Australian Government

Australian Small Business and Family Enterprise Ombudsman

7 September 2021

Mr Simon Arnold
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Small and Family Business Division
Markets Group
The Treasury
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via email: *Simon.Arnold@Treasury.gov.au*

Dear Mr Arnold

Exposure Draft in-confidence: Competition and Consumer (Industry Codes – Franchising) Amendment (Penalties) Regulations 2021

Thank you for the opportunity to comment on the proposed changes to penalties in the Franchising Code of Conduct (the Code). Our Office supports right-sized regulation in order to promote better practice behaviour and outcomes for small and family businesses. The Code should provide a framework for the base level of acceptable behaviour and establish what appropriate behaviour should entail, at a minimum, from both franchisors and franchisees.

Supporting and sustaining the positive symbiotic, mutually and mutually respectful commercial relationship that are at the heart of good franchising should be the objective of the Code and reforms to it.

Our Office has received over 1,600 enquiries and requests for assistance relating to franchising since 1 January 2019 and has firsthand experience of the impacts of the current Code, dispute resolution mechanisms and related compliance measures.

In regards to the Codes remedy options; compliance; and penalties, including their severity, we offer the below comments:

General comments and the intent of the Code

The framework for enforcing Code compliance is vital to the function of the Code and these components should add substance and value to the franchise sector. While we are generally supportive of the changes to the penalty system, we believe there is scope for further improvements in order to make it simpler for parties to pursue and defend their own economic interests.

The reality is that most parties who interact with the Code have a one-off dispute that is not picked up by the current enforcement and penalty regime. For these individuals, harmed by Code non-compliance and ineffective enforcement, they feel grievously let down. Had more timely and

responsive enforcement mechanisms and access to remedies been available, much of the hardship canvassed in the media and as part of parliament's most recent inquiry could have been abated.

As such, we advocate for a broader suite of tools that can support Code compliance and enforcement to include measures for access to timely justice; remedies that focus on minimising harm and achieving appropriate restoration for those adversely impacted; and penalties that are proportionate to the deliberateness and harmfulness of the breach, and more readily actionable.

Since 2019 the Australian Competition and Consumer Commission (ACCC) has investigated six cases relating to alleged breaches of the Code (Ultra Tune Australia, Rewash, Bob Jane Corporation, Back in Motion Physiotherapy, Jump Swim and Megasave). We recognise that the ACCC must use its limited enforcement resources in a disciplined way that results in the Commission targeting the most significant of breaches, in cases of systemic non-compliance and more deliberate offending against the Code. These cases tend to recognise more manifest abuses of power imbalances, malicious intent, deliberateness of action, the degree of harm caused, and the 'educative' value of prominent convictions to encourage Code compliance. As understandable as the ACCC's enforcement parameters are, the low number and prioritisation of cases each year and unavoidable delays arising from the Court process, resulting in far too many instances of poor Code behaviour going unchallenged or where perpetrations are held to account long after the economic and personal harm of Code breaches is beyond remedy.

Our Office receives regular complaints about the penalty system, noting perceptions that it does not offer a suitable remedy for the complainant and is hard to enforce. As such, we support a system that helps attract the attention of both parties and need for early corrective action, and guides them towards remediation and dialogue that leads to a mutually satisfactory solution. This should acknowledge the differences in disputes between two small businesses, in comparison to disputes between one large business and one small business. Further, it will require our Office to work together with the ACCC and the Small and Family Business Division to call out poor behaviour and seek to implement mechanisms that allow for remedies and solutions.

For example, if a franchisor does not disclose the required documents under clause 9(1) in 14 days before entry, rather than immediately applying a significant penalty, the franchisee should always be granted at least 14 days from when they have received all of the documents, as the Code currently intends. Code non-compliance at the early stage of a franchise relationship may make a prospective franchisee reconsider their options, including whether to proceed at all. This allows the franchisee the opportunity to examine and seek advice about the documents and consider the likely future conduct of the franchisor before making an important investment decision.

