Submission by the Franchise Council of Australia to Mr Alan Wein in relation to the Department of Industry, Innovation, Science, Research and Tertiary Education, Discussion Paper: Review of the Franchising Code of Conduct, 2013.

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The FCA supports our regulatory framework

The Franchise Council of Australia is the peak industry body for the franchise sector, representing franchisors, franchisees, service providers and suppliers involved in franchising. The FCA is a strong supporter of the current regulatory framework, which is clearly best practice when compared to other regulatory regimes around the world.

The regulatory framework includes the Franchising Code of Conduct, but also includes the prohibitions on misleading or deceptive conduct and unconscionable conduct contained in the Competition and Consumer Act, which have wide potential application to franchising. The oversight of the sector by the Australian Competition and Consumer Commission, arguably Australia's best resourced and most effective regulator, has recently been supplemented by the appointment of Federal and State Small Business Commissioners. This comprehensive framework supports, but does not unreasonably interfere with, the fundamental principles of contract law that underpin business dealings throughout the Western world.

The FCA welcomes the appointment of Mr Alan Wein to review and report on the effectiveness of the recent amendments to the Franchising Code of Conduct. Although this is a scheduled review, it should be considered in the context of the many previous reviews of the franchise sector[1]. The collective input and wisdom of those involved in previous reviews and inquiries have created our current regulatory environment, which the FCA believes fairly balances the interests of franchisors and franchisees in this dynamic industry sector where almost all participants are small businesses[2]. The FCA supports the terms of reference for the review, as they should hopefully ensure that issues that have been considered in detail by past inquiries do not need to be revisited.

It is critical that any legislative reforms are based on careful analysis of evidence and proper process, and are not introduced simply to appease individuals or organizations. The focus of the current review is on the efficacy and effectiveness of the 2008 and 2010 reforms. In that context it is worth noting that the FCA supported the 2010 reforms notwithstanding that we felt there was little evidence that the issues that were the subject of concern were in fact material problems. However the 2010 reforms were essentially disclosure oriented, and did not change legal fundamentals or involve significant additional compliance costs.

The evidence clearly demonstrates that the current regulatory framework is working well. The Franchising Australia 2012 Survey confirmed the relatively low levels of disputation in the sector, and the Spring 2012 PricewaterhouseCoopers Franchise Sector Indicator confirmed that the franchise sector continued to outperform the general economy notwithstanding relatively difficult economic times. ACCC complaints, and disputes where a mediator is appointed by the Office of Franchise Mediator, remain at fairly consistent low levels. The FCA is not aware of any dispute or ACCC complaint that in fact related to the subject matter of the 2010 amendments to the Code.

These conclusions are consistent with the results were obtained in a survey conducted by the Griffith University Asia-Pacific Centre for Franchising Excellence Report, entitled *Survival of*

[1] No sector has had greater scrutiny than the franchise sector, with *the Swanson Report, the Blunt Report, the Beddall Report, the Franchising Task Force Report, the Gardini Report, the Franchising Code Council Disputes Review, the Fair Trading Report, the Matthews Report, the SA Franchising Inquiry, the WA Franchising Inquiry, the Opportunity not Opportunism Report, the Expert Panel Report on Unconscionable Conduct* and several minor reports and reviews. The Franchising Code of Conduct itself has been amended 4 times since 1998!

[2] The FCA estimates that around 95% of franchisors, and virtually 100% of franchisees, are small businesses for the purposes of the typical Government definition. Small business is highly sensitive to the financial impact of regulation.

the fittest: The performance of franchised versus independent small business during economic uncertainty and recovery. They surveyed franchisees and independent businesses, and compared the two. They also compared successful and failed franchisees. Extracts from the Report are included in Annexure E. The comparison with independent operators reinforces that franchisees are already substantially better off, and de-bunked some of the myths around the fairness of franchise agreements.

> *"Most franchisee experts reported that potential franchisees were provided with more information than would be available to independent operators. In particular, most suggested that franchising was more transparent, and provided more detailed information to potential entrants as it had a structure behind it."*
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> *"Most successful franchisees considered the franchise agreement to be "both fair and equitable" and "franchising matched their expectations", whereas struggling or exited franchisees felt the franchise agreement "did not provide a true representation of what was expected." "However in the context of shopping centre leases a different picture emerges…" "All interviewees expressed concern in terms of the nature of shopping centre lease agreements and the propensity for landlords to act unethically in increasing rent requirements."*[3]

The survey found that 84% of surviving franchisees and 80% of failed franchisees felt that there was enough information given to them to make an informed decision about buying my franchise.

The feedback from failed franchisees, already identified in the Report as being a group more likely to blame others, was particularly insightful. Only 28% of failed franchisees wished there was more information. Furthermore, even failed franchisees rated information given as very relevant (85%), very accurate (80%), very complete (77%) and very helpful (85%). The vast majority of failed franchisees also reported that they fully understood their obligations in the franchise agreement (85%) and felt them to be fair and equitable (84%). The percentages for successful franchisees were very similar, and indeed (as you would expect) even slightly higher. [4]

It seems beyond rational argument that the disclosure and pre-contractual process set out in the Code is working as intended.

[3] See Annexure E to this submission for page references and further extracts and comments.
[4] See Annexure E to this submission for page references and further information.

Enough is enough!

Although the FCA is prepared to consider further improvements to the regulatory framework, the FCA believes that the current balance is appropriate and no material changes are necessary.

The clear message from all FCA members is summarized in 3 words – "enough is enough". For example in the FCA Industry Forums conducted prior to lodging this submission 93% of people felt that on the whole the 2008 and 2010 disclosure amendments ensure franchisees are provided with adequate information. 7% were unsure, and 0% disagreed.[5]

The Code has already been amended 4 times since 1998, which seems to demonstrate an inordinate focus on franchising. FCA members have also hardened in their opposition to regulatory appeasement. They feel that much of the recent legislative debate, and many of the 2010 changes to the Code, have been consequences of the dispute between Competitive Foods and KFC – two large corporations more than able to look after their own business and legal interests.

There is also a degree of frustration that many of those advocating further changes are either academics with little practical experience in franchising, or failed former franchisees with a personal axe to grind. The FCA is aware of the personal circumstances of many of these former franchisees, and would urge verification of any allegations they make. In the context of franchisee submissions, the recent research by Griffith University is insightful.[6] They surveyed independent business operators and franchisees, and made the following observations:-

> *"Franchisees and independent contractors have distinctly different motivations for entering business and possess different psychological traits. Franchisees seek the security of a franchise network and are risk avoiders... Franchisees rated their pre-entry experiences (access to information, due diligence and decision making ability) positively and they valued the franchisor-franchisee relationship. However their adaptability and autonomy levels were lower than independent business owners and they were more likely to suffer stress and regret."*
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> *"Given their overall greater feelings of confidence and autonomy, independents were more willing to take responsibility for failure or setbacks than franchisees, who tended to attribute blame to external factors."*[7]

This is consistent with observations of industry experts like psychologist Greg Nathan, who notes that blaming others is a fundamental and indeed healthy coping mechanism that helps people move on from adversity. It also helps explain why assertions from franchisees that appear reasonable and accurate at first instance often fail verification. Such an allegation against a leading franchising by a strident former franchisee was investigated by the ACCC, and given wide publicity. The ACCC found that the franchisor had not acted unlawfully, and then ACCC Chairman Graeme Samuel was prompted to comment in relation to the complaint that "*it should not be assumed that where there is smoke there is always fire."*

[5] See Annexure C to this submission.
[6] See Annexure E to this submission for page references and further information.
[7] See Annexure E.

It is a fact of franchising that if something goes wrong for a franchisee, there is always someone to blame. That is not intended to discredit all franchisee complaints, but simply put them into context given the nature of the franchise relationship.

It is important that the public have a positive perception of franchising, and that there be full confidence that expected protections apply. Accordingly the FCA is prepared to contemplate an amendment to the Code to expressly incorporate the current common law duty of good faith into all franchise agreements, and consider the introduction of specific and commensurate penalties for blatant non-compliance with the fundamental requirements of the Code. The FCA also supports the broader view of unconscionable conduct taken by the ACCC in its enforcement role in the franchise sector in cases such as *ACCC v Simply No-Knead (Franchising) Pty Ltd*[8]. As we stated in our submission to the Expert Committee established to examine unconscionable conduct, we consider that unconscionable conduct is more broadly interpreted in franchising that it is in areas such as retail leasing, where the ACCC was less successful n its legal actions.

The current penalty regime contained in the Competition and Consumer Act is not suited to franchising, as the financial penalties are excessive. It should also be noted that pecuniary penalties do not apply to misleading or deceptive conduct, so it would be unreasonable to impose such penalties for any breach of the Code, which almost by definition is significantly less heinous. Penalties for breach of the Code should be tailor-made, carefully targeted at only the flagrant and fundamental breaches, and be commensurate. We would support a penalty of say $50,000 for failure to have a disclosure document, and perhaps $5,000 for failure to update a disclosure document. However penalties should only apply to fundamental breaches of these provisions, not technical breaches. Further, we would oppose the application of pecuniary penalties to the vast majority of obligations under the Code.

We understand the ACCC is also seeking to be able to levy Infringement Notices for less fundamental breaches of the Code. It is important to ensure the intent of industry codes is not thwarted by a draconian penalty regime. There are genuine interpretational difficulties with quite a number of provisions of the Code. If broader penalties such as Infringement Notices were to be introduced the Code would need to be revised to clarify interpretational uncertainties, perhaps with the ACCC also empowered to give interpretational rulings. The ACCC would also need to publish clear enforcement guidelines so that the sector knew the potential consequences of its actions, and there was some rigour around enforcement activities that could be open to abuse. In this context we have heard of the ACCC "bundling" Infringement Notices, meaning that they issue multiple Infringement Notices for essentially a single breach. A $1,000 Infringement Notice for failing to include certain important information in a disclosure document might seem reasonable and appropriate, but not if the ACCC issues one Infringement Notice for every affected franchisee.

The FCA will also be proposing a number of drafting simplifications to the Code in a separate submission by the FCA Legal Committee. If the Code is simplified and disclosure made more focused, compliance costs for both franchisors and franchisees reduce. The FCA considers that the Code, and the disclosure document, could be significantly simplified without reducing the protection provided to franchisees or impacting on the quality of information provided. There is also the opportunity to develop a form of disclosure document more relevant to mobile service based franchise systems, and simplify the master franchise disclosure requirements. The FCA would like to work with the relevant Department to undertake a Code simplification project.

[8] [2000] FCA 1365.

The FCA supports strengthening the recommendation for franchisees to obtain legal and business advice prior to signing a franchise agreement, perhaps by making it a requirement. There are some implementation challenges, but the FCA is prepared to work with Government to endeavour to develop a better framework. The failure of franchisees to seek advice is a significant concern. That said, the FCA opposes any legislation that would impose further burdens on franchisors as a consequence of some franchisees failing to take advantage of available remedies and opportunities.

The FCA opposes changes to the Code that add compliance cost, discriminate against the franchise sector, increase the potential for dispute or create uncertainty. For these reasons the FCA opposes:-

- the introduction of consumer law "unfair" contracts laws into business transactions, as such concepts have no application in business transactions;

- the introduction of a new defined statutory duty of good faith, as this is unnecessary and will create uncertainty and cost; and

- any requirement to pay compensation at end of the franchise term or any other interference with the fundamental principle as enunciated by the High Court of Australia in *Ranoa Pty Ltd v BP Oil Distribution Ltd* that the term of the franchise agreement ends at the expiration of the time period specified in the franchise agreement.

The FCA also believes that mediation remains the best and most cost-effective method for resolving franchising disputes, and does not support the creation of any ombudsman or providing dispute jurisdiction to any new court or tribunal. Such action would actually reduce the effectiveness of mediation and increase disputation.

Background

The Franchise Council of Australia (the **FCA**) is the peak industry body representing franchisors, franchisees, service providers and suppliers involved in franchising. The FCA welcomes the opportunity to assist in the review of the Franchising Code of Conduct (**Code**).

