a buyer is not found within a reasonable time.

  Consultation with industry revealed that the cost of this reform may not be justified by the benefits. In particular:

  - If franchisees had the right to terminate upon the insolvency of the franchisor, some stakeholders argued this would undermine the value and viability of the franchise systems as a whole in the event of franchisor failure, leading to a negative impact on other franchisees and the creditors of the franchisor.

  - Administrators of insolvent franchisor companies may be hampered in their ability to perform other statutory functions. For example, an incoming buyer may be deterred by an impending deadline after which franchisees will be able to terminate their agreements.

- It was further recommended that franchisees should be made unsecured creditors of the franchisor by notionally apportioning the franchise fee across the term of the franchise agreement. This would mean that the fee for the unexpired portion of the franchise agreement would become a debt in the event the franchise agreement ended due to the franchisor's failure.

  Consultation with industry revealed that the cost of this reform was unlikely to be justified by the benefits. In particular:

  - Not all franchise systems require an upfront franchise fee or renewal fee so the recommendations in relation to unsecured creditors could not feasibly be implemented in such franchise arrangements. Alternatives such as a nominal debt would be equally problematic.

  - Some stakeholders considered this may in fact increase the prospect of franchisor insolvency since directors of franchisors may need to factor potential payments to franchisees into solvency considerations.

  - Some stakeholders considered the proposed debt would have a negative impact on the treatment of this income for the franchisor from a taxation and accounting perspective. This would be complicated in the event of the sale of the franchise system to a new franchisor.

  - The existence of such a right may lead franchisees to have unrealistic expectations about the prospect of recovering some or all of the franchise fee in the event of franchisor failure because in practice, if a franchisor is insolvent, the franchisee would be unlikely to actually receive the full amount (or in some cases any of the amount) notionally owed to them.

For the reasons stated above, both of these reforms were also considered to have a negative impact on the franchisor's credit worthiness, or increase the cost of access to finance for the franchisor. Some stakeholders argued this would also increase the cost of credit for franchisees, since their access to credit is also dependent on the financials of the franchisor.

Finally, it was unclear how significant a problem franchisor failure is. During the Review and subsequent consultation, no representations or evidence was received directly from any individual franchisees that had been adversely affected by the failure of their franchisor.

Accordingly, instead of implementing this recommendation, it is proposed to highlight the risk of failure in an information statement to be provided to the franchisee before they enter into the franchise agreement (see below on page 29). It is also expected that other proposed reforms, such as introducing an obligation to act in good faith, will improve the general operating environment for franchisees including in the circumstances of franchisor failure.

Keeping marketing funds in a trust account

- Among other reforms to the treatment of marketing funds, the Review recommended that marketing funds be held as trust funds. Stakeholders argued requiring marketing funds to be formally treated as trust funds would be problematic. In particular:
  - Given franchisors are not required to maintain a marketing fund, the additional compliance burdens associated with keeping a trust account may deter franchisors from setting up marketing funds at all. This may deprive franchisees of the transparency provided for relating to marketing by other provisions of the Franchising Code.
  - This could have an impact on taxation arrangements and the treatment from a taxation and accounting perspective. Some stakeholders argued this would significantly increase the legal and administrative burdens on franchisors.
  - If marketing funds were held in trust, this could impact franchisors credit worthiness or the cost of credit for a franchisor.

Accordingly, while other recommendations relating to the treatment of marketing funds have been adopted, this particular recommendation is unjustified when the potential costs are considered.

Requiring franchisors to provide disclosure six months before a renewal is offered

- It was recommended to the Government that franchisors should be required to provide formal disclosure to franchisees at least six-months before they are offered a renewal or extension of their franchise agreement (rather than the default 14-day rule which otherwise would apply). However, existing franchisees already have the ability to request a disclosure document at any point during the term of the franchise agreement (as long as they don't request more than one document per year). So in most circumstances, a franchisee could already initiate a request for disclosure six-months before they are offered a renewal or extension of their franchise agreement.

Accordingly, given the compliance costs involved for the franchisor in providing formal disclosure, instead it was considered sufficient to simply remind the franchisee of this entitlement at the time when the franchisor is required to state whether it will renew the franchise agreement (i.e. six months before the end of the agreement). This proposed reform is noted below.

Master franchisor disclosure

- The Review recommended that master franchisors be required to provide a separate, short, form of disclosure that would in turn be provided by subfranchisors to subfranchisees. During consultation, a simpler way of implementing the policy intent of this recommendation was identified.

  If the recommendation was adopted in its entirety, this would result in the franchisee still receiving multiple disclosure documents, and would on the other hand deprive subfranchisors of useful information from the master franchisor that would otherwise have to be set out in the full disclosure document.

  As an alternative, this recommendation has been implemented by adding additional information to the existing disclosure document in relation to master franchise agreements, and relieving master franchisors of the obligation to provide disclosure to subfranchisees, since subfranchisees will now receive all relevant information from the subfranchisor in a single disclosure document.

Examples of possible franchise structures

Dispute resolution

- It was recommended that the Code should be amended to make it clear that the obligation to try to resolve a dispute by mediating in a reconciliatory manner applies to dispute resolution in any forum (such as through a Small Business Commissioner), not just through the Government-funded Office of the Franchising Mediation Adviser.

  However, this obligation has been superseded by a comprehensive obligation to act in good faith, which will extend to dispute resolution. Accordingly, it would create unnecessary duplication in the Franchising Code to retain the requirement to mediate in a reconciliatory manner.

However, it is proposed to implement the bulk of the Review recommendations and this is reflected in the proposed revised Franchising Code, and amendments to the CCA, which are set out at **Attachments A** and **B** respectively. Key changes include:

Improvements to reduce red tape and complexity

- Simplifying disclosure in multi-tiered franchise systems by removing the requirement that master franchisors provide disclosure to franchisees even where there is no direct relationship with the franchisee, and the franchisee has already received disclosure from the intermediate party (the subfranchisor). In addition to reducing compliance costs in multi-tiered systems, this will improve disclosure as franchisees will receive more targeted information.
- Ensuring that foreign and master franchisors are not obliged to maintain a disclosure document if they are not actively involved in franchising. This will reduce expenditure on legal and compliance activities where there is no benefit to be gained by franchisees from those activities.
- Removing the redundant short-form disclosure document format from Annexure 2 of the Franchising Code. This will streamline and simplify the code.
- Removing disclosure obligations in relation to summarising provisions of the franchise agreement in the disclosure document. The disclosure document is not meant to be a substitute for closely reading the franchise agreement, and these provisions make the disclosure document unnecessarily lengthy and complex.
- Making a range of other drafting improvements to the Franchising Code to address ambiguity and improve consistency of practice among the industry.

