

26th Annual International Franchise Association and IBA Joint Conference in Washington DC on Wednesday 19 May 2010

'News from Around the World'

Franchise Developments 'Down Under'

1 Background

- 1.1 The Australian Franchising Code of Conduct (**the Code**) is a mandatory industry code prescribed under the *Trade Practices Act 1974* (Cth) (**the Act**). Its purpose is to regulate the conduct of participants in franchise arrangements, which it does by primarily requiring franchisors to disclose specific facts to franchisees and to observe certain procedures in their dealings with franchisees.
- 1.2 Failure to comply with the Code has serious consequences for a franchisor and directors of a non-compliant corporate entity may also incur accessorial personal liability.
- 1.3 Since 1 March 2008 the Code also applies to foreign franchisors even if a single master franchise is granted for Australia.

2 Australian Government Inquiries into Franchising

- 2.1 Few, sectors in Australia have been subject to such extensive Federal and State Government Inquiries over the last few years.
- 2.2 The Federal Government initiated a review of the Code on 28 June 2006 which resulted in the introduction of far reaching changes to the Code that commenced on 1 March 2008.
- 2.3 In addition to State based Government Franchise Inquiries during April and May 2008, the Federal Government's Parliamentary Joint Committee on Corporations and Financial Services (**Joint Committee**) conducted a further Inquiry and released its report into the operation of the Code on 1 December 2008.

3 Major changes recommended by the Joint Committee

Express good faith obligations

- 3.1 Whilst recognising that such an amendment only states what the law in Australia currently requires through an implied duty of good faith, the Joint Committee concluded that inserting it expressly would *'ensure that what has already been stated in the Courts will be upper most in Franchisor's minds when contemplating non-renewal or termination without breach - that is, that*

any decision to do so would not be made capriciously and without consideration for the reasonable rights of the other party to the agreement.'

- 3.2 The recommendation appears to have been motivated by a perceived deliberate failure by some franchisors to renew franchise agreements, some franchisors allegedly making 'windfall' profits by reselling the franchise and the loss of goodwill or its transferability by outgoing franchisees in those circumstances.

Pecuniary penalties

- 3.3 The Joint Committee recommended that pecuniary penalties be inserted in the Act for breaches of the Code.
- 3.4 In addition the Australian Consumer and Competition Commission (**ACCC**) also requested that its investigatory powers be enhanced so that it could conduct pro-active checks of franchisors records and activities, i.e. the ability to conduct risk based audits.

Statement of liabilities

- 3.5 The Joint Committee recommended that disclosure documents include a clear statement of the liabilities and consequences applying to franchisees in the event of franchisor failure.
- 3.6 The concern appears to be that the Code does not contain a reciprocal termination provision for the benefit of franchisees for franchisor insolvency, many of whom have no avenue to exit a franchise system if the franchisor is insolvent.

Registration system for franchisors

- 3.7 Consistent with the recommendations of the Western Australian and South Australian State Inquiries, the Joint Committee recommended that Government should investigate the benefits of developing a simple on-line registration system and annually providing a 'guarantee' that they are meeting their obligations under the Code and the Act. This would not require them to lodge their franchise agreements or disclosure documents or have them approved.
- 3.8 If implemented it may lure prospective franchisees into a false belief that registration means vetting and compliance and reduce reliance on expert advice, due diligence and the like.
- 3.9 If the 'guarantee' is implemented, it will result in significant franchisor business practice changes and costs likely to be passed on to franchisees. Apart from excessive cost, professional advisers are unlikely to issue an unqualified compliance guarantee to a franchisor. If they do, they may not enjoy any professional indemnity insurance protection. A franchisor can only attempt to comply, but cannot guarantee compliance as the Code and the Act are instruments subject to interpretation by Courts have been often differently interpreted by different Courts.

Prior disclosure and end of term arrangements

- 3.10 This will include the process that would apply in determining end of term arrangements. That process should have 'due regard' to the potential transferability of equity in the value of the business as a going concern. While the Joint Committee recognised the right of franchisors to decline to renew franchise agreements on expiration and rejected the calls for an automatic (indefinite) right of renewal, it stated that a franchisee is entitled to reasonable notice of any decision not to renew and that that decision should not be made in order to extract extra payments from a franchisee, nor to generate a 'windfall' gain for the Franchisor.

4 Federal Government response to Joint Committee report

Background

- 4.1 On 5 November 2009 the Federal Government announced major changes to the Franchising Code of Conduct (**Code**) and the *Trade Practices Act 1974* (Cth) (**Act**). The changes, detailed in a report, are a response to the report issued by the Joint Committee.
- 4.2 The Government also flagged that, in light of the numerous inquiries over the last four years, there would not be another review until 2013.