The FCA is a membership based organisation, and is committed to developing a strong and financially viable sector. Whilst the interests of its members may differ from time to time, the FCA represents the sector as a whole, and does not prefer the interests of one group of stakeholders over another. Rather, the FCA is committed to establishing world's best standards within franchising, as it is these practices that will ensure the sector's continued growth. The FCA actively supports initiatives that it considers to be necessary and which will enhance the operation of the sector.

The franchise sector has been a major contributor to the Australian economy, with most recent statistics indicating annual industry turnover of in excess of $125 billion. There are approximately 70,000 businesses employing in excess of 600,000 people. As 95% of franchisors, and almost all franchisees, are small businesses, the sector is particularly sensitive to the cost of regulation. Similarly as the key assets of most franchisors and franchisees are intangible, the sector is vulnerable to the impact of litigation. Australia has learnt from the US and Canada, and instigated mediation as the cornerstone of dispute resolution. Mediation has been a great success, and has fostered a collaborative approach to dispute resolution. Any attempt to create any form of adversarial environment, or any new legal remedies that encourage opportunistic plaintiff law firms to enter the sector, must be resisted.

The FCA is committed to working collaboratively with Government to ensure we have an effective and efficient regulatory framework. To this end, the FCA has provided submissions in relation to all recent inquiries into franchising (both at a State and Federal level), as well as comments in relation to issues relevant to the sector, such as the proposed Australian Consumer Law (**ACL**). Many of the FCA's suggestions have been implemented by Government. The FCA supported the introduction of the Code in 1998, and also supported the Code amendments made in 2007 and 2010.

In preparing this submission the FCA sought comment from its members in industry forums conducted in Canberra, Melbourne, Sydney and Brisbane. The FCA's Legal Committee has also conducted its own review of the Code over the past 12 months. The results of this consultation form the basis of this submission, and represents the views of approximately 150 people who attended these events. A list of the organisations that participated in these forums, and the development of this submission, is included in Annexure A. Annexure A also contains the tabulated results of the survey conducted at these industry forums. The FCA is confident that the views presented are representative of the broader franchising community.

This submission has been drafted by FCA Deputy Chairman Stephen Giles. Stephen is also co-author of *Giles Redfern & Terry - Franchising Law & Practice*, the authoritative legal text for the Australian franchise sector. This publication contains a detailed chronology of the development of the Australian franchising regulatory framework drawn form Franchising Law & Practice. This publication is a recommended resource for those seeking more detail on the comments about the history of Australian franchising that are contained in this submission. Annexure E includes a number of extracts from the Griffith University Asia-Pacific Centre for Franchising Excellence Report - *Survival of the fittest: The performance of franchised versus independent small business during economic uncertainty and recovery*. This Report is also a highly recommended resource.

The Terms of Reference

To provide a framework for the content of this submission, the FCA notes the Terms of Reference are to inquire into:-

(1) the efficacy of the 2007 amendments (Trade Practices (Industry Codes – Franchising) Amendment Regulation 2007 (No 1));

(2) the efficacy of the 2010 amendments (Trade Practices (Industry Codes – Franchising) Amendment Regulation 2010 (No 1));

(3) good faith in franchising;

(4) the rights of franchisees at the end of the term of their franchise agreements, including recognition for any contribution they have made to the building of the franchise; and

(5) the operation of the provisions of the CCA 2010 as they relate to enforcement of the Code.

The Terms of Reference of the review are designed to build upon previous reviews and detailed inquiries into franchising. The collective input and wisdom of those involved in previous reviews and inquiries have created our current regulatory environment, which the FCA believes fairly balances the interests of franchisors and franchisees in this dynamic industry sector where almost all participants are small businesses[9].

Although it is important to allow all seeking to make a submission on the regulatory framework to be heard, it is important that the review does not re-examine matters that have been comprehensively addressed by previous inquiries. The review must respect the legislative and policy responses of previous inquiries and decisions. In this context it should be noted that the 2010 reforms to the Code were undertaken after extensive inquiries into franchising not just Federally, but at a State level in South Australia and Western Australia. The issue of good faith was also considered in detail in the deliberations of the 3-person Expert Committee appointed to consider unconscionable conduct. The legal and commercial reasoning in the report of the Expert Committee is compelling, and highly relevant in the context of the current consideration of good faith.

It is critical that any legislative reforms are based on careful analysis of evidence and proper process, and are not introduced simply to appease individuals or organizations[10]. The focus of the current review is on the efficacy and effectiveness of the 2010 reforms. In that context it is worth noting that the FCA supported the 2010 reforms notwithstanding that it felt there was little evidence that the issues that were the subject of concern were in fact material problems. That continues to be our view. The Franchising Australia 2012 Survey confirmed the relatively low levels of disputation in the sector, and the Spring 2012

[9] The FCA estimates that around 95% of franchisors, and virtually 100% of franchisees, are small businesses for the purposes of the typical Government definition. Small business is highly sensitive to the financial impact of regulation.

[10] The "concerns" were clearly particularly important to Competitive Foods in the context of a specific legal dispute between this large corporation and KFC. The FCA remains of the view that there was no evidence produced which showed that these issues were genuine industry problems. For example in relation to the issue of extension of the term of franchise agreements, material produced to previous inquiries showed that franchisees secured an extension of their agreement in over 95% of instances. This reinforces the FCA's view that the market dynamics, such as scarcity of franchisees, cost of training and the fact that most franchisors are unable to profitably operate company locations already address any concerns and no legislative intervention is required. The FCA is not aware of any complaint to the ACCC in relation to failure to grant an extension of term in circumstances that might cause concern.

PricewaterhouseCoopers Franchise Sector Indicator confirmed that the franchise sector continued to outperform the general economy notwithstanding relatively difficult economic times. ACCC complaints, and disputes where a mediator is appointed by the Office of Franchise Mediator, remain at fairly consistent low levels. The FCA is not aware of any dispute or ACCC complaint that in fact related to the subject matter of the 2010 amendments to the Code.

The FCA's view is that if there is a concern, the concern should be addressed by specific amendments to the Code, rather than some catch all general prohibition. There are already catch all prohibitions for misleading or deceptive conduct and unconscionable conduct in the Competition and Consumer Act. The FCA has supported improvements to disclosure as this is consistent with the policy framework for the Code, which supports rather than overrides the contractual process.

In considering any legislative reform it is also vital to note that there are around 70,000 binding franchise agreements currently in place. The FCA strongly opposes any legislative change that varies existing contractual arrangements that have been fairly negotiated by the parties. This issue is directly relevant to the efficacy of the 2010 reforms, and the framing of any recommendations of the current review. Any change in the area of good faith, end of term arrangements or compensation would directly impact existing agreements. The commercial terms of those arrangements, including initial fees paid, royalty rates and length of the term, have been negotiated and agreed based on the current state of the law. The integrity of those agreements must be respected.

General Comments

The FCA is strongly supportive of the current regulatory framework for the franchise sector. The FCA believes it strikes a fair balance between protection for franchisees and compliance cost for franchisors. The Australian regulatory framework features not just the Code, but is strongly supported by the prohibitions on false and misleading conduct, misleading and deceptive conduct and unconscionable conduct contained in the *Competition and Consumer Act 2010* (**CCA**). The CCA and the Code are overseen by the Australian Competition and Consumer Commission (**ACCC**), which is a well resourced and highly effective regulator. State Small Business Commissioners also undertake some oversight of the regulatory framework.

Franchising is by its nature a contractual relationship, as indeed are most business relationships. Some business relationships that are conceptually similar to a franchise agreement, such as a commercial lease, are regulated. Others, such as an agency arrangement, a contracting arrangement, a distribution agreement, a joint venture agreement and a partnership, are not regulated at all. No business relationship is as heavily regulated in Australia as the franchise relationship, and the Australian regulatory framework is already the most extensive of any Western country. Although the FCA supports the current regulatory framework, it is worth noting that the regulatory framework in Australia is more comprehensive than the USA's, not to mention New Zealand, the United Kingdom, Singapore and Hong Kong – Commonwealth countries that have chosen not to regulate the franchise sector at all!

It should also be noted that the Code disclosure obligations are now arguably more extensive and prescriptive than those that apply to corporate fundraising under the *Corporations Act 2001* (**Corporations Act**), notwithstanding that those obliged to comply with the Corporations Act are large corporations and many recipients of the information are individual investors rather than business people. This is somewhat ironic given that franchising was historically regulated under the Corporations Act, but it was felt that the corporate regulatory framework was too complex and costly for a sector comprised largely of small businesses.

It is possible to have a network of businesses across the country without being a franchise, and most franchised businesses compete against businesses that face no specific regulation of their business relationship. This is an important point to note for two reasons:-

(1) franchised businesses must not be regulated in a manner that puts them at a material competitive disadvantage when compared to other business structures; and

(2) to date, businesses operating as franchises have chosen not to attempt to structure themselves outside the franchise legislation, but it is possible in most cases to do so. If franchise regulation becomes too onerous, businesses will choose other frameworks over the franchise model, to the detriment of those intended to benefit from the further amendments to the regulatory regime.

The regulatory regime for franchising is conceptually similar to that which applies globally in franchising, as well as in leasing and other commercial relationships involving independent business owners. It honours the fundamental principle of freedom of contract that underpins commerce throughout the Western world, but provides important enhancements:-

(1) processes to ensure that all parties are free to contract without pressure or undue influence, notably the 14 day hiatus period from provision of disclosure before a franchise agreement can be signed and the 7 day cooling off period;

(2) disclosure requirements that ensure each party has access to relevant information in the possession of the other party. A disclosure document prepared and provided in accordance with the Code's requirements contains extensive information about almost every conceivable aspect of the franchise, the franchisor and the franchise agreement including business set up and operating costs;

(3) information is included in the disclosure document to enable prospective franchisees to contact existing and former franchisees, and in the mandatory content on page 1 of each disclosure document it is recommended to franchisees that they make such enquiries;

(4) requirements to update material information if it changes, and advise franchisees;

(5) prohibitions on false, misleading or deceptive conduct including misleading representations as to the revenue, profit or likely success of the franchised business. In a relationship such as a franchise the duty to avoid misleading conduct is likely to include a positive duty to avoid remaining silent if a franchisor is aware of material information relevant to the franchise;

(6) a prohibition on unconscionable conduct; and

(7) specific provisions that regulate the types of provisions that can be included in the franchise contract in key areas such as transfer, termination, waivers and dispute resolution.

The Code goes further, establishing additional processes to attempt to ensure a prospective franchisee makes a fully informed decision. There are warnings in the mandatory content on page 1 of each disclosure document about the nature of franchising, and some of the risks. Prospective franchisees are urged by the Code to obtain, and franchisors must recommend that they obtain, legal and business advice, and a certification process supports this requirement.

The regulatory framework is built on two fundamental principles: responsible franchisor behaviour; and effective franchisee due diligence. The Code supports these two principles. Indeed the Code regime is arguably foolproof if it is followed by franchisors and franchisees.

The FCA considers that these two fundamental principles must BOTH remain as the cornerstone of the regulatory framework for franchising. Some past reform proposals have sought to reduce the due diligence obligation on prospective franchisees, or interfere with the principle of freedom of contract. To the extent that franchisors are not acting lawfully, in that they have not complied with the Code or have engaged in misleading, deceptive or unconscionable conduct or acted in breach of the common law implied duty of good faith, action should be taken against them. Similarly a franchisee should accept the consequences to the extent that the franchisee fails to use the available Code information and processes that are expressly designed to facilitate proper due diligence. The regulatory framework should not be designed for those who ignore their own due diligence obligations, as this imposes an unfair burden and unreasonable compliance obligations on others.

That said, the FCA supports initiatives designed to enhance the operation of the current regulatory framework, notably:-

(1) increased obligations on a prospective franchisee to obtain legal and business advice, including possibly making such a requirement mandatory;

(2) simplification of the Code, including the content of the disclosure document, to make it easier and less costly for prospective franchisees to read and understand the nature of the business relationship and the information provided; and

(3) translation of information concerning the franchise regulatory framework into languages other than English.