Improvements to disclosure to address information asymmetry

- Ensuring that franchisors remind franchisees of their entitlement to a current disclosure document when notifying them that they intend to renew the franchise agreement. This promotes informed decision-making by franchisees relating to renewal or extension of the franchising relationship.
- Requiring franchisors to provide disclosure in relation to the respective rights and obligations of the parties to conduct and benefit from online trading activities. This change responds to

the growing importance of online trading in the economy, and the way this is impacting on traditional sales models in franchise systems.

- Requiring franchisors to provide an information statement to prospective franchisees regarding the risks and rewards of franchising as early as possible. The information statement will be generic across the franchising industry. It will be included as an Annexure to the Code and has been drafted in consultation with both franchisee and franchisor representatives to ensure that it achieves a balance between the risks and rewards of franchising. It covers issues such as due diligence, what franchising is, why someone would consider franchising, what is involved in a franchising relationship, unexpected expenses, the risks of franchising and where to find more information. The provision of this statement will help franchisees to understand the pros and cons of the franchising model at a formative decision-making stage, which may precede formal disclosure and entry into the franchise agreement.

- Ensuring that franchisees receiving meaningful information about expenditure of marketing and other cooperative funds. This will encourage a more transparent relationship in an area which can cause conflict between franchisees and franchisors.

- Requiring franchisors to disclose materially relevant facts about their associates to franchisees, such as if an associate has civil proceedings in Australia brought against them by franchisees in the system. This will promote transparency and support the original policy intent of this provision, particularly for franchise systems with complex corporate structures.

Improvements to address concerns about conduct within the franchising sector

- Requiring both franchisors and franchisees to act in good faith in their dealings with one another. This is an important change that will underpin the Franchising Code as a whole and improve standards of conduct within the sector.

  – The efficiency and commercial success of a franchising system relies on co-operation between a franchisor and franchisee. As outlined above in the problem section, while the scope of problematic behaviours in the franchising sector is not large, the impact of certain behaviours can be significant in isolated cases. For example:

    : Cost shifting to the franchisee or not maintaining the franchisee's margin – if a franchisor engaged in this behaviour to the extent that it was impacting on the profits of the franchisee.

    : Another example is the broad impact that the behaviour of one 'rogue' franchisee can have on the brand of a franchise system. This has become more of an issue as the spread of information via social media has escalated, meaning that potentially incorrect and damaging information can spread quickly, and the damage can be difficult to undo.

  – While the notion of good faith exists in common law relating to contracts generally, there is not a consensus on whether the concept applies to all aspects of a contract. The proposed obligation to act in good faith in relation to franchising agreements will apply in respect of any matter arising under or in relation to a franchise agreement and the

Code. This will extend the application of good faith to the negotiation of a franchise agreement, performance of the franchise agreement and the termination of that franchise agreement.

- This obligation will require parties to a franchise agreement to act honestly, not arbitrarily and to cooperate to achieve the purposes of the franchise agreement. These principles have been discussed and considered relevant in the case law to the consideration of whether a party has acted in good faith. This does not prevent a party acting in their own commercial interests. For example, if a franchise agreement does not include a clause allowing the franchisee to seek its renewal, this does not mean that the franchisor has not acted in good faith in negotiating the agreement. Additionally, the proposed obligation does not limit the obligation imposed by the common law. The ACCC will provide educational information on the changes to the Franchising Code. Preventing franchisors from unduly interfering with prospective franchisees' ability to speak with ex-franchisees to enable franchisees to conduct due diligence of this nature wherever possible.

Improvements to address concerns about onerous contractual terms in the franchising sector

- Addressing concerns regarding the imposition of significant and unforeseen capital expenditure by prohibiting franchisors from imposing such expenditure on franchisees subject to a number of exceptions. This will help franchisees make an informed assessment about the viability of the franchised business.
- Ensuring that franchisors cannot enforce restraints of trade clauses against franchisees in certain circumstances. This will promote competition and ensure that franchisees have sufficient options available to them if the franchisor chooses not to offer them a renewal of their franchise agreement.
- Ensuring that franchisors cannot impose their costs of dispute resolution on franchisees through the franchise agreement, to ensure franchisees are able to raise disputes without unfairly bearing the costs this may result in for the franchisor.
- Ensuring that franchisors cannot use the franchise agreement to require the franchisee to resolve disputes in a state other than the state in which the franchisee's business is based. This will promote access to affordable dispute resolution for franchisees.

Improvements to the overall effectiveness of the Franchising Code

- Improving the enforcement options available to the ACCC for breaches of the Franchising Code. These include pecuniary penalties, infringement notices and a modest increase in the scope of documents the ACCC can request, including to substantiate the information in a disclosure document. This will encourage compliance with the Franchising Code and improve standards of conduct within the sector.

5.2.2. What are the qualitative costs and benefits of this option?

It is envisaged the most tangible impact of the proposed changes will only be significant in the areas where a specific problem has been identified. The problem section of this paper discusses in detail the size and nature of the issues identified in the franchising industry. Extensive consultation with the franchising sector has occurred to ensure the impacts of the proposed changes have been thoroughly explored. This section extensively discusses the views of stakeholders and then the costs and benefits of the proposed changes.

Views from stakeholders obtained through consultation

The provision of a generic risk statement:

Submissions to the Review, from groups representing both franchisors and franchisees, called for a short document to be provided to franchisees to improve their understanding of the franchise relationship at the earliest possible time.

