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OF AUSTRALIA

Business Law Section

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Department of Industry, Innovation, Climate Change,
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Via email: franchisingcodereview@innovation.gov.au

8 July 2013

Dear Sir or Madam,

Review of Franchising Code of Conduct

I have pleasure in enclosing a submission on the recommendations in the Review of the Franchising Code of Conduct undertaken by Mr Alan Wein.

The submission has been prepared by the Competition and Consumer Committee of the Business Law Section of the Law Council of Australia.

Yours faithfully,

John Keeves
Acting Section Chairman

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Review of the Franchising Code of Conduct: Industry Consultation

Submission by the Competition and Consumer Committee of the Business Law Section of the Law Council of Australia

8 July 2013

1. Introduction

The Competition and Consumer Committee of the Business Law Section of the Law Council of Australia (**Committee**) appreciates the opportunity to make submissions concerning the recommendations in the Review of the Franchising Code of Conduct (**Code**) presented by Mr Alan Wein (**Wein Report**).

2. Executive summary

The Committee's submission focuses on the following issues raised by the Wein Report:

- Recommendation 9 – Express obligation to act in good faith. The Committee opposes the recommendation to amend the Code to include an express obligation to act in good faith. Instead, the Committee considers that either of Option 4 (education as a complement to Option 1) or Option 5 (Code requirement for good faith clauses in Franchise Agreements) would represent a more prudent and effective response to this issue; and
- Recommendation 15 - Enforcement of the Code, in particular the proposal to introduce civil penalties for breaches of the Code, and an expanded audit right. The Committee's view is that the introduction of civil penalties is not warranted, and the expansion of the ACCC's audit rights would be unduly burdensome and invasive.

3. Recommendation 9: good faith

The Committee has considered the concerns underlying proposals to import a defined duty of good faith in franchise dealings. Some industry participants regard the status quo as providing insufficient or uncertain protection of their interests against conduct that may be regarded as lacking good faith. On this issue, as is detailed in section 4 of this submission, it is likely that the extent of the problem has been overstated. Equally, the unintended negative effects of prescriptive statutory remedies may be under appreciated.

In response to the five options canvassed in the Wein Report for addressing concerns raised by franchisees and other stakeholders, the Committee:

- supports Options 1 and 4;
- considers that, if further certainty is regarded as necessary, Option 5 is a more prudent response than Options 2 or 3; and
- opposes Options 2 and 3.

The Committee is concerned that Options 3 and 4 may exacerbate existing uncertainty, and increase, rather than reduce compliance costs. That is why the Committee opposed, and continues to oppose creating a Code definition of a duty of good faith to be applied in proscribing conduct inconsistent with that duty,

particularly if this change will be accompanied by pecuniary penalties for breach of the Code. Such an approach will necessarily lead to parallel development of the concept of good faith, increasing uncertainty and cost. This is addressed in more detail in section 3 of the Committee's previous submission dated 22 February 2013, a copy of which is provided with this submission, for ease of reference. The Committee refers in particular to paragraphs 3.17 to 3.30 of its February 2013 submission.

Options 1 and 4

The Committee supports the proposal to complement the current legal framework with education for parties about their existing rights and obligations. As the Productivity Commission states in its Draft Report on Regulator Engagement with Small Business:¹

“Ensuring that business can readily access and understand information about their regulatory rights and obligations is critical for effective regulation”

As has been observed in several submissions, including the Committee's February 2013 submission² the existing law may imply good faith duties in franchise agreements in a manner that takes the particular circumstances of the case into account and recognises that parties to commercial contracts will necessarily act in their own legitimate commercial interests. If rights already exist, Option 4 (improved education of parties about their existing rights and obligations) represents a direct and proportionate response to the concerns of franchisees who may be unaware of their existing rights.