Specific questions raised by the Discussion Paper

1 Has the additional disclosure requirement regarding the potential for franchisor failure effectively addressed concerns about franchisees entering into franchise agreements without considering the risk of franchisor failure?

FCA Response: Yes. The FCA felt in 2010 that there was no material evidence that this was a genuine industry concern. Rather, it was more of a hypothetical issue raised by academics. Further, the FCA felt that the consequences were potentially quite different, depending on the nature of the business and other relevant circumstances, and insolvency did not necessarily disadvantage franchisees. The FCA also felt that the advice requirement currently contained in the Code best addresses this issue. If a franchisee obtains legal and business advice, the advisors will be able to discuss this issue in the context of the specific situation for that franchise, as not all circumstances will be the same.

The FCA agrees with the Government position that any risk analysis is best undertaken by the franchisee. We felt that any concerns were best addressed in general information provided by organisations such as the ACCC and the FCA, and by amending the explicit warning on the face of the disclosure document to specifically draw attention to the matter. To supplement this, the FCA produced a draft Risk Statement for consideration by Government as an industry response, and also amended the FCA publication *The Franchisee's Guide* to specifically include a chapter on this issue. Annexure B to this submission contains a copy of Chapter 9 of The Franchisee's Guide.

2 Does the sector have any concerns regarding the operation of this requirement?

FCA Response: No. See above. The FCA would happily support the provision of a simple and relatively generic risk statement, or the creation of other educational materials to assist to prepare franchisees for business or conduct due diligence. However the FCA does not support any requirement for a franchisor to produce its own risk statement in relation to the specific franchise, as this would impose unreasonable compliance costs, cut across the recommended practice of not providing forecasts and discourage franchisees from taking proper responsibility for their own due diligence and obtaining appropriate advice.

3 Have amendments to the Franchising Code improved the transparency of financial information for franchisees? If not, why not? If so, what benefit is this having for franchisees?

FCA Response: Yes, and from an already very high standard of disclosure.

It is worth noting the extent of the financial disclosure currently required by the Code, being:-

- Clause 17, amended in the 2008 Code amendments to require detail of **all** of the marketing funds receipts and payments and to provide an automatic entitlement to franchisees to receive the financial statement within 30 days of preparation. (Prior to 2008, only certain information was required, and the financial statement only needed to be provided if a franchisee requested it.);
- Item 9 of the disclosure document, amended in 2008 to include disclosure of rebates and the entities providing the rebates;
- Item 11.3, which was amended n 2008 to require the specific information concerning the particular site or territory to be provided in a separate document with the disclosure document rather than made available for inspection at a separate location and time;
- Item 20.1, which was amended in 2008 to include consolidated entities as well as the franchisor entity;
- Item 13.6A, included in the 2010 amendments and requiring descriptions and full details of

"each recurring or isolated payment" that is requires or "reasonably foreseeable by the franchisor". In essence this requires a franchisor to list every possible payment relating to the franchise. It is hard to imagine greater possible transparency of financial information;

- Item 13A, which requires a franchisor to disclose whether the franchisor will require the franchisee to undertake "unforeseen significant capital expenditure that was not disclosed by the franchisor before the franchisee entered into the franchise agreement";

- Item 13B, which requires the franchisor to disclose whether the franchisor will attribute the franchisor's costs, including legal costs, to the franchisee; and

- Item 20.2A, which requires the disclosure for 2 years of financial information for any consolidated entity of which the franchisor is part.

These amendments have significantly increased transparency, although even without these amendments there was already considerable transparency. It is not possible to rationally argue that there is not extremely transparent disclosure of financial information. Indeed it is hard to imagine more comprehensive and transparent disclosure.

Unfortunately disclosure comes at considerable compliance cost to most franchisors. Further, some of the 2010 changes are difficult to interpret, and almost by definition unachievable. For example the provisions in relation to disclosure of "unforeseen" expenditure – if it was unforeseen, by definition it could not really be disclosed!

The issue of financial disclosure is quite vexed. In most instances the financial position of the franchisor is largely irrelevant to a prospective franchisee unless the franchisor is close to insolvency. Similarly the disclosure of every conceivable payment or expense, and the serious consequences for not doing so or missing some item, imposes a heavy compliance cost. In practice it is generally honoured by franchisors giving an almost meaningless range of expenses. The FCA considers that there would be significant opportunities to streamline this process, by including a list of items or perhaps enabling a franchisor to provide without attached legal liability details of existing outlets. If some form of indemnity from liability for misleading or deceptive conduct were provided, franchisors could provide revenue information and better tailor financial information provided.

A prospective franchisee now has access to comprehensive information concerning: establishment and operating costs; and the history of the site and territory of the proposed franchise. The legal costs and rebates issues were more emotional than material business issues, but enhanced disclosure was nevertheless supported by the FCA.

Disclosure of this information is useful and relevant. Additional disclosure concerning rebates is opposed, as that involves confidential information, involves third parties, disadvantages franchise networks relative to other networks and is likely to disadvantage franchisees in negotiations with suppliers. The ACCC will examine rebate arrangements, and has an appropriate "light touch" regulatory role if prices paid by franchisees are higher than they ought to be.

The Code disclosure obligations must also be seen in conjunction with the prohibition on misleading or deceptive conduct contained in s18 of the ACL. Franchisors are strongly discouraged by the law from making projections as to a future event, such as future turnover or profit. If franchisors were granted some form of immunity from action under s18 it would be possible for franchisors to be more forthcoming about their expectations as to revenue and profit. However, revenue and profit is affected so significantly by factors outside the franchisor's control, including operator performance, that such information would need to be heavily qualified.

4 Does the sector have any concerns regarding the operation of these amendments?

FCA Response: No, although the obligation to provide such financial detail already imposes a substantial financial burden on franchisors. The FCA considers that there is potential to simplify the disclosure requirements without reducing the benefit to franchisees. The FCA would strongly oppose any further amendments in this area.

5 Have the amendments regarding unilateral variation, transfer and novation been effective in addressing concerns about franchisors' ability to make changes to franchise agreements? Why or why not?

FCA Response: Yes, although they may have created unintended problems for franchising practitioners.

The FCA believes that there is little evidence of any franchisors making material unilateral changes to franchise agreements. In the rare cases when this occurs, it is to address a change to the business system. This is an important, legitimate right that the franchisor needs to have to ensure the system remains relevant in the market. In the context of an existing contractual relationship it is practically difficult for a franchisor to introduce any system change except with broad consensus with its franchisees. So the FCA has no major concerns in relation to the 2010 amendments concerning unilateral variation, but would oppose any extension of these obligations or any prohibition on making unilateral variations to the franchise system to ensure the system remains relevant or addresses changed business or legal circumstances.

There is however considerable uncertainty in relation to the application of the novation section in normal franchising practice, including in relation to the precise meaning of "novation" in this context. Most practitioners accept that an incoming franchisee ought to be able to have a franchise agreement direct with the franchisor, rather than via an assignment. However it is also common practice to require the incoming franchisee to either take an assignment of the current franchise agreement, or sign the then current franchise agreement. Disclosure of whether the franchise agreement will be amended strikes a reasonable balance, but the precise application of the clause should be clarified. Specifically, can a franchisor require a transferee of a novation to sign the then current franchise agreement as suggested by s17D of Annexure 1 of the Code? Or is a franchisor prevented by clause 3 of the Code which defines "novation" as "… entry into into a new franchise with a proposed transferee *on the same terms as the terminated franchise* [emphasis added]".

6 Does the sector have any concerns regarding the operation of these amendments?

FCA Response: Only as set out above. In practice the provisions operate well, although the novation changes are somewhat ambiguous.

7 Have the changes to the Franchising Code led to improved franchisee knowledge about franchisors and their conduct before they enter into franchise agreements? Why or why not?

FCA Response: Yes, and from an already high starting point. The disclosure of contact details for franchisees that have left the system is important, as it addresses any concerns that past problems would not be discovered. The disclosure time frame for materially relevant facts was reduced substantially to 14 days, which was a sensible amendment, supported by the FCA.

The FCA considers that the ability for a prospective franchisee to contact existing franchisees is one of the most important protections provided by the Code. It is explicitly mentioned in the mandatory content on page 1 of a disclosure document.

It is worth noting that since 1998, when the Code was introduced, the disclosure document has been supplemented by a wide variety of websites, blogs and information sources. A simple Google search is now probably the most common search activity undertaken by prospective franchisees. So there is ample information available to a prospective franchisee and the franchisee's advisors.

8 Is the information being provided useful to franchisees?

FCA Response: Yes, very useful.

9 What effect has the requirement to provide this additional information had on franchisors?

FCA Response: Minimal additional compliance burden.

10 Does the sector have any concerns regarding the operation of the new provision?

FCA Response: No.

11 What impact has the removal of the foreign franchisor exemption had on the sector?

FCA Response: The FCA supported the removal of the complete exemption that applied to foreign franchisors, as its removal placed foreign franchisors on the same footing as Australian franchisors and addressed legitimate concerns about the conduct of foreign based franchise systems. The removal of the exemption has had benefits for the Australian franchise sector, and has not resulted in any decline in foreign investment into Australia. Foreign franchise systems still see Australia as an important and accessible market.

The FCA considers the removal of the exemption was justified, as there were numerous examples of foreign systems that had not been successful when entering the Australian market. There is greater risk for an Australian franchisee or master franchisee taking on a brand and system that has proven to be successful overseas when compared to a proven Australian system. Foreign franchise systems were targeting unit franchisees via franchise expos and similar activities.

That said, the requirement for foreign franchise systems to update their disclosure document annually is unnecessarily onerous if they are not granting franchises in Australia. This problem is caused not so much by the foreign franchise situation, but by the complexity of the master franchise disclosure regime. A franchisee in a franchise system where the ultimate owner of the intellectual property is located overseas (or indeed any multi-level network) will receive multiple disclosure documents. Invariably this only serves to add cost and complexity to the advice process, and confuse the franchisee unnecessarily.

The FCA believes that conceptually the franchisor party to the franchise agreement is the party that ought to be responsible for disclosure, and that party should have an obligation to explain the operation of any master franchise or multi-level arrangement and provide any pertinent details about any related entities. The requirement to provide multiple disclosure documents is cumbersome and expensive, and should be streamlined.

The FCA has considered the submission of the International Franchise Association in relation to the partial restoration of the exemption, and concurs with the views expressed by the IFA. Indeed the proposed simplification could apply to all franchise systems. The master franchising provisions are poorly drafted, add compliance cost, and do not provide franchisees with meaningful disclosure.

12 Has the removal of the exemption caused any issues?

FCA Response: Indirectly, when combined with the obligation to update a disclosure document annually and in the context of a master franchise relationship. The FCA would support an amendment to the Code, to apply to all franchise systems, that:-

(1) removed the obligation to update a disclosure document annually in the context of a master franchise arrangement where the franchisor was a foreign entity and the arrangement was a master franchise; and

(2) avoided the obligation to update a disclosure document if the franchisor was no longer granting and did not intend to grant franchises in Australia.

Alternatively the FCA would support an exemption regime as set out in the submission of the International Franchise Association. That exemption could apply not only to foreign franchisors, but in any case when the exemptions applied.

13 On the whole, do the 2008 and 2010 disclosure amendments ensure franchisees are provided with adequate information?

FCA Response: Yes. Disclosure documents contain a vast amount of information about the franchisor and the franchise business being offered to the franchisee. The volume and detail of information provided gives franchisees an excellent starting point from which to understand the business opportunity being offered and the franchisor that is offering it.

The 2008 amendments added a wide array of further protections for franchisees, largely by requiring further matters to be disclosed and further information to be provided to prospective franchisees prior to (and during) a franchise relationship. The 2010 amendments added further disclosure requirements, many in relation to more specific aspects of the franchise relationship. For example: payments to third parties; significant capital expenditure; attribution of legal costs; unilateral variation; confidentiality; and end of term arrangements.