Some of the arguments raised in response to the consultation paper favouring implementation of a generic risk statement were that it would:

- make for better decision making by prospective franchisees by providing prospective franchisees with knowledge of franchising and an understanding of the need for due diligence;
- have the potential to reduce friction between franchisees and franchisors as a result of franchisees better assessing the risks of entering a franchise agreement; and
- deter unsuited persons from entering into franchising.

Other responses suggested some negative impacts to implementation of the recommendation:

- creating more statements and disclosure would not address the problem of franchisees not seeking professional advice;
- the statement would not cover all possible issues a prospective franchisee might face;
- it is unfair to ask a franchisor to state, up front, the negatives of franchising;
- the existing system adequately protects franchisees and additional disclosure would not put them in a better position;
- a generic statement would be too general to provide useful information, particularly as each franchise network can be structured differently; and
- it may lead franchisees to ignore the disclosure document.

Mr Wein envisaged that this recommendation would assist prospective franchisees with a simple snapshot of some of the pitfalls and benefits of franchising without requiring them to read a lengthy contract. A contract may be provided to a franchisee after a number of discussions with the franchisor, by which time, they may already be emotionally committed to entering the franchise.

Research undertaken by Griffith University released in 2013 indicated that over 50 per cent of franchisees surveyed made their mind up before they reviewed the available information. It also found that over 80 per cent of franchisees who did not undertake pre-entry education relied on information being given to them rather than seeking it out themselves.[51]

Previous reviews of the Franchising Code have recommended that the industry develop this type of risk statement however this does not appear to have occurred. The objective of this recommendation is to ensure a prospective franchisee has a basic understanding of the franchise relationship before they are financially and emotionally committed to entering a franchise

[51] L. Frazer et. al, *Preparation for Franchising: A study of prospective and current franchisees*, 2013, p. 50.

agreement. Consultation with groups both representing franchisors and franchisees has occurred to ensure that this document is balanced. Additionally, the compliance costs associated with this change are very low given the statement is generic and has been drafted as an Annexure to the Franchising Code.

Improvements to onerous contractual terms in the franchise sector:

As part of the Review, Mr Wein recommended that 'Decisions made by the franchisor requiring franchisees to incur significant capital expenditure need to be subjected to a test of reasonableness.' Mr Wein identified that the current item 13A of Annexure 1 is not effective. Many submitters to the Review contended that presently the regulation just results in franchisors disclosing a very long list of expenses, many of which never occur.

Responses from the consultation process also indicated that the current regime is not working effectively. One response stated **'**A continuation of the status quo will allow this inconsistency of disclosure to continue, and the relatively bland nature of what is disclosed to be relatively meaningless.' A number of other respondents indicated that franchisors already produce business cases to support significant expenditure and it is just a matter of these details being passed onto the franchisee.

Other responses to the consultation paper indicated that currently, significant capital expenditure is imposed on franchisees toward the end of the franchise agreement. If the franchisee is unable to recoup their capital investment in the time remaining in the franchise agreement then the expense may not be 'reasonable'.

During the consultation process, arguments for and against defining the terms 'unreasonable' and 'significant' were made. For example, several responses to the consultation paper argued that franchisors already prepare business cases for significant capital expenditure and it would simply be a matter of providing these to the franchisee. They argued that this would not result in costs as this type of cost/benefit analysis is already available.

Another respondent indicated the status quo should not continue, arguing that the list provided to comply with item 13A of Annexure 1 of the Code in its current form is of little use to franchisors or franchisees.

To address the concerns raised in the consultation process, a 'conditional prohibition' on significant capital expenditure will be introduced. This will still allow expenditure to be imposed by a franchisor if:

- it is disclosed through the regular disclosure process;
- if it is agreed to, or approved by, the majority of franchisees;
- the expenditure is required to comply with legal obligations; or
- the franchisor considers the expenditure necessary and can be justified by a rationale for the investment, an explanation of the amount of the expenditure, the anticipated outcomes and benefits and the expected risks for making the investment.

Marketing funds:

A consistent theme in submissions to the Review was a view that marketing funds are a common source of dispute between franchisees and franchisors, are prone to improper or questionable use by the franchisor and lack transparency.

> This area remains a significant source of dispute and the disclosure amendments have not resolved the problems.[52]
>
> … more and more issues arise with marketing funds all the time and it is an area where franchisees and franchisors are often in dispute and undoubtedly will continue to be for as long as there is franchising.[53]

One franchisee representative group stated the proposed changes to marketing funds would result in the 'removal of risk, uncertainty, friction costs and dispute costs in an area of significant controversy in franchising. More efficient allocation of marketing funds to true marketing expenses will be made within the sector, and removal of inappropriate practices in relation to marketing costs will contribute to the overall reputation of the industry for new franchisees.'

Concerns raised through consultation about how a franchisor spends allocated marketing funds have been addressed by a clarifying amendment to the Franchising Code specifying marketing funds can be used for expenses such as 'legitimate marketing or advertising expenses'.

Others were concerned about some aspects of the recommended changes, particularly relating to holding the funds in a trust account. Consultation on the issue of holding marketing funds found that this would be a significant regulatory burden and have unintended consequences. Consultation with franchisor representatives indicated that holding the funds in a separate bank account is appropriate but they should not be held in a trust account as there is the potential for a number of unintended consequences and the compliance burden would outweigh the potential benefits.

Consultation raised the issue of an additional cost associated with the potential for an annual marketing fund audit. However, this is still subject to a vote by franchisees and therefore the cost imposed by an audit is still at the discretion of the industry participants.

The requirement for company-owned units to contribute on the same basis as franchisees will improve the equity in the franchise relationship. This may be an 'opportunity cost' for the franchisor given they may have previously used these funds for other purposes but the funds will still contribute to the business overall and would not be lost to a 'sunk cost' such as legal fees.

Good faith:

In terms of the scope of the obligation, there is a mixture of support for it to apply before, during and after a franchise agreement, but also support for an obligation to act in good faith to have a more limited application to just the exercise of the franchise agreement. It was suggested by some that if an obligation to act in good faith is extended to the negotiation of a franchise agreement, a franchisor may incur significant costs in negotiating individual franchise agreements, as a franchisor

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[52] Dr Elizabeth Spencer and Mr Simon Young, submission to the Franchising Code Review*,* p 6.
[53] Alert, Bywaters Timms law firm, *Franchise Marketing and other cooperative funds*. See also Queensland Law Society Franchising Law Committee, submission to the review.

may be required to implement changes to a franchise agreement requested by a potential franchisee.