Application of compliance

As discussed above, far more disputes arise in the franchising system than can be adequately addressed by the penalty regime. Other measures could be implemented alongside the use of penalties in order to ensure parties covered by the Code are complying with its intent. We suggest the following framework in order to ensure access to justice for all parties:

Infringement penalties

Penalty Infringement Notices (PINs) should be implemented in order to provide a timely sanction that would trigger effectively corrective action and early steps to remedy disputes between franchisees and franchisors. These provide for a more efficient mechanism to acknowledge deliberate misbehaviour and give both parties certainty that action is being taken. PINs would also serve as a way to ensure breaches are on the record and to enable a compliance correction solution

to be achieved in a timely manner that supports Code objectives, harm minimisation and responsive 'field' solutions, capable of supporting ongoing commercial relationships, freeing up Court-focused resources and remedies for more systemic abuses, egregious conduct and repeat infringements that could warrant the full extent of available penalties.

Public disclosure

Often the most effective way to curtail misbehaviour and to trigger code-compliant adjustments in conduct is to ensure breaches are publicly known. This draws on reputational risk and public discourse in order to encourage parties to behave appropriately. Just as recent Code amendments require the reporting on ASBFEO ADR activity, our Office or some other process/agency should be authorised to routinely and regularly publicly disclose this type of Code enforcement information. For ASBFEO a register to that effect would be consistent with our current powers. As such, this option should be encouraged in conjunction with other compliance options as an effective tool to improve the franchise landscape.

Small Business and Franchising List in the Federal Circuit Court

The power imbalances between powerful parties and smaller parties are pervasive and difficult to address through the current system. Unfortunately, the escalation of disputes from Alternative Dispute Resolution (ADR) processes to a determinative decision making judgement is to escalate through the Court system. This avenue currently requires Federal Court action that actually accentuates the power and resource imbalance between small business owners and better resourced large businesses who can use their extensive legal teams, Court manoeuvrings and knowledge, and delaying tactics on top of busy Court schedule to drain the smaller litigant resources and resolve to pressure the smaller party into an outcome.

As such, a determinative and more timely 'smaller claims'-type List in the Federal Circuit and Family Court should be created to handle small business, franchising and industry code related disputes and ACCC enforcement cases where the penalty being sought is commensurate with the jurisdiction . It should be priced to be accessible for all parties, with each party responsible for their own costs, including a filing fee. The Court Book of evidence should be limited and the rules of evidence simplified. The cases should be timed so that they are resolved within one month, ensuring it is an efficient process that adds value and is worth the time and effort of all parties.

This Federal Circuit and Family Court List option should be an alternative to the current method, providing swift and effective resolution much faster, with stream-lined evidentiary rules and producing a more affordable access to justice than is available the Federal Court of Australia. It will grant greater access to justice by allowing small businesses to pursue and defend their own commercial interests, reduce the reliance on ACCC litigation and be free of the smaller party of the 'cost order gorilla'. This measure would also encourage the ACCC to pursue more responsive litigation with significant but not the greatest available penalty as the enforcement goal, supporting stronger and more consistent Code compliance activity by the regulator.

The determinative nature of this process would also benefit disputes that our Office administers through mediation, conciliation and arbitration. This is due to the creation of a viable and accessible option for escalation for both parties, which will further incentivise remediation through the Codes dispute resolution process. The creation of such a list within the Federal Circuit and Family Court of Australia would benefit all Commonwealth Industry Codes and small business disputes by strengthening and aligning resolution pathways across different sectors.

It would also help to address the *'gaps in the assistance and dispute resolution ecosystem for Australian small businesses'* highlighted in the McGregor Independent Review of ASBFEO (June 2021). It is a substantial and strategic access to justice reform initiative worthy of support.

Nudge

Finally, in order to implement these changes in an effective manner there is a need to continue to develop alternative measures to motivate parties to resolve disputes and find appropriate remedies for small business owners. We would welcome the opportunity to work with the Small and Family Business Division and the ACCC in order to "nudge" parties to obtain determinations on just terms and effect fair outcomes for each party. We look forwards to this continued work and collaboration.

Size of the penalties

The general increases from 300 to 600 penalty units should be standardised against breaches of the Code that cause harm to a party and where there is a clear burden of proof. Alternatively, clauses that are highly subjective, like the good faith clauses, will be difficult to prove and implementing incredibly high penalties will do little to support resolutions that remedy the breaches. Instead there should be public disclosure of parties that do not act in good faith, through publication of their non-compliance with ADR along with the extra measures mentioned above.