Option 5

When compared to the proposals in Options 3 and 4, the relative merits of Option 5 include:

- greater likelihood of maintaining consistency with the common law;
- greater flexibility to allow the consideration of particular circumstances of each case;
- use of good faith as an obligation agreed between two contracting parties, rather than a statutory standard to be enforced by regulators, who are external to that relationship.

The Committee recognises that some interests may regard regulatory enforcement as a benefit of Options 2 and 3. However, it has not been demonstrated that there is sufficient prevalence of “bad faith” conduct in the industry to justify such a fundamental change in the regulatory structure. The Committee observes that it is

¹ Productivity Commission Draft Report: Regulator Engagement with Small Business, paragraph 5.7.

² Business Law Section, Law Council of Australia Submission February 2013, p5.

not clear whether any of the “problematic behaviours” reported at pages 70 and 71 of the Wein Report would:

- already be addressed by existing consumer protection laws; or
- be clearly or necessarily in breach of a duty of good faith, so that a statutory prohibition based on the concept could be more efficiently applied than the existing law.

In these circumstances, the Committee considers that the most prudent and proportionate approach would be to follow Options 1 and 4. If the Code must be amended to increase certainty, Option 5 presents substantially less risk of unintended effects and increased regulatory costs. Of all the options, the Committee regards Option 3 as presenting the greatest threat to certainty and efficient regulation of the industry.

4. Recommendations 15(a) and (b): penalties and infringement notices for breach of the Code

The Committee supports Option 1, that is, to retain existing arrangements. Alternatively, the industry code framework should be reviewed with a view to determine whether penalties/infringement notices are the most appropriate enforcement tool within that framework (Option 4).

The main arguments for the introduction of civil penalties for breaches of the Code raised in the course of the Wein review were that:

- penalties would operate as an effective deterrent to breaching the Code, and this would assist the ACCC in its enforcement role.³ The submissions suggested a growing frustration with perceived inactivity by the ACCC, possibly due to a misunderstanding of the ACCC’s role;
- due to the cost of justice, franchisees do not possess the resources to pursue franchisors, ie the sector is characterised by an imbalance of power and therefore the state should intervene⁴.

The Committee’s view is that the introduction of penalties and infringement notices for a breach of the Code is not the best option for the following reasons.

(a) Penalties do not address the problem of franchisor misconduct, since:

(i) the problem is overstated

ACCC statistics suggest that franchisee complaints are dropping.⁵ The Franchising Australia 2012 report, published by APCFE estimates that the

3 ACCC initial submission to the Wein Report, page 5

4 Wein Report, page 129 citing a confidential submission, and submission by Colin Dorrian

5 Wein Report, page 132, citing ACCC statistics

proportion of franchisees in dispute with their franchisor in 2011 was 1.5%, and that this figure has remained constant over the last decade.⁶

The ACCC January 2013 Small Business Report⁷ states that of the franchisors it audited, the majority were found to be complying with the Code, and that many are monitoring their own compliance.

Various avenues of public enforcement for breaches of the Code are already available to the ACCC, such as public warning notices (section 51ADA); injunctions (section 80), non-punitive orders (section 86C), undertakings (section 87B); applying to a court to remedy losses on behalf of franchisees who were not part of the legal proceedings, but suffered harm from the same act or omission (section 51ADB); seeking remedial orders from a court (eg variation of a contract) (section 87); and conducting audits to monitor compliance with the Code (s 51ADD).

Given the large number of existing enforcement options, it seems likely that if there were a need for greater enforcement, then these remedies would have been used and shown to fail. The Productivity Commission draft report "Regulator Engagement with Small Business"⁸ cautions against a regulatory response in relation to incorrectly perceived risk in the small business context, due to the increased compliance costs, reputational damage to the regulator, and foregone industry investment that follow such regulation.⁹

(ii) franchisor misconduct largely relates to non-Code matters;

In the ACCC's 'Small Business, Franchising and Industry Codes Half Yearly Report' for July-December 2012,¹⁰ the ACCC reported that only 88 of the complaints it received were Code-related issues. The ACCC did not elect to seek any remedies in relation to those complaints, possibly indicating that in the ACCC's view the complaints did not warrant a regulatory response. Over seventy five percent of franchising complaints made to the ACCC related to non Code related issues (ie consumer protection or competition related issues)¹¹ for which penalties are available.