The compliance costs (legal fees) of ensuring that a franchise agreement complies with the obligation to act in good faith are factored into the costs discussed below under compliance costs. As it is assumed that a franchisor will seek additional legal advice to ensure that their agreement complies with the obligation, a franchisor will still be able to use a standard form contract. The good faith obligation would only impact negotiations in that both parties would need to act cooperatively and honestly. It does not compel a franchisor to make requested additions to a franchise agreement made by a prospective franchisee.

Consultation also raised the possibility that there may be circumstances where a failure to renew did amount to not acting in good faith, depending on the individual circumstances. Some franchisors argued that the nature of franchising is that it is a relationship for a specified period of time. Therefore, it would not be appropriate for a franchisee to claim a breach of a good faith obligation for a non-renewal of their agreement. To address this concern, the Code will include a clause which clearly indicates that a franchise agreement is not required to include a clause which allows a franchisee to seek renewal.

Irrespective of the necessary regulatory amendments, the concept of ‘good faith’ in commercial dealings will continue to be assessed by the courts. A benefit of this is that the codification of good faith for the franchising sector participants may improve conduct in the franchising sector by setting a standard of practice and providing an educative influence. Stakeholders have 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 ensuring that honesty, integrity and professionalism are principles adhered to in the franchising industry.

The most common objection to the introduction of an express obligation to act in good faith into the Code is that the scope of the requirement is unclear; the common law is continuing to develop and is not sufficiently certain. Similarly, it is recognised that it is undesirable for the obligation to further complicate the common law doctrine of good faith and be inconsistent. This is consistent with the industry code framework that industry codes should reduce complexity.

Under the current arrangements, good faith may already be implied into franchise agreements via the unwritten, common law. Treasury has been told that many franchisors and franchisees are already acting in a manner consistent with a good faith obligation. This offers support for the retention of the status quo; regulatory amendments are unnecessary as the policy intent is already being achieved. However, it has also been argued by many from the different sectors in franchising that under the current arrangements, good faith obligations are unclear; not all franchisees and franchisors are acting in good faith; the obligation can be contracted out of; or, they are not aware that they have an obligation to act in good faith.

During consultation, it was raised that even though there is not a clear definition of good faith, parties generally understand it to mean acting fairly and honestly.

To address the concerns of stakeholders regarding the uncertainty of such an obligation and at the same time the need for clarity around the meaning of good faith in the Franchising Code, guidance on the meaning of good faith will be provided without limiting the obligation imposed by the common law.

Concern was also raised in consultation regarding the importance of avoiding duplicative state-based regulation, which was likely to be implemented by some states if the Australian Government does not implement an obligation for parties to a franchise agreement to act in good faith. Inconsistent regulation across state borders creates substantial costs for franchisors. Some submitters to the Review outlined the problems encountered in the USA when a business is forced to comply with different regulations in different states. A consistent national regulation means that businesses operating across Australia have one set of rules they need to abide by.

Some stakeholders were concerned about the impact this introduction might have on investment in Australia. Other stakeholders argued that rather than being a disincentive, the obligation would attract investment and additional franchisees due to the confidence they would have in the conduct in the franchising sector in Australia.

During consultation, the relational nature of franchising was raised on a number of occasions. This is seen as a main difference between a franchise agreement and other commercial agreements. 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 discreet, one-off exchanges between parties on clearly defined terms that characterise ordinary contractual agreements. The introduction of an obligation of good faith is in a way recognising the special relational nature of a franchise agreement.[54]

On balance, the evidence to the Review and evidence received throughout the consultation process was supportive of the introduction of an obligation to act in good faith into the Franchising Code.

Restraint of trade

Consultation on Mr Wein’s recommendation on restraint of trade provided differing views from stakeholders. Some responses indicated that it is inconsistent with the nature of goodwill in a franchise – that goodwill is owned by the franchisor and not the franchisee.

Others disagreed and thought the recommendation did not go far enough. They felt it would not protect franchisees who are not in breach of their franchise agreement from losing their business; that it would not provide for fair and equitable compensation at the end of a franchise agreement; and restraint of trade clauses are not relevant to all franchised businesses.

The implementation of this recommendation will help to balance the rights of franchisees and franchisors at the end of a franchise agreement. It will offer some relief to franchisees who have honoured their franchise agreement and through no fault of their own, have been refused renewal by the franchisor, but wish to continue in a business similar to the one in which they have built experience. Currently, former franchisees may be prevented from doing so due to the operation of a restraint of trade or ‘no compete’ clause which can have serious consequences on their ability to earn a living and result in significant hardship. While this scenario is uncommon, it is inappropriate

[54] Andrew Terry and Cary Di Lernia discuss the relational nature of franchising and how this is distinct from typical contractual arrangements which involve a one-off exchange in their article ‘Franchising and the Quest for the Holy Grail: Good Faith or Good Intentions?’, Melbourne University Law Review, 2009.

to put in place adequate safeguards to avoid grossly unfair outcomes for the franchisee at the end of the franchise agreement. The proposed change is that a restraint of trade clause will have no effect after the agreement has expired, if a narrow set of conditions can be met by the franchisee, including that the franchisee was not in breach; had not infringed the intellectual property of the franchisor; and has not claimed genuine compensation for non-renewal.

Dispute resolution

There was broad support throughout consultation for the changes proposed to the dispute resolution provisions which would mean that franchisors could not impose their costs of dispute resolution on franchisees through the franchise agreement, and that franchisors could not use the franchise agreement to require the franchisee to resolve disputes in a state other than the state in which the franchisee's business is based.

Responses to the consultation process indicated that while concerns may be raised about litigation in a 'foreign' jurisdiction, if the franchisor is prepared to issue a franchise in that jurisdiction (and be subject to the relevant state laws regarding its franchisee's business) then it is not too onerous to expect the franchisor to be subject to the laws of that jurisdiction.

