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ADR in the Australian franchising sector

'Charlatans and rogues' or just another dysfunctional family? — Part 1

Elizabeth Spencer

A process of dispute resolution for franchising under the mandatory industry code, the Franchising Code of Conduct (the Code), has been in effect since October 1998. A mediation procedure outlined in Part 4 of the Code constitutes the centrepiece of this process. This mediation procedure is a great step forward from the days when there was no formally recognised mechanism for resolving disputes in franchising. There are ways, however, in which the process and procedures can serve the parties more comprehensively. This paper identifies some aspects of the nature of franchising that may be significant in the design of a dispute system to meet the needs of this unique business arrangement.

Part 1 looks at the nature of the franchise relationship and the agreements and other influences that support it; it then introduces the two government organisations which come into play when there is a dispute in franchising, the Australian Competition and Consumer Commission (ACCC) and the Office of the Mediation Adviser (OMA). In Part 2, conflict management and dispute system design theory provide the basis for an analysis of dispute procedure under Part 4 of the Franchising Code of Conduct.

The franchise relationship

The franchising arrangement is a long-term commitment to a difficult project,

often entered into with an abundance of optimism; it is not infrequently compared to a marriage. It may be more accurate to say that a franchise is like an extended family. The marriage analogy implies a dyad, while the franchise structure is usually extensive, involving multiple layers that may include investor, master franchisor, franchisor, sub-franchisor, franchisee and employee.¹ The focus of this extended family is nevertheless the franchisor/franchisee relationship. Over time this relationship suffers the stresses and strains of the many challenges it faces. While the franchisor and franchisee have a shared interest in the success of the franchisee operation, they often have quite different ideas about how this success should be achieved, and both may lack the skills and tools required to reconcile these ideas.

Traditionally in franchising, uniformity was considered the ultimate value to a successful operation. Uniformity of products, as well as in levels of service, cleanliness and other standards, has long been considered the key to the success of franchises. As the court stated in a noted Canadian case, '... it is vital to the integrity and success of the entire franchise system that the standards be uniform and that they be enforced ... maintenance of identity and uniformity must be central to continued operation of the system for all.'² Concomitant with this emphasis

on uniformity, franchising has been characterised by tightly-controlled, hierarchical organisational structures — a system of 'command and control'.

A body of academic research indicates that such management is counter-productive to the health of the organisation financially and that it is deleterious to the relationships which are crucial to the survival of the franchise.³ By widening the gap in divergent expectations and perceived commitments, command and control increases the costs of bargaining, monitoring and administration. Even if franchisors are able to structure contracts to their benefit (for example, so that they are immune to encroachment claims by franchisees in court) having unhappy, unproductive franchisees is not the recipe for a successful franchise system.

Along with the recognition that command and control impedes processes by which conflict can be resolved has come a shift in the focus of marketing and management research in the past decade. Research points to a variety of motivations for both the franchisor and the franchisee to enter franchising. Understanding these motivations is useful in managing the relationship. Because these motivations change, it is necessary to understand the dynamic of the franchise relationship as it passes through several stages of development. These stages can be summarised

roughly as follows:

- At start-up and in the early years the franchisor has a greater level of know-how and control. New franchisees require from the franchisor not only training and guidance but also reassurance; without it they may fail. Franchisor support at this stage is an important factor in avoiding problems later.
- After the first few years of operation the franchisee is comfortable with the operation of the franchise and becomes more confident in asserting her ideas and opinions.⁴ Conflicts are more likely to arise because of this increased franchisee confidence; the franchisee feels less dependent upon the franchisor and strong enough to challenge them. The franchisee senses that she understands the market and the business at a local level better than the franchisor. She may be frustrated that her good ideas cannot be easily implemented, if at all. She continues to pay the fees but perhaps with a decreasing appreciation of the benefits of the relationship.
- These 'growing pains' often level off as the franchise unit matures. The relationship may enjoy a relatively harmonious and profitable period. Here, as at any stage, the relationship is threatened by a range of issues with disruptive potential; the key is to optimise cooperation and communication.
- Termination is the final challenge for the relationship. Many difficult issues must be resolved, regarding approval of a successor by the franchisor, additional fees and costs, ownership of goodwill and other property of the franchise, and so on.

The franchise agreement

Because it concerns a long-term relationship, a franchise contract is a *relational contract*, as distinguished from a one-off, *discrete contract*, say the sale of a house (one of the saving graces is that most of the time you never see the other side again after settlement). Relational contracts should be treated differently from discrete contracts in two fundamental ways.

