



CREA LEGAL

Review of the Franchising Code of Conduct

Steven Crea provides his thoughts on the 18 recommendations proposed following the latest review of the franchising code of conduct:

Recommendation 1:

The Code be amended so that the provision of a notice under clause 20A of the Code, if it states the franchisor's intention to renew a franchise agreement, triggers a requirement to provide disclosure. A franchisee should not be bound by its exercise of an option to renew prior to the provision of disclosure by the franchisor.

Comment:

I disagree with this recommendation and support the option of retaining the existing arrangements.

Disclosure is not required prior to or simultaneously with the franchisor's clause 20A notification of whether it intends to renew the franchise or enter into a new franchise, it is required prior to the franchisee committing to the renewal, i.e. entering into the franchise for the new term (whether that be a new franchise or renewal of existing).

The code already imposes a requirement for a disclosure to be provided prior to this event. Therefore the franchisee always has the benefit of a disclosure document and can make an informed decision prior to committing to the renewal.

Another related issue which should be addressed is that the provisions for notification of end of term arrangements presume that franchises have a fixed term which expires and is then either renewed or not. Many franchises are not structured in this format. In automotive franchises for example it is common to have a mechanism for automatic on-going renewal (subject to the satisfaction of certain stated pre-conditions). Such agreements are often stated to automatically renew or extend unless one party notifies the other that they do not wish to continue.

It is unclear whether a franchisor is required to comply with the clause 20A notification requirement in such circumstances. If a notification is required, some guidance on the timing of the notice is necessary.

Recommendation 2:

The Code be amended to:

- prescribe a short-form of disclosure that a foreign or master franchisor must provide to a master franchisee instead of requiring the foreign or master franchisor to provide disclosure in accordance with Annexure 1 of the Code;
- ensure that only franchisees who do not also act as franchisors are provided with the full Annexure 1 disclosure document by their immediate franchisor; and
- require that a copy of all short-form disclosure documents provided in accordance with (a) are provided to franchisees as an item of disclosure under Annexure 1.

The reduced disclosure document mentioned in (a) should include information such as:

- if applicable, any short-form disclosure document that has been provided to the disclosing party for the franchise;
- the basic contact details and background information of the foreign franchisor or master franchisor;
- the essential obligations that have been delegated under the master franchise agreement;
- information regarding intellectual property including the ownership or licensing arrangements that the franchisee will have rights to; and
- what the impact will be on the subfranchisee if the master franchisee is terminated or not renewed.

Comment:

I agree with the recommendation as the information relevant to the franchisee is the information of its immediate franchisor.

If a franchisor does not have sufficient rights itself to grant the franchise, the franchisee will have sufficient recourse through existing legal principles.

Also, as part of a franchisee's due diligence, they can of course ask a franchisor to deduce its rights to grant the franchise.

Recommendation 3:

The Code be amended to ensure that a franchisor is required to disclose the rights of the franchisor and franchisee to conduct and benefit from online sales, including an ability of the franchisor to conduct online sales.

Comment:

I agree with the recommendation however suggest that the requirement should be to disclose rights to make any 'direct' sales, not just 'on-line' sales.

Recommendation 4:

The Code be amended to remove Annexure 2 (Short form disclosure document for franchisee or prospective franchisee).

Comment:

I agree with this recommendation because the expected annual turnover is a very problematic concept. Case law has demonstrated that a franchisor must stay well away from estimating turnover due to the risk that it will be interpreted as an enforceable representation. Also, very few viable franchised business fall under this threshold.

Recommendation 5:

The Code be amended to require franchisors to provide prospective franchisees with a short summary of the key risks and matters they should be aware of when going into franchising, based on the following principles:

- a. the summary should be generic (as per the existing warnings in item 1 of Annexure 1 to the Code);
- b. the summary should provide more detail than the current item 1 of Annexure 1 to the Code, but should not be more than one to two pages in length;
- c. the summary should be a standalone document rather than incorporated into the disclosure document; and
- d. the summary should be provided to franchisees at their first point of contact with a franchisor (that is, at the time of enquiring about a franchise opportunity).

Comment:

I disagree with this recommendation for the following reasons:

- a. Franchisor's having the discretion to determine what is a 'key risk' is problematic and will be subject to very different interpretations.
- b. To be explained properly, key risks may require lengthy explanation which could not be contained in two pages.