Enhanced enforcement tools for the ACCC

Responses to consultation indicated support for an increase in the enforcement options available to the ACCC. Some respondents indicated caution regarding the scope of the powers and the way in which the ACCC may utilise them, with a view to preventing the recommended changes imposing an unreasonable burden on the sector.

These concerns have been addressed by:

- Limiting the maximum pecuniary penalty to 300 penalty units (currently $51,000);
- Setting the amount for infringement notices at 50 penalty units ($8,500) for a body corporate and 10 penalty units ($1,700) in any other case;
- Limiting the items of the Franchising Code which attract penalties; and
- Ensuring that the increase in type of documents the ACCC can obtain is more limited than contemplated by Mr Wein's recommendation, by restricting the power to documents the franchisor is required to obtain from a franchisee, and ones that are required to substantiate statements in a disclosure document.

The proposed refinements to the Franchising Code bring with them a range of costs and benefits.

Benefits include:

<u>More efficient business dealings due to a clearer and less complex Franchising Code – leading to a more attractive investment environment</u>

- Foreign and master franchisors will not have to incur the expense of maintaining and giving disclosure documents if they are not actively involved in granting franchises. This will reduce legal expenses, and reduce the time spent by staff of foreign and master franchisor's involved in compliance activities. This, in turn, could lead to an improved investment environment in Australia for foreign franchisors considering doing business in Australia. The sector may also attract more local investment.

- The Franchising Code will be streamlined by the removal of the redundant short-form disclosure document currently set out in Annexure 2 to the Franchising Code.

- Franchisors will need to spend less time and incur less legal expense in complying with current disclosure requirements which merely result in repetition of the terms of the franchise agreement.

- The Franchising Code will be more consistent with industry practice by allowing the franchisor to receive information as set out in the franchise agreement before agreeing to a transfer or novation of the agreement. This will reduce uncertainty and improve consistency of practice among the industry.

- Franchisors, and franchisees, will benefit from a number of drafting improvements to the Franchising Code to address ambiguity and improve consistency of practice among the industry. This may reduce legal costs, uncertainty and improve consistency of practice among the industry.

- Re-making the Franchising Code regulation for another ten years to avoid the need for further reviews to address the sunsetting of the existing Code. In the absence of emerging policy concerns regarding the Franchising Code, this will promote regulatory stability.

More informed business decisions due to having addressed information asymmetries

- Franchisees will be better informed about the business opportunity being presented to them by receiving more timely and fulsome disclosure on key issues such as online trading, marketing and cooperative funds and significant capital expenditure. This, in turn, could be expected to lead to more economically efficient decisions and reduced disputation by ensuring expectations are managed, where appropriate, through the disclosure document.

- The provision of an information statement by franchisors as soon as it becomes apparent that they are likely to enter into a franchise agreement with a prospective franchisee is also expected to focus prospective franchisees' minds before they are psychologically, emotionally and financially committed to pursuing a franchise opportunity. This will encourage better due diligence and facilitate a more rational approach to decision-making by prospective franchisees.

Less unfair conduct within the franchising sector

- Amendments to the Code to improve standards of conduct within the franchising industry (e.g. the requirement for both franchisors and franchisees to act in good faith in their dealings with one another). As expressed by the results of the consultation discussed above, this should lead to reduced disputation and increased confidence in the sector (which may also enhance investment).

- Another benefit of implementing the obligation to act in good faith into the national Franchising Code is that it will assist in maintaining one consistent framework in Australia. As indicated in the Review 'submissions to the review that address this subject are overwhelming in their support for the retention of a single, national scheme'.[55]

- Australia is recognised internationally as having robust franchising legislation, 'providing great clarity and protection to franchisees.'[56] In countries comparable to Australia, such as New Zealand, Canada, the United Kingdom and the United States of America, there is no specific national franchise regulation. In these countries, there is not a general statutory requirement on parties to a franchise agreement to act towards each other in good faith; however, some jurisdictions do enforce a common law obligation for parties to act in good faith. Additionally, in some countries, franchising industry associations might require parties to exercise fairness in their dealings. As such, an obligation to act in good faith in franchising is not inconsistent with comparable international regimes.

- In Australia, the concept of good faith is not new. For example, both Western Australia and South Australia have attempted to implement state-based legislation which included an obligation on parties to act in good faith towards each other; section 228 of *the Fair Work Act 2009* (Cth) requires good faith bargaining; section 13 of the *Insurance Contracts Act 1984* (Cth) states that a "contract of insurance is a contract based on the utmost good faith and there is implied in such a contract a provision requiring each party to it to act towards the other party … with the utmost good faith"; the *Native Title Act 1993* (Cth) incorporates the concept of good faith, including in relation to negotiation under section 31; and sections 32 and 45 of the Oilcode require good faith in the renewal of fuel re-selling agreements and mediation, respectively.

Less onerous contractual terms within the franchising sector

- The prohibition of terms in franchise agreements which inequitably distribute the costs of dispute resolution will reduce the cost of disputation for franchisees, who are less likely to be able to afford to formally raise a dispute. Franchisees can then use this money in pursuit of more productive outcomes for the business.

- The prohibition of significant capital expenditure, subject to some exceptions, will provide franchisees with more certainty regarding the financial commitment they are entering into, and incentivise franchisors to clearly understand and communicate to franchisees the costs involved in running the business prior to signing the franchisee onto the franchise agreement.

- Placing reasonable limitations on the use of restraint of trade clauses in franchise agreements will promote competition and facilitate franchisees utilising skills which would otherwise not be utilised.

Improved compliance with the Franchising Code through enhanced enforcement tools for the regulator and greater sanctions for breach

[55] Mr Alan Wein, *Review of the Franchising Code of Conduct* (April 2013), p. 18.
[56] McDonalds submission to the review of the Franchising Code of Conduct, p. 2.

- Improving the enforcement options available to the ACCC for breaches of the Franchising Code will deter breaches and provide an incentive for an improved approach to compliance. This in turn will improve standards of conduct across the sector.