Good faith obligation

- 4.3 The Government acknowledged that good faith is still evolving and that a generic good faith obligation will increase uncertainty and, potentially result in adverse commercial consequences for the sector.
- 4.4 Instead it considered it best to identify specific franchising behaviours that would reasonably be considered to be inappropriate and to implement arrangements and policies to address those in a targeted manner.
- 4.5 At this stage, the Government intends to amend the Code:
- 4.5.1 Specifically in relation to end of term arrangements and dispute resolution.
 - 4.5.2 A list of specific good faith behaviours to be included.
 - 4.5.3 Note that the Code does not limit any common law requirements of good faith.

End of term

- 4.6 This will require franchisors to consider the following:
- 4.6.1 *'Would the prospective franchisee have any options to renew or extend the agreement beyond the original term? If so, what processes would the franchisor use to determine whether or not to renew or extend the agreement?'*

- 4.6.2 *'Information on whether or not the prospective franchisee would be entitled to an exit payment at the end of the term and, if so, how the exit payment will be determined and/or earned.'*
- 4.6.3 *'Details on what arrangements would apply to unsold stock and/or equipment. For example, would the franchisor buy the stock and/or equipment back at the end of the term? If so, how would price be determined?'*
- 4.6.4 *'Details on whether or not the prospective franchisee would have the right to sell the business at the end of the term. If the franchisor would have first right of refusal in any right to sell the business, how would value be determined?'*

Dispute resolution

- 4.7 To encourage parties to approach the dispute in a reconciliatory manner, the Government will amend the Code to include a non-exhaustive list of behaviours which may impair the effectiveness of a dispute resolution process under the Code.
- 4.8 This list of behaviours will include:
 - 4.8.1 Attending and participating in meetings at reasonable times and reasonable locations.
 - 4.8.2 Making intentions clear at the outset of a mediation (that is, if the aim is to negotiate an exit arrangement, this should be disclosed).
 - 4.8.3 Observing confidentiality obligations during and after the mediation process.
 - 4.8.4 Not damaging the franchise brand during the dispute including providing inferior goods, services or support.

Expert panel

- 4.9 In recognition of the need to define specific franchising behaviours to ensure a targeted good faith obligation, the Government established an expert panel to report on a list of specified behaviours to be incorporated into the Code that are inappropriate in a franchising arrangement. In creating this list, the expert panel will have particular reference to:
 - 4.9.1 Unforeseen capital expenditure.
 - 4.9.2 Unilateral contract variation.
 - 4.9.3 Attribution of legal costs.
 - 4.9.4 Confidentiality agreements.
 - 4.9.5 Franchisor-initiated changes to franchise agreements when a franchisee is trying to sell the business.

Unconscionable conduct

- 4.10 Under the *Trade Practices Amendment (Australian Consumer Law) Bill 2009 (Australian Consumer Law)*, introduced on 24 June 2009, the Government has indicated that it will increase the range of penalties and enforcement of measures available for unfair practices and unconscionable conduct and that these will be available in a franchising context.
- 4.11 Further, the Government has indicated that it will introduce amendments into the unconscionable conduct provisions of the Act to provide:
- 4.11.1 That the terms of a contract, the process of settling a contract, as well as the ongoing behaviour of a franchisor are relevant to a finding of unconscionable conduct.
- 4.11.2 For a specific list of examples that constitute unconscionable conduct, particularly in relation to the franchising sector. This list will be created by the same expert panel that will be advising on the inclusion of specific good faith obligations under the Code.

Penalties

- 4.12 Civil penalties of up to \$1.1 million for corporations and \$220,000 for individuals will apply to anyone engaged in unconscionable conduct or making false or misleading representations to franchisees.

5 Strengthened ACCC powers

Random audits

- 5.1 The ACCC will not be required to have any belief about non-compliance before conducting an audit.
- 5.2 However, the ACCC's audit powers will be restricted to information that is required to be kept under the Code.
- 5.3 Any further investigation by the ACCC, if required, would only occur under its existing investigative powers but before the ACCC can invoke this inquisitive process, it has to have a reasonable basis to believe there has been a breach of the Act.

Substantiation notices

- 5.4 The ACCC will be able to issue substantiation notices, requiring persons to substantiate any claims they make in promoting their goods or services. These notices will likely be utilised by the ACCC to seek information which will assist in determining whether a breach of the Code or other codes has occurred.

Public warnings

- 5.5 In addition to its investigative powers, the ACCC will be authorised to publicly 'name and shame' rogue or unscrupulous franchisors.

