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Review of the Franchising Code of Conduct

1.0 Summary

The Shopping Centre Council of Australia's submission to the Review of the Franchising Code of Conduct is confined to two aspects of the Terms of Reference: the notion of "good faith in franchising" and "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."

'Good faith' is a concept which is generally impossible to define and is therefore not a legal standard suitable for insertion as a statutory provision. Neither in Australia, nor elsewhere, is there a clearly defined, well understood, statutory doctrine of 'good faith'. This can only add to business uncertainty and put the conduct of many business affairs into the hands of the courts, therefore adding to the cost of doing business in Australia. It would be contrary to good regulatory and legislative principles for the Federal Parliament to impose on a business relationship an obligation which can't be defined or explained and is so open to a variety of different interpretations that it would not permit the development of a coherent and clear body of law. The Government should therefore reject, as it has in the past, calls for the insertion of a statutory obligation of 'good faith'. If there are specific concerns about particular business conduct these should be addressed directly in the Code.

Similarly the Government should reject calls for automatic renewal of franchise agreements or for the payment of compensation if an agreement is not renewed. Such claims turn the notion of contract law on its head. The franchise agreement is a contract between the franchisor and the franchisee for the use of the business system, for an agreed price, for an agreed term, and on agreed conditions. Like any other contract, the franchise agreement has a finite life and implies no ongoing right to possession or occupancy. The parties to a franchise agreement are legally bound to fulfil the contract's negotiated terms – no more, no less. If a franchisee requires a longer term in order ensure an adequate return on their investment, then they should be prepared to negotiate a longer term at the outset and to take on the additional business risk that comes from that longer term. The Federal Parliament should not be in the business of forcing an unwilling party to enter into commercial arrangements which the party does not believe is to its benefit.

2. Good faith in franchising

As the Discussion Paper notes, the Franchising Code of Conduct ("the Code") was amended in 2010 to clarify that it does not limit any obligation on parties to a franchise agreement, imposed by the common law, to act in good faith. There is no justification in going further by imposing an explicit obligation of good faith.

'Good faith' is a concept or a principle which is generally impossible to define and is therefore not a legal standard suitable for insertion as a statutory provision. We demonstrated in our submission in September 2008 to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into the Franchising Code of Conduct ("the Joint Committee") that, neither in Australia nor elsewhere, is there a clearly defined, well understood, statutory doctrine of 'good faith'.

We note below just a few comments by legal commentators we cited in that submission:

- *"To say that the role of good faith in Australian contract law is currently unsettled and that the law is in a state of flux would be an understatement. It may be closer to the mark to say that it is in a state of utter confusion."*¹
- *"Despite the increased use of implied and express terms of 'good faith' in contracts over the last 10 years, there is still little agreement about the exact meaning of the obligation."*²
- *"There is no uniformly agreed definition of 'good faith'."*³
- *"The recognition of good faith as a principle inherent in contractual relationships has caused sufficient judicial angst for its place to continue to be doubted within Anglo-Australian jurisprudence."*⁴
- *"Perhaps the most important unresolved issue in Australian contract law today is the extent to which the law recognises an implied requirement of good faith in performance and enforcement."*⁵
- *"One of the stumbling blocks is that Australian law has yet to come to terms with the concept of good faith. Firstly, it is difficult to compose a workable definition and secondly there is the issue of the standard of conduct which will amount to a breach of a duty of good faith, or simply bad faith."*⁶

These comments demonstrate that claims that "the concept of good faith has not only received strong judicial support, but has now reached a point in Australia where its nature and scope is being defined with an increasing degree of precision", and that "there is a ready body of law on which a statutory duty of good faith could readily and usefully draw upon in seeking to promote ethical business conduct"⁷, are nonsensical.

The Joint Committee's report in December 2008 noted "the lack of a universally accepted specific definition of good faith" and cited the wide range of views among legal practitioners and others who made submissions to the Joint Committee (pp. 102-107). The Joint Committee did not attempt to distil, from these submissions, a definition of its own. Despite being unable to define what is meant by "good faith" the Joint Committee proceeded to recommend the inclusion in the Code of an obligation on franchisors and franchisees to "act in good faith in relation to all aspects of a franchise agreement". This recommendation was made notwithstanding the uncertainty this would create for franchisors and franchisees.