If this option is adopted, these benefits are expected to guard against state-based regulation and promote confidence and harmony in the franchising sector for the foreseeable future.

Costs include:

Cost of transitioning to a revised regulatory regime

- There will be costs involved in transitioning to the revised regulatory regime, such as the need for legal advice and education of the franchisor's staff regarding the changes. These are discussed further below where a quantitative analysis of the proposed changes is conducted. However, some costs are difficulty to quantify.

    : Improved enforcement tools available to the ACCC need not, of themselves, result in transitional costs because parties to the Franchising Code should already be complying with the Franchising Code as a mandatory law. However, it is possible that some franchise systems will look to update and/or and enhance their compliance models based on the additional sanctions which may apply for breaches of the Franchising Code.

Ongoing costs of complying with the amended code

- There will be ongoing costs involved in transitioning to the revised regulatory regime, for example the need to provide an information statement to all future prospective franchisees. These costs are fleshed out further below, where a quantitative analysis of the proposed changes is set out. However, some costs are difficulty to quantify, or are not appropriately characterised as compliance costs. For example:

    Good faith

    : It is noted above that good faith may improve standards of conduct within the industry and therefore lead to reduced disputation. On the other hand, good faith could have the potential to increase disputation, as it arms parties with a flexible course of action which could be relevant to a broad range of conduct, particularly in the short term before courts have had an opportunity to interpret the language of the obligation. However, in the long term, the scope of the provision would become clearer.

    : The ACCC will provide educational information on the changes to the Franchising Code. This will be aimed at educating the sector and be of a similar form to the current educational material which exists in the franchising sector.[57]

[57] For example, in 2013 the ACCC released a three page general guidance pamphlet on supply arrangements in franchise relationships, see: http://www.accc.gov.au/publications/competition-issues-in-franchising-supplier-arrangements.

: The requirement to act in good faith will apply to the negotiation of the contract and behaviour during dispute resolution; as well as the operation of the contract. It is not possible to estimate a specific addition or reduction in negotiation time that would come as a result of the introduction of an obligation to act in good faith into the Code. One view is that this obligation could extend the negotiation period as a franchisor may have to make changes to a franchise agreement based on negotiations with a franchisee. Another view expressed as part of consultation was that this obligation would provide a minimum standard of conduct in the franchise industry. This could have the effect of reducing negotiation periods as both parties could be confident of an honest discussion about the franchise agreement. The views of stakeholders on the introduction of an obligation to act in good faith are discussed in more detail above.

: In its submission to the Review, McDonald's Australia raised concerns about the introduction of good faith. McDonald's discussed the introduction of good faith in Iowa in the USA, stating that following the introduction of good faith there was 'a significant decrease in the amount of new franchises being granted, and several companies halting expansion plans for Iowa or opting for a company-owned expansion model.' The response to the introduction of good faith in Australia is likely to be small due to a number of differences including:

- Australia has a national system for franchising regulation, unlike that in the USA – there is a consistency in Australia when operating between states and territories that does not exist in the USA;
- The approach adopted to implement the good faith obligation is different – in Iowa, good faith applied in the performance and enforcement of the franchise contract and was defined as "honesty in fact and the observance of reasoning commercial standards of fair dealing in the trade" [58], whereas the obligation in Australia will not limit the common law that has applied and will extend its application to the negotiation, performance, termination and dispute resolution elements of the franchise relationship; and
- A transitional cost for legal advice to ensure compliance with the proposed good faith obligation, factored into the compliance costs discussed in this document, are calculated to be offset by the reduction in regulatory burdens from the proposed changes in their entirety. Regulatory impact costs will primarily be felt during the transitional stage (the first 12 months) of the operation of the proposed amendments. In relation to good faith, costs relate to legal advice to ensure that contracts will meet good faith requirements. [59]

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[58] See, for example, Angela Hurst, 'The Impact of the Iowa Franchise Law on Restaurant Franchisor Engagement' [1997], p. 15.

[59] Estimated to equal approximately three additional hours per franchisor.

Marketing funds

: One new requirement in relation to marketing funds is that a franchisor's corporate owned units must contribute to any marketing fund on the same basis as the franchised unit – to ensure the franchisor is not subsidising its own marketing costs from franchisees' contributions. This will involve an opportunity cost to the franchisor, as it will be required to utilise the income from corporate owned units for the purposes of marketing, reducing the flexibility of franchisors in terms of the use of income from corporate owned units. The impact of this will be moderated by the fact that, for franchise systems who have marketing funds, it is understood around half of these receive contributions from the franchisors corporate owned units. The impact will be further mitigated by other amendments designed to ensure marketing and advertising funds are used only for legitimate marketing or advertising purposes.

Capital expenditure

: There is a new prohibition on franchisors imposing significant capital expenditure on franchisees unless such expenditure is disclosed, has been approved by and is required of a majority of franchisees, or the franchisor can justify the expenditure by reference to the costs and likely benefits. Franchisors seeking to rely on this last exemption – that the franchisor can justify the expenditure – will need to expend time and possibly receive legal advice in the course of doing so. However, it is very difficult to quantify how likely it would be that a franchisor would need to rely on this exemption. It is assumed that in the great majority of cases, capital expenditure will have been disclosed to a franchisee, or would be agreed by the franchisee or a majority of franchisees. Furthermore, consultation has indicated that franchisors are already accustomed to the practice of justifying additional expenditure required of the franchisee, given that this is sound business practice in any event.

5.2.3. What are the quantitative costs and benefits of this option?

The Commonwealth Treasury has undertaken a detailed process to assist it in understanding the financial impact on businesses of adopting Option Two – a refined and revised Franchising Code. To do this, it has utilised the Business Cost Calculator available through the Office of Best Practice Regulation.[60] Consistent with regulatory impact analysis requirements, quantification has only been undertaken in relation to those changes which are expected to result in more than a nominal or minor increase or decrease in compliance costs.

The below discussion relates to some of the working assumptions adopted in the process of quantifying compliance costs (and compliance savings) flowing from the proposed changes.

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[60] Further information on the Business Cost Calculator is available from the Office of Best Practice Regulation website.

