

Our ref: Franchising Law Committee

20 February 2013

Franchising Code Review Secretariat
Business Conditions Branch
Department of Industry, Innovation, Science, Research and Tertiary Education
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Dear Secretariat

2013 REVIEW OF THE FRANCHISING CODE OF CONDUCT

Please find **attached** the Society's submission to the 2013 Review of the Franchising Code of Conduct. Thank you for granting the Society an extension of time to lodge our submission.

The submission was written with the assistance of the Franchising Law Committee of the Queensland Law Society. Please note the submission is not confidential.

Please do not hesitate to contact me or have a member of your staff contact our Policy Solicitor, Louise Pennisi on (07) 3842 5872 or l.pennisi@qls.com.au if you wish to discuss these concepts further.

Yours faithfully

Annette Bradfield
President

Submission

2013 Review of the Franchising Code of Conduct

Franchising Code Review Secretariat

*A Submission of the
Queensland Law Society*

20 February 2013

Table of Contents

About QLS	3
Acronyms and Terms	3
Terms of Reference	3
1. <i>Good Faith in Franchising</i>	3
2. <i>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)</i>	4
3. <i>Operation of the provisions of the Competition and Consumer Act 2010 as they relate to enforcement of the Franchising Code</i>	6
Discussion Questions:	7
1. <i>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?</i>	7
2. <i>Does the sector have any concerns regarding the operation of this requirement?</i>	7
3. <i>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?</i>	7
4. <i>Does the sector have any concerns regarding the operation of these amendments?</i>	8
5. <i>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?</i>	9
6. <i>Does the sector have any concerns regarding the operation of these amendments?</i>	11
7. <i>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?</i>	11
8. <i>Is the information being provided useful to franchisees?</i>	11
9. <i>What effect has the requirement to provide this additional information had on franchisors?</i>	12
10. <i>Does the sector have any concerns regarding the operation of the new provisions?</i>	12
11. <i>What impact has the removal of the foreign franchisor exemption had on the sector?</i>	12
12. <i>Has the removal of the exemption caused any issues?</i>	13
13. <i>On the whole, do the 2008 and 2010 disclosure amendments ensure franchisees are provided with adequate information?</i>	14
14. <i>Is the extra onus on franchisors justified by the benefit this disclosure is providing to franchisees?</i>	14
15. <i>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?</i>	15
16. <i>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?</i>	15
17. <i>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?</i>	15
18. <i>If an explicit obligation of good faith is introduced, should 'good faith' be defined? If so, how should it be defined?</i>	16

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?.....* 16
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?.....* 17
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?.....* 17
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?.....* 17
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?.....* 18
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?.....* 18
25. *Does the sector have concerns regarding the operation of the amendments?.....* 19
26. *Is the current enforcement framework adequate to deal with the conduct in the franchising industry?* 19
27. *How can compliance with the Franchising Code be improved?.....* 19
28. *What additional enforcement options, if any, should be considered in response to breaches of the Franchising Code?.....* 20
29. *What options are available to businesses to address breaches of the Franchising Code, or any other adverse conduct in the franchising industry?* 21

About QLS

The Queensland Law Society (QLS) is the peak professional body for the State's legal practitioners. We represent and promote more than 8,500 legal professionals, increase community understanding of the law, help protect the rights of individuals and advise the community about the many benefits solicitors can provide.

Our members and the members of the Franchise Law Committee represent a diverse cross-section of franchisors, franchisees including master franchisors, master franchisees, and other suppliers of goods and services to the franchising sector.

Acronyms and terms

Please note this submission will use the following acronyms and terms:

- ACL – Australian Consumer Law;
- CCA – *Competition and Consumer Act 2010* (Cth)
- Code – *Franchising Code of Conduct*
- SME – Small to medium enterprises

Terms of reference

1. *Good faith in franchising*

The Society has written to the Commonwealth Small Business Minister on this issue and still maintains the view that there is considerable concern by sector stakeholders in imposing a statutory definition of “good faith” in addition to the “duty of good faith” implied into franchise agreements under the common law in most jurisdictions in Australia.

The common law concept of “good faith” is broad, all-encompassing and evolves through developments in case law. Changes in the common law, over time, ensure that the doctrine of good faith remains flexible and relevant to changes in society. To define it in the Code will effectively narrow its scope.

It is therefore the view of the Society that it be left to the courts to determine the nature and extent of the duty of good faith. The Society considers that this will ensure consistency as the concept of “good faith” is not limited to franchise agreements, but cuts across all tenets of commercial dealings. It would therefore cause a great deal of confusion to define good faith for franchise agreements and then have a different interpretation of good faith for other commercial agreements. The Society therefore strongly recommends that there be no duty of good faith defined and set out in the Code.

