DLA Piper Australia
201 Elizabeth Street
Sydney NSW 2000
Australia
DX 107 Sydney
T +61 2 9286 8000
F +61 2 9283 4144
W www.dlapiper.com

Review of the Franchising Code of Conduct

DLA Piper Submission

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INTRODUCTION

1. DLA Piper welcomes the opportunity to provide our submission on the Government's review of the Franchising Code of Conduct. DLA Piper routinely provides clients with legal advice on the application of, and compliance with, the Franchising Code of Conduct, including foreign franchisors entering the Australian market, and this submission is largely based on this experience.

2. In this submission we have not responded to all of the discussion questions posed in the *Discussion Paper: Review of the Franchising Code of Conduct*, by Alan Wein dated January 2013 (**Discussion Paper**) but rather those issues we consider to be of most importance. We have included a heading of the relevant term of reference in each section.

EFFICACY OF THE 2008 AND 2010 AMENDMENTS TO THE FRANCHISING CODE

Exemption for foreign franchisors

> DLA Piper submits that the removal of the foreign franchisor exemption has created an unnecessary compliance burden for foreign franchisors for limited benefit.
>
> It also contributes to a negative perception that Australia is a costly and overly regulated business environment. This may act as a deterrent against new entrants into the Australian market.
>
> Accordingly, we submit that the exemption should be reinstated in full **or** reinstated for franchisors that grant a franchise to a sophisticated investor, a subsidiary or a related body corporate.

3. The 2008 amendment to the Code removed the exemption applicable to overseas franchisors (where the franchisor was a resident, domiciled or incorporated outside of Australia) and only entered into a franchise agreement with a single franchisee.

4. The effect of the 2008 amendment is that an overseas franchisor who grants a single master franchise in Australia is required to comply with the disclosure obligations under the Code. In particular, both the franchisor and the master franchisee must either:

   4.1 provide the prospective subfranchisee with both a disclosure document from the franchisor for the franchise and a disclosure document from the master franchisee for the subfranchise; or

   4.2 provide the subfranchisee with a joint disclosure document that details the respective obligations of the franchisor and the master franchisee in the operation of the franchise.

5. The franchisor owes a duty of disclosure to both the master franchisee as well as the franchisee.

6. This has resulted in an increase in the regulatory burden and costs for franchisors.

7. We note that this is not regulated in the same way in other jurisdictions (in particular the United States). This contributes to a negative perception that Australia is a costly and overly regulated business environment. This may act as a deterrent against new entrants into the Australian market.

8. DLA Piper submits that this exemption should be reinstated.

9. If it is not reinstated, DLA Piper submits that, at the very least, it should be reinstated to apply to foreign franchisors who have granted a single franchise or master franchise to:

   9.1 a person who satisfies a set of agreed criteria to qualify as a "sophisticated investor" (see below);

   9.2 a subsidiary of the foreign franchisor; or

   9.3 a related body corporate of the foreign franchisor.

10. We would also like to highlight that reinstatement of the exemption would not affect the obligations of master franchisees in Australia, who have been appointed by foreign franchisors, to comply with the Code in respect of their agreements with their Australian sub-franchisees. Sub-franchisees in Australia will continue to have the Code's protections in respect of their franchise agreements with the Australian master franchisee.

Sophisticated investor exemption

DLA Piper submits that the Code should not apply to master franchisees or to franchisees who meet certain criteria that qualify them as "sophisticated investors" or "knowledgeable franchisees".

11. Often franchisors enter into franchise agreements with master franchisees which are public companies or controlled by public companies. In these circumstances, providing a disclosure document and a copy of the Code to, and requiring franchisee statements from, such franchisees can amount to over-regulation and over-reach into commercial relationships between sophisticated businesses.

12. Accordingly, DLA Piper submits that an exemption apply where the:

    12.1 franchisee is or is controlled by, a public company (listed or unlisted) (as defined in the *Corporations Act 2001* (Cth));

    12.2 franchisee is, or is controlled by, a large proprietary company (as defined in the *Corporations Act 2001* (Cth));

    12.3 franchisee's business has a turnover or revenue above a particular threshold; or

    12.4 franchisee is required to invest a certain level of working capital to commence operation of the franchised business.

13. DLA Piper further submits that, in respect of paragraphs 12.1 and 12.2 above, this means the onus is properly placed on the sophisticated controlling shareholder to provide information and support to its minority shareholder(s) rather than place this burden on the franchisor.

14. Some foreign jurisdictions (for example, in the United States) currently have a similar exemption. Accordingly, in the interests of attracting investment in the region we submit that a similar exemption be introduced in Australia.

Fractional franchise exemption

DLA Piper submits that the limited application of the fractional franchise exemption further illustrates the need for the foreign investment exemption to be reinstated.

15. The Code does not apply to a franchise agreement in some limited circumstances, one being where all of the following apply[1]:

    15.1 the franchise agreement is for goods or services that are substantially the same as those supplied by the franchisee before entering into the franchise agreement;

    15.2 the franchisee has supplied those goods or services of that kind for at least two years immediately before entering into the franchise agreement; and

    15.3 sales under the franchise are likely to provide no more than 20% of the franchisee's gross turnover for good or services of that kind for the first year of the franchise.

16. This is commonly referred to as the "fractional franchise exemption" and we have adopted this terminology in this submission.

17. In our experience, the fractional franchise exemption has had more of a role to play since the removal of the foreign franchise exemption. In our view, the fractional franchise exemption is inadequate.

18. The Code does not contemplate application of the exemption to a corporate group and it is unclear whether a legal entity that executes a franchise agreement must be the same as that which was operating the other business. For example, if a new entity is set up to act as a stand alone franchisee it is unclear whether the exemption will apply.

19. Companies will choose particular structures for legal and tax reasons. The application of this exemption results in the Code applying in some circumstances and not in others.

Motor vehicles

DLA Piper submits that the breadth of the definition of "motor vehicle" is extremely wide and should either: (i) be narrowed or clarified as to its application to "motor vehicles" that are not cars, such as boats and agricultural machinery; or (ii) appropriate exemptions need to be included to ensure the Code does not apply to persons who are not participants in the franchising industry.

20. Whether an agreement is regulated by the Code will depend upon whether the agreement fits the definition of a "franchise agreement".

21. There are a number of conjunctive requirements set out at clause 4(1) of the Code such as that:

    21.1 the agreement can be written, oral or implied;

    21.2 one party (the franchisor) grants a right to another party (the franchisee) to conduct a business under a system or marketing plan and is able to exert substantial control over the operation of that business;

[1] Clause 5(3)(b) of the Code.

21.3 the business will be associated with a trademark or symbol owned, used or specified by the franchisor or an associate; and

21.4 the franchisee is required to pay, or agree to pay, a fee before starting business.

22. In addition, and of interest for the purpose of this submission, there is a deeming provision at clause 4(2) that provides that any "motor vehicle dealership agreement" will be deemed a franchise agreement. Accordingly, a "motor vehicle dealership agreement" is a franchise agreement whether or not it meets all, or indeed any, of the requirements set out at clause 4(1) and noted above.

23. The definition of "motor vehicle" (as set out at clause 3(1) of the Code) is very broad. It includes "a vehicle that uses, or is designed to use, volatile spirit, gas, oil, electricity or any other power (except human or animal power) as the principal means of propulsion, but does not include a vehicle used, or designed to be used, on a railway or tramway".

24. The breadth of this definition, and the application of the deeming clause, is such that it captures agreements that would not otherwise have been considered franchise agreements (by reference to clause 4(1) of the Code).

25. Effectively, the Code's application is determined not by the relationship between the parties and in accordance with the Code's purpose but rather by the nature of the products distributed, regardless of the nature of the legal and commercial relationship between parties.

26. "Motor vehicle dealerships" in the automotive industry are likely to have some of the conjunctive requirements set out at clause 4(1) of the Code (for example, the operation of the franchised business will substantially or materially be associated with a trade mark). However, unlike automotive industry "motor vehicle dealerships", agreements to distribute other products (such as agricultural machinery, ride-on lawn mowers or boats) may not have any of the elements set out in the conjunctive requirements at clause 4(1) of the Code whatsoever, particularly where such products are retailed by multi-brand independent distributors of that product and/or of a diverse range of products, one of which is the product classified as a "motor vehicle" for the purposes of the Code.

27. Manufacturers, distributors and wholesalers of these products (outside the automotive industry) are not able to rely on the structure of their distribution arrangements to show they are not "franchise agreements" because of the automatic application of the Code by virtue of clause 4(2) of the Code.

28. In pure product distribution or reseller agreements for products that are caught by the definition of "motor vehicle", the relationship between the parties is not in any way comparable to a business format franchising relationship which involves a system or marketing plan substantially determined, controlled or suggested by the franchisor. In these circumstances, unless the parties are eligible for an applicable exemption, they are subject to the regulatory burdens and costs associated with the Code. Furthermore, they are subject to a regulatory framework that in many respects does not bear relevance to the nature of their business relationship.

29. The only exemption currently available in such circumstances is the fractional franchise exemption in clause 5(3)(b) of the Code. As discussed above, there are a number of issues involved with applying this exemption making it unreliable in certain circumstances. Further, it requires such manufacturers and wholesalers of "motor vehicle" products to go to the effort and expense of obtaining legal advice to determine the extent of their obligations and to rely on information provided to them by their resellers. It also limits the pool of

potential resellers to those who will be able to fall within the fractional franchise exemption, should the manufacturer wish to avoid the Code's application in a particular circumstance.

30. The reinstatement of a foreign franchise exemption would at least provide an exemption for overseas distributors that grant reseller rights to one organisation in Australia. Therefore, the breadth of the definition of "motor vehicle" and the deeming clause further illustrate the necessity to ensure there are other appropriate exemptions in the Code (please refer to our comments on the need for a sophisticated investor exemption).

GOOD FAITH IN FRANCHISING

The amendments in 2010 to the Franchising Code and the proposed insertion of an overarching obligation to act in good faith

DLA Piper submits that the Code is appropriate given that the law is not settled in this area.

31. The 2010 amendment to the Franchising Code clarified that the Code did not limit any obligation imposed by the unwritten law on parties to a franchise agreement to act in good faith (as per section 23A).

32. As highlighted in the Discussion Paper, this explicitly preserved and drew the attention of the parties to the possibility of taking action pursuant to the common law relating to good faith.

33. Notwithstanding this amendment, there is still a push by some for the inclusion of an explicit obligation of good faith to be included in the Code.

34. In our view, there are proper remedies for franchisees for any imbalance of bargaining power without the need to include an explicit good faith obligation. As highlighted in the Discussion Paper, there are statutory obligations relating to unfair practices set out in the Australian Consumer Law. Further, the law on unconscionability, equitable estoppel and promissory estoppel are available to ensure that there are appropriate remedies for injustice.

35. We also submit that inclusion of an explicit obligation is inappropriate given that there is no uniformity in Australia in relation to good faith in terms of content, form or even whether there is a general implication at law requiring parties to act in good faith in negotiating a contract or performing a contract.

36. There was a series of New South Wales Court of Appeal decisions from 1991 to 2001 which saw good faith recognised as a sufficiently certain concept to found a legally enforceable obligation to negotiate in good faith and as the foundation of a duty that may be implied into a contract.[2]

37. However, other intermediate courts have reacted differently in some circumstances with caution[3] and even doubt.[4]

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[2] *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* (1991) 24 NSWLR 1, *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, *Hughes Bros Pty Ltd v Trustees of Roman Catholic Church* (1993) 31 NSWLR 91, *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349 and *Burger King Corp v Hungry Jack's Pty Ltd* (2001) 69 NSWLR 558.

[3] *Central Exchange v Anaconda* (2002) 26 WAR 33.

38. The High Court has yet to express a conclusive position.[5] Therefore, in our view, until the High Court has had an opportunity to definitively review the doctrine, the obligation to act in good faith should not be prescribed in the Code as it is an evolving concept.

39. It is also unclear to us how the obligation to act in good faith would apply, if introduced into the Code. For example, is it a general duty, one that applies to pre-contractual negotiation, or to the exercise of rights and powers under a concluded contract only?

RIGHTS OF FRANCHISEES AT THE END OF THE TERM

Rights of franchisees at the end of the term

DLA Piper submits that the rights of franchisees at the end of the franchise term are adequate.

40. The amendments in 2010 provide franchisees with adequate disclosure about the end of term arrangements that will apply. In particular, franchisors are required to disclose:

    40.1 whether the franchisee will have any options to renew, extend or extend the scope of the franchise agreement, and if so, the process the franchisors will use to determine whether to renew, extend or extend the scope of the agreement or enter into a new agreement;

    40.2 whether the franchisee will be entitled to an exit payment, and if so, how it will be determined or earned;

    40.3 details of the arrangements that will apply to unsold stock, marketing material, equipment and other assets purchased when the franchise agreement was entered into – including whether the franchisor will purchase these assets and, if so, how prices will be determined;

    40.4 whether the franchisee will have the right to sell the business at the end of the franchise agreement and, if so, whether the franchisor will have first right of refusal, and how market value will be determined; and

    40.5 whether the franchisor will consider any significant capital expenditure by the franchisee during the franchise agreement in determining the arrangements to apply at the end of the franchise agreement.

41. In our view, this level of transparency sufficiently protects the franchisees in relation to the end of term arrangements.

42. Further, the notice of non-renewal clause which requires the franchisor to notify a franchisee at least 6 months before the end of the term of the franchisor's decision to renew or not, or enter a new agreement (or 1 month if the term is for less than 6 months) is entirely appropriate in our view.

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[4] *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228; *Wenzel v ASX Ltd* (2002) 125 FCR 570 at 586-587.

[5] *Royal Botanic Gardens Royal Botanic Gardens & Domain Trust v South Sydney Council*(2002) 240 CLR 45 at [40], [88], [155].

43. DLA Piper submits that a franchisee's misunderstanding of the terms of a franchise should not be a reason to amend the Code. Franchisee misunderstanding should be addressed through other avenues.

Recognition for any contribution by the franchisee

DLA Piper submits that recognition for any contribution by the franchisee should be left to the parties to negotiate.

44. In our view, any attempt to codify rights for franchisees in the Code (such as transfer of proprietary rights in the franchise system or in the brand, intellectual property and reputation of the franchisor or of a third party) would effectively override contractual terms negotiated between the parties.

45. Classic contract theory emphasizes the freedom of parties to contract on terms of their choice.

46. As noted above, it is our view that the Code requirements in respect of disclosure as to end of term arrangements and minimum notice periods of non-renewal effectively ensure that franchisees are informed of any end of term arrangements and mandate a minimum notice period for non-renewal. Accordingly, DLA Piper submits that any end of term arrangements should properly remain a matter for commercial agreement between the parties.

47. In our view, the franchisee is entitled to the revenue earned, but good will in the franchise should automatically accrue to the franchisor in the absence of agreement to the contrary. Good will is, and will likely always be, exclusively associated with the franchisor. A customer will rarely recognise the individual franchise owner.

THE OPERATION OF THE PROVISIONS OF THE COMPETITION AND CONSUMER ACT 2010 AS THEY RELATE TO THE ENFORCEMENT OF THE CODE

The current enforcement framework

DLA Piper submits that the current enforcement framework to deal with compliance with the Code is adequate.

48. There are already a number of available remedies and penalties which can be applied when a party breaches the Code.

49. Briefly (as these have been extrapolated in the Discussion Paper), courts can impose a number of remedies (such as compensation, court enforceable undertakings or public warning notices) and civil pecuniary penalties in some circumstances (such as for misrepresentation).

50. Even with this range of remedies and penalties available, some have argued that civil penalty provisions are necessary in order to ensure that there are consequences for non-compliance with the Code. As noted in the Discussion Paper, the Joint Committee Report[6]

[6] The Parliamentary Joint Committee on Corporations and Financial Services, *Opportunity not opportunism: improiving conduct in Australian franchising* (2008).

referred to evidence from the ACCC that the implementation of such penalties would also in part address concerns that the Code and the regulator lacked teeth.

51. We would disagree with this point. We have reviewed the Australian Competition and Consumer Commission (**ACCC**) Annual Report for 2011 - 2012. There are three points of interest:

   51.1 the Chairman, Rod Sims, in noting the key areas of focus over the medium-term did not identify franchising as an issue (although he notes that close attention to alleged unconscionable conduct will be paid to business-to-business markets);[7]

   51.2 the Chairman further reports that audit notices were served on 20 franchisors aimed at ensuring the businesses were complying with the Code. He states that most businesses were compliant and the audits revealed breaches by a small number of franchisors and were being investigated; and[8]

   51.3 there have been less complaints or inquiries about a franchise matter in the 2011 - 2012 period when compared to 2010 - 2011.[9]

52. In our view this indicates that the ACCC is already effectively dealing with any breaches of the Code with existing powers.

53. We also note the case of *Master of Education Services Pty Ltd v Ketchell* in the High Court where the court noted that there is flexibility in the type of relief available courts are able to award. The High Court found that a franchisee is able to seek such relief as was appropriate to the circumstances of the case and continued: "some cases of non-compliance with cl 11 [requiring a written statement that a franchisee has received, read and understood a disclosure document] might involve substantial non-disclosure; others may only involve a failure to obtain the written statement, confirming that the franchisee has read and understood the disclosure document and the Code."[10]

54. Although this case interpreted the *Trade Practices Act* 1974 (Cth) (the predecessor to the *Competition and Consumer Act* 2010 (Cth), it illustrates that the High Court does not recognise any deficiencies in the available remedies it can apply under the Code.

55. We would also argue that any aggravating conduct of a franchisor would be caught under the applicable provisions of the Australian Consumer Law in any event.

We would like to thank you for taking the time to consider DLA Piper's submission.

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[7] Australian Competition and Consumer Commission, Annual Report 2011 - 12, 16 October 2012, pg 8.

[8] Australian Competition and Consumer Commission, Annual Report 2011 - 12, 16 October 2012, pg 4.

[9] Australian Competition and Consumer Commission, Annual Report 2011 - 12, 16 October 2012, pg 138.

[10] *Master of Education Services Pty Ltd v Ketchell* [2008] HCA 3 per Gummow ACJ, Kirby, Hayne, Crennan and Kiefel JJ at [39].