Selecting certain risks as 'key risks' will have the unintended consequences of creating an impression that all others are not key and reduce the franchisee's focus on these other risks.

Recommendation 6:

The Code be amended to:

- a. Provide franchisees and franchisors with a right to terminate the franchise agreement in the event that any administrator of the other party does not turn the business around, or a new buyer is not found for the franchise system, within a reasonable time (for example 60 days) after the appointment of an administrator. It should be made possible for the courts to make an order extending this timeframe in appropriate cases. It should also be clear that the parties can negotiate a right to terminate at an earlier stage.
- b. Ensure the franchisees can be made unsecured creditors of the franchisor by notionally apportioning the franchise fee across the term of the franchise agreement, so that any amount referable to the unexpired portion of the franchise agreement would become a debt in the event the franchise agreement ended due to the franchisor's failure.

Comment:

I disagree with this recommendation. Being in administration does not of necessarily bring an end to the business of the franchisor and should not provide grounds for termination of franchise. If the franchisor under administration is in breach of its obligations under the franchise, franchisees can seek a remedy for breach and if the franchisor's business ultimately ceases due to insolvency, the franchise will terminate on that event.

Recommendation 7:

The Code be amended to prohibit franchisors from imposing unreasonable significant unforeseen capital expenditure. 'Unreasonable' and 'significant' should be defined, with a view to a franchisor being able to demonstrate a business case for capital investment in the franchised business.

Comment:

I suggest a distinction is required between the imposition of requirements necessitating expenditure during the term of a franchise and those which may be imposed as a condition of renewal.

There is no issue with such requirement being imposed as conditions of renewal as the franchisee is free to reject those terms.

I agree that disclosure is necessary if the franchisor has unilateral rights to impose such requirements during the term. In my view such disclosure should be limited to a statement that the rights exist and the relevant clause reference in the agreement.

The proposed basis for defining 'significant' and 'unreasonable' i.e. whether a business case exists for such investment is very problematic. To embark upon this exercise would necessitate estimates of future revenue. Case law has demonstrated that this must be avoided by franchisors due to the representation created.

Recommendation 8:

The Code be amended with respect to the administration of marketing funds based on the following principles:

- a. a franchisor should separately account for marketing and advertising costs;
- b. contributions to marketing funds from individual franchisees should be held on trust for franchisees generally, with the franchisor to have wide discretion as to how to expend the funds (subject to principle 'e' below);
- c. company-owned units must be required to contribute to the marketing and advertising fund on the same basis as franchised units;
- d. the marketing and advertising fund should only be used for expenses which are clearly disclosed to franchisees by way of the disclosure document, and which are legitimate marketing and advertising expenses;
- e. a once yearly independent audit should be conducted on marketing funds over a certain threshold value, with no capacity for franchisees to vote against such an audit; and
- f. the results of the audit (where applicable) and other detailed information about the expenditure of marketing and advertising funds should be made available to franchisees yearly.

Comment:

I agree with the recommendations. High level of regulation around marketing activity is reasonable and necessary to ensure franchisors behave responsibly in dealing with what are significant amounts of money.

Recommendation 9:

The Code be amended to include an express obligation to act in good faith. Such an obligation should:

- a. extend to the negotiation of a franchise agreement, the performance of a franchise agreement, the performance of obligations under the Code, and the resolution of any disputes between the parties whether or not there is a valid franchise agreement at the time of the dispute;
- b. not be defined, instead the unwritten law relating to good faith should be incorporated in a manner similar to the unconscionable conduct prohibition set out in section 20 of the Australian Consumer Law;
- c. apply to both the franchisor and franchisee or prospective franchisee and the agents of these parties;
- d. not be able to be limited or excluded by any provision of the contract between the parties (such provisions should be declared void);
- e. be clearly stated as not preventing a party from acting in its legitimate commercial interests; and
- f. expressly exclude an argument that a franchisor has not acted in good faith because there is no term in a franchise agreement specifying a right of renewal.

Comment:

I agree with the recommendation to amend the code to include an obligation to act in good faith but only in the performance of a franchise agreement.

