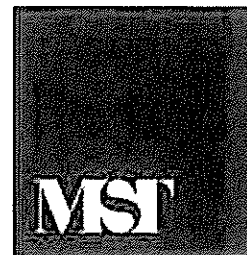


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12 February 2013

Our Ref: PC:1300095

**By email and post: [franchisingcodereview@innovation.gov.au](mailto:franchisingcodereview@innovation.gov.au)**

Dear Sirs

## **2013 Review of the Franchising Code of Conduct**

I enclose my Submission in relation to the 2013 review of the Franchising Code of Conduct.

I am happy to give evidence at any public or private hearings conducted as part of the review, if so required.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Philip Colman', written over a white background.

**PHILIP COLMAN**

Principal  
Accredited Commercial Litigation Specialist

Direct Line: [REDACTED]

Email: [REDACTED]

Enc

# Submission in relation to 2013 Review of Franchisor Code of Conduct

by Philip Colman  
Principal  
Mason Sier Turnbull Lawyers

## Credentials

1. I have practiced as a lawyer in the franchising sector since 1981 and for the past 15 years, at least 70% of my practice has involved acting for and advising franchisees and franchisors.
2. Since 2007, I have focused my practice in the dispute resolution and litigation area and I have participated in over 100 mediations representing franchisees and franchisors and assisted my clients in relation to investigations conducted by the ACCC.
3. From 1993 I have been accredited by the Law Institute of Victoria as a specialist in Commercial Litigation and between 2010 and 2012 I chaired the Commercial Litigation Advisory Committee of the Law Institute of Victoria.
4. I have presented and been asked to present on franchising related topics at:
  - (a) Numerous legal symposia organised by the Franchise Council of Australia;
  - (b) International Bar Association and International Franchise Association legal symposia;
  - (c) Seminars conducted by private CPD organisations, such as Legalwise; and
  - (d) In house seminars for clients and corporate counsel.
5. I have written numerous articles touching on good faith in franchising and unconscionable conduct.
6. Through my experience, I have seen a wide range of problems that have arisen in franchising both through the eyes of franchisees and franchisors.
7. This submission reflects my personal views and is not influenced by the views of any of my clients or other lawyers.

### Terms of Reference of the Review

8. I note that the reviewer, Mr Wein, is required to inquire into:
- (a) The efficacy of the 2007 amendments to the Franchising Code of Conduct (“the Code”);
  - (b) The efficacy of the 2010 amendments to the Code;
  - (c) Good faith in franchising;
  - (d) Rights of franchisees at end of term; and
  - (e) Enforcement of the Code.
9. I will deal with each of these topics under separate headings.

### Efficacy of 2007 Code Amendments

10. In my submission, there are two areas of major concern arising out of the 2007 Code Amendments. I detail these below.

#### *Clause 10(c) - Franchise Agreement in form in which it is to be executed*

11. The requirement that a franchisor must provide a prospective franchisee with a copy of the franchise agreement in the form in which it is to be executed with the franchisor’s disclosure document<sup>1</sup> appears to have been inserted with good intentions - after all, franchisees should receive the agreement the franchisor intends that the franchisee executes.
12. However, this creates problems where, after proper disclosure has been given, the franchisor and prospective franchisee enter into negotiations and agree to vary the terms of the franchise agreement from that provided with the disclosure document.
13. On a literal interpretation of clause 10 (c) of the Code the franchisor, having concluded its negotiations with the prospective franchisee, is then required to give the prospective franchisee another disclosure document with the amended franchise agreement in the form it is to be executed, then have to wait another 14 days before it

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<sup>1</sup> Now clause 10(c) of the Code

would be lawful for the franchisor and the prospective franchisee to enter into the franchise agreement.

14. This is uncommercial and frustrating for both franchisors and prospective franchisees, especially where the changes have been requested by the franchisee and are in the franchisee's favour. Imagine the farce if, in the second 14 day period, further amendments were negotiated and agreed upon.
15. The underlying purpose of the disclosure document<sup>2</sup> would still be achieved if clause 10(c) was amended to read:

"a copy of the franchise agreement, in the form in which ~~it is~~ the franchisor intends it to be executed".

16. A further problem arises where, at the time disclosure is given, the identity of the franchisee is not known (often the company that will become the franchisee has not been incorporated). Again, if on day 14 after disclosure, the franchisee informed the franchisor that a newly incorporated company will be taking the franchise, there would again be a need for further disclosure and the parties would have to wait another 14 days before the franchise agreement could be executed, hence delaying completion of the transaction.
17. This problem could be overcome by amending the Code to provide that the name of the franchisee or any person connected with the franchisee who will become party to the franchise agreement need not be inserted in the copy of the franchise agreement to be given under clause 10(a) of the Code. Allowing this will not detract from the disclosure given to the prospective franchisee - they know who they are or which entity will be entering into the franchise agreement.

#### *Foreign Franchisors*

18. In my submission, there is no genuine reason why foreign franchisors should not be bound by the Code.
19. However, insofar as the disclosure document is concerned, foreign franchisors from jurisdictions where there is a requirement for mandatory disclosure to prospective franchisees should be exempted from the layout provisions in clause 7 of the Code

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<sup>2</sup> See clause 6A of the Code

and be allowed, as an alternative, to provide to the Australian based prospective franchisee:

- (a) A copy of the disclosure document or like document that they are required to provide to prospective franchisees in their home jurisdiction; and
  - (b) An addendum that includes those things that are required under Annexure 1 or Annexure 2 (as applicable) that are not included in the disclosure document or like document that they are required to provide to prospective franchisees in their home jurisdiction.
20. Such an amendment will greatly reduce the costs of foreign franchisors whilst still ensure that the Australian based prospective franchisee obtains the same level of disclosure as it would have received if the franchisor was not from a foreign jurisdiction.

#### **Efficacy of 2010 Code Amendments**

21. In my submission, there are two areas of major concern arising out of the 2010 Code Amendments. I detail these below.

##### *Payments to third parties - item 13.6A of Annexure 1*

22. I submit that this requirement should be substantially watered down primarily because, in practice, the information provided by the franchisors is often meaningless. Franchisors often have some idea of the types of expenses a prospective franchisee will incur, but they are not able to reasonably estimate or give a meaningful range of such expenses.
23. I therefore submit that this obligation should be limited to the franchisor disclosing just the types of expenses a franchisor might incur and the obligations in paragraphs (b) to (e) of item 13.6A and items 13.7 and 13.8 be removed.

##### *Behaviour in Dispute Resolution*

24. Being currently involved in a matter where a franchisee has embarked on an aggressive social media and media campaign pending mediation, which has in turn incited death threats against the directors of my franchisor client, I am sensitive the these provisions.

25. In my view the Code should be amended to set standards of behaviour for all parties that apply to all forms of dispute resolution, not just those under the Code or under provisions of the franchise agreement.
26. Presently, it is possible for a franchisee to instigate mediation under State Small Business Commissioner laws, yet not be restricted by the rules of behaviour set out in clause 29(8) of the Code.
27. I further submit that the behavioural rules should be expanded to specifically prohibit publicising the dispute or subject matter of the dispute in any form of publicly accessible media.

*End of Term*

28. I submit that the existing provisions are adequate and I invite you to read paragraphs 42 to 52 below.

**Good Faith in Franchising**

29. Given the relational nature of the franchise relationship, I am firmly of the view and submit that the Code should be amended to require franchisors, franchisees and prospective franchisees to act honestly and in good faith towards each other:
  - (a) During the term of a franchise agreement;
  - (b) In connection with any form of dispute resolution process under the Code or other legislation throughout Australia (such as those available under Small Business Commissioner laws); and
  - (c) After the expiration of the term of the franchise agreement in relation to matters arising from the franchise agreement.
30. Note that I seek that the concept of honesty also be added. I say this because honesty is a fundamental community standard and I have seen too many instances where franchisees and franchisors have not been honest towards each other and I believe the Code should promote such high standards of conduct. For example, I have been involved in cases where a franchisee has signed statements of the type required by clause 11(2) of the Code to the effect that they have received legal advice about the

proposed franchise agreement (thereby giving the franchisor some comfort that the franchisee has been so advised) only to later allege that no such advice was obtained.

31. To mandate these obligations to act in good faith in the Code would be to reinforce the weight of judicial authority in Australia in cases such as:
- (a) *Far Horizons Pty Ltd v McDonalds Australia Ltd* [2002] VSC 310, where Byrne J stated that:
    - (i) There is to be implied into every franchise agreement a term of good faith and fair dealing that obliges each party to exercise the powers conferred on it by the agreement in good faith and reasonably and not capriciously or for some extraneous purpose; and
    - (ii) The scope of the duty is fettered in that it cannot operate to deny to a party the right to exercise a power conferred by the contract for the promotion or protection of its legitimate commercial interests.
  - (b) *AMC Commercial Cleaning (NSW) Pty Ltd v Coade* [2010] NSWSC 832 where Rein J stated that there was no dispute as to the legal principles relevant to franchises and referred to his comments in *J F Keir Pty Ltd v Priority Management Systems Pty Ltd* (administrators appointed) 2007 NSWSC 789, that "a franchisor is required to act reasonably and honestly (to an objective standard), not to act for an ulterior motive, to recognise and have regard to the legitimate interest of both parties in the enjoyment of the fruits of the contract, and to avoid rendering the franchisee's interest under the agreement nugatory or worthless or seriously undermining it".
  - (c) *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* Unreported BC200605745 where the court stated that although it had not been established in that case that the franchisees were vulnerable or substantially disadvantaged, authorities have indicated that the franchise relationship may frequently attract an obligation of good faith because often there is inequality in bargaining power.
32. Defining the concept of good faith can be either left to the Courts or an attempt can be made to define it.

33. If the former approach is preferred, a similar provision to section 20 of the *Australian Consumer Law* could be inserted. For example:
- "A person must not, in connection with a franchise agreement, engage in conduct that is not in good faith within the meaning of the unwritten law from time to time."
34. If the latter approach is preferred reference can be made to case law and writings on this subject.
35. Sir Anthony Mason in his article "*Contract, Good Faith and Equitable Standards in Dealing*" (2000) 116 *Law Quarterly Review* 66 stated that good faith comprised three notions:
- (a) An obligation on the parties to cooperate in achieving the contractual objects;
  - (b) Compliance with honest standards of conduct; and
  - (c) Compliance with standards of conduct which are reasonable, having regard to the interests of the parties.
36. This approach has been cited with approval in a number of cases including *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187 and *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151.
37. In *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR, Finkelstein J held that an implied term would require a contracting party to act in good faith and fairly not only in relation to the performance of a contractual obligation but also in the exercise of a power conferred by the contract. He continued on to state that the implied term imposes an obligation upon the party not to act capriciously, however, it would not operate so as to restrict actions designed to promote the legitimate interests of the party. Provided that the party exercising the power acts reasonably in all the circumstances, the duty to act fairly and in good faith will be ordinarily satisfied.
38. Good faith is often equated with the concept of reasonableness. Although the Victorian and New South Wales courts diverge on the basis of an implied duty of good faith, it appears that their approach to the content of such a term is more aligned,



in that while the duty of good faith may require a party to consider the interests of another, it will not require that party to act against its own interests in doing so. Bryne J in *Far Horizons v McDonalds Australia* (2000) VSC 310 described a breach of the obligation of good faith as where a party seeks to further an ulterior purpose or a purpose extraneous to that for which a right or power is conferred.

39. While the precise nature of the duty of good faith remains uncertain, it is clear that the guiding principle in most cases will be whether or not a party was acting to pursue its own legitimate interests, or whether its motivation was to frustrate or harm the other party. However, a duty of good faith falls well short of a fiduciary duty. A duty of good faith does not require a party to exercise its rights for the benefit of the other party or refrain from exercising its rights or deriving a benefit where to do so conflicts with the interests of the other party.
40. I stress that the obligations must be imposed on all parties to the franchising relationship. Regrettably, I have seen many instances of franchisees behaving poorly in the lead up to mediations, including the posting of denigrating comments on internet blogs and social media and discussing the subject matter of their dispute with mainstream media. Whilst such conduct may constitute a breach of clause 29(8) of the Code, it would not do so, if the pending mediation was under the Code, but instead mediation under Small Business Commissioner laws.
41. Clearly such action would be considered bad faith and the mandating of obligations for parties to act in good faith would give the franchisor access to remedies for Code breaches in these circumstances.

#### **Rights of Franchisees at End of Term**

42. I submit that the rights of a franchisee at the end of the term of a franchise agreement (by this I mean, at the end of the last term of the franchise agreement if options to renew have been exercised or the end of the initial term of the franchise agreement where no options to renew are reserved to the franchisee in the franchise agreement) should be governed by the franchise agreement itself.
43. I say this because:

- (a) The nature of a franchise is the granting of a licence or permission by the franchisor to allow the franchisee to use and obtain benefit from the franchisor's intellectual property and/or systems, where ownership of those rights never passes to the franchisee;
  - (b) The owner of such property should be entitled to set the terms upon which it will allow others to use it, including through granting rights for a finite term; and
  - (c) To require franchisors to provide some compensation to a franchisee at the end of the term would be tantamount to requiring the franchisor to pay a price to buy back what the franchisor already owns.
44. The franchisor's position is akin to a landlord. A landlord grants a tenant a right to occupy premises for a finite term and when that term expires, the tenant must vacate the premises, even though the tenant may have vastly improved the premises at its cost (similar to a franchisee building up goodwill during the term of a franchise agreement). The rights of a landlord are enshrined into tenancy law in Australia and there seems to be no basis to distinguish between the landlord/tenant relationship and the franchisor/franchisee relationship – both involve the granting of rights to use differing types of property for finite terms.
45. In my experience, too many franchisees do not understand what a franchise is and that, absent an entitlement in the franchise agreement, the goodwill of the franchised business evaporates at the end of the term.
46. The 2010 Amendments to the Code sought to redress this by requiring franchisors to insert into their Disclosure Document "arrangements to apply at the end of the franchise agreement"<sup>3</sup>.
47. In my opinion, the lack of understanding by franchisees as to what will occur at the end of the term is caused by factors such as:
- (a) Franchisees not reading or understanding item 17C of the Disclosure Document;

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<sup>3</sup> Item 17C of Annexure 1

- (b) Item 17C of the Disclosure Document being hidden in a mass of daunting paperwork;
  - (c) Franchisees receiving no, or inadequate, advice;
  - (d) Franchisees, despite being properly advised and fully understanding item 17C of the Disclosure Document, believing “it will not happen to me – surely if I am a good franchisee, my franchisor will grant me another term.”
48. Incidences of such false expectations by franchisees might be reduced if the Code mandated:
- (a) The provision of a Government or ACCC produced booklet explaining what a franchise is, including the fact that at the end of the term of the franchise agreement the franchisee may be required to vacate business premises and make good the premises and/or cease operating the business without any compensation for the value of the business;
  - (b) Requiring franchisors (perhaps after the statement required on page 1 of the Disclosure Document) to state clearly:
    - (i) What rights are being granted to the franchisee;
    - (ii) How long they will have those rights;
    - (iii) Whether the franchisee will have any option to seek an extension of those rights and, if so, the circumstances in which the franchisor may refuse to do so; and
    - (iv) What the franchisee can expect to receive at the end of the term (for example as statement such as, “When the term of your franchise agreement comes to an end, you will not longer be permitted to operate the franchised business. You will not receive any money for the loss of these rights, unless this is specified in the franchise agreement.”
49. Franchisee advocates argue that franchisors engage in the unscrupulous practice of “churning”, whereby franchisors effectively re-acquire a franchisee’s business for nothing or a small sum, and then re-sell it at a huge profit.

50. When the term of a franchise agreement comes to an end, the franchisee no longer has the right to operate the business (just as the tenant whose lease has expired, no longer has the right to occupy the premises and conduct a business therefrom). The franchisee retains ownership of the tangible assets of the business (equipment, plant, vehicles and the like) and in the absence of the franchisor exercising any option to purchase those assets, the franchisee is free to sell those assets. Therefore, all that the franchisor obtains at the end of the term is the freedom to re-grant the franchise rights to someone else. That is not churning.
51. If the Government mandated that franchisor must pay a reasonable sum for the goodwill of the franchisee's business at the end of the term:
- (a) The calculation of goodwill should exclude any goodwill associated with the franchisor's intellectual property, reputation, brands and systems (as this belongs to the franchisor);
  - (b) Added cost will arise from:
    - (i) The likelihood of disputes as to value; and
    - (ii) The need to engage Valuers;
  - (c) Such a requirement should not apply to existing franchise agreements and should only apply to franchise agreements entered into after the commencement of such laws (I say this because, if franchisors are required to compensate franchisees for goodwill at the end of the term they may wish to increase fees payable under the franchise agreement); and
  - (d) There is a risk that franchising (with a much higher success rate than non-franchised businesses) will decline significantly.
52. For all of these reasons, I submit that the rights of a franchisee at the end of the term of a franchise agreement should be governed by the franchise agreement itself and supplemented by more transparent disclosure are suggested above.

### **Enforcement of the Code**

53. I submit that the civil remedies available under the *Competition and Consumer Act 2010* (Cth) ("CCA") are adequate.

54. I agree with the rationale behind the government's past decision against allowing the ACCC to seek civil pecuniary penalties for a breach of the Code.
55. The reality is that the ACCC rarely brings civil proceedings against franchisees or franchisors that have breached the Code alone and that with the higher standard of proof required in a proceeding seeking civil pecuniary penalties, it is unlikely that the ACCC would issue such proceedings, given its other enforcement powers.

**Conclusion**

56. I welcome this review. There are many other aspects of the Code that I believe require attention, but not that these are outside the terms of reference.
57. I am happy to give evidence at any public or private hearings conducted as part of the review, if so required.

**PHILIP COLMAN**

12 February 2013