If it is decided that an express obligation of good faith be inserted into the Code then the Society recommends that –

1. it be stated to be the ‘common law’ duty of good faith; that there be no definition of good faith inserted into the Code and that it be left to the courts to determine the nature and extent of the liability; and
2. the obligation should be imposed on all parties to the franchise agreement so that both franchisors and franchisees have the obligation to act in good faith.

2. *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)*

The Society believes that this raises a number of issues that need to be considered.

Proponents for franchisees being entitled to accrued goodwill generally rely on the following:

- Continuity of co-operation between independent parties with a view to distribute/market goods.
- Both franchisor and franchisee invest resources in order to create or capture market share for particular goods.
- Both franchisor and franchisee may contribute towards recognition of the brand under which the goods or services are distributed or marketed;
- Both franchisor and franchisee establish or improve a customer base which at the end of the agreement term becomes part of the other contracting party's assets.
- If a franchisee wishes to retain the customer base they will have to engage in competing goods and invest additional effort to sway customer affinity to those goods offered under a different trade mark. In itself, this will be difficult and complicated; especially if post agreement restraints of trade apply.

Those advocating against a goodwill payment to a franchisee at the end of the term generally rely on the following arguments:

- The fundamental nature of a franchise agreement is the provision of goods or services according to the franchisor's business concept.
- The franchisee acquires the opportunity to earn income for the term of the franchise. This is distinct from, say, independent SMEs who establish their own business, trademarks etc and build goodwill that has capital value. A franchise provides potential income for a fixed term without the franchisee having paid capital contributions to the establishment, development and maintenance of the franchise business systems, processes, brands etc.

- The franchisee purchases and sells (or resells) the goods just as the franchisor would, by using the franchisor's selling concept (marketing and know how), trade mark, assistance, advice, control and the like. These are elements of a franchisor's goodwill. In franchising, critical elements of such goodwill include intellectual property rights, business systems, locations and relationships with suppliers.
- In contrast, the franchisor operates under its own trade mark, using or attempting to develop its own goodwill and such goodwill belongs to the franchisor.
- The franchisor uses its own intellectual property rights, business systems, distribution channels, location and relationship with customers which it can continue to use even after the end of the term of the franchise relationship.
- Consumer perception dictates that franchisor goodwill is exclusively associated with the franchisor and more often than not, the identity of an individual franchisee is unknown or irrelevant to the consumer. It is often said that in a franchise system, the franchisor's goodwill, in particular its intellectual property rights (such as the McDonalds 'Golden Arches') are the driving force behind attracting custom to a franchise outlet.
- The franchisor develops a great deal of marketing know-how on its own, while the franchisee obtains it from the franchisor in the form of a business system. Through assistance, control and continued development, the franchisor keeps the system at the cutting edge of competition.
- Upon termination of the franchise agreement, the franchisor retains its goodwill independently of the franchisee. The franchisee knew from the outset that its status in the franchise system was not everlasting. It is a fixed term agreement granting the franchisee rights to use the franchisor's property for a fixed term. This is underpinned by consumer perception associating franchisor goodwill with the franchisor and not the franchisee.
- A franchise agreement ordinarily stipulates that goodwill belongs to the franchisor and accordingly the issue of compensation for the franchisee is not taken into consideration because the parties have assumed from the outset that there is no such compensation.
- In the eyes of consumers, the goodwill of the franchise system demonstrates corporate homogeneity and their loyalty is attached to the franchise system and not the individual franchise owner. The advantage of developed franchise systems lies exactly in the fact that, by entering the system, the franchisee benefits from the franchisor's goodwill from day one. This is illustrated by people queuing up in the first days of opening McDonald's restaurants in Moscow, Belgrade and other places. In less known franchise systems, this may not be the case but generally, agreement terms are more favourable for those franchisees compared with developed franchise systems.

- Arguably, each franchisee contributes something to the franchisor's goodwill, but the franchisor's contribution is by definition and most often in a practical sense the greatest. The franchisor is the developer, initiator, organiser and controller of the entire system and it is accordingly reasonable, and this is reflected by decades of jurisprudence, to consider that the goodwill belongs to the franchisor.

Room for arguing compensation payable to the franchisee is further narrowed because franchise agreements invariably stipulate the term of the agreement and any renewal terms and conditions that apply to a franchisee when exercising renewal options. Arguably, adequate remedies already exist if a franchisor fails to renew a franchise agreement if the franchisee complied with the conditions for renewal. Unlawful refusal will amount to a breach of the agreement by repudiation or possibly unconscionable conduct. However, if the agreement does not provide for renewal, the franchisee knows before entering into the agreement that the franchisee's rights under the agreement will terminate on the expiry of the term, in which case the franchisee should not be entitled to compensation.

3. Operation of the provisions of the Competition and Consumer Act 2010 as they relate to enforcement of the Franchising Code

The Society's comments on this point are contained under item 28 below. For the sake of brevity we will not repeat them here.