A good faith obligation should not extend to the negotiation of a franchise agreement as it could impact on freedom of contract. The concept of good faith in negotiations is subjective and impossible to determine. No interference is needed in this context because either party is free to decline the terms offered in negotiations. Nor should this extend to resolution of disputes as the current dispute resolution provisions work very well to achieve this. If a party fails to act in good faith in a dispute, they risk being penalised by a court.

Additional consideration is required as to the breath of application of such a provision. There is a need to capture all existing franchises, not just impose a term into franchises entered into after the codification of the requirement. Therefore, the requirement needs to be drafted to state that all franchises are taken to include a good faith provision.

Recommendation 10:

The Code be amended to ensure that a written request from a franchisee that its details not be disclosed to prospective franchisees has in fact been initiated by the franchisee, for example by prohibiting a franchisor from initiating, procuring or encouraging such a request from a franchisee.

Comment:

I agree that franchisees should have to initiate the non-disclosure of their details. Currently these requests are being solicited by franchisors.

A provision to this effect will be need to be accompanied by a mechanism whereby an exiting franchisee is put on notice that they need to make a request for non-disclosure of their details. I suggest a form of notice is prescribed and must be issued to an exiting franchisee on or before the franchise termination date.

Clarification is required on what will satisfy the requirement for the 'contact details of each franchisee'. In most cases, a franchisee is a Pty Ltd company and its' contact details are its registered address (often an accountant's office), the inclusion of which provides limited or no value. I suggest the requirement is to provide the address and last known phone number of the directors of the franchisee in the event that the franchisee is a corporation.

Recommendation 11:

That subclause 20(4) of the Code be amended to read:

- a. The franchisor is taken to have given consent to the transfer or novation if the franchisor does not, within 42 days after the request was made, or all information reasonably required by the franchisor under the franchise agreement has been provided, whichever is the latter, give to the franchisee written notice:

- i. that consent is withheld; and
 - ii. setting out why consent is withheld.
- b. The franchisee should take all reasonable steps to provide all information required under the franchise agreement to enable the franchisor to be able to properly evaluate the request.

[Amendments underlined]

Comment:

I agree with this recommendation. Clearly the 42 day time period should commence from when the franchisor has all the information reasonably required to make an assessment of its decision of whether it will consent to the transfer.

This is consistent with many franchisors' current practice as they have identified this issue and taken measures to achieve the same outcome intended by the recommendation.

Further, in cases of a the transfer being due to a sale of the franchised business, the 42 days should not commence prior to the franchisor also receiving evidence that a binding agreement has been reached with a buyer. Currently, requests can and are often made in advance of this and franchisors are forced to spend considerable effort and resources on assessing a potential transferee who may never become a franchisee because the sale agreement is never concluded by the parties.

Recommendation 12:

The Code be amended to state that, if all of the following conditions are satisfied:

- a. the franchisee wishes to have the franchise agreement renewed on substantially the same terms;
- b. the franchisee is not in breach of the agreement;
- c. the agreement does not contain provisions allowing a franchisee to make a claim for compensation in the event that the franchise is not renewed;
- d. the franchisee abides by all confidentiality clauses in the agreement and does not infringe the intellectual property of the franchisor; and
- e. the franchisor does not renew the franchise agreement;

any restraint of trade clauses in the franchise agreement which prevent the franchisee from carrying on a similar business in competition with the franchisor, are not enforceable by the franchisor against the franchisee.

Comment:

I disagree with this recommendation. It is problematic to prescribe when it would and would not be reasonable to impose post-franchise restraints. Parties can rely on the common law and it should be left to the courts to determine whether a restraint is reasonable following an in depth analysis of the circumstances of each case.

Recommendation 13:

The Code should be amended to provide that clause 29(8) applies to participation in any alternative dispute resolution process whether under OFMA, state small business commissioners, privately retained; court appointed or otherwise.

Comment:

I agree that the principles of conduct in dispute resolution should apply to any form of franchise dispute resolution.

Recommendation 14:

Amend the Code to ensure that franchisors cannot:

- a. attribute the legal costs of dispute resolution to a franchisee unless ordered by a court;
- b. require a franchisee to litigate outside the jurisdiction in which the franchisee's business primarily operates.

Comment:

I agree that franchisors should be prevented from making franchisees liable for legal costs. I also agree that the court's appropriate forum test should be bolstered to give a disadvantaged party (which of course can be franchisee or franchisor) sufficient scope to challenge the forum.