General assumptions and parameters

In quantifying the costs and savings associated with changes to the Franchising Code, the following general assumptions have been applied:

- The cost of legal advice is $500 per hour.[61]
- The average cost of an owner/manager's time is $35 per hour.[62]
- The average cost of an employee's time is $27 per hour.[63]
- The average cost of a manager's time is $50 per hour.[64]
- Changes to the Franchising Code will only apply prospectively.
- There are approximately 1180 franchisors operating under the Franchising Code.[65]

Costings have been prepared on the basis of a 10 year period from when the changes take effect.

Considerations and assumptions underpinning certain changes which will result in a net compliance cost increase

- Reviewing disclosure and other documentation as a result of recommendations relating to online activities, marketing funds, foreign franchisor details, capital expenditure, and the obligation to act in good faith. Regulatory impact costs will primarily be felt upfront during the transitional stage during the first 12 months of the operation of the amendments. In relation to good faith, costs relate to legal advice to ensure that contracts will meet good faith requirements. The additional legal costs, which will total $2,950,000, have been factored into legal advice costs in the table below (on page 45) which includes the cost of legal advice to update the disclosure document as a result of other amendments to the code. These costs are calculated over a 10 year period. More than half of the cost of the legal advice is to update disclosure documents to comply with the proposed obligation to act in good faith.

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[61] This figure is based on consultation with industry sources.

[62] According to the Australian Bureau of Statistics Publication 6306.0 *Employee Earning and Hours Australia* (May 2012), the average weekly cash earnings of an owner manager of an incorporated enterprise is $1,331.10. Based on owners working a 38 hour week, this equates to approximately $35 per hour. This publication was released 23 January 2013 and is available from the Australian Bureau of Statistics website.

[63] According to the Australian Bureau of Statistics Publication 6306.0 *Employee Earning and Hours Australia* (May 2012), the average weekly cash earnings of a non-managerial employee is $1,031. Based on employees working a 38 hour week, this equates to approximately $27 per hour. This publication was released 23 January 2013 and is available from the Australian Bureau of Statistics website.

[64] According to the Australian Bureau of Statistics Publication 6306.0 *Employee Earning and Hours Australia* (May 2012), the average weekly cash earnings of a managerial employee is $1,926. Based on employees working a 38 hour week, this equates to approximately $50 per hour. This publication was released 23 January 2013 and is available from the Australian Bureau of Statistics website.

[65] Research by Griffith University, presented in the Franchising Australia 2012 report. An electronic copy of the report is available from the Griffith University website.

- : The primary cost involved will be franchisors having to pay their legal advisers for the additional time involved in preparing disclosure documentation as a result of these changes.

- The provision to prospective franchisees of an information statement in addition to formal disclosure.
  - : The only cost to the franchisor would be through the additional time in sending the franchisee the document, and this would take approximately 15 minutes per statement.
  - : For 2002 – 2012, there was an average of 1,890 new franchisees per year. Each franchisor takes on an average of 1.6 new franchisees per year.
  - : The risk statement would most often be provided by email or in person, eliminating the cost of posting the statement to a franchisee.
- More stringent regulation of capital expenditure imposed on franchisees.
  - : The costs of this are difficult to quantify however see comments above at page [32 and 41].
- Increased ability for franchisees to vote for an audit of their marketing funds.
  - : Under the proposed change to the Code, franchisors will have to conduct the vote on an audit of the marketing fund every year as opposed to every three years. This will result in a minor compliance cost increase. Feedback to Treasury from industry representatives is that this process is straightforward. The vote is usually conducted at a regular meeting of franchisees, through voting buttons in an Outlook email or sending a form out and franchisees returning it with a yes or no vote.
  - : Franchisors will have to conduct the vote an additional seven times over a 10 year period. Currently, approximately 60 per cent of franchise systems have a marketing fund.[66]
- The imposition of a statutory obligation to act in good faith.
  - : The costs of this are difficult to quantify however see comments above at page 39 and the cost of legal advice discussed above on page 42.
- An expansion to the information the ACCC can request as part of an audit:
  - : There will be a slight increase in the time and legal costs for a franchisor complying with an audit under 51ADD of the CCA. The additional documents that the ACCC will be able to request are central to the operation of the franchise and should routinely be kept as part of the ordinary course of business by franchisors.

[66] This figure is based on consultation with industry sources.

- Expanding the obligation to disclose materially relevant facts by ensuring this captures not only the franchisor, but also associates of the franchisor.

  : The costs associated with this are expected to be negligible.[67]

Considerations and assumptions underpinning changes which will result in a net compliance cost saving

- Simplification of foreign and master franchisor disclosure requirements.

  : 32 per cent of systems in Australia use a master/foreign franchisor structure. This equates to 377 franchisors.[68]

- Removal of items 15, 16, 17 & 17B of Annexure 1

  : This will save franchisors an average of eight hours of legal advice per year.[69]

Conclusions regarding compliance costs

The following table sets out the result of the costings analysis undertaken by the Treasury in relation to the Franchising Code. It shows that, based on the costs that can be quantified, there will be a net annual compliance saving to the franchising sector of $8,608,917.50.

[67] This information is based on consultation with industry sources.

[68] Research by Griffith University, presented in the Franchising Australia 2012 report (page 85). An electronic copy of the report is available from the Griffith University website.

[69] This figure is based on consultation with industry sources.

Regulatory Burden and Cost Offset (RBCO) Estimate Table				
Average Annual Compliance Costs (from Business as usual)				
Costs ($m)	Business	Community Organisations	Individuals	Total Cost
Total by Sector	$437,882.50	n/a	n/a	$437,882.50
Cost offset ($m)				
Agency	$9,046,800	n/a	n/a	$9,046,800
Within portfolio	n/a	n/a	n/a	n/a
Outside portfolio	n/a	n/a	n/a	n/a
Total by Sector	$9,046,800	n/a	n/a	$9,046,800

Proposal is cost neutral? yes X no
Proposal is deregulatory X yes ☐ no
Balance of cost offsets $8,608,917.50

5.3. Option 3: 'Light touch' regulatory option

5.3.1. What does this option involve?

Under this option there would be no legislative changes to the Franchising Code or the CCA. Instead, the Government would take other action to address the problems identified such as initiatives to improve the education levels of franchisees prior to entering into franchising. Equipping franchisees, through education, with improved understanding of the importance of due diligence and other key information regarding operating a franchise may address the problems that have been identified by the sector including through the Review process.