Discussion Questions:

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?*

We are of the view that the additional disclosure requirement has provided the franchisee only the machinery to consider the risk of franchisor failure. The effectiveness of the additional disclosure requirement is subjective and conditional on a number of factors including:

- whether the franchisee has read and understood the warning;
- the knowledge and experience of the franchisee; and
- whether the franchisee has obtained legal and financial advice.

In essence, this is an issue about education and ensuring there is appropriate external literature to assist franchisees to consider potential risks. Legal practitioners and financial advisers assist franchisees in identifying risks, however as not all franchisees seek advice, it is important that there be a repository for franchisees, to cater to their knowledge and experience (with both elementary and comprehensive guides to suit varying needs).

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

The Society does not have any broad concerns about the operation of the requirement, however stresses, from a practical perspective, that the additional disclosure requirement must be supplemented with further education and literature so that franchisees may investigate and turn their minds to risks and issues that may arise.

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?*

Financial details – clause 20

In our submission to the Small Business Minister we noted that clause 20 in the disclosure requirements needs to be updated to include an obligation to attach either the accounts or the audit report to the disclosure document. Most franchise systems do acknowledge that there is a requirement to do so but there are some who refuse to provide the documents because the obligation is not clear.

To some extent, there has been an improvement in transparency however this benefit is dependent on a variety of factors:

- For well-established franchise systems financial disclosure will be available and easier than the start ups franchise systems. This should be acknowledged.
- For inexperienced franchisees who do not seek legal and financial advice, extensive financial disclosure may be overwhelming.

In addition, it should be made clear whether it is mandatory if a franchisor cannot produce two financial years' accounts whether they then need to produce an audit report instead. In many new franchise systems the financial reports may not be available for two complete financial years.

Amending clause 20 would remove these ambiguities and ensure improved transparency of financial information.

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

Clause 13.6A – payments to third parties

In our view, the wording of this provision causes confusion for franchisors. Franchisors are not aware of the scope of the payment types which should be disclosed. For example, is a franchisor required to disclose to franchisees that the franchisee will be required to pay wages, Workcover premiums, superannuation contributions and taxes in connection with the operation of the franchised business? Alternatively, the amendment may only be intended to encompass the day to day payments to third parties incurred in the actual operation of the business, such as electricity expenses, stock purchases or even the franchisee's accountancy fees.

The provision is unclear as to the extent of the disclosure required and what areas are intended to be covered in the disclosure. A number of disclosure documents have very wide ranges of not only the types of payments, but also the upper and lower estimate of the amount payable, due to the different types of franchised businesses operating within the single franchise system and accordingly the end result is almost meaningless.

Clause 13A - Unforeseen significant capital expenditure

Many disclosure statements now simply contain a statement to the effect that upgrades to plant and equipment or the premises will be required. They are not specific about when those expenditures will be required and neither are they specific about the amount of the expenditure. The franchisor is not required to provide details of the capital expenditure. If a franchisee in a large shopping centre is expected to upgrade their premises at the end of five years and that upgrade will cost many thousands of dollars, then the disclosure document needs to be specific about that type of possible future expenditure.

Further, what are the consequences if the franchisor fails to disclose the possible capital expenditure? Does that mean the franchisor cannot insist on the franchisee undertaking an upgrade that may actually be essential to the efficient operation of the franchised business such as the introduction of a new point of sale system with integrated pricing that would assist the franchisee and save time?

The clause needs to be more specific about what is required to be disclosed and more specific about the amounts of the possible capital expenditure that will be undertaken.

Clause 13B – Costs of dispute resolution

It is submitted that a clause in a franchise agreement that requires that a franchisee pay the franchisor's costs on mediation and the franchisee asks for an amendment to which the franchisor does not amend, is not actually an "agreement" for the franchisee to pay those costs as required under clause 31(2) of the Code. As such this needs to be specified or clarified within this provision to avoid uncertainty.

Clause 12 - Financial reports of marketing funds

In our opinion there are a number of ongoing issues with marketing funds:

1. The Code places no requirement on the franchisor to have a separate account for the marketing fund. Often franchisors have one account and mix their own funds with marketing fund money. There should be an obligation for a separate bank account. That would also make the auditing of the fund easier (should it be required).
2. The financial statements provided by franchisors do not particularise the expenditure to the satisfaction of franchisees. For example the statement will read "advertising cost" without stating how much was spent on each different type of advertising. The issue is that franchisors believe that information to be commercially sensitive and do not want it to be released in the public domain. However, franchisees require further information on how their funds are being spent.
3. There is no obligation on the franchisor to actually spend any money received on advertising. So they can simply accumulate funds and not engage in any advertising.
4. There is no limit on the amount a franchisor can charge for administration expenses. If a franchisor chooses to rent expensive premises for its business, how much of the cost of those premises should be payable from the marketing fund? For example, if space within the franchisor's business premises is utilised by the marketing department, then a portion of the marketing fund may be utilised in the payment for the use of that space, this is regardless of the cost of the premises.