Recommendation 15:

The Competition and Consumer Act 2010 (CCA) be amended to:

- a. allow civil pecuniary penalties to a maximum of \$50 000 to be available as a remedy for a breach of the Code;
- b. allow the ACCC to issue an infringement notice for a breach of the Code;
- c. allow the ACCC to use its powers under section 51ADD of the CCA (its random audit powers) to assess a franchisor's compliance with all aspects of the Code, not just to require the production of documents created under the Code;
- d. include a breach of the Code in the contraventions for which the court may make an order under section 86E (Order disqualifying a person from managing corporations); and
- e. specify that the court can make franchising specific orders under section 87, including orders requiring a franchisor to:
 - i. give a royalty free period to a franchisee affected by a breach of the Code; and
 - ii. pay a sum of money specific by the court into any marketing or cooperative fund applicable to that franchise system.

Comment:

I agree the ACCC should be able to issue infringement notices and impose penalties to a maximum of \$50,000 per infringement of the code. Current sanctions are insufficient to promote a strong focus on code compliance by many franchisors. We need serious penalties which are imposed by the ACCC in a swift and decisive manner to bring about a change in attitude. Importantly, the ACCC's enforcement regime should operate independent of the parties' rights against each other. The ACCC should not be looking into resulting damages to parties to determine appropriate sanctions. A damaged party should seek their own remedy against the other outside of the ACCC's process.

I agree that the CCA should be amended to include audit powers for the ACCC in franchising matters.

I suggest that the ACCC should be able to seek an order from a court disqualifying a person from being a director of a corporation due to a breach of the code but not from managing a corporation as the scope of 'managing a corporation' is far too wide and would be very difficult to enforce.

There is no need for the amendment as the court already has sufficient provision under section 87 of the CCA to make orders for compensation due to franchising breaches. These specific types of orders are already known to courts.

Recommendation 16:

An analysis of the impact of a minimum term and standard contractual terms for motor vehicle agreements should be undertaken prior to a future review of the Code.

Comment:

I disagree that a motor vehicle dealership has unique characteristics which require a separate and independent review. The only difference with automotive is that the investment required is significantly higher than most other franchises. However, it is important to note that so too are the potential returns.

The parties to a motor vehicle franchise are free to negotiate the terms of a franchise in just the same way as in any other franchise relationship and freedom of contract is paramount. Franchised motor vehicle dealers have the benefit of franchise disclosure statements and should develop a sound awareness of the commercial terms offered by a franchisor prior to entering into the franchise. They are experienced negotiators and tend to have significant resources which could be utilised to engage industry specific expert advisors. It is quite irresponsible for a franchisee with these characteristics to enter into franchises without conducting sufficient due diligence which is common in automotive in my experience, and then later claim to be in need of legislative protection regarding such things as tenure. They have at their disposal the means to negotiate appropriate tenure relative to their investment levels prior to entering into the franchise and should do so.

There is an issue which runs counter to the concerns of this recommendation and is often overlooked. Franchised automotive dealers can have significant bargaining power in their franchise relationship if they often own or control the dealership land. In key metropolitan areas vacant commercial land of sufficient size for a dealership is extremely scarce and valuable. There are two considerations here regarding tenure:

1. Franchisors cannot afford to lose these sites out of their network and may therefore be locked into long term relationships with sub-standard franchisees, and
2. Commercially focused franchisees wish to maintain an ability to utilise the land for an alternative use or an alternative automotive brand where the returns may be higher. The vast majority of non-renewal rights are reciprocal which provides scope to achieve this.

In any event, motor vehicle franchisors also invest heavily in their distribution network and an important aspect of this is the location of the dealerships. A franchisor suffers significant network disruption and loss of business from a change of franchisee, particularly if a relocation is involved, so the option of not renewing a franchisee (if available) is a drastic measure. Therefore, exercising non-renewal rights are not a franchisor's preference unless there are extremely compelling reasons which outweigh the inevitable damage to the franchisor's business and its brand.

Recommendation 17:

There should not be another review of the Code for a minimum of five years after any amendments to the Code take effect in response to this report.

Comment:

I agree that the code should not be reviewed again for another 5 years to provide the industry with some certainty and stability.

Recommendation 18:

The Code be amended to make the policy intent of the provisions clearer, remove ambiguities, and improve consistency