First, they must accommodate change. Although practitioners draft contracts as specifically as possible,

the contract cannot anticipate every contingency in a long-term business association. Highly specific and rigid contract terms are incompatible with the flexibility necessary to maintain the parties' relationship over the duration of the agreement.

Second, relational contracts must accommodate the needs of both sides in the relationship. If one party takes unfair advantage in the negotiation of the agreement, it can undermine the relationship permanently. While the side that takes advantage may believe it is making a better deal for itself, it may not be. If the relationship suffers in franchising, both sides suffer. In a discrete contract, the subject matter of the contract is relatively independent of the parties' relationship. In a relational contract, the subject matter of the contract is the relationship.

In franchising it is common to find that the relationship is underpinned by multiple agreements, the most important of which is the basic franchise agreement. This agreement may be as 'bare bones' as the regulatory environment and norms of business practice will allow, or, as is more likely under current practice in Australia, it may be comprehensive, running from 80 to 100 pages or more. In the interests of economy, certainty and control the franchisor will want to maintain as much consistency as possible in the basic agreement. Uniform agreements may also protect the franchisor from accusations of treating individual franchisees unfairly. This is not to say that there is no room for negotiation of the franchise agreement. Agreements between master franchisor and franchisor are more likely to conform to the requirements of the master franchisor and the law of its home jurisdiction, but, between franchisor and sub-franchisor agreements can reflect local norms and requirements.

The basic agreement provides the structure which supports varying configurations of ancillary agreements. Such agreements may include the operations manual, financing agreement, letters of credit, non-competition agreement, guarantee and indemnity, transfer agreement, termination agreement, release, supply

agreement, equipment purchase or lease agreement, software licence, letters of intent, joint venture agreement, methods of payment, trademark licence, and registered user agreement. While the basic agreement is relatively inflexible, ancillary agreements allow for greater specificity and flexibility. They can accommodate change that may be imposed by external forces as well as change initiated by the parties.

The range of agreements that may be used in franchise arrangements is testimony to the diversity and complexity of the franchise relationship. The need for many different contracts and agreements also underlines the inadequacy of any single agreement to address these complexities. The question necessarily arises, how well can the legal structures of contract serve the needs of parties in a complex, long-term relationship such as franchising?

While practitioners recommend that the franchise contract address issues as specifically as possible, contract cannot anticipate every contingency. Many aspects of the franchise relationship, including franchisor and franchisee motivation and commitment, change over time. While we see that interdependence has replaced command and control as the framework for understanding the complexities of franchise relationships,⁵ this interdependence is a constantly changing balance. A rigid contractual framework with rigid substantive requirements cannot offer the flexibility necessary to maintain the parties' relationship over the duration of the agreement.

A body of research addresses the problem of the inadequacy of classical contract theory to address commercial relationships of extended duration.⁶ According to the relational theory of contracts, when there is a lengthy or complex performance involved, contractual planning is important; however, business people may see the cost of planning for conflict as unnecessary.⁷ While they value trouble-free, continuing relationships,⁸ business people are uncomfortable with both formal contracts and litigation.⁹ They prefer means other than legal means for

ensuring smooth business relationships. Therefore, the theory goes, the discrete front-end bargain (that is the contract, the franchise agreement) is less significant to the parties' performance than the non-contractual 'glue' that holds the relationship together.

This 'glue' includes the norms which arise out of business relationships and course of dealing, as well as many outside influences.¹⁰ Franchisee associations, field representatives, online chat groups and franchisee opinion leaders support the relationship, as do third parties or other interested parties, such as master franchisors, employees, suppliers and family members. The business relationship is affected by banks and insurers, and by consumer and community interest groups. Finally, government, in the forms of regulation and judicial interpretation, can impact significantly on the structure of the franchise relations. In Australia, as a subset of this last category, third-party interveners such as mediators also influence the franchise in the course of managing disputes.

Beyond the franchise agreement: two key third party organisations

Contract alone is insufficient to address the problems that arise in the course of long-term complex contracts such as those found in franchising. Third party regulators and outside advisers are part of the 'glue' other than the contract that keeps business relationships together. In Australia, the two government, or government-funded, organisations concerned with franchising are the ACCC and OMA. The ACCC promulgates the Code; it is responsible for education about and enforcement of the Code, as well as other regulations that affect franchising, such as consumer protection provisions and competition law. OMA facilitates the process of mediation for parties who have reached that stage in a dispute.