These issues need to be addressed or some further guidance given.

We refer to our response in item 3 above and observe that whilst there is some improvement, some franchise systems have not been provided with this, for example, on a sale.

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?***

17A - Unilateral variation

The Society considers there is still confusion as to what is required for disclosure. For example:

- Some franchisors are listing in the disclosure document every single alteration made to the document since 1 July 2010 including correction of typographical errors. This information is of no benefit to a franchisee or a prospective franchisee and simply creates “information overload” for the franchisee;
- some franchisors simply answer the question with a “yes” and without giving any further information; and
- some franchisors disclose a list of clauses that have been amended since 1 July 2010.

The amendment is not clear as to whether a franchisor is required to list every amendment made to the franchise agreement due to the franchisor updating its standard agreement. Franchise agreements are constantly updated by the franchisor and the updated document becomes the “then current agreement” that is offered to new franchisees, on a sale or on a renewal.

Alternatively, is the provision only intended to encompass amendments made by the franchisor to a franchise agreement entered into between a franchisee and the franchisor and that apply during the term? Such as, an amendment to a territory in accordance with conditions set out in the franchise agreement. There are very few franchise agreements which allow a franchisor to unilaterally vary a franchise agreement throughout the term of the franchise. Some do set out that changes to boundaries of territories can be made on certain conditions being met.

The Code needs to specify exactly what changes are contemplated by the clause.

There are also practical implications involved. The third component to clause 17A is prospective. It is not possible for the franchisor to exclusively list variations which will occur in the future.

The legislation needs to be clearer and set out what is a unilateral variation.

Clause 17D – Amendment of franchise agreement on transfer or novation of franchise

It is submitted that a franchisor should not be entitled to change a franchise agreement, on or before a transfer or novation of the franchise by the franchisee, to such an extent that the business being sold is something completely different to that which the franchisee intended to sell or the business which operated immediately prior to the transfer or novation. This issue was considered by the court in the case of *ACCC v Seal a Fridge Pty Ltd* when the court held that to make such a change would derogate from the very right the franchisee was trying to sell.

Whilst a franchisor needs the right to be able to amend its document because of changes in the law, the system and procedures, it should not be able to make whatever changes it wants during the term of a franchise and then take advantage of the sale by a franchisee to introduce such changes and make them mandatory for a purchaser.

The other issue that needs to be considered is that the definition of “novation” in the Code is not what is considered to be a novation in normal practice. A novation is considered to be the parties entering into a deed where one party (in this case, the purchaser) simply replaces the outgoing party to the agreement. There is no new document signed.

The definition in the Code is generally what occurs in practice on a normal sale of a franchise – in other words, on a transfer of a franchise, the franchise agreement is terminated and the franchisor and the purchaser enter into a new franchise agreement.

This definition of “novation” should be clarified.

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

These concerns have been outlined in item 5 above.

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

As raised previously, this is subjective and the Society cannot say whether there has been an improvement. However the observations from our members is that generally the provision of further information can assist in allowing the franchisee to make informed decisions.

However in circumstances where the franchisor is asked and provides insufficient answers, this may demonstrate that franchisor education is required. ACCC factsheets then may assist to provide guidance and examples.

8. Is the information being provided useful to franchisees?

Access to franchisees

Many franchisors now include as a standard clause in a deed to be signed by a franchisee on their departure from the system, a provision under which the franchisee is making the request by signing the deed, that their name and contact details not be published in future disclosure documents. It has also become common practice that those franchisors would not agree for that provision to be deleted and require the franchisee to make that election.

The use of the provision of this kind which forces a franchisee to sign a provision may circumvent (if unilaterally imposed by the franchisor) the intention in the Code of allowing new franchisees to access details of previous franchisees to ascertain information about the franchisor. It is common for franchisors to seek consent for non-disclosure where a franchisee has left the system, other than on good terms.

Confidentiality

Generally this provision is adhered to and clear answers are given.

Materially relevant facts

There is nothing in the Code that requires a franchisor to give a notice when there is a change in ownership of the franchise system. One could argue that such a change would fit within a number of the requirements in clause 18(2) such as (a) or (h). The Society has been informed of a situation where the franchisor sold its business and a franchisee has become aware only to have the franchisor claim that clause 18 was not relevant, so no disclosure has been necessary.

Therefore the Society suggests that clause 18 be updated to include an obligation to notify franchisees on a change of ownership of the franchise system and this may require an adjustment to paragraphs 18(2)(a) or (h).

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

The Society considers that the requirement to provide additional information has not been a serious impost on time or resources.