(b) Penalties would increase public and private costs, and would also lead to greater uncertainty of regulatory outcomes, potentially deterring investors and funders

The Code is an industry code concerned with achieving minimum standards of conduct in industry rather than imposing a strict form of

6 *Franchising Australia 2012*, Asia-Pacific Centre for Franchising Excellence, p.13

7 ACCC, Small Business, Franchising and Industry Codes Half Yearly Report (July – December 2012).

8 *Ibid*, at page 60

9 *Ibid*, at page 63

10 *Ibid*.

11 Wein Report, page 133

regulation, and as result the Code is general and imprecise in its terms. It is not always drafted to make it clear whether or not a breach has occurred. For example:

- Section 4(1) of the Code defines what is meant by 'franchise agreement'. The meaning of a 'system or marketing plan substantially determined, controlled or suggested' by the franchisor is unclear. For example, does this include control exerted by a licensor of a trade mark over the use of their trade mark (as is required in order to maintain ownership under the Trade Marks Act 1995)? How much must be 'suggested' in order to trigger the operation of the section?
- Section 6B of the Code outlines circumstances in which a franchisor must issue a new disclosure document, following an 'extension of the scope' of a franchise agreement. The meaning of 'extend the scope' is unclear. For example, if a franchisee moves premises into a larger site, will this be an extension of scope? What about if their marketing area is increased, or they are authorised to use an additional business name? What if the range of goods and services they are authorised to sell is increased?

Those governed by a civil penalty regime need to know the exact nature of their duties and liabilities. Uncertainty in this respect increases costs of business for both franchisors and franchisees and is likely to encourage more litigation. Uncertainty also dilutes the intended deterrent effect of a civil penalty regime. Compliance costs can be disproportionately greater for small business such as franchisees and most franchisors.¹² The Productivity Commission report referred to above suggested that a risk analysis should be carried out in relation to small business types, and that 'low-risk' businesses (which franchises are likely to be) should have a lighter regulatory burden.¹³

The ALRC 2003 report into penalties suggested that penalties should only be imposed by primary legislation, and not regulations such as a code of practice.¹⁴ The Committee suggests that before a penalty regime could be imposed, the Code would require amendment so as to be clearer in its terms, as proposed in Option 4.

(c) The cost of justice should not lead to a policy response that transfers the burden to the public purse, particularly when franchising disputes are often commercial in nature

Access to justice issues are important and complex. Past responses to these issues have included state funding of impecunious litigants, creation

¹² Productivity Commission report at n1 above, page 67 onwards

¹³ Ibid, Chapter 4

¹⁴ ALRC "Principled Regulation Report" 2003, at [6.70] and [6.30]

of the role of ombudsman and the establishment of low-cost courts and tribunals where each party bears its own costs. These avenues avoid or mitigate shifting private litigation costs to the public purse.

It is unclear that the state should fund regulatory action as a response to cost of justice issues and the imbalance of power/resources between participants in the franchising sector. Similar issues and imbalances exist in other commercial relationships (such as distribution agreements) and the policy justification for funding regulatory action in one industry sector over another is problematic.

As civil penalties are 'founded on the notion of preventing or punishing public harm',¹⁵ for their imposition to be justified the conduct to which they are attached should involve a public harm. The imposition of civil penalties will be appropriate if the cost to the public purse is justified by the scale of public benefits that would accrue from a successful prosecution.

It is unclear that the public benefits achieved through the imposition of civil penalties for breaches of the Code would outweigh public enforcement costs. Complaints about franchisor conduct do not appear to primarily relate to breaches of the Code.¹⁶ Existing regulatory remedies have not been pursued, possibly because the ACCC does not consider that there is a need to do so, either because the breaches are largely technical in nature or because no clear breach is evident.