The Office of the Mediation Adviser

The ACCC is not the only organisation parties may call when seeking outside help with a dispute.

The Office of the Mediation Adviser (OMA) was established in 1998 by the Office of Small Business in the Federal Department of Employment Workplace Relations and Small Business.

According to its website, the role of OMA is to 'help franchisors and franchisees to resolve their problems and disputes without going to court.'¹¹

OMA's performance of this role consists primarily of assigning mediators from a list which it maintains. OMA does not undertake to recommend procedures or educate parties. It does, however, provide guidelines for conduct of mediation.¹² The OMA website also states that the office offers a 'free telephone advisory service for franchisees or franchisors who have a dispute ... [by staff] trained to deal with enquiries about franchising disputes.' While OMA does offer advice by staff trained to deal with enquiries, the advice it offers appears to be limited to how to proceed with mediation, and how to have a mediator assigned to them by OMA. According to David Newton, Director of OMA, 'our role essentially is to appoint mediators.'¹³

Since it was established in late 1998 OMA has received 1078 dispute enquiries. About one third are referred by the ACCC, about one sixth by the Franchising Council of Australia, one sixth through previous use or word of mouth and the remaining third from the OMA website and various government departments.¹⁴ David Newton notes that there are few referrals from law firms, and indicates that OMA is currently investigating the reasons for this. Despite this lack of referrals from a key source, the number of inquiries is increasing, with the number in 2002 running 50 per cent higher than 2001. In 2003, the rate of inquiries from 1 January to 19 March was 30 per cent higher than for the same period in 2002.

This increase is attributed by OMA not to increased numbers of disputes, but rather to increased awareness of mediation as a cost-effective method of resolving differences. There are, however, no current figures to support this. In the 1999 Review of the Franchising Code of Conduct, 74 per cent of franchisors were aware of

OMA and the mediation provisions of the Code, while only 40 per cent of franchisees knew about OMA. The Review suggested that franchisors should be required to inform franchisees about OMA and Part 4 of the Code,¹⁵ but this suggestion was not formally adopted. More recent surveys have not reviewed the issue; therefore it is not clear to what extent the situation has improved in recent months. Eighty-five per cent of notices of disputes filed with OMA are reportedly from franchisees, but one cannot conclude that there is therefore greater awareness of OMA on the part of franchisees.

Of the inquiries received by OMA, about one-third proceed to mediation. There is no record of what happens to the other two-thirds of enquiries. The notification period is 21 days, and there is speculation that some disputes settle during this period. Apart from mediation, OMA does not recommend dispute resolution procedures to the parties.

In total OMA has appointed mediators for 308 mediations, roughly 70 per year since its inception in 1998. About 10 per cent of disputes settle after appointment of a mediator but before going to mediation. Of the disputes that are mediated, just over 62 per cent resulted in settlement. While over 70 per cent is a healthy rate of settlement, if only 30 per cent of all inquiries (about 124 of 380) are referred to mediation, then only about 20-25 per cent of all inquiries to OMA achieve resolution through the mediation process. It would be valuable to track the other 75-80 per cent.

Mediators on the OMA Panel must meet certain minimum qualifications. Some of Australia's most respected mediators are among the 100 or so mediators on the OMA panel. As there is an awareness that cost is a critical factor in parties' dispute resolution behaviour, many mediators on the Panel discount their services from one-third to one-half their normal rates. The average cost for mediation through OMA is estimated at a total of about \$700 per party, a huge potential saving over litigation. Unfortunately, even the modest cost of the mediation discourages some franchisees. For

example, while mediators often suggest that parties obtain legal advice as part of preparation for mediation, the cost prevents many parties from obtaining such advice.¹⁶ It has recently been suggested that a fund be set up to provide financial assistance for dispute resolution.¹⁷ That is not a new idea; the 1997 Report on Fair Trading recommended dispute resolution procedures that would be funded by compulsory registration fees.¹⁸

There have been close to 350 mediations conducted under the Code process since OMA was created in 1998.¹⁹ Many inquiries to OMA, however, do not proceed to mediation. And the fact remains that an untold number of disputes do not subscribe to the process at all. At the moment, there is no system in place to track their nature or disposition. Of the 400 or so disputes that have been mediated, because mediation is a confidential process, little is known about their outcomes or the level of satisfaction of the parties, especially months or years after the process has been completed. More information about parties' experiences and satisfaction with the process is crucial to serve the sector better.