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

The concerns of the Society are listed in paragraph 8 above. There is an issue in relation to franchisors circumventing the obligation to disclose details of past franchisees and this ought to be addressed. Otherwise there are no concerns about the operation of the new provisions but the Society does see that there needs to be ongoing education regarding these disclosure requirements particularly in relation to the continuous disclosure of materially relevant facts pursuant to clause 18.

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

It is difficult to discern any significant impact arising from the exemption. Certainly, master franchisees of foreign franchisors are now entitled to the benefit of the Code in relation to the provision of disclosure documents although not all foreign franchisors are willing or able to comply with the disclosure requirements. The Society is not aware of any particular impact of the removal of the exemption but would expect that master franchisees will benefit from the obligation for the foreign franchisor to provide disclosure.

However, as a general statement the provisions regarding disclosure in annexure 1 are not particularly suited to disclosure regarding a master franchise and are more suited to disclosure regarding a unit franchise (sub-franchisee).

The benefit of removing the exemption means that further information is provided to sub-franchisees about their master franchisor's rights and limitations, and consequently the strength and limitation of the sub-franchisee's rights, given their rights come from the master franchisee whose rights come from the master franchisor.

Arguably, this has assisted sub-franchisees in Australia having a better understanding of their rights and limitations, although we comment in paragraph 12 about deficiencies in the information that is in fact provided to sub-franchisees.

12. Has the removal of the exemption caused any issues?

Apart from the issues faced by foreign franchisors in being required to comply with the Code there are some practical difficulties faced by master franchisees in circumstances where the foreign franchisor does not give a disclosure document to the master franchisee. Clause 6B(2) provides that if a sub-franchisor (master franchisee) proposes to grant a sub-franchise both the foreign franchisor and the master franchisee must provide disclosure. If the foreign franchisor has not provided a master franchise disclosure document, or refuses to provide a joint disclosure document, then strictly the master franchisee will not comply with the disclosure obligations in clause 6B and would be in breach of the Code. To circumvent this, some master franchisees prepare the foreign franchisor's disclosure document (usually at its cost) and then need to have the foreign franchisor agree to sign, which not always happens.

Possible solutions are:

- (a) for clause 6B to be amended so that the master franchisee is only obliged to provide a copy of the master franchise disclosure document, or a joint disclosure document, to the extent that the foreign franchisor has provided disclosure to the master franchisee; and if so
- (b) allow for the master franchisee to provide a modified disclosure document, disclosing relevant information regarding the master franchise agreement but without requiring the foreign franchisor to be a party to it, to provide financials or provide any ongoing disclosure. Clause 6B should specifically provide that the master franchisee is not required to provide a copy of its actual master franchise agreement (which may contain commercially sensitive information of the master franchisee).

Another issue is that the disclosure obligations in clause 6B result in two sets of disclosure documents being given to a sub-franchisee (unless a joint disclosure document is given) which can actually be confusing and increase the amount of the franchisee's legal expenses. This is an issue in relation to the operation of clause 6B generally and does not specifically arise because of the removal of the foreign franchisor exemption.

In any case, whilst the provision of a copy of the master franchise disclosure document to a sub-franchisee does provide some additional information about the master franchise, the provision of this document itself does not address the key risks faced by sub-franchisees. There is nothing in the disclosure document warning the sub-franchisee that

they may lose all their rights if the master franchise agreement is terminated. The sub-franchise agreements rarely provide that the franchisor (foreign or otherwise) will assume the master franchisee's obligations under the sub-franchise agreements on termination of the master franchise agreement. Therefore on such termination, the sub-franchisees rights also terminate. This is one of the key risks faced by sub-franchisees that is not addressed by the obligation for two disclosure documents to be provided.

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

The Society considers that on the whole the 2008 and 2010 disclosure amendments have assisted franchisees being provided with adequate information to make informed decisions as to whether to enter into, renew or extend the scope of their franchise. The amendments further provide for certain additional information updates and disclosure throughout the Term of any franchise agreement or the opportunity and/or right to seek such information during the relevant Term.

These amendments provide more detailed information on the franchise business opportunity as well as assisting prospective or existing franchisees to be aware of issues and/or situations that they may not otherwise have considered. Additionally, they provide a more comprehensive warning and details as to reasonably foreseeable franchise costs, confidentiality obligations, potential for unilateral changes to agreements and end of term arrangements, to name a few of the amendments. More information about the background and behaviour of the franchisor and its associates, as well as relationships with suppliers are now included. The information now required under the amendments arguably also enables greater opportunities to conduct a proper due diligence into the franchisor, the franchise and its' territory to assist prospective and current franchisees understand potential opportunities, risks and costs if they proceed with the franchise.

See also point 14 below.

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

To an extent the extra onus is justified, especially given the franchisor is generally in the best position to collate and provide such information on a more efficient and effective basis and such information can be important to enable a an existing or prospective franchisee to make an informed decision. However, the benefit of this disclosure is diminished if the franchisee does not read and understand the information contained within such documents or that can be requested from the franchisor, nor follow up or obtain legal and financial advice.