¹ *Good Faith in Australian Contract Law* by JW Carter and Elisabeth Peden

² *The meaning of contractual 'good faith'* by Dr Elisabeth Peden

³ See for example *Aiton Australia Pty Ltd v Transfield Pty Ltd* (2000) 16 BCL 70 at [156] per Einstein J; R Brownsword

⁴ *Too Much Concern Too Soon? Rationalising the Elements of Section 51AC of the Trade Practices Act* by Philip Tucker

⁵ *Interpretation, Good Faith and the 'True Meaning' of Contracts: The Royal Botanic Decision* by JW Carter and Andrew Stewart

⁶ *Outline of the Interaction of Retail Tenancy Issues and Section 51AC*

⁷ Associate Professor Frank Zumbo submission to SA Inquiry, February 2008, p.17

As noted above, the Joint Committee's recommendation was not adopted by the Federal Government. Following a review by an Expert Panel, the Government amended the Code to insert the requirements noted in the first paragraph of this section.

We note, incidentally, that the Joint Committee cited (p.102), as evidence of statutory precedent, the obligation of 'good faith' contained in the Victorian *Fair Trading Act 1999*. The following year, in 2009, the Victorian Parliament passed the *Fair Trading and Other Acts Amendment Bill* which, among other things, removed from the *Fair Trading Act* reference to 'good faith', apparently because its meaning was unclear.

It should also be noted that the notion of a general duty of 'good faith' in commercial dealings, including in franchising, was also considered in 2008 by the Senate Economics Committee in its examination of the need, scope and content of a definition of unconscionable conduct in the (then) *Trade Practices Act*. This was expressly rejected by the Committee.

'Good faith' is a principle used by the courts in the construction and/or implication of contractual terms i.e. to fill in the gaps of contractual commitments. When used by the courts it is used in conjunction with other established common law rules which govern the construction and interpretation of contracts and have the purpose of determining objectively the parties' intentions when entering into the contract. This is consistent with preserving the sanctity of contract.

'Good faith' cannot stand on its own. There must first be an agreement with an objectively ascertainable common purpose, with respect to which the parties must be 'faithful' and with which the implied term must be consistent.

Since 'good faith' cannot be satisfactorily defined or commonly understood it is unlikely to result in any change to the business practices of franchisors or franchisees and can only add to business uncertainty. It makes little sense, and is contrary to good regulatory and legislative principles, for the Government to impose on franchisors and franchisees an obligation which can't be defined or explained and is so open to a variety of different interpretations that it would not permit the development of a coherent and clear body of law.

Franchisors and franchisees could have no confidence that they were acting in good faith in their day to day dealings. If they were to seek legal advice, it would be impossible (as the Joint Committee's report demonstrates) for franchisors or franchisees to receive clear, consistent and meaningful advice on what this obligation demands of them in a practical sense.

The obligation would therefore add substantial costs to the franchising industry in Australia. While it is not possible to quantify those costs it is not an exaggeration to suggest that major franchisors will each require their own separate legal advice on what the obligations of such a clause will mean for their own business behaviour. This would be a substantial cost for franchisors and a particularly frustrating cost since, as the Joint Committee's report conceded, this legal advice will almost certainly leave them none the wiser.

The introduction of a general duty of 'good faith' will put the conduct of many business affairs in the hands of the judiciary. This will enable courts to force parties to contract with each other on terms decided by the courts, including on terms which contradict those agreed by the parties in their initial franchise agreement.

The insertion of a statutory obligation of good faith would also fail the tests set out in the Australian Government's *Principles of Good Regulatory Process*. In particular, those principles require that "effective guidance should be provided to relevant regulators and regulated parties in order to ensure that the policy intent of the regulation is clear, as well as the expected compliance requirements." It is obvious, from the commentators cited above, that this requirement can't be fulfilled.