- 5.6 It is proposed that the written 'public warning' notice, to be introduced under the Australian Consumer Law, will only be made where the ACCC:
- 5.6.1 Have reasonable grounds to suspect that the conduct may constitute a contravention of a provision of the consumer protections provisions of the Act.
 - 5.6.2 Is satisfied that one or more persons has suffered, or is likely to suffer detriment as a result of the conduct.
 - 5.6.3 Is satisfied that it is in the public interest to issue the notice.

Class actions by ACCC

- 5.7 It is intended that the ACCC will be allowed to apply for Court orders providing redress to all 'harmed' franchisees without the need for franchisees to be party to the legal proceedings. This could include orders for a person to pay a pecuniary penalty for breach of the unfair practices and unconscionable conduct provisions of the Act.
- 5.8 The reasoning behind the proposed amendment is to assist 'harmed' franchisees unable to afford the cost of legal action against a franchisor for redress.

6 Expert panel report

6.1 Background

- 6.1.1 The three man expert panel appointed in November 2009 submitted its report in February 2010 on Strengthening Statutory Unconscionability Conduct and the Code to the Federal Government.
- 6.1.2 On 3 March 2010 the Federal Government released the report and advised of the government's support for the panel's findings.

6.2 Findings in relation to the Code

- 6.2.1 By way of summary, the following behaviours would continue to be permitted subject to the additional disclosure and comments described in 6.3 below:
 - Unilateral variation of franchise agreements;
 - Capital expenditure requirements on franchisees;
 - Amendments to a franchise agreement where the franchisee is seeking to sell its business;
 - Clauses attributing legal costs; and
 - Confidentiality agreement requirements.

6.3 Disclosure requirements for each of these should include:

- 6.3.1 In relation to **unilateral variation**, franchisor disclosure of the circumstances in which:
- Unilateral variations can take place; and
 - Whether the franchisor has unilaterally varied its franchise agreement in the past three years.
- 6.3.2 In relation to **capital expenditure**, franchisor disclosure of:
- The possibility of unforeseen capital expenditure by the franchisee, particularly as a result of the franchisor amending the operations manual; and
 - Whether significant capital expenditure would be a factor considered in deciding to renew the franchise agreement.
- 6.3.3 In relation to amendments to a franchise agreement where the **franchisee is seeking to sell its business**, franchisor disclosure of that possibility:
- In relation to clauses attributing legal costs, the franchisor disclosure of cost attribution of dispute resolution; and
 - In relation to confidentiality agreements, franchisor disclosure alerting prospective franchisees to the categories of information that cannot be discussed with existing or former franchisees.

6.4 Summary in relation to the unconscionable conduct provisions of the Act

- 6.4.1 To remedy the current uncertainty about what is unconscionable conduct for the purposes of the Act, a set of **interpretative principles** (rather than a list of examples) will be used as an aid to interpretation.
- 6.4.2 The principles will recognise that the concept of unconscionable conduct under the Act will not be limited by equitable and common law doctrines of unconscionability.
- 6.4.3 The principles will most likely include the following:
- The court may consider the terms and progress of a contract;
 - The provisions may apply to systems of conduct or patterns of behaviour; and

- The identification of a special disadvantage is not necessary to attract the application of the provisions.
- 6.4.4 A short simple 'plain English' document will be developed to be provided to prospective franchisees before they are 'psychologically, financially and legally committed to entering a franchise agreement'.

7 What this means for franchisors

- 7.1 As a result of the proposed amendments, franchisors will need to:
- 7.1.1 Ensure that their records are always complete, up to date and accurate because they could be subject to a compliance audit at any time;
 - 7.1.2 Ensure that they are able to substantiate any representations in relation to their goods and services as they may be subject to a substantiation notice at any time;
 - 7.1.3 Amend their disclosure documents to include a warning that the franchising is a business and like any other business, the franchise or franchisor could fail during the franchise term;
 - 7.1.4 Amend their disclosure documents and franchise agreements to deal specifically with end of term arrangements;
 - 7.1.5 Notify franchisees no later than 6 months before the end of the term whether or not they agree to renew the agreement; and
 - 7.1.6 Follow the behaviours to be set out in the Code in relation to dispute resolution.
- 7.2 Critically, franchisors will be more exposed to alleged contraventions of the Act and in particular the proposed extended unconscionable conduct interpretative principles. In addition to increased penalties the range of civil remedies available to franchisees will also be expanded.
- 7.3 Given an impending Federal Government election, it is not certain when these changes will be introduced.
- 7.4 Despite tighter control over franchise behaviour and increased disclosure obligations, the Federal Government has rejected many Joint Committee recommendations which had the ability to disrupt the profitable functioning of franchising as a business model.

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