In the Society's opinion, the extra onus currently placed on franchisors is justified and should result in a substantial benefit to prospective and existing franchisees by giving them the opportunity to conduct a proper review and due diligence into the purchase, renewal or extension of the franchise (please see point 13 above). Nevertheless, as already mentioned, the benefit of the added disclosure is proportionate to how the franchisee uses and understands or takes active steps to understand the information provided.

Furthermore, the Society submits that any further amendments to increase disclosure must be carefully considered. Franchisor disclosure is already very substantial, even more so in master franchising situations where a sub franchisee is required to be provided with a master franchisor's disclosure document as well as the master franchisee's disclosure document (or the master franchisee can create a joint disclosure document containing disclosures by both master franchisor and master franchisee). Information for the sake of providing further information may cloud the more pertinent information and not assist prospective or current franchisees to make informed decisions.

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?

The Society considers there is no need to insert an overarching obligation to act in good faith as the Society believes the targeted amendments in 2010 to the Franchising Code addressed the specific issues.

It is noted that there has already been substantial consideration of this point from various Federal Government inquiries in the past and the final view has been to not provide for such a specific good faith amendment. There are a number of laws (in particular those rights and obligations under the CCA) that the Society submits already offer suitable protection to parties, and the 2010 amendments to the Code have sought to provide further information so as to seek to adequately address the underlying specific concerns more appropriately than an overarching broad good faith obligation, as well as allowing good faith the flexibility to develop, apply and be relevant via its application under the common law.

For further information please refer to our response above at item 1 under the Terms of Reference.

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?

Clause 23A does not apply in the way suggested. Clause 23A makes it clear that nothing in the Code would limit the common law implied obligation to act in good faith to be applied by the courts. Ultimately there is no provision in the Code that would override any common law obligation that the courts could determine what is implied to that franchise agreement.

The provision clearly contemplates an implied obligation can be imposed by the courts but the Code of itself does not modify, exclude or restrict that common law implied obligation.

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?

The issue at the moment is that although many of the Courts in various states and territories have clearly stated that there is an implied obligation to act in good faith in all franchise agreements, many franchisors do not accept that the implied obligation exists in

all cases or jurisdictions or in fact to franchise agreements generally as opposed to other forms of contracts.

There is no evidence to suggest that an obligation to act in good faith would only apply to franchise agreements that are regulated by the Code. Other franchise agreements that are not covered by the Code (whether covered by OilCode or not) may still have a common law obligation to act in good faith implied.

There are times when parties would allege that such an obligation would apply to particular conduct because it is not clearly set out in the Code. Arguably the specific issue that would be remedied if an obligation was inserted into the Code, would be that all parties would have to accept that the obligation does exist and there would not then need to be a dispute about its existence, but rather its application in those particular circumstances to the exercise of a right or power or the performance of an obligation.

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

If a specific obligation to act in good faith was introduced into the Code, it should be drafted in the widest of terms so that it complements common law principles and provisions of the ACL.

As discussed above, the application of the concept of “good faith” is not limited to franchise agreements, but cuts across all tenets of commercial dealings. It would cause a great deal of confusion to provide a definition of good faith that applied only for franchise agreements regulated by the Code and then have a different interpretation of good faith for other commercial agreements or franchise agreements that were not regulated by the Code. The Society therefore strongly recommends that there be no duty of good faith defined and set out in the Code.

Please see our comments about at item 1 under “Terms of Reference.”

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?

The scope of the obligation should mirror the common law. It should apply to all contractual dealings between parties to a franchise agreement which would include both the performance of contractual obligations and the exercise of rights and powers under the franchise agreement by either party. There are obligations imposed on parties to a franchise agreement under the Code and there is divergence of opinion whether the obligation to act in good faith should apply to all or any of those Code obligations such as those contained in clauses 20, 20A, 21, 22, 23 and Part 4.

If the obligation was to specifically override any contractual language in the franchise agreement that sought to exclude or modify any implied obligation to act in good faith then the obligation should be expressed as a mandatory obligation.

It is also acknowledged that there are already comprehensive remedies already available under the ACL for misleading and deceptive conduct which may apply to pre-contractual

negotiations. There are also comprehensive remedies available for breaches of the unconscionable conduct provisions of the ACL as well.

The obligation to act in good faith, if applied to dispute resolution, should be cast widely and not just be limited to dispute resolution conducted under the franchise agreement or Code but to any dispute resolution process used by the parties to resolve the dispute.

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?

The Society considers that this is an issue for the courts to grant relief suitable to the circumstances of the case.