Further, the franchisee-franchisor relationship is essentially a private relationship between two businesses. The damage that results from the contravening conduct of a franchisor is often limited to damage to the particular franchisee. Where the outcome of a dispute primarily affects the private rights of the disputants, government resources may be better focused elsewhere.

(d) The ACCC's use of infringement notices in other contexts has been problematic

The Committee has serious concerns about the use of infringement notices on a regular basis, because they effectively reverse the onus of proof and thereby risk undermining fundamental principles of justice. The ACCC has on a number of occasions issued multiple infringement notices (the amount of a single infringement notice is \$10,200) in relation to particular conduct, which has resulted in a very high penalties.¹⁷ This is not, in the Committee's view, an intended outcome of the infringement notice remedy,

15 Australian Law Reform Commission, *Securing Compliance: Civil and Administrative Penalties in Federal Jurisdictions* DP 65 (2002), 2.46.

16 Australian Competition & Consumer Commission, *Parliament of Australia, Small Business in Focus, Report No.5* (2012).

17 For example, 27 infringement notices totalling \$178,200 were issued simultaneously to Singtel Optus in the 'MaxCap' matter (refer: <http://www.accc.gov.au/content/index.php/ml/itemId/977517>). See also the ACCC submission (pp.4 – 5) to the PC draft report: "Regulator Engagement with Small Business" 3 July 2013 where the ACCC states that it has issued multiple infringement notices on 15 occasions.

which is the imposition of a penalty through an administrative process rather than through the courts. The ACCC has submitted that when it issues infringement notices, it decides whether to issue multiple notices (and hence increase the overall penalty) based on a number of factors including whether circumstances make it desirable to issue multiple notices so as to deter similar conduct by the specific business involved or the broader industry.¹⁸ It appears that the ACCC may be applying non-transparent and non-reviewable penalty principles when setting penalties. This is problematic in the case of small businesses that are unlikely to have the resources to challenge an infringement notice.

The current approach is contrary to the Commonwealth Guide to Framing Commonwealth Offences,¹⁹ which states that an infringement notice scheme should be employed for relatively minor, high volume offences where the nature of the offence is such that guilt or innocence can be assessed based on objective criteria rather than complex legal distinctions. Serious offences should be prosecuted in Court.

If an infringement notice regime is to be introduced, the Committee suggests that:

- there should be clear direction in the legislation that the issue of such a notice cannot be accompanied by the regulator extracting an enforceable undertaking in relation to the matter under dispute under the relevant legislation, for to do so undermines the assertion by Government that the issue of an infringement notice does not carry with it an implication of guilt on the part of the person to whom the notice is issued, and
- the legislation should not allow the issue of multiple infringement notices for matters that may technically involve a number of contraventions but arise out of one course of conduct. This is undesirable from the point of view of certainty and proportionality, and would be likely to have additional impact in the case of franchising (if, for example the breach related to a disclosure document). Alternatively, if multiple infringement notices may be issued, then the legislation should cap the total amount payable to a specified amount (say, \$50,000, assuming that is the maximum amount for a single penalty).

18 ACCC submission (pp.4 – 5) to the PC draft report, page 5

19 A Guide to Framing Commonwealth Offences, Infringement Notices and Enforcement Powers, AGS, September 2011, page 58

(e) Prosecution of franchisors is a blunt tool that may not materially assist a franchisee, and may damage other franchisees in the same network.

It is unclear that an ACCC prosecution will assist the individual franchisee, or other franchisees of the same franchisor. Any civil penalty will be retained by Government. Prosecution of a franchisor also has the potential to harm the brand of the franchisor, which could have undesirable flow on effects to the franchising business as a whole, and to its other franchisees. Further, prosecution of a franchisor could delay pursuit of civil remedies by franchisees.