This could include such practical measures as:

- Promoting awareness of existing education programs available to franchisees and franchisors (including pre-entry education programs);

- Developing new programs of this nature for franchisees and franchisors; and

- The ACCC taking a more active role in relation to prosecuting breaches of the Franchising Code with existing enforcement tools, and relevant provisions of the Australian Consumer Law. This will increase awareness among the sector of the Franchising Code and the role of the ACCC.

5.3.2. What are the qualitative costs and benefits of this option?

Costs of this option include:

- The voluntary nature of participation in education, and the limited ability to reach all of the sector's participants, means that ultimately the benefits of this approach will be less widespread than under Option 2. This is problematic given that parties who are less likely to seek out, or take up, opportunities such as pre-entry education may be the same parties who would benefit most from such initiatives.

- The Franchising Code will not respond optimally to identified problems such as information asymmetry and will therefore be less effective in meeting its policy objectives outlined at the beginning of this RIS. As a result, franchisees and franchisors will be making economically inefficient decisions and complying with unnecessary regulation.

- The compliance cost savings identified under Option 2 will not be realised by the sector. This will contribute to inefficient allocation of resources.

- While this option will lower costs for franchisors and franchisees, it will impose new costs on the Government in developing and publicising programs and administering the Franchising Code, including the high cost of enforcement.

Benefits of this option include:

- Regulatory stability and development of case law is promoted by infrequent changes to the law. The Franchising Code was introduced in 1998 and since then has been amended 4 times, in 1999, 2001, 2007 and most recently in 2010. However, it is noted that regulatory stability will not necessarily be promoted by maintaining the current Franchising Code due to the possible emergence of state-based franchising regulation.

- This would allow time for other regulatory reforms to be progressed which are relevant to franchising. For example, the Government has committed to an independent review of competition laws and policy and has further stated its preference that unfair contract terms protection be available for small business. Any regulatory changes which flow from these Government policies may be relevant to decisions regarding the Franchising Code. For example, if a franchise agreement was covered by a general rule voiding unfair contract terms, some of the changes to the Franchising Code proposed in Option 2 (above) may not be necessary.

6. Consultation

6.1. Previous consultation

As noted above, the Franchising Code has been subject to a number of reviews since it was introduced in 1998. Most recently, in 2013, a comprehensive independent review was conducted by Mr Alan Wein, followed by extensive consultation on the implementation of Mr Wein's recommendations. This included a concerted effort to raise awareness about the Review. The views of stakeholders expressed in consultation are detailed above in the impact analysis of the recommended option (see page 31 onwards). The consultation can be broken down into the following phases.

6.1.1. Release of discussion paper

In January 2013, a discussion paper was released to facilitate consultation following the public release of the terms of reference for the Review and a call for submissions. The discussion paper posed a number of questions for consideration.

6.1.2. Submissions to the Review

A call for submissions to inform the Review was made on 4 January 2013. The formal date for close of submissions was 15 February 2013. The Review received a total of 73 submissions from a range of stakeholders including government bodies, academics, professional advisers, industry associations, and individual franchisors and franchisees.

6.1.3. Meetings with key stakeholders across Australia

From January – March 2013, Mr Wein held a number of meetings with stakeholders across Australia, including government bodies and representatives, academics, professional advisers, industry associations, and individual franchisors and franchisees.

6.1.4. Consultation paper on review recommendations

The Review report was publicly released on 17 May 2013. On 17 June 2013, a consultation paper was subsequently released to seek feedback on the recommendations made by Mr Wein and options for addressing the problems he identified in the course of the Review. The purpose of the discussion paper was to facilitate further consultation on potential changes to franchising regulation.

6.1.5. Responses to consultation paper

A total of 169 responses were received to the consultation paper, again from a range of stakeholders.

6.1.6. Targeted consultation

In addition to public calls for responses to the consultation paper, targeted consultation was undertaken by government officials to further clarify the impact of particular changes to franchising regulation, where this was not clear from the submissions or responses received to the consultation paper. This involved ongoing contact with key industry bodies, professional advisers and other stakeholders over a number of months.

6.2. Future consultation

It is envisaged that draft legislation to implement the recommended option will be publicly exposed for comment during 2014 (see **Attachments A** and **B**). This will allow stakeholders to respond to the detail of how the proposed changes are implemented. While this consultation is not intended as an opportunity to revisit the policy behind the proposed changes, it will be a means of understanding any unintended consequences which may flow from the particular way in which the policy is proposed to be implemented.

7. Conclusion and recommended option

A thorough review and consultation process has resulted in a number of suggestions being put to the Government for improvements to the Franchising Code, and the provisions of the CCA which provide for its enforcement by the ACCC. These suggestions have been tested and considered according to their respective costs and benefits throughout a comprehensive consultation process. The package of changes which are put forward in Option 2, as described in Part 5, respond to problems in a manner that ensures the costs of taking action are outweighed by the benefits. The proposal in Option 2 is an opportunity to improve the Franchising Code's consistency with its original objectives, while at the same time reducing red tape and complexity for the sector.

It is recommended that the Government reform and refine franchising regulation in accordance with Option 2 as described in Part 5.

8. Implementation and review

The implementation of Option 2, as described in Part 5, will be achieved by amendments to the CCA and the Franchising Code. Copies of those prospective amendments have been prepared and are included at **Attachments A** and **B**.

As noted above, it is intended to conduct a further, final round of consultation whereby Attachments A and B are exposed for a period of public comment. Subject to any minor changes resulting from the period of public comment, the amending bill and proposed regulation will then be progressed through the Parliament and the Federal Executive Council.

It is intended that the regulation prescribing the Franchising Code will be both amended and remade to facilitate a further period of 10 years before the automatic repeal provisions of the *Legislative Instruments Act 2003* take effect.