The courts have a wide discretion to fashion orders for conduct which may breach the CCA and ACL. The Society further considers that because of the broad range of conduct in franchising that would be subject to this obligation, there would be no benefit in simply having an offence of strict liability giving rise to a financial penalty (for either party) where that obligation to act in good faith has been breached. It is not clear whether the ACCC would be empowered to investigate and prosecute for breaches of a contractual duty of good faith, however that may be different to the ACCC wishing to investigate and prosecute if the conduct alleged relates to a breach of a statutory provision of the Code that obliges the party to act in good faith when fulfilling its Code obligations (for example when engaging in dispute resolution under Part 4 of the Code).

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?

The Society considers that a breach of a good faith obligation should not be deemed to be unconscionable conduct under the ACL.

Whether particular conduct that comprises a breach of any codified obligation of good faith will amount to unconscionable conduct should be left to the courts to determine in line with existing ACL provisions. The position should continue that the common law sits side by side with statutory law. The Society does not see any need for any special provisions to be inserted into ACL unless it was specifically intended that the ACL convey some special form of relief.

The Society does not believe it is necessary to include provisions of strict liability or any provision which would seek to reverse the onus of proof onto a party to demonstrate that they had acted in good faith.

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?

This depends upon the breadth and extent of the proposed amendment. If the amendment were to simply introduce an obligation to act in good faith as imposed by the common law then there would not be any need for any further amendments other than to

clause 23A of the Code to make it clear it is to be expressed to apply to the parties to a franchise agreement regulated by the Code.

Some of the provisions in the Code are imprecise in many respects and as a consequence the application of a good faith obligation or any penalty regime would require close scrutiny of that language to identify improvements needed to that language to prevent any inappropriate application or ambiguity.

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?*

The amendments regarding end of term arrangements and renewal notices have not been effective in addressing concerns about inappropriate conduct at the end of the term of franchise agreements.

Franchisors often attempt to introduce completely new terms into a franchise agreement on a renewal from those that existed during the previous term. This is particularly in circumstances where the market has changed, or there have been advances in technology or other movements which need to be reflected in the franchise agreement, thus necessitating new terms. (Take for example the use of social media in marketing over the last few years.) Whilst franchisors do have the right to update their agreements for changes in the law, technology etc, the amendments regarding end of term arrangements and renewal notices do not address concerns about what a franchisor is able to introduce on a renewal. Whilst it is common for a franchisor to provide detail of end of term arrangements by stating that they will require a franchisee to enter into a new franchise agreement upon renewal, the amendments have not had the effect of requiring franchisors to adequately detail what changes will be made to the agreement, particularly in relation to fees.

However, the end of term arrangements amendment does highlight to a franchisee that at the end of the term they are not automatically entitled to a new term and whether or not they will be entitled to any payment relating to goodwill.

For three or five year term agreements entered into after 2010, it is also too early to determine whether the provisions relating to renewal notices will be effective.

The Society considers that rather than further amending disclosure requirements in this regard, the issue of end of term arrangements and renewal notices is an ongoing issue for franchise education.

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?*

The Society has observed that there has been little or no change in conduct and behaviour in relation to mediation, with initial difficulties in getting parties to even set a date. Due to the confidential nature of a mediation, following a dispute it is difficult for a court to consider whether the parties have acted in a reconciliatory manner.

The Society recommends that a time limit be set within which the mediation is to be held and both parties are obliged to act appropriately in setting the date for the mediation. The issue that has arisen many times is that a party is simply “not available” for an extended period of time making it impossible to set the date for the mediation to be held in a reasonable time. In the same regard, the Society recommends that steps are taken to ensure that the process is not manipulated by parties to simply delay the process or to issue a poorly constructed notice of dispute merely to delay a requirement to remedy a failure to comply with obligations in the franchise agreement.

Whilst the Society does not feel that the dispute resolution procedures should be limited to obligations in the franchise agreement, the question of what constitutes a ‘dispute’ is pertinent and should be clarified.

With regard to a proposed time limit for mediation, the Society feels that three months from the issue of the Notice of Dispute is a reasonable time within which the mediation should be held, unless otherwise agreed by both parties.

Further there should be a further obligation that the Notice of Dispute must clearly and concisely set out the issues so that the recipient is fully informed about the nature of the dispute.

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

There are no concerns regarding the operation of the amendments other than as set out above.

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

The Society feels that the current enforcement framework is adequate, however it is ultimately an issue of funding and resourcing. There is also some concern for those franchisees who may not be able to afford legal representation and who may not have their concerns investigated by the ACCC due to a lack of funding and resourcing. This has resulted in many franchisees simply walking away from their businesses which can leave them in debt for many years. The Society recommends that the enforcement framework be considered to ensure representation of all franchisees regardless of resources.

27. How can compliance with the Franchising Code be improved?

The Society considers that compliance with the *Franchising Code* can be improved by ensuring there is access to education for both the franchisor and franchisee. As some parties may not be fluent in English, the Society recommends there be access to foreign language factsheets and that the warning statements have translations.