There is also a need for an advice and referral process at the preliminary or notice stage; this too is a logical part of an expanded role for OMA. At the other end of the process, and indeed throughout the process, feedback should be gathered through interviews and surveys, and analysed to adjust and refine the system. A feedback procedure post-mediation enables OMA to maintain some information regarding the nature of disputes among franchisors and franchisees. Efforts should also be made to survey franchisors and franchisees who do not use the process.²⁰

As it operates currently, OMA is primarily a mediator referral service, with a limited ancillary role to promote mediation for small business. This narrow scope forfeits a valuable opportunity. As the first port of call for parties with disputes, part of OMA's mandate could be to help parties identify the appropriate responses for a range of dispute situations. OMA is uniquely positioned to diagnose, to

educate, and to guide parties in achieving the best outcomes in handling disputes. A narrowly circumscribed agenda may have been appropriate in the initial stages of instituting the process, perhaps helping to ensure OMA's success at the start. Five years on, however, OMA's role should no longer remain so narrowly circumscribed; OMA is uniquely positioned to build on its success and take on an expanded role in the process.

Negotiating in the shadow of the ACCC

The ACCC is the regulatory agency charged with administering the Trade Practices Act (TPA). The Franchising Code of Conduct (the Code) is the first mandatory industry code established pursuant to s 51AD of the TPA; violation of the Code is a violation of the TPA. The ACCC is the promulgator, administrator and enforcer of the Code, although original proposals envisioned a new, separate administrative body to oversee the Code.²¹ The ACCC handles inquiries, primarily from franchisees, on all aspects of the Code.

For the year ending 30 June 2002, the ACCC received 240 inquiries and complaints per quarter related to franchising. The figure was 150 per quarter in the previous year. This increase is attributed largely to amendments to the Code as well as travel industry disruptions²² in that year.

The ACCC's functions encompass law enforcement and information dissemination, subject to external review by courts, tribunals, Parliament, independent reviews and the Commonwealth Ombudsman. The main criteria for the ACCC to take on an issue include whether there is 'blatant disregard for the law', whether the problem appears widespread, and whether a clarification of the law may be warranted.²³ If such criteria are met, then the case is referred to the Enforcement Committee, which may obtain court-enforceable undertakings, or take the case to litigation. If, on the other hand, the ACCC judges the dispute to be essentially a private matter, it will encourage the parties to try mediation, and will frequently refer parties to OMA.

Despite efforts to emphasise

mediation, litigation is still the most common means of resolving significant disputes in franchising.²⁴ While ACCC officials prefer to project an image of problem-solvers rather than watchdogs, reporting that litigation occurs in only a small fraction of the total number of cases that are referred to it,²⁵ there may be situations where preparing to litigate can have as much impact as completed litigation. The Franchising Council of Australia (FCA) noted in a public submission to the Review of the Trade Practices Act (the Dawson Inquiry) that the ACCC is perceived as reluctant to negotiate, preferring instead a 'trial by media' approach that is not suitable when dealing with the type of small businesses typically found in the franchising sector.²⁶

The fact is that the ACCC can choose to play a role as a party in a dispute, or not to play a role, in a way that OMA never does. The ACCC may choose to litigate, obtain an undertaking, refer parties to OMA or discourage a party from pursuing an issue. This sort of role has the makings of a convening function, though this function is probably more appropriately placed with OMA. The ACCC's controversial involvement as a participant highlights the differences between it and OMA. It also highlights the potential role for OMA as an impartial, advisory body.

Conclusion

The ACCC's role as primary regulator and participant contrasts with OMA's role as an advisory service. The ACCC performs the functions of information and enforcement. OMA's current function, as practiced and as stated, is mainly to assign mediators.

For franchisees, and perhaps for some franchisors as well, there is a need to clarify the respective roles of the ACCC and OMA, so that parties to a dispute understand when to contact one and when the other. Franchisors have the benefit of an industry association, the FCA, that educates them on such issues. While franchisees are permitted to join the FCA, it is acknowledged to be predominantly a franchisor organisation.