The disclosure required by franchisors is extensive. When coupled with the requirement that prospective franchisees (as well as franchisees who are renewing, extending or extending the scope of a franchise) seek independent advice, there is a huge amount of available, useful information to review.

By comparison to other industries, the franchising sector requires extensive disclosure. For example, the financial sector, generally considered to be highly regulated, has less stringent disclosure requirements when raising funds from investors. The disclosure requirements for prospectuses are broad but not nearly as detailed as those required in franchising. Similarly there are much less onerous disclosure and conduct obligations applying to landlords in retail tenancy arrangements notwithstanding that the vast majority of complaints to Small Business Commissioners relate to major retail shopping centres. The retail tenancy issue is particularly pertinent to franchising, as in the FCA's experience many disputes between franchisors and franchisees can be traced to retail tenancy problems.

14 Is the extra onus on franchisors justified by the benefit this disclosure is providing to franchisees?

FCA Response: Yes, it is reasonable in all the circumstances but only just. Further amendments are unnecessary, and would impose unreasonable additional compliance obligations. Franchise disclosure documents often now exceed the size of the franchise agreement itself, and when the agreement and the mandatory copy of the Code are added to the disclosure document franchisees can often receive in excess of 150 pages of documentation. Further disclosure is not justified, and indeed considerable simplification is appropriate and desirable.

Although there is a heavy compliance burden on franchisors in producing and providing such in-depth disclosure it is the most appropriate way for such disclosure to be achieved. It is most efficient for the bulk of the disclosure burden to fall to the franchisor. It is cheaper for the franchisor to provide disclosure information than for prospective franchisees to collect it through a due diligence process. Further, if franchisees were expected to find such information through due diligence processes it would be done a multitude of times (by each franchisee or prospective franchisee choosing to do so). There is little doubt that some of the cost of disclosure is passed on to franchisees as part of the cost of running a franchise system. Further costs to franchisors will simply raise the cost of franchising. There is a balance to be struck between the benefits to the sector of disclosure versus the costs. The current balance is appropriate.

15 How effective were the targeted amendments in 2010 to the Franchising Code in addressing specific issues, instead of inserting an overarching obligation to act in good faith?

FCA Response: The so-called good faith discussion is simply the latest version of an attempt by some parties to amend the law that has been rejected on numerous occasions by the Federal Parliament. The Expert Committee considered whether it was appropriate to amend the law in relation to unconscionable conduct to address alleged, but unsubstantiated and largely hypothetical, concerns that unacceptable conduct was occurring in franchising and other sectors.

The FCA's position in relation to issues such as good faith and unconscionable conduct is:-

(1) any inappropriate or undesirable conduct should be addressed by specific regulation focused on that conduct, not by general catch-all regulation;

(2) any general prohibitions, such as the current prohibitions relating to misleading or deceptive conduct or unconscionable conduct, should apply to all business and should not unfairly target the franchise sector; and

(3) if any changes are considered necessary, implementation should not be via good faith or the Code, but rather via the unconscionable conduct provisions of the CCA.

The FCA considers that the 2010 amendments were appropriate and legally effective, as they supported the current legal position and did not seek to retrospectively change the law in a manner that had the potential to unfairly influence 70,000 existing franchise agreements.

The FCA does not believe there is any need to change the law, and would prefer any focus on general conduct prohibitions be via the CCA. Nevertheless, the FCA concedes that there remains some uncertainty in relation to whether a duty of good faith would be implied into all franchise agreements. The FCA also recognises that clarification of the legal situation in relation to good faith in franchising might assist attempts to persuade State Governments to withdraw or not pursue new and different statutory duties that would create additional obligations and legal uncertainty.

Accordingly the FCA would support further enhancement to the obligation of good faith by replacing the existing wording of clause 23A of the Code with the following:-

23A Common law duty of good faith implied into all franchise agreements

A party to a franchise agreement will comply with the common law duty of good faith within the meaning of the unwritten law, from time to time, of the States and Territories in exercising any right or power under a franchise agreement.

The FCA agrees with the reasoning behind the 2010 amendments, notably that they keep clarity and avoid the need for parties to pay for judicial interpretation to understand their responsibilities. The common law rules in relation to good faith were specifically retained in the Code. Any new definition would create uncertainty where none currently exists, and would drive up franchising costs with no discernable benefit. The rules of common law good faith are consistent with the industry code and Government policy that codes clearly set out obligations rather than aims or ideals. The Regulatory Impact Statement to inform the Government's response to the 2008 Joint Committee Report remains relevant.

The FCA also believes that the concept of "good faith" is not well understood. To this end some commentary on the law is included in Annexure C to this submission. When the concept of good faith as it would be interpreted by the courts is carefully considered it seems beyond rational argument that any legislative reform in this area would be fraught with problems and would create considerable uncertainty.

16 How effective is section 23A of the Franchising Code, which provides that nothing in the common law limits the obligation to act in good faith?

FCA Response: See comments above.

17 What specific issues would be remedied by inserting an obligation to act in good faith into the Franchising Code which would not otherwise be addressed under the unwritten law or by the ACL?

FCA Response: None. However the FCA suggestion would enhance confidence in the sector, and remove any uncertainty as to whether an implied duty exists.

18 If an explicit obligation of good faith is introduced, should 'good faith' be defined? If so, how should it be defined?

FCA Response: No. The FCA strongly opposes any new statutory definition of good faith. There is sound legal argument that the common law doctrine of good faith is currently applicable to all franchise agreements. As such, adding a statutory definition will give rise to significant uncertainty. It would either act concurrently with the current duty of good faith, or if carefully worded, replace it. Neither option will allow for clarity of effect. If the two duties are concurrent it will be very difficult to

determine the limits of each duty. If the statutory duty of good faith is to replace the common law doctrine there will be uncertainty as to the effect of the duty. The common law doctrine of good faith is one that has some history of judicial development. Any new statutory definition of good faith would have to be judicially tested to confirm its effect. A statutory definition would, most likely, be unique to franchising and therefore rarely be the subject of judicial consideration. It would be very difficult for franchise related parties to understand the effect of any new statutory definition of good faith.

Any new duty of good faith will impact on around 70,000 current franchise agreements, negotiated and agreed based on the law at the time of execution. The FCA strongly opposes any retrospective regulation. If new laws are enacted, franchisors are likely to increase initial and possibly ongoing fees to compensate. This is to the ultimate detriment of franchisees and consumers.

See Annexure C for a more detailed discussion of the law of good faith.

19 If an explicit obligation to act in good faith is introduced, what should its scope be? That is, should it extend to: the negotiation of a franchise agreement, and/or the execution of a franchise agreement, and/or the ending of a franchise agreement, and/or dispute resolution in franchising?

FCA Response: Any specific obligation to act in good faith should be a codification of the existing common law duty, and not some new and different defined duty. The question as to the possible extent of the duty in fact demonstrate why there is no need for some new and different duty:-

- The prohibition on misleading and deceptive conduct already provides strong and comprehensive protection in relation to the negotiation and execution phase of the franchise relationship;
- Specific provisions of the Code regulate termination of a franchise agreement, and these provisions are supported by the general prohibition on unconscionable conduct. A franchisor is unable to terminate a franchise agreement in bad faith, as the implied duty of good faith would apply in most circumstances. (And in all cases if the FCA's recommendation set out above is accepted.);
- The term of the franchise agreement is set by agreement and in the context of negotiations on the amount of the initial and ongoing fees and other commercial terms. Freedom of contract underpins all business transactions, and there is complete certainty as to the application of the law in this area due to the High Court of Australia decision in *Ranoa Pty Ltd v BP Oil Distribution Ltd* that the term of the franchise agreement ends at the expiration of the time period specified in the franchise agreement;
- The Code already contains specific and quite detailed obligations in relation to disputes that extend far beyond any duty of good faith.

This analysis shows that there is no legal void to be filled by some new and different statutory duty.

20 If a specific obligation to act in good faith was introduced into the Franchising Code, what would be an appropriate consequence for breaching such an obligation?

FCA Response: Essentially the obligation relates to a specific power or duty, so the sanction would automatically apply. For example if a franchisor purported to terminate the franchise agreement, but did so in breach of the duty of good faith, the termination would be set aside and treated as wrongful termination. Current CCA remedies would be adequate. No additional sanctions or penalties would be required. Again the question posed demonstrates the problems with such a duty.

The discussion of the law of good faith in Annexure B shows how problematic sanctions would be in the context of any statutory duty of good faith. It also demonstrates that the most appropriate area for any reform would be in unconscionable conduct rather than in good faith.

21 If a specific obligation to act in good faith was introduced into the Franchising Code, how would such an obligation interact with the provisions of the ACL?

FCA Response: See 'Part 1 – General Comments' above, and Annexure B. The existing common law duty already interfaces with the CCA. The new codification of the common law duty would provide

access to existing CCA remedies, but should not attract specific or new penalties.

22 If the Franchising Code was amended to contain an explicit obligation to act in good faith, would there need to be other consequential amendments to the Franchising Code?

FCA Response: Not as far as the FCA can see, provided the duty is introduced in the manner recommended by the FCA.

23 Have the amendments regarding end of term arrangements and renewal notices been effective in addressing concerns about inappropriate conduct at the end of the term of franchise agreements? Why or why not?

FCA Response: Yes. By improving disclosure about, and management of, end of term arrangements, both parties are clearer about what will happen at the end of the term and how such decisions are made. Clarity and improved communication helps to reduce the opportunity for dispute.

There is no objective way to compare the occurrence of end of term disputes before and after the 2010 Code amendments. The ACCC is now collecting useful data in relation to complaints and enquiries in the franchising sector. However, this data goes back only to 1 July 2010. With such a short history of data collection it is difficult to take much from the results so far. The most common causes for complaint are, from the most common: misleading conduct / false representations, disclosure, unconscionable conduct and termination of franchise agreement. The two most recent periods of ACCC data released (Jan – June 2012 and July – Dec 2012) show a significant dip in complaints related to termination of franchise agreement.

It is also worth noting that there is little to no evidence of franchisees expressing concern about end of term arrangements in the franchising sector prior to the 2010 amendments apart from concerns expressed by Competitive Foods in relation to a decision by Yum not to grant it a further extension of its agreements. Even then, evidence produced by Competitive Foods, presumably to show why their specific case was different to industry norms, showed that franchisees secured an extension of the term of their franchise agreement on expiry of the fixed term in well over 90% of cases.

One of the main commercial reasons why franchise agreements have a specific and limited term is that the initial fees charged by franchisors are much lower than would otherwise be the case if there was an obligation to grant an indefinite term or pay compensation at end of term. If end of term arrangements were altered, the whole commercial arrangement between franchisors and franchisees would alter. One likely consequence would be higher initial and ongoing fees.

The FCA also rejects the assertion that there is any lack of clarity around end of term arrangements. The legal position is well understood – indeed there are few areas of law where the legal principles are so clear. The High Court of Australia specifically ruled on this issue in *Ranoa Pty Ltd v BP Oil Distribution Ltd* that the term of the franchise agreement ends at the expiration of the time period specified in the franchise agreement. This case pre-dated the introduction of the Code, and is therefore fairly seen as a fundamental pillar of Australian franchising law and practice.

The Terms of Reference refer to recognition to franchisees for any contribution they have made to building the franchise. In this context some fundamental points need to be made:-

(1) The franchisee typically is entitled to all of the going concern value of the franchised business, and has a statutory right of assignment in the Code. Thousands of franchised businesses are sold every year, with the franchisee receiving the full net proceeds in normal circumstances;

(2) As a matter of law it is well understood, just as is the case in the context of a commercial lease, that all rights granted under the franchise agreement cease on expiry of the franchise agreement. See our detailed comments above;

(3) Few franchised businesses have much value above stock and fixed assets (which themselves are highly customised and rarely of much value except in the specific business and location) if the business ceases to operate, as most of the assets are essentially intangible; and

(4) Franchisees have clear rights if their franchise agreement is unlawfully terminated.