Most of the obligations in the Code are imposed on franchisors, and difficulties often arise because franchisees do not understand their legal or business obligations fully, and choose not to obtain legal and accounting advice (or cannot afford to do so). Obtaining such advice is of particular importance given that franchise agreements used in many

systems are lengthy and contain very detailed legal provisions. Whilst the disclosure document provided to franchisees is required to explain the operation of a number of important clauses in the franchise agreement, it is uncertain whether franchisees read or fully understand such matters. Pre-franchise education for prospective franchisees may serve to improve compliance.

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

Penalties

The consideration of whether penalties for breaches of the Code should be introduced has long been debated.

The South Australian Economic and Finance Committee recommended in 2008 the introduction of specific penalties for breaches of the disclosure requirements under the Code. The Society considered this issue and observed that the purpose of the disclosure requirements was to facilitate informed decision making.

The Society's view is that penalties (whether it be for breach of disclosure obligations or otherwise) may prove counterproductive and may fail to enhance best franchising practice. Presently the CCA and the common law provide adequate remedies to franchisees for damages suffered, which has been strengthened by the ACCC's 'class action' power.

The Society therefore does not recommend that a penalty regime be introduced for breaches of provisions of the Code.

There are other compelling reasons not to introduce penalties for breaching the Code. First, not all obligations imposed in the clauses of the Code are equal and the consequences arising from a breach of these obligations are not the same.

Similarly not all participants in franchising have the same or similar characteristics. Our members believe that the vast majority of franchisors are themselves small businesses, whilst some other franchisors may be large national or multi-national companies turning over more than seven figure sums. A one size fits all approach could have a significant negative impact on the franchising sector.

As a consequence, to apply a blanket fine for any breach of the Code, can be a totally disproportionate response to the loss (if any) actually suffered especially in circumstances where the effect of the penalty may have either little or no impact on the future conduct of the party or a significant negative impact on the continued viability of the franchise network.

By way of example, consider a scenario where there has been a technical breach of the disclosure requirements by a franchisor, for example, a failure to attach a copy of the Code to the disclosure document at the time disclosure was given. If the franchisor then remedied the technical breach and gave a copy of the Code and no loss is suffered by the franchisee, then that should be the end of the matter.

As the franchisor has technically breached the Code, the franchisor may incur a fine. If the fine is a nominal amount, it is likely to have little effect on deterrence. However if the fine is substantial, for example, \$10,000, it may have a significant impact on the future viability

and operations of the franchisor and indirectly a flow on affect to other franchisees in the network.

An excessive punitive result should not normally be the objective of the fine.

The threat by a disputant of referring a matter to the ACCC to encourage them to impose a fine or penalty also has the potential to be used unfairly by a disputant as a commercial pressure point to force a franchisor to compromise or settle a dispute on terms that would otherwise not be agreeable to them.

Further if a franchisee initiates a civil action against the franchisor and is successful, the likelihood of court orders for damages and costs as well as the fine would be akin to double jeopardy. The Society therefore submits that there are significant challenges in:

- ascertaining which clauses of the Code should trigger the penalty provisions;
- ascertaining what the penalty (if any) should be; and
- ensuring proportionality between the infringement, the loss suffered by the franchising party, the fine proposed and the financial status of the franchising party.

Secondly, it has not been proven that fines improve compliance. Our members have found that education is a much more significant factor in cultivating promoting compliance with the Code.

Thirdly, inconsistencies may arise with the Oil Code if only the Code is amended.

Fourthly, it has not been established that there is a significant problem with franchising disputes. The ACCC's comparison of Franchising and Small Business Complaints and Enquiries reveals that the majority of disputes are by small business and in relation to the ACL. The Society therefore queries the utility of introducing penalties only for franchising matters.

The Society strongly opposes the introduction of penalties for breaches, however if penalties were to be introduced, the Society considers that penalties apply to all parties of a franchising agreement and that the amendments form part of the ACL.

Further the provisions for the penalties would need to be very clear about when they are to apply and be commensurate with the breach so that a small breach did not lead to a large penalty.

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

Options available to businesses to address breaches of the Code or any other adverse conduct include:

- Mediation;
- Litigation; and
- Investigation by the ACCC.

In addition to these options, we consider that the Code itself already contains machinery that militates against adverse conduct. For instance, the obligation on franchisors to provide a

disclosure document to franchisees setting out in detail the operation of the franchise system, supply arrangements, and matters pertaining to intellectual property rights, litigation and financial affairs etc, is likely to “incentivise” franchisors to act with propriety. By acting inconsistently with its disclosure document, a franchisor not only runs the risk of engaging in misleading or deceptive conduct (which in our view the CCA already effectively deals with), but also risks confusing its franchisees, which is ultimately detrimental to the operation and profitability of the franchise system. This is an outcome that is not in the party’s interests.

Thank you again for the opportunity to provide comments and submissions for the 2013 Franchising Code of Conduct Review.