Roughly half the notices of disputes filed with OMA were referred after

inquiries to the ACCC or the FCA. To an outside observer, it is not clear to what extent the two bodies work cooperatively to increase efficiency and satisfaction for their constituencies. CEO of the Franchising Council of Australia, Richard Evans, suggests that there is a 'gap' between the ACCC and OMA. As an example of who might fall into this 'gap', Evans cites small claims between franchisors and franchisees, claims that may be suited to neither avenue.²⁷ There are likely to be other disputes that do not find their appropriate method of resolution; currently there is not a sufficient procedure to determine how these various needs can best be addressed. It is important that OMA monitor the nature and scope of the disputes processed through it, and that it coordinate with the ACCC in evaluating the suitability of procedures for disputes that are handled privately as well as publicly. The ACCC and OMA can either impede or encourage improved communications and better management of conflict for franchising; if they accomplish the latter, every participant in the sector will benefit. ●

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Endnotes

1. The ACCC acknowledges the challenge it faces in regulating a sector where three or four parties may be involved, rather than the usual two, and where the ongoing health of relationships among these parties is critical. ACCC Commissioner of Small Business, John Martin, notes that it requires a shift in culture for the ACCC to address issues which involve multiple parties in an ongoing business relationship as opposed to the usual two-party dispute which often does not involve a continuing business relationship. Proceedings of the ACCC Franchising Consultative Panel Meeting, 20 March 2003.

2. *Coordinated Corporate Services*

Ltd v National Video Inc (1984) 2 CPR (2d) 251, 255.

3. Selden Andrew C, 'Organisation Design for Successful Franchising', 20 *Franchise Law Journal* 1 (2000) at 24.

4. See Phan, P, Butler, J and Lee, S, 'Crossing Mother: Entrepreneur-Franchisees' Attempts to Reduce Franchisor Influence', *Journal of Business Venturing* 11, 370-402 (1996) at 382.

5. Selden, Andrew C, 'Organisation Design for Successful Franchising' (2000) 20 *Franchise Law Journal* 1 at 24-27.

6. For an outline of the development of this area of scholarship see Schanze, E, 'Symbiotic Contracts: Exploring Long

13. Proceedings of the ACCC Franchising Consultative Panel Meeting, 20 March 2003.

14. Telephone interview with OMA Director, David Newton, April 2003.

15. Review of the FCC: Report of the Franchising Policy Council (May 2000), Appendix 4, Discussion Paper No 2, Key Findings of Franchising Industry Statistical Survey, Section 4.2 at 80.

16. See note 14, above.

17. Proceedings of the ACCC Franchising Consultative Panel Meeting, 20 March 2003.

18. See Finding a Balance – Towards Fair Trading in Australia. Report by House of Representatives Standing

It is important that OMA monitor the nature and scope of the disputes processed through it, and that it coordinate with the ACCC in evaluating the suitability of procedures for disputes that are handled privately as well as publicly.

Term Agency Structures between Contract and Corporation', in Joerges, Christian, ed, *Franchising and the Law: Theoretical and Comparative Approaches in Europe and the United States*, Nomos Verlagsgesellschaft, Baden-Baden (1991) at 78-90.

7. Macaulay, Stewart, 'Long-term Continuing Relations: The American Experience Regulating Dealerships and Franchises' in Joerges, Christian, ed, *Franchising and the Law: Theoretical and Comparative Approaches in Europe and the United States*, Nomos Verlagsgesellschaft, Baden-Baden (1991) at 188.

8. Tillotson, *Contract Law in Perspective*, 3d Edition, (1995) Cavendish Publishing Ltd, London at 28.

9. See above note 7 at 188.

10. Kidwell, John, 'Symposium: Law, Private Governance and Continuing Relationships: Relational Contract: Comment: A Caveat', 1985 *Wisconsin Law Review* 615 at 615.

11. See <www.mediationadviser.com.au>.

12. Ibid.

Committee on Industry, Science and Technology, May 1997.

19. The number is higher than the number of mediators appointed by OMA, as the parties have the option of appointing their own mediator.

20. Slaiku and Hasson, *Controlling the Costs of Conflict: How to Design a System for Your Organisation*, (1998) at 158.

21. See note 18, above.

22. September 11 and the collapse of Ansett.

23. Telephone interview with Brendan Bailey, ACCC, 9 February 2003.

24. Frazer and Weaven, *Franchising Australia 2002 Survey*, Griffith University and the Franchising Council of Australia (2002).

25. Telephone interview with Brendan Bailey, ACCC, 9 February 2003. Mr Bailey indicated that the ACCC litigates 'only a fraction of one per cent of the substantive complaints it receives.'

26. ACCC, Franchising Consultative Panel: Summary of Discussion (Draft), April 2003 at 3.

27. See note 17, above.