3. End of the franchise agreement

It has been asserted that there is a 'problem' in franchising because the present franchising regime in Australia provides little protection for the interests of the franchisee at the end of a franchise agreement. It is further argued that: *"... franchise agreements often do not address the entitlement by the franchisee to goodwill on termination or expiry of the franchise agreement. If it is referred to, it is usually to deny the franchisee any rights. In either case the benefit of any goodwill reverts to the franchisor."*⁸

The so-called problem is further said to be:

- *"Over the length of the agreement, franchisees' financial and personal effort contributes to the brand. Presently, this input does not entitle franchisees to compensation or legal recourse unless it is stated in the franchise agreement."*⁹
- *"...most agreements are entered into for a term that is not sufficient to allow return on the initial investment."*¹⁰

Various proposals have been made to address this "problem". It has been argued that *"at the end of the [franchise] agreement there should be an entitlement to the renewal or compensation on the basis of the goodwill that has been built up during the term of the franchise agreement"*¹¹. Alternatively, it has been argued the Code or the *Competition and Consumer Act* should be amended to require that a franchisor who fails or refuses to renew a franchise agreement on expiry engages in conduct that is unconscionable, unless specified exemptions apply.

This issue was also investigated by the Joint Committee in 2008. Some of the franchisees who made submissions to this inquiry argued that the franchisee should be entitled to compensation from the franchisor in the event that the franchise agreement is not renewed. In the words of one franchisee: *"When a franchise is terminated or their franchise agreement is not renewed, the franchisor takes ownership of the goodwill generated by the franchisee through their investment and hard work. . . . It should not be legal for a franchisor to take over a franchise without fairly compensating the franchisee."*

Not surprisingly franchisors had a different view. The Cheesecake Shop, for example, argued that the claim that the franchise generates the goodwill *"neglects the fact that the master franchisee has used the franchisor's brand and significant brand awareness, marketing expertise and the franchisor's systems. It fails to take into account the necessary contribution of the franchisor's training and on-going assistance to the franchisee's success."*

The Cheesecake Shop further pointed out that if the law was changed to require a franchisor to pay a goodwill payment *"[the franchisor] will have to increase the royalty it receives from franchisees to ensure it has the funds to pay the goodwill."*

Arguments over how much the franchisee actually contributes to the goodwill of a franchised business also depend very much on the nature of the franchise. One McDonald's store, for example, is very much the same as another. Indeed McDonald's strength is built on the fact that its systems and products are faithfully replicated around the country. In this case the goodwill is entirely referable to the franchisor. In other franchise systems, particularly those in the services area, a franchisee obviously plays a greater role in the success of the product and the service that is provided.

⁸ Inquiry into the Operation of Franchise Businesses in Western Australia, April 2008, at 63

⁹ Inquiry into the Operation of Franchise Businesses in Western Australia, April 2008, at 21

¹⁰ See Franchisees Association of Australia Incorporated committee Hansard (SA), 2 April 2008, p.138; SA Franchises Report at 63

¹¹ Inquiry into the Operation of Franchise Businesses in Western Australia, April 2008, at 20

The Joint Committee declined to support arguments for an automatic right to renew a franchise agreement or a requirement for good cause to be shown for not renewing the agreement. *"The committee is of the view that franchisors should be entitled to decline to renew franchise agreements on expiration if that is their choice. The committee therefore does not support an automatic right to renewal or the requirement for good cause to be shown for not renewing a franchise agreement. It is not the role of the law to force unwilling parties to enter into any commercial arrangement, including new franchise agreements."* (p.80).

The Joint Committee recommended that the Code be amended to require franchisors to disclose to franchisees, before an agreement is entered into, what processes will apply in determining the end of term arrangements. While the Committee appears, illogically, to have supported some form of *"potential transferability of equity"* as part of those end of term arrangements, it did not recommend this be included in the Code. The Committee appears to have accepted that this is something that could be part of commercial negotiations between the franchisor and the franchisee.

The Code was amended in 2010 to require franchisors to provide six months' notice of their decision to renew or not to renew an agreement. Franchisors are now also obligated to disclose, at the outset, what arrangements apply at the end of the agreement.

We strongly oppose any further restrictions being imposed at the end of the franchise agreement for a number of reasons.

First, according to figures that have been presented to various government inquiries the rate of non-renewal of franchise agreements is very low, less than 4% a year, which means the vast majority of franchise agreements are renewed on expiry and that the theoretical "problem" above does not generally exist.