(f) There are better alternatives, including education and greater resourcing of the ACCC

The APCFE report cites that 65% of franchisors utilise a Code of Conduct compliance program, and a growing reliance by franchisors on compliance programs managed by a third party²⁰. This suggests that a positive effect of the 2010 changes to the Code was to increase franchisor awareness of the need for compliance, partly achieving the public benefit that might otherwise be sought through the introduction of penalties.

Other methods of addressing franchisee concerns may be more effective than introducing civil penalties. For example:

- the ACCC could be better resourced to conduct a larger number of audits of franchisor compliance. The APCFE report suggests that only 4% of franchisors were audited for compliance by the ACCC.²¹ An alternative to the introduction of civil penalties may be to provide the ACCC with more resources to audit franchise businesses. The benefits of this approach are that it would better educate franchisors about the need for compliance, and provide the ACCC with more opportunities to seek remedial action where necessary;
- franchisees could be given access to a Franchising Ombudsman which could also serve the purpose of educating franchisees about what is and is not a breach of the Code, and
- the Code could be amended to require franchising contracts to include provisions that each party bear its own costs of a dispute under that contract.

20 Franchising Australia 2012, Asia-pacific Centre for Franchising Excellence, p 64.

21 Ibid at 58.

5. Recommendation 15(c): Audit powers

The Committee considers that the ACCC's existing audit powers are sufficient (option 1) for the following reasons:

(a) There is no widespread support for increased audit powers

Only the ACCC's submission supported an increased audit power. The only other submission on the subject suggested that the ACCC should carry out more audits²² using its existing audit power.

(b) The ACCC should not have unchecked powers to review the documents of private persons, particularly given the existence of its s155 power

The ACCC proposed it be given wider audit powers to assist it to check 'supporting' documents, or in scenarios where a franchisor was not required by the Code to produce documents. The ACCC's audit powers only apply to information or a document which is kept, generated or published under the Code.

It is relatively unusual for a regulatory body to have the power to compel private persons to produce documents without significant statutory safeguards. For example, the ACCC can only use its investigatory powers under section 155 of the Competition and Consumer Act (2010) Cth where it has reason to believe that there may have been a breach of that Act. This safeguard was included because the right of the state to compel production of information from citizens – in circumstances where there is no privilege against self incrimination, as is the case for companies - has been historically regarded as an intrusion into a citizen's right to conduct their affairs in private. Recipients of section 155 notices can and have challenged the ACCC regarding the issue of notices, ensuring judicial scrutiny over the ACCC's decision to issue a section 155 notice and the scope of the notice.

By contrast, there is no real ability to scrutinise the ACCC's decision to audit a franchisor. The safeguard in place is that the material which can be audited is strictly limited. If that audit throws up an issue, the ACCC may then exercise its s155 power. It would be unusual and undesirable for an administrative body to have the ability to review a wide range of internal documents of a corporation without safeguards, including the requirement that there be a reasonably based belief that there may have been a breach of a relevant law.

22 Wein Report, page 143

(c) The scope of an enhanced audit power would lead to uncertainty and regulatory cost

The ACCC submission stated that it would like to have powers to request information to demonstrate franchisor compliance with the Code. It is unclear how widely such an audit right would operate in practice. For example, it could require the production of information underlying:

- annual financial statements produced by franchisors detailing marketing funds, receipts, and expenses (clause 17 of the Code);
- the reasons for refusal of a transfer of a franchise agreement (clause 18);
- the failure of a franchisor to resolve a dispute at mediation (clause 29).

An audit request may well be very onerous and costly, based on the Committee's experience in acting for recipients of section 155 notices.

6. Further Contact

The Committee would be pleased to discuss any of the matters outlined in this submission further should it be desired. Please contact Michael Corrigan on (02) 9353 4187 or by email mcorrigan@claytonutz.com or Sarah Russell on (08) 9220 0493 or by email srussell@francisburt.com.au to facilitate further discussions.