We acknowledge that there are some benefits to higher penalties. For example, having the higher penalties assists in motivating both parties to discuss solutions outside the penalty system, with the threat of the large penalties acting as an extra motivation to find a resolution. We recognise that the ACCC believes that with the increase of penalties to the Australian Consumer Law has had a material impact in ensuring that larger businesses are taking their ACL responsibilities (and any allegations of breaches) more seriously, which the ACCC has judged from the level of engagement and greater willingness to remediate any concerning conduct that the Commission may observe.

While the Court process with determine appropriate level of penalties to breaches taking into account a range of factors, the presence of the maximum proposed penalties may produce unintended consequences that should be considered. For example, smaller franchisors may find it difficult to obtain insurance that covers such a large amount, particularly professional indemnity insurance and Directors and Officer's insurance, which are already difficult to obtain given the hardening insurance market.

As such, the Department should work closely with both the ACCC and our Office to clearly promote a principles-based enforcement of these penalties to highlight that small businesses are not potentially exposed to the undue higher penalties. This should aim to build confidence in insurers that the penalties are intended to target systemic breaches and are unlikely to result in an influx of new claims.

Specific clauses

Our Office supports consistency and predictability in regards to the penalties in the Code. As such, while a more robust sliding scale for penalties may be more effective, we acknowledge that 600 penalty units is an appropriate option as determined through the Government's response to the Fairness in Franchising Report. These should be used in conjunction with the mechanisms discussed above to have effective compliance and help find appropriate remedies. We offer the below comments on specific clauses and their proposed penalties:

Decreases to clauses with a proposed penalty of $10 million+

Due to the unintended consequences and a preference to use a more robust framework to ensure compliance and find remedies, many of the proposed penalties of $10 million+ should be reduced to 600 penalty units and be accompanied by a strengthened suite of options that mitigate or remedy the harm of the breach. These include the following:

1. **Clause 6(1) Obligation to act in good faith – applies to both franchisor and franchisee:** While the obligation to act in good faith is extremely important for an effective Code, it is also very difficult to prove and enforce compliance. This means that enforcement would require costly legal proceedings, which under the current system are relatively inaccessible. Given the complexities of enforcing the Clause and the increased liability and risk this would impose on all parties, we suggest changing the penalty to 600 penalty units.
2. **Clause 9(1) Franchisor must provide disclosure 14 days before entry into franchise agreement:** There is a real possibility that this Clause will be breached by mistake. The intent of this clause, to always allow at least 14 days to review and seek advice about the information, is an example of how the Code could work in a sensible and practical way. Therefore, as the prescriptive 14-day limit may result in cases where documents are provided in a shorter timeframe without ill-intent, this Clause should be subject to the baseline 600 penalty units (as it currently stands at 300 penalty units) instead of the maximum amount of $10 million+. In addition, there should be effort from regulators to ensure the 14-day minimum time frame is met, even after an unintended misstep.
3. **Clause 28(3): Termination no breach – notice required:** For consistency and fairness this clause should also receive 600 penalty units. This is because a large fine will not benefit the franchisee who has still had their contract terminated. Instead, this clause should be subject to infringements and there should be a focus on publicising the behaviour in order to motivate both parties to negotiate and reach a solution. Further, this may help give the complainant a faster result and help deter future instances of the behaviour.
4. **Clauses 31(3)-(4) regarding marketing funds:** Marketing funds are a complex franchising arrangement that have been correctly identified as a concern. However, a penalty of $10 million+ also risks smaller franchisors who make legitimate mistakes being disproportionately penalised. As such, the penalty should be changed to 600 penalty units.
5. **Clause 41A(3) Requirement to attend Alternative Dispute Resolution (ADR):** Given this Clause will also have a large impact on franchisees and small business franchisors, applying the maximum penalty could have unintended consequences. For example, ADR can be used by one party (with more power and resources) as a threat due to the shared cost burden. A more effective way to approach non-compliance would be through publication of the non-compliant behaviour.

Agreement for clauses that incur a $10 million + penalty

Sometimes a large penalty can be a useful tool where the consequences of the breach are severe. It can also be used as an option to incentivise parties to find alternative solutions that offer remedies to the complainant, particularly in conjunction with other motivating factors such as publication of breaches. As such, some of these penalties should remain at the higher amount, as discussed below:

1. **Clause 17(1)-(2): Franchisor must disclose materially relevant facts:** When materially relevant facts are withheld from a franchisee the consequences may not surface for a long time and the harm to the franchisee can be severe. We have seen multiple cases where this is pertinent:

   Jump Swim: The franchisor for Jump Swim School failed to mention to prospective franchisees the delays in swimming pool builds that were occurring for other franchisees. As the ACCC noted in its investigation, many franchisees made considerable investment in the Jump Swim School

franchise, but failed to end up with an operable franchise within 12 months, or within a reasonable timeframe. Had they been aware of the expected delays, they may have made a different decision with their investment.

Car dealers: We have also seen well-publicised cases where automotive franchisors did not provide information to their franchisees about their plans to leave the market. This resulted in franchisees investing significant capital expenditure into their business. For example, some franchisees renovated showrooms to the specific requirements of the franchisor, only to have the franchisor withdraw and leave the franchisee with the assets and the expense to remove intellectual property.

As such, the larger penalty proposed is suitable as a tool to deter this conduct in the first instance. This needs to be in combination with other actions that are used in order to help prevent the breach from taking place. The large penalty offers an effective opportunity to begin negotiations for a remedy that will actually benefit the complainant.

2. **Clause 33: Franchisor must not restrict or impair association of franchisees:** Similar to disclosing materially relevant facts, the consequences of this clause may not materialise for many years and can have severe consequences. We have seen cases where a franchisor has actively managed a group of franchisees so they were excluded from information and association. For example, we have heard from franchisees who believe they were excluded from meetings or that invitations for some meetings were selective and group meetings were discouraged. As such, the larger penalty proposed is suitable as a tool to deter this conduct in the first instance. Further, if this breach has occurred, the large penalty offers an effective opportunity to begin negotiations for a remedy.

Increases to clauses with no penalty

To help ensure consistency some of the clauses that do not currently incur a penalty should incur 600 penalty units. Again, this will assist in providing consistency and allows a solid base to implement other means of achieving remedies, as mentioned above. As such, the below clauses should incur 600 penalty units for breaches:

1. **Clause 22 Franchise agreement must not require franchisee to pay franchisors dispute costs:** Each party should have to pay for their own dispute related costs. Unfortunately, we often see disputes where a franchisee will remedy the breach but a franchisor will still charge a fee for the issue of the breach notice. In effect, this means a franchisor is passing on the cost of a dispute and should be deterred through the Code. As such, the penalty should be changed from no penalty to 600 penalty units.
2. **Clause 25 Transfer obligations, including franchisor must not unreasonably withhold consent to transfer:** Our Office, through its dispute resolution functions, has found that transferring a franchise can be difficult. For example, we have seen cases where the franchisee has found a potential buyer but the franchisor blocked the purchase by calling on a clause in the franchise agreement to have the first opportunity to buy the franchise, only to reject the offer. In order to help prevent franchisors from unfairly impeding the transfer of a franchise, this penalty should be changed from no penalty to 600 penalty units. This should be used in conjunction with other factors, such as a measure that ensures a party allows the transfer or must buy the franchise if they have been found to have block it unfairly.
3. **Clause 27(4) Franchisor cannot terminate if breach remedied:** We often see cases where a franchisor issues a breach notice and a franchisee believes they have remedied the breach but the franchisor rejects the remedy and continues progress on the termination. To help

prevent spurious cases of a franchisor not accepting the remedy, the penalty should be changed from no penalty to 600 penalty units. To further assists this function, there should also be a measure in the Code that means a franchisor must disclose how many times they have tried to terminate after a breach is resolved and why the franchisor still sought to terminate.

Thank you for the opportunity to comment. If you would like to discuss this matter further, please contact Mr Luke Collins on 02 6213 7540 or at luke.collins@asbfeo.gov.au.

Yours sincerely

The Hon. Bruce Billson
Australian Small Business and Family Enterprise Ombudsman