Second, the notion that franchise agreements should automatically be renewed or a franchisee is entitled to compensation if an agreement is not renewed turns the notion of contract law on its head. A franchise agreement is a contract and, like any other contract, the parties are legally bound to fulfil its terms – no more, no less.

The franchise agreement is a contract between the franchisor and the franchisee for the use of the business system, for an agreed price, for an agreed term, and on agreed conditions. Like any other contract, the franchise agreement has a finite life and implies no ongoing right to possession or occupancy.

If a franchisee requires a longer term in order ensure an adequate return on their investment, then they should be prepared to negotiate a longer term at the outset and to take on the additional business risk that comes from that longer term.

Third, franchisors need the right to not renew a franchise agreement in order to take account of changed commercial circumstances. This is particularly so in retailing which is a very dynamic industry and where all retailers face significant competition, including from online retailing, and where significant structural changes are occurring at a very rapid rate. The introduction of further restrictions at the end of the franchise agreement creates inflexibility in a commercial environment where maximum flexibility is required to respond to rapid changes.

There are also situations where a franchisor does not renew a franchise agreement in order to protect loyalty to, and the success of, the brand.

Fourth, we disagree with the argument that, because a franchisor and franchisee share an interest in the viability and success of the business, there should be a "transferability of equity", or goodwill payment, when the agreement ends.

The notion of "goodwill" is much more complex than is suggested by the quotation which introduced this section. The Productivity Commission examined "goodwill" in some detail in its report on the market for retail tenancy leases in Australia in 2008 and its findings are relevant to the franchisor and franchisee relationship.

The Productivity Commission noted that goodwill is derived from three major components: that which results from the location of the business; that which results from the product or brand; and that which results from managerial skill and capacity.

The first component, *location-based* or *site goodwill*, obviously has nothing to do with the franchisor or franchisee if the franchisor does not own the freehold of the premises. The Productivity Commission noted that "*as retail tenants do not own the location in which they operate, any location-based goodwill associated with a retail space would be the property of the landlord. Further, if the total goodwill of a retail business is conditional on location its value would only exist while the tenant [the franchisor] has the right to operate in that retail location – that is, the life of the lease as negotiated between the parties.*"¹²

By contrast, *product* or *brand goodwill*, rests solely with the franchisor. In effect it is the reputation of the business and the reason why a purchaser would be willing to pay a higher price for the business than is justified by the net value of the assets of the business. This is part and parcel of the franchising system. A franchisee simply 'buys in' to an established business system for a term specified by the franchise agreement.

The third component, *human capital goodwill*, is undoubtedly attributable mainly to the efforts of the franchisee and is sometimes referred to as *personal goodwill*. Since this goodwill lies with the franchisee it continues to exist beyond the expiry of a franchise agreement. The franchisee can take these managerial skills and capabilities and set up a similar business, outside the particular franchise system, in a different location.

The Productivity Commission noted that "*...only one of these [three] components [of goodwill] is fully transferable on the sale of a business if location is not owned - the product/brand reputation. If goodwill is dependent on the managerial ability of the owner, it cannot (usually) be bought or sold - it lies with the individual.*"

It is our view that as 'personal goodwill' cannot usually be bought or sold at termination ("it lies with the individual") then 'personal goodwill' remains with the individual and he or she should not be entitled to any compensation in relation to it.

There is therefore no justification for further amendments to the Code in relation to the rights of franchisees or franchisees at the end of the term of a franchise agreement.

¹² The Market for Retail Tenancy Leases in Australia, March 2008, at 118

4. Shopping Centre Council of Australia

The Shopping Centre Council of Australia represents the major owners and managers of shopping centres. Our members are AMP Capital Investors, Brookfield Office Properties, Charter Hall Retail REIT, Colonial First State Global Asset Management, DEXUS Property Group, Eureka Funds Management, Federation Centres, GPT Group, ISPT, Ipoh Management Services, Jen Retail Properties, Jones Lang LaSalle, Lend Lease Retail, McConaghy Group, McConaghy Properties, Mirvac, Perron Group, Precision Group, QIC, Savills, Stockland, Westfield Group and Westfield Retail Trust.

The Shopping Centre Council would be happy to discuss any aspect of this submission. Please do not hesitate to contact:

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Yours sincerely,

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