The FCA does not support any amendments to the Code to create some form of entitlement to compensation. The FCA considers that market forces, the prohibition on unconscionable conduct and the specific transfer rights of franchisees in the Code adequately address all legitimate concerns. At times franchisors do pay money to franchisees on termination, but it would be impossible to create any form of wording or formula that would have any meaning or relevance. In most cases franchisors incur significant costs and losses when they have to take over the operation of a failed franchised business. Any circumstance where a franchisor unjustly profits from a specific situation is already addressed by prohibitions on unconscionable conduct, and legal principles of unjust enrichment.

24 Has conduct and behaviour during mediation changed since the introduction of the 2010 amendments to the Franchising Code, including requiring parties to approach mediation in a reconciliatory manner? If so, in what ways?

FCA Response: Yes. Codifying what is deemed to be reconciliatory behaviour gives all parties some concrete examples of what is required in dispute resolution. Such direction helps to avoid the most common and basic problems during dispute resolution which is simply parties not being willing to work toward resolution of the dispute. Though such clarification is clearly not going to affect all cases or the way they are handled, it gives parties a clearer idea of what is expected at mediation, in preparation and in the ongoing franchise relationship.

25 Does the sector have concerns regarding the operation of the amendments?

FCA Response: No.

26 Is the current enforcement framework adequate to deal with the conduct in the franchising industry?

FCA Response: Yes. The ACCC is a very well established and effective national regulator which regulates consumer law in Australia. It has extensive powers. The ACCC can issue: substantiation notices, infringement notices, public warning notices and audit notices. All these notices can be issued by the ACCC without courts being involved and without need to show (or even for some notices, suspect) that the CCA has been breached. This gives the ACCC powerful tools to check that the Code and the CCA are being complied with and penalise entities that are non-compliant. The infringement notice carries with it a penalty of $10,200 for a corporation.

As well as its powers in relation to notices, the ACCC is also able to apply for civil and in some cases criminal sanctions against people and entities that fail to comply with the CCA. Though there are no financial sanctions available for failure to comply with the Code specifically there are many serious financial sanctions available for behaviour which breaches the CCA, for example: false and misleading conduct, price fixing and anti-competitive conduct. The CCA provides for not only financial penalties but a range of other penalties. Misleading and deceptive conduct and unconscionable conduct, which are clearly more serious, currently attract no financial penalties, but can be subject to orders for compensation etc.

Breaches of the Code should be treated consistently, as to do otherwise would unfairly treat franchise networks relative to their competitors that are not franchised, and thereby disadvantage small business. Significant penalties for breaches of the Code will apply uniquely to the franchise sector and apply a cost that will detrimentally affect the sector as a whole.

However, the FCA would support the inclusion of a small number of explicit penalties for specific breaches of the Code, notably:-

(1) failure to prepare a disclosure document - $30,000;

(2) failure to update a disclosure document - $5,000; and

(3) failure to provide a disclosure document to a prospective franchisee - $2,000.

27 How can compliance with the Franchising Code be improved?

FCA Response: The FCA considers that franchisor compliance levels are high. The ACCC is active in enforcement, and has random audit and various other powers. There is no evidence of any endemic issues, and enforcement action in relation to audits has been relatively low. During 2012, the ACCC audited 20 franchisors. The majority were found to be complying with the Code. The ACCC has not reported any formal enforcement action as a result of those audits

Improved franchisee compliance, notably in relation to using the existing Code processes and information and advice framework, will improve overall outcomes.

Failure to obtain legal and business advice is a major concern. The FCA would support the following:-

(1) simplification of the Code and disclosure obligations to make disclosure material shorter, more relevant and easier to understand; and

(2) enhanced requirements concerning advice, including possibly making it mandatory for a franchisee to seek independent advice unless certain exemptions are met. Exemptions could include being an existing franchisee, a sophisticated investor, a lawyer or an accountant.

28 What additional enforcement options, if any, should be considered in response to breaches of the Franchising Code?

FCA Response: None.

29 What options are available to businesses to address breaches of the Franchising Code, or any other adverse conduct in the franchising industry?

FCA Response: There is a comprehensive array of options, including:-

(1) complaint to the ACCC;

(2) complaint to a State Small Business Commissioner;

(3) complaint to the Federal Small Business Commissioner;

(4) compulsory mediation under the Code;

(5) Franchisee Advisory Councils and discussions with other franchisees;

(6) FCA Member Standards and the FCA's member complaint process;

(7) involvement of a lawyer, and threat of or actual legal action;

(8) media involvement;

(9) complaint to a local Member of Parliament; and

(10) blogs and various franchising websites and forums.

Given the number and quality of options listed above it would be inappropriate to add any new options. The strength of the current systems will be improved by increased experience and expertise. Spreading the disputes and complaints over a greater number of bodies will reduce the skill and efficiency of the current bodies without a commensurate benefit. There is no benefit for the Victorian Civil and Administrative Tribunal to hear franchising matters nor of a franchising ombudsman. The systems currently in place are many and varied. The most effective use of further financial input is to provide more specific franchise related funding to those already set-up and effective bodies. Any further non-judicial attempts within the franchising sector to regulate the sector or resolve disputes will only reduce the effectiveness of mediation.

The FCA would support a franchisee advocate or dispute facilitator role within the Small Business Commissioners' offices. The FCA would also support steps to improve the quality of mediators hearing franchising matters. Clearly the mediator is fundamental to the success of mediated dispute. Ensuring that mediators are sufficiently skilled and experienced will improve outcomes at mediation.

It may also be worth considering directing franchisees, formally, to the ACCC and its education offerings in disclosure documents. The ACCC reported in its July – December 2012 Small Business, Franchising and Industry Codes report that the free online franchising education program funded by the ACCC and run by Griffith University has more than 3590 registrants. Given the uptake of this education program, and the unending benefits of improved knowledge of the sector to all members of the franchising community, it is worth considering formal notification of its availability. A sentence could simply be added to the mandatory content on page 1 of each disclosure document. For example, a final sentence added: "The Australian Competition and Consumer Commission is publically funded and offers franchising education programs as well as other information and support services to franchisees."

Annexure A

[List of organisations involved in the franchise industry forums, and tabulated results of the surveys conducted at the industry forums, excluding those organisations that requested that their participation be kept confidential. Franchisors, franchisees and master franchisees are only identified by brand.]

7-Eleven	Expense Reduction Analysts	Just Cuts	Rain & Horne
AGL	Fastway	LaPorchetta	Recruitment Coach
Anytime Fitness	Fastway	Lease 1	Robert James Lawyers
ANZ Mobile Lending	Franchise Advice	LJ Hooker	Sail Time Australia
ANZ Mobile Lending	Franchise Garage	Lolly Potz	San Churro
Aon	Franchise Relationships	Luxottica	Signet
Appliance Tagging Services	Franchise Systems	Madgwicks Lawyers	Sleepy's
AT Services	Gelatissimo	MCW	Smith Lawyers
Australian Sign Clinics	Gloria Jeans	Minter Ellison	Snapon
Battery World	Godfreys	Mr Rentals	Sothertons
BDC	Griffith University	Mrs Fields	Spectrum Analysis
BDO	Harvey World	NAB	Storage Kings
Bendigo Bank	Hill Mayoh	Nandos	Swaab Attorneys
BFC Stores	Horseland	Newsxpress	Tatts Lotteries
Clark Rubber	Hotondo Homes	Noodlebox	The Coffee Emporium
Clark Rubber	Hungry Jacks	Norton Rose	Think water
CM International	HWLE Lawyers	Ozskin	Thomsons Lawyers
Coffee Club	ICMI	Pack and Send	Total Span
DCS Lawyers	Ignite PR	Pandora	Wisewould Mahony
Ecowash	iinet	Poolwerx	Xero
Endota Spas	Jims Fencing	Primus on line	Xpresso Delight
			Yum Brands

Franchising Code Review Survey

The following table sets out the results of a survey taken at the FCA Industry Forums conducted in Sydney, Melbourne and Brisbane in the week commencing February 4, 2013. Around 150 people were surveyed, from the organisations set out in the list above.

	Yes	No	Don't Know
1. Has the additional disclosure requirement regarding the potential for franchisor failure effectively addressed concerns about franchisees entering into franchise agreements without considering this risk?	54%	29%	18%
2. Have amendments to the Code improved the transparency of financial information for franchisees?	82%	18%	0%
3. Have the amendments regarding unilateral variation, transfer and novation been effective in addressing concerns about franchisors' ability to make changes to franchise agreements?	57%	14%	29%
4. Have the changes to the Franchising Code led to improved franchisee knowledge about franchisors and their conduct before they enter into franchise agreements?	86%	11%	4%
5. Is the information being provided useful to franchisees?	75%	4%	21%
6. On the whole, do the 2008 and 2010 disclosure amendments ensure franchisees are provided with adequate information?	93%	0%	7%
7. Have the amendments regarding end of term arrangements and renewal notices been effective in addressing concerns about inappropriate conduct at the end of the term of franchise agreements?	75%	11%	14%
8. Has conduct and behaviour during mediation changed since the introduction of the 2010 amendments to the Franchising Code, including requiring parties to approach mediation in a reconciliatory manner?	25%	7%	68%
9. Is the current enforcement framework adequate to deal with the conduct in the franchising industry?	68%	21%	11%

The results speak largely for themselves, with the decisive answers to questions 2, 4 and 6 clearly supporting the FCA's contention that enough is enough. Comments in relation to the response to question 9 show some people voted "no" in support of the FCA's position on additional penalties.

Annexure B

CHAPTER 9 of 'The Franchisee's Guide' a publication by the Franchise Council of Australia, Phil Blain and Stephen Giles. This Chapter was included in the Franchisee's Guide was included as a specific industry response to the 2010 Federal inquiry into franchising, and supplements the additional warning including on the front page of the disclosure document in the 2010 amendments to the Code. It explains in detail the risks, and possible consequences to a franchisee, of franchisor failure.

What happens if the Franchisor goes broke?

Fortunately this is a rare occurrence, but as part of your due diligence it is worthwhile turning your mind to the worst case scenario. There have been cases where franchisees have been seriously affected when their franchisor becomes insolvent.

The purpose of this chapter is to highlight what could occur, and some of the possible consequences. Importantly there might be some things you can do and questions you can ask to improve your situation. It may even be appropriate to ask for some amendments to your franchise agreement to protect you.

How could you be affected?

So what will happen if your franchisor goes broke, and how badly will you be affected? That depends on a number of things:

1 The reasons for failure. If the franchisor fails because customers no longer want the product, those same reasons would affect your business. So check your business is not a fad, and work hard in collaboration with other franchisees and your franchisor to make sure the business always remains relevant to customers. And be careful if your franchise relies on the sale of produce that needs to be imported, as exchange rate fluctuations and customs and import complications need to be built into your planning;

2 The extent of the failure, and whether it is terminal. It maybe that the franchisor enters into insolvency to restructure itself, or to seek relief from one or two particular obligations. This is particularly common in the US, and becoming more common in Australia. Alternatively the franchise assets may be quickly sold to another company (or even to a group of franchisees) that is keen and able to take on the responsibilities as your franchisor. In these cases the impact is likely to be less severe, but you still need to be able to ride out the storm until the franchisors comes out of insolvency or a new franchisor is established, or buys the business and is able to fully resume the relationship;

3 The level of interdependence between franchisor and franchisee at a business level. The higher level of interdependence, the greater the risk to a franchisee. To understand what is meant by this, consider the following example. In the event of the failure of a typical real estate franchise a franchisee may be able to simply continue trading under the brand, or (provided this is allowed under the franchise agreement or can be achieved by negotiation or legal action) exit the network and join a new network. In this case the franchisor and franchisee are not particularly interdependent.

4 On the other hand if the franchisor is also your supplier, holds the head lease of the premises and provides essential services or support, you as a franchisee are more vulnerable. You are dependent on the franchisor to carry out your day to day dealings with customers, so if it fails you are in more trouble. This is also the case if, instead of you paying the franchisor franchise fees and royalties, the franchisor receives money from customers and pays you a commission. Such a situation applies in some financial services companies, and was also a major problem for the franchisees of Kleenmaid when it failed. You are then often a creditor of the franchisor as well as being affected as a franchisee.

Another example of serious consequences is the failure of the Kleins business, where the franchisor was the supplier and in many cases not only held the head lease but provided substantial rent subsidies to some franchisees. When the franchisor failed the franchisees could not afford to pay the true market rent, and so the landlord terminated the leases and found another tenant.

Kleenmaid and Kleins show how franchisees can be affected. Of course the real problem in both cases was that the underlying business and products had lost their appeal to customers and the retail concepts were the subject of significant competition. The problems were not caused by franchising itself.

5 The skills, experience and financial strength of the franchisee. Franchisees new into the business who require training or support, are still establishing their customer base or are highly geared are more vulnerable;

6 The nature of the insolvency. There are various types of insolvency – receivership, administration, liquidation, personal bankruptcy. Each is slightly different, and the appointed insolvency officials have different powers and obligations. For example under administration the administrator actually has power to stop creditors such as landlords from taking action to recover their assets. A detailed analysis of the difference is beyond the scope of this chapter, but the nature of the insolvency will influence how a franchisee should act.

Additional protections

There are a few things you can do to ensure you are as protected as possible in the event that your franchisor becomes insolvent. Here is a brief checklist:

1 Look for warning signs in the financial statements attached to your disclosure document. Classic warning signs are that a related entity or director has been previously been insolvent, the franchisor has been making losses, there are few net assets on the balance sheet or there have been unsatisfied judgements against the franchisor;

2 Discuss with your legal and business advisers the possible consequences to you of failure of your franchisor;

3 Consider whether you will be able to continue to use the trade mark and other intellectual property if the franchisor fails. Usually you will be able to do so provided you continue to pay royalties;

4 Consider whether you want to negotiate any amendments to the franchise agreement to provide additional rights or protection. For example you may want to be able to renegotiate the fees or be relived of certain obligations in the event of franchisor insolvency, or you might want to be able to exit the network. If so, you could negotiate a clause giving you the right to terminate the franchise agreement in such a case. This right would also include a release from any post-termination restraint of trade clause that might otherwise apply.

5 Consider if you would like to have an option to buy certain assets, although in some cases the insolvency official of the franchisor might be able to avoid being bound by such a clause.

Don't jump too hastily if problems arise. If you leave the network you will not be able to continue to use the trade mark or any other intellectual property once the franchise agreement is terminated. Be careful not to underestimate the value of the brand, or overestimate your ability to go it alone. It is not a pleasant experience when a franchisor becomes insolvent. However in most cases franchisees are less affected than employees, suppliers and creditors. Insolvency laws have been designed to encourage companies to enter into insolvency earlier. As a consequence they are better placed to emerge and continue in some form.

What to do if problems occur?

There are often early warning signs of insolvency – late payment of invoices, loss of key employees, cut backs in spending. However insolvency can still occur quite quickly and franchisees could easily be caught unawares.

Here are a few suggestions as to what to do if your franchisor becomes insolvent:

1 Speak to the franchisor's staff and gather as much information as you can;

2 Find out the name of the administrator, liquidator or receiver and obtain as much information as possible;

3 Contact other franchisees, as they will be in the same boat. It is critical to act collaboratively, at least in the early stages;

4 Get expert legal advice immediately so you understand exactly the legal consequences of the insolvency. Often legal advice can be provided to the group, at considerable cost savings;

5 Consider your own personal position, as it may be different to the position of other franchisees. You will probably need to speak to your accountant, and possibly get your own legal advice if your position is not covered by any group advice;

6 Find out what other franchisees are doing, and keep in touch. If group negotiations are happening, keep informed;

7 Be pro-active in dealing with the insolvency firm appointed. Often they will try to placate you, as they will be keen to continue to receive royalties. However this is also a good time to negotiate, particularly if you want any concessions or wish to exit the network;

8 Assess your position and develop a strategy;

9 In due course consider your legal rights. The Code and the *Competition and Consumer Act* give you remedies not available to others. For example you may be able to sue the directors and other employees of the franchisor if they have breached the Code or engaged in misleading or deceptive conduct. You may also be able to gain assistance from the ACCC. In many cases when a franchisor becomes insolvent there is little left for unsecured creditors, so a damages claim against the company might be worthless. However in the case of a franchisee it might enable you to set off money you owe the franchisor, and may enable legal action to be taken against any individual aiding, abetting or being knowingly involved in any breach.

Annexure C

This legal analysis of the current law in relation to good faith has been prepared and provided by Norton Rose Australia.

1 **Common law**

The duty of good faith at common law generally encompasses two distinct duties, being:

(1) the duty to negotiate in good faith (**pre contractual duty**); and

(2) the duty to act in good faith in the performance of contracts (**post contractual duty**).

By virtue of the requirement not to act fraudulently, a positive duty of honesty in contractual negotiations is clearly established in Australian law. Sometimes the law will extend the basic requirement of honesty further, by imposing a positive obligation of disclosure. The enactment of the Franchising Code of Conduct is a perfect example.

A combination of the comprehensive disclosure obligations contained in the Franchising Code of Conduct and the prohibitions on misleading or deceptive conduct and unconscionable conduct make the duty to negotiate in good faith redundant. These explicit legal obligations go far beyond any obligation to negotiate in good faith, which has traditionally been regarded as most problematic in any event. For example in *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd*[11] the majority of the Court of Appeal held that an obligation to *"proceed in good faith to consult together upon the formulation of a more comprehensive and detailed joint venture agreement"*, was too illusory, vague and uncertain to be enforceable. As identified in the *Coal Cliff* case, the main problem with a term requiring parties to exercise good faith in contract negotiations is that the term is likely to be void for uncertainty. Therefore, it is likely the courts will only enforce an **express term** requiring parties to negotiate in good faith where the term contains sufficient criteria about what the parties mean by good faith, to enable the court to determine whether the term has been breached.

In addition to the uncertainty question, there are other problems regarding an express term requiring good faith in contract negotiations. Some of these problems include:

- what agreement (if any) would have been struck had the obligation not been breached?
- what damages, if more than nominal, would flow?

Any statutory requirement to negotiate in good faith would be likely to be regarded as meaningless. The point was raised in the UK case of *Walford v Miles*[12] where the plaintiffs argued that the agreement included an implied term that "the defendants would continue to negotiate in good faith with the plaintiffs". The House of Lords refuted this suggestion saying:

- an implied duty to negotiate in good faith is meaningless without content;
- an implied duty would be unworkable in practice, and inherently inconsistent with the position of a negotiating party as while in negotiation either party could break off at any time and for any reason.

[11] (1991) 24 NSWLR 1
[12] [1992] 1 All ER 453

1.2 **Statute**

There is no general statutory provision requiring parties to exercise good faith in negotiating a commercial contract. Nevertheless, pursuant to s51AC(3)(k) of the TPA, "good faith" is one of a host of matters to which courts are directed to have regard to when determining if a corporation has engaged in unconscionable conduct. The key, in the context of contractual negotiations, is that s51AC is not only confined to concluded contracts for the supply or acquisition of goods and services but also extends to **the possible supply or acquisition of goods and services**.

This provision illustrates how good faith is best applied in contractual negotiations and relationships – as a factor to be considered in relation to prohibited conduct such as unconscionable conduct, rather than as illegal conduct itself.

1.3 **Agreements, contract negotiations and mediation**

In *Aiton Australian Pty Ltd v Transfield*[13], Einstein J upheld an express obligation to negotiate in good faith in the context of mediation. The essential or core content of an obligation to negotiate in good faith was expressed in the following terms:

(a) to undertake to subject oneself to the process of negotiation;

(b) to undertake in subjecting oneself to that process, to have an open mind in the sense of:

(i) a willingness to consider such options for the resolution of the dispute as may be propounded by the opposing party or by a mediator, as appropriate; and

(ii) a willingness to give consideration to putting forward options for the resolution of the dispute.

The provisions of the Franchising Code of Conduct specifically address conduct in mediation, and so there is no room for any implied duty of good faith. The Code provisions indeed go much further than any implied duty would extend.

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2 **Implied contractual terms**

2.1 It is useful to consider how terms can be implied into a contract when considering any duty of good faith in the context of a franchising arrangement, even if that duty becomes an express duty.

Essentially a court looks to the presumed intention of the parties. In the case of a formal contract, complete on its face[14], there are 5 strict requirements to satisfy before a term is implied in fact. The 5 requirements were set down by the Privy Council in *BP Refinery (Westernport) Pty Ltd v Hastings Shire Council Pty Ltd*[15] and adopted by the High Court in *Codelfa Construction Pty Limited v State Rail Authority of NSW*[16]*:-*

(a) the term must be reasonable and equitable;

(b) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it;

(c) it must be so obvious that it goes without saying;

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[13] [1999] NSWSC 996

[14] In the case of a contract which does not contain all the terms, a term may be implied if the term is necessary, for the reasonable or effective operation of a contract in the same nature as the contract and not inconsistent with the express terms of the contract, see *Hawkins v Clayton* (1988) 164 CLR 539 per Deane J at 573 (cited in Breen v Williams) (1996) 186 CLR 71, also ***Byrne*** *& Frew v Australian* ***Airlines*** *Ltd* (1995) 185 CLR 410 per McHugh & Gummow JJ at 442

[15] (1977) 180 CLR 266

[16] (1982) 149 CLR 337

(d) it must be capable of clear expression;

(e) it must not contradict any express term of the contract.

2.2 As the law currently stands in Australia, there is no (general) term, implied in law, requiring the parties to act in good faith when performing the contract. However, in *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd*[17], Gummow J suggested that, where a contract would otherwise be void for uncertainty, an obligation to act in good faith may be implied, in order to give the agreement business efficacy.

2.3 However, in some cases it has been suggested that an implication of good faith in contract performance may, subject to the terms of the contract, be made as a **matter of law** (*Alcatel Australia Ltd v Scarcella*[18]) or as a **matter of the facts** of the case (*Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL (Receivers and Managers Appointed) (Administrator Appointed)*[19]).

2.4 Recent cases have shown that a duty to act in good faith may be implied in specific contexts particularly in relation to contracts for the provision of services, or to give business efficacy to a particular contract. In NSW it appears that an implied duty of good faith exists, though whether such a term is implied in law or in fact is a matter of debate. In Victoria the battle continues as to whether any implied duty of good faith exists at all.

2.5 Perhaps the most relevant case to the franchise sector is *Burger King Corp v Hungry Jacks Pty Ltd*[20], where in the context of a franchise agreement three judges of the NSW Court of Appeal delivered a joint judgment whereby they made the following comments:

- "Courts in various Australian jurisdictions have, for the most part, proceeded upon an assumption that there **may** be implied, a**s a legal incident of a commercial contract**, terms of good faith and reasonableness".
- "Case law …. indicates that obligations of good faith and reasonableness will be more readily implied in standard form contracts, particularly if such contracts contain a general power of termination".
- "The cases where these terms are to be implied are not limited to standard form agreements. *Alcatel* itself, which involved a 50 year lease agreement of commercial premises, provides an example of a one off contract where such terms were implied".
- "There also appears to be increasing acceptance …. that if terms of good faith and reasonableness are to be implied, they are to be implied as a matter of law. We consider that to be correct".

2.6 The Burger King case seems to indicate that a duty to act in good faith is likely to be applied in most if not all cases given the nature of the franchise relationship, and the creation of specific disclosure and conduct obligations in the Code.

2.7 Although Victorian courts have long recognised the doctrine of good faith, they have, more often than not, decided matters on other bases thereby avoiding the conceptual difficulty that can attend to the concept of a duty of good faith. The exception to this rule, again in a franchising case, was Justice Byrne's decision in *Far Horizons v McDonalds Australia*[21] where his Honour:

- said he did not see himself as at liberty to depart from the considerable authority in Australia following the decision in *Renard Constructions.*
- proceeded on the basis that there is to be implied in a franchise agreement a term of good faith and fair dealing which obliges each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and

[17] (1993) 45 FCR 84 at 94; 117 ALR 393 at 404
[18] (1998) 44 NSWLR 349 at 369
[19] [2005] VSCA 228
[20] [2001] NSWCA 187
[21] [2000] VSC 310

- said that such a term is a **legal incident** of the franchise agreement.

2.8 Although the Victorian Court of Appeal decision in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL (Receivers and Managers Appointed) (Administrator Appointed)*[22] the Court of Appeal specifically stated its reluctance to:

> "…conclude that commercial contracts are a class of contracts carrying an implied term of good faith as a **legal incident**, so that an obligation of good faith applies indiscriminately to all of the rights and powers conferred by a contract."

Nevertheless, in *Esso* the court did say:

> "it may be appropriate in a particular case to import such an obligation to **protect a vulnerable party from exploitive conduct** which subverts the original purpose for which the contract was made. Implication in this fashion is perhaps ad hoc implication meeting the tests laid down in *BP Refinery (Westernport)*, rather than an implication as a matter of law creating a legal incident of contracts of a certain type." (emphasis added)

2.9 The underlying policy behind the court's decision to imply a duty of good faith in fact, as opposed to blanket implication as a matter of law, is best highlighted by the following passage from the judgment of Chief Justice Warren:

> "Ultimately, the interests of certainty in commercial activity should be interfered with only when the relationship between the parties is unbalanced and one party is at a substantial disadvantage, or is particularly vulnerable in the prevailing context."

2.10 The decision in *Esso* has been applied in Victoria in *Panasonic v Broadtel*[23]. In that case it was held that:

> "The Court [in *Esso*] said that **the law** does not always imply a duty of good faith into commercial contracts. So much may be accepted. But the Court went on to say that it may be appropriate in a particular case to imply such an obligation. The question in the present case, therefore, will be whether the implication should be made. Broadtel relies on both the terms and the context of the agreement — that is, the nature of the business relationship between the parties — and on considerations of business efficacy. Whether those matters will suffice to justify the implication will be a **matter for decision by the trial Judge**."

2.11 Thus it appears that in Victoria, the position remains that implying a term of good faith may be appropriate to protect a vulnerable party from exploitative conduct which subverts the original purposes for which the contract was made. Therefore, if the term is to be implied, it will only be **implied in fact**, not in law.

2.12 The High Court has not yet comprehensively considered this issue. As such, it has not expressly endorsed the implication of a duty of good faith into commercial contracts in fact or as a matter of law. The issue was raised before the court in *Royal Botanic Gardens and Domain Trust v South Sydney Council*[24] but the court thought it was an inappropriate occasion to discuss the matter. Nevertheless, Justice Kirby took the opportunity to comment on the point. In particular, his Honour commented that:

> "In Australia, such an implied term appears to conflict with fundamental notions of caveat emptor that are inherent (statute and equitable intervention apart) in common law conceptions of economic freedom. It also appears to be inconsistent with the law as it has developed in this country in respect of the introduction of implied terms into written contracts" (footnote refers to *BP Refinery (Westernport)* and *Codelfa*).

[22] [2005] VSCA 228
[23] [2007] VSC 273
[24] (2002) 186 ALR 289

3 What does it mean if a term is implied - what does "good faith" in the performance of a contract require?

3.1 Once it is established that a duty of good faith exists it is necessary to look at exactly what the obligation requires. In summary, the current view in both Victoria and New South Wales is that the duty of good faith sits somewhere between a mere duty to act honestly and the onerous obligations that are imposed on a fiduciary. In particular, the duty of good faith may extend to require one party to consider the interests of another but it will not require that party to subordinate its own interests to those of another party.

3.2 The Victorian Court of Appeal touched on the content of an implied duty of good faith in *Esso*. In arriving at its decision that Southern Pacific Petroleum would not have breached the implied duty (if it actually existed) in that particular case, the court followed the reasoning of:

- Priestley JA in *Renard Constructions* who equated good faith with reasonableness;
- Finkelstein J in *Garry Rogers Motors Aust Pty Ltd v Subaru (Aust) Pty Ltd*[25], who said that the obligation of good faith required a party "not to act capriciously";
- Walker J in the US decision of *Metropolitan Life Insurance Co. v RPR Nabisco Inc*[26], who described the breach of the obligation of good faith as seeking to prevent the performance of a contract or withholding its benefits;
- Byrne J in *Far Horizons v McDonalds Australia*[27] and Sheller JA in *Alcatel Australia Ltd v Scarcella*[28] who described the breach of the obligation of good faith as seeking to further an ulterior purpose or purpose extraneous to that for which a right or power is conferred.

3.3 A detailed and helpful consideration of the nature and content of the duty of good faith can be found in Justice Barrett's judgment in the *Overlook v Foxtel*[29] case. In that judgment His Honour referred to a number of judicial and academic comments and noted that:

- The concept of good faith embraced no less than three related notions, "being:
  - (a) an obligation on the parties to co-operate in achieving the contractual objects (loyalty to the promise itself);
  - (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."[30]
- It must be accepted that the party subject to the obligation is not required to subordinate the party's own interests, so long as pursuit of those interests does not entail unreasonable interference with the enjoyment of a benefit conferred by the express contractual terms so that the enjoyment becomes (or could become), "nugatory, worthless or, perhaps, seriously undermined" [words used by McHugh and Gummow JJ in *Byrne v Australian Airlines Ltd*[31]].
- "Most basically, by using the obligation to perform in good faith as a principle of construction the courts are merely required to ensure that the parties have genuinely adhered to the bargain which they entered into... Strict rights may not be adhered to, if in the context of the contract as a whole, this would subvert the character of the contract…"[32]
- The implied obligation of good faith underwrites the spirit of the contract and supports the integrity of its character. A party is precluded from cynical resort to the black letter. But no party is fixed

[25] (1999) ATPR 41-703
[26] 716 F Supp 1504, 1517 (SDNY, 1989)
[27] (2000) VSC 310
[28] (1998) 44 NSWLR 349
[29] ibid
[30] Sir Anthony Mason in his 1993 Cambridge Lecture (see now (2000) 116 LQR 66 at 69)
[31] (1995) 185 CLR 410
[32] "Incorporation of Terms of Good Faith in Contract Law in Australia", (2001) 23 Syd L Rev 222

with the duty to subordinate self-interest entirely which is the lot of the fiduciary. The duty is not a duty to prefer the interests of the other contracting party. It is, rather, a duty to recognise and to have due regard to the legitimate interests of both the parties in the enjoyment of the fruits of the contract as delineated by its terms.

- In many ways, the implied obligation of good faith is best regarded as an obligation to eschew bad faith.

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4 **Can you contract out of a duty of good faith?**

4.1 It is clear that the parties to a contract can contract out of a duty to act in good faith either by reference to the duty, or by the inclusion of a specific provision that gives a party an express power or discretion. A term will not be implied if it is inconsistent with an express term.

4.2 In *Vodafone Pacific v Mobile Innovations Ltd*[33], the NSW Court of Appeal held that a clause providing Vodafone with the sole discretion to determine target levels of connections of new subscribers, prevented the Court from implying a term that Vodafone act in good faith and reasonably when exercising the power to determine those target levels. In addition, there was also another clause of the agreement which provided: "To the full extent permitted by Law and other than as expressly set out in this Agreement the parties exclude all implied terms … "

4.3 It is also possible for the parties to agree to an express term that there is no implied duty of good faith.

4.4 Any statutory duty to act in good faith would seem to fraught with problems given:-

(1) The fact it can be excluded by an express term;

(2) The fact that conduct that might otherwise come with a general duty can be expressly authorised, thereby overriding the general duty;

(3) The difficulty in determining the consequences of failure to act in good faith; and

(4) The fact that good faith is generally viewed in the context of all relevant circumstances, which may differ substantially from case to case.

[33] [2004] NSWCA 15

Annexure D

A selection of recently published articles on franchising that merit consideration in the context of the current inquiry into franchising.

Smartcompany Tuesday, 12 February 2013 *Advice from Australia's top entrepreneurs and small business experts.*

No systemic problems with franchising

Author: *Richard Evans* on 12 February 2013

Business is risky. It's a cliché but it is true, especially in market economies like Australia. There is no guarantee of success, and in a competitive market all aspects of a business model are constantly under pressure.

Consumers drive demand and success in small business relies on them spending; and if clients aren't buying, there is no amount of regulation or legislation that will alter this self-evident truth. Failure is just one bad decision away; and if failure comes, it could mean the loss of everything.

So why do small business investors, who mitigate their business risk by joining an established brand, expect to have regulations and legislation introduced to protect them from market failure? Why does the National Franchisee Coalition (NFC) want greater law to protect them from market failure than already exists in the highly regulated franchise market?

The NFC speaks of rogue franchisors, of churning, of unscrupulous behaviour of franchisors, but where is the evidence? It is extraordinary the media and some politicians listen to the cries of a very loud unrepresentative few, and not look at the evidence within the market.

In any market there are unscrupulous people trying to take advantage, and this is the reason we have a regulated market, with the ACCC as its guardian.

But where is the evidence of the systemic failure of the franchise market? Where is the systemic unscrupulous behaviour of franchisors to warrant further regulation to protect franchisees from market failure? Where is the evidence of systemic churning? Where is the evidence of unfair dealing, especially when the Franchise Code is so prescriptive?

The ACCC has none, nor do the research universities, nor the Office of Mediation Advisor, or indeed, the various small business commissioners. Yet, a small unrepresentative body, with little market credibility, gains a policy ear with no reference to any examples, case studies or research.

The Australian franchise market is the most regulated in the world. It has a substantial Code requiring franchisors to provide full disclosure on an annual basis; it has government accredited education; tertiary institutions providing research and education; an active regulator and a system of mediation that leads other industries. Yet disgruntled former franchisees still want more.

The Code does not guarantee success for a franchise system; it does not stop a franchisee from over investing; it does not require a franchisee to disclose; it does not require a franchisee to follow the franchise system, the very essence of success; the Code does not guarantee a franchisee will get their money back if they fail.

The Code does require the franchisor to provide full disclosure annually; it does require the franchisee to seek advice and complete due diligence prior to signing a contract; it does require a franchisor to provide a list of current and previous franchisees, so a prospective franchisee can talk to them about their experiences; the Code provides adequate protection, as do the trade laws associated with any other Australian business.

Before denigrating the most success franchise regulatory scheme in the world, which is copied by many other nations, perhaps the NFC can point to examples of systemic market failure, case studies of churning and unfair practice; and perhaps, they can provide evidence of their members having done adequate education and due diligence prior to entering the franchise sector.

The sad fact is that many who enter the franchise market believe it to be an entrée to financial success. It can be, but it requires the franchisee to follow the system and work hard. Sadly, this is not the case with many who fail. Those that want a greater say in franchise operations should perhaps start their own brand as many franchisors have themselves done, rather than change and challenge those brands that have already done the hard yards of start-up and experienced the pain of growth.

We do not need more regulation in Australia. What we need is greater franchisee disclosure, more pre-entry education, and more access to the established mediation processes through ongoing education via government agencies and the established industry body.

Punish those that take advantage, but do not denigrate a world-leading franchise sector that has created a significantly fair market since the introduction of the Code in 1997.

Richard Evans is an award winning franchisee and author of the Australian Franchising Handbook. He is also a former member of the Federal Parliamentary Inquiry into Franchising that led to the introduction of the Franchising Code of Conduct in 1998.

Canadian warnings against good faith, class actions, and State based regulation of franchising

© Stephen Giles, Partner, Norton Rose Australia, November 2012

I recently attended the Ontario Bar Association Franchise Law Conference in Toronto, attended by over 120 of Canada's leading franchise lawyers. I was keen to learn first hand and in detail about their regulatory environment, particularly as people like Frank Zumbo occasionally and vaguely point to Canada in the context of State based regulation of franchising and good faith in particular.

I am now convinced that our regulation of franchising is world's best practice, and it would be a serious mistake to introduce any aspect of Canadian franchise regulation to Australia. Measured fairly against principles of access to justice, regulatory certainty, compliance cost and dispute resolution efficiency Australia comes out miles ahead.

Regulatory fundamentals

Australia has a comprehensive Federal framework of franchise regulation through the Franchising Code of Conduct ("the Code") and the provisions of the Competition and Consumer Act ("the CCA"). It has followed the US prior disclosure model, with very prescriptive content requirements that go beyond those required in the US and indeed all other countries. The Code also has unique features not found in other countries, such as a mediation based dispute resolution framework and explicit emphasis on franchisees obtaining legal and business advice. The specific franchise legislation is strongly supported by the general prohibitions on misleading or deceptive conduct and unconscionable conduct contained in the Federal Competition and Consumer Act.

Canada also has quite unique franchise regulation, with State (Province) disclosure based legislation. The laws are conceptually similar in each Province, but there are material differences. To add complexity some parts of Canada operate like Australia under the English common law system, whereas other parts operate under the European civil law system. There is no Federal regulation, and no regulator to oversee the operation of the legislation. So the cost of regulatory compliance for franchisors is higher in Canada than in Australia.

In both countries a duty of good faith would be implied into most franchise agreements, but Canada has gone further in some Provinces and enacted a statutory good faith and fair dealing obligation.

Legislative certainty

Statutory good faith and fair dealing obligations have introduced greater uncertainty into Canadian law. In two recent cases the claims against leading franchisors Tim Horton's[34] and Dunkin' Donuts[35] related not to misrepresentation or breach of contract, but rather the capacity of franchisors to actually implement management and business decisions they were contractually entitled to make. In the Tim Horton's case it was changes to the franchise system to lower costs, introduce new products and streamline the menu, and in Dunkin' Donuts it was the extent of the obligations of the franchisor to develop successful strategies to combat the market entry of a major competitor. If the franchisors in these cases are unsuccessful on appeal there will be many franchisors worried that the law now allows every management decision they make to be second-guessed with the benefit of 20/20 hindsight.

Australian and Canadian franchise laws both provide substantial and relevant information to prospective franchisees. Their laws also protect franchisees from misrepresentation, misleading conduct and extreme or unconscionable conduct, albeit by slightly different means. The Australian legislation is slightly more comprehensive, but in terms of substantive protections provided to franchisees there is little material difference between the two countries except in States where there is an explicit statutory fair dealing obligation. In these States, such as Quebec, there is considerable concern that the legislators have gone too far.

Access to justice

Rather than have a regulatory body such as the Australian Competition and Consumer Commission (the ACCC) overseeing the legislation and taking investigative or enforcement action, Canada relies on the capacity of franchisees to take court action to enforce their rights. They have enhanced the legal rights of franchisees via statutory good faith obligations, and supported this by class action rules to enable franchisees to band together to issue class action proceedings.

[34] *Fairview Donut Inc v The TDL Group Corp, 2012 ONSC 1252*
[35] *Bertico Inc v Dunkin' Brands Canada Ltd, 2012 QCCS 2809*

Even though Canadian franchisees arguably have more favourable laws at their disposal, Australian law clearly delivers substantially better access to justice for franchisees. In this context it is important to distinguish between access to the courts, and access to justice, as I believe they are very different things. I use the term more colloquially. For a franchisor and a franchisee access to justice means convenient and cost-effective access to an outcome that a fair-minded party would consider just.

The Australian model delivers a vastly superior outcome, for the following key reasons:-

1. The ACCC oversees the Australian regulatory framework, and is a well-resourced and capable regulator with strong investigative and enforcement powers.

2. The benefits provided by the class action provisions are largely illusory, with the legal profession being the major beneficiary. By definition class actions relate to systemic rather than one off conduct by a franchisor. In Australia this conduct will typically be investigated, at no cost to the franchisee, by the ACCC or by one of the State Small Business Commissioners. In Canada there are no regulators, so civil action needs to be taken to achieve redress. This needs to be funded by the franchisees, including the costs of investigation.

3. The investigative powers of a franchisee are limited to the normal court discovery process. The ACCC on the other hand has extensive powers of investigation. If the ACCC finds that there has been a serious breach of the law it will take its own enforcement action that may include seeking remedies for affected franchisees. Information obtained by the ACCC during an investigation is routinely provided to franchisees.

4. The Australian framework provides quick, low cost dispute resolution through mediation.

5. Class actions are like a duel with lethal weapons, in that the unsuccessful party is often wiped out. If the franchisor loses and is unable to pay the awarded damages and costs, the franchisees involved in the litigation score a very pyrrhic victory. Those franchisees not involved in the litigation are also likely to be seriously injured in the cross-fire.

<u>Dispute resolution</u>

The mediation based dispute resolution framework in the Australian legislation is a vastly superior method of dispute resolution when compared to the Canadian approach. Mediations typically occur within a few months of the dispute arising, and the relatively minimal costs of the mediation are shared equally between the parties. Litigation and arbitration are adversarial, expensive, protracted, and rarely yield a mutually acceptable outcome. There is invariably a winner and a loser.

Although there is much more litigation in Canada, there is less consideration of the merits of the cases. Many of the court cases relate to court procedure concerning class actions, such as whether the court should certify the case for a class action, whether the court pleadings comply with the rules, and what are the best tactics to be used to prevent a court from certifying a class action or at least narrow the issues. Part of the problem is that the courts are certifying a lot of cases, as in the context of good faith and fair dealing requirements it is very difficult to prevent certification on the basis that a franchisee does not have at least an arguable case. As a consequence franchisors and franchisees become locked in to a highly adversarial, expensive and largely winner take all framework. Frequently they spend tens and hundreds of thousands of dollars before even talking about settling the matter.

The contrast with Australia is profound. Very few franchising cases make it to court in Australia. I believe there are three reasons for this:-

1. The involvement of the ACCC as industry regulator;

2. The fact that franchisees have quite powerful remedies under the Code and the CCA, so a franchisor cannot be confident of success if the matter ultimately reaches court; and

3. The mediation based dispute resolution framework included in the Code.

According to published statistics by the Office of Franchise Mediation Advisor over 80% of franchising disputes in Australia are resolved by mediation, typically resulting not in a winner and a loser but in an agreed outcome that is mutually satisfactory. This is a stunning outcome about which Australia should be very proud. There is very little use of mediation in Canada, and unlike Australia there is no mandatory obligation to participate in mediation contained in their franchise legislation except in one Province. [check]

The ACCC should also receive credit for the role it plays. It is much more difficult for endemic problems to arise in Australia, as problems come to the notice of the ACCC and it usually acts very quickly and decisively. Franchisees have someone to contact, whereas in Canada their only resort is civil litigation.

Conclusion

The regulation of franchising in Australia produces superior outcomes when compared to the Canadian model as there is greater legislative certainty, the compliance costs are lower, there is greater access to justice and disputes are resolved more cheaply, quickly and constructively.

So the next time an ill-informed academic muses about the merits of incorporating some aspects of a foreign regulatory model into the Australian framework we can confidently say that these musings are not for the real world. Franchisors and franchisees in Australia would be much worse off if any aspects of the Canadian regulatory framework were introduced into Australia. The only beneficiaries would be Australian lawyers, particularly those involved in litigation.

The Australian regulatory framework for franchising is world's best practice. It strikes a fair balance between the interests of the parties, and creates an environment for proper collaboration between franchisors and franchisees.

Annexure E – Explaining franchisee behaviour

This annexure includes extracts from the Griffith University Asia-Pacific Centre for Franchising Excellence Report *Survival of the fittest: The performance of franchised versus independent small business during economic uncertainty and recovery.* This Report is a recommended resource for those seeking a deeper understanding of the franchise relationship.

Perhaps the greatest challenge for regulators in the franchise sector is determining the extent to which legislation interferes with what on the face of it ought to be a normal business contractual relationship. Some countries – the United Kingdom, Singapore, Hong Kong and New Zealand – have felt no need to intervene at all. Australia on the other hand has taken a far more paternalistic approach. Yet some remain unsatisfied, urging Government to intervene still further.

The Griffith University Report sheds important light on the regulatory framework. It arguably demonstrates that not only is further legislative intervention not necessary, but it may well be fruitless. The Report confirms current information is adequate for those prepared to make what might be expected to be normal efforts to undertake due diligence. The Report shows a clear correlation between effort put into due diligence and success. The same no doubt applies to the operation of the business itself. It is clear that for those that make the effort, the framework works well and there is more than adequate information. For those that have access to the same information, but do not make the effort, it is not obvious what else can be done or indeed even should be done.

Extract	**Page**	**Comment**
"Franchisees and independent contractors have distinctly different motivations for entering business and possess different psychological traits. Franchisees seek the security of a franchise network and are risk avoiders.. Franchisees rated their pre-entry experiences (access to information, due diligence and decision making ability) positively and they valued the franchisor-franchisee relationship. However their adaptability and autonomy levels were lower than independent business owners and they were more likely to suffer stress and regret."	i	The highlighted words are interesting, and perhaps help explain why it is an ongoing challenge to meet a franchisee's expectations.
"Given their overall greater feelings of confidence and autonomy, independents were more willing to take responsibility for failure or setbacks than franchisees, who tended to attribute blame to external factors."	ii	Psychologist Greg Nathan notes that blaming others is a fundamental and valid human coping mechanism, and helps avoid consequences such as depression. Understanding that blaming is a natural behaviour also helps explain why some franchisee allegations that appear on face value to be honestly made ultimately prove to be false.
"The research revealed that economic conditions affected all businesses similarly and that personal factors such as motivations, personality, decision making autonomy and adaptability were more likely to affect business survival than external factors."	ii	This is consistent with the FCA experience that the differences between views in most disputes relate to mismatched expectations rather than any inappropriate behaviour. And that most businesses fail for

		business rather than "franchising" reasons.
"Successful franchisees believed that sufficient information was available to them, spent considerable time in researching the business opportunity, sought considerable external guidance and were actively and personally involved throughout the evaluation phase. On the other hand struggling or failed franchisees believed that available information was insufficient…underutilised (or even discounted) independent external advice and would overemphasise the importance of … entering small business over and above other pre-entry considerations."	14,15	This reinforces the FCA's view that there is adequate information available for franchisees. It also indicates that further information is unlikely to assist those that do not properly use the current framework.
"..just under half of the interviewees indicated that they had ignored or overridden the advice provided by external advisors in their quest to become self-employed."	12	It is not the role of legislation to protect people who choose not to take advantage of the current legislative framework.
"The lure of being one's own boss appeared to impact the conduct of adequate due diligence."	12	
"… it was apparent that successful franchisees exerted significantly more effort in conducting adequate due diligence than struggling or exited franchisees."	11	It is also logical that those who put the appropriate effort into due diligence will also put the appropriate effort into business operations. Regulation should not be drafted to protect those who are not prepared to put in sufficient effort to due diligence.
"Most franchisee experts reported that potential franchisees were provided with more information than would be available to independent operators. In particular, most suggested that franchising was more transparent, and provided more detailed information to potential entrants as it had a structure behind it."	13,14	This confirms that franchisee experts have adequate information. It also provides a useful reminder of the context of franchising vis a vis small business generally.
Most successful franchisees considered the franchise agreement to be "both fair and equitable" and "franchising matched their expectations", whereas struggling or exited franchisees felt the franchise agreement "did not provide a true representation of what was expected." "However in the context of shopping centre leases a different picture emerges…" "All interviewees expressed concern in terms of the nature of shopping centre lease agreements and the propensity for landlords to act unethically in increasing rent requirements."	20,22	Further evidence that the current franchising laws work, particularly when the contrast with retail tenancies is provided. The tenancy example shows that if there is a genuine problem, all parties will see it as a problem.
84% of surviving franchisees and 80% of failed franchisees felt that there was enough information given to me to make an informed decision about buying my franchise. Interestingly, only 28% of failed franchisees wished there was more information.	65	These figures support the FCA's contention that current information is comprehensive.
Failed franchisees rated information given as very relevant (85%), very accurate (80%), very complete (77%) and very helpful (85%). Failed franchisees fully understood their obligations in the franchise agreement (85%) and felt them to be fair and equitable (84%). The percentages for successful franchisees were only slightly higher.	67	These figures provide strong statistical support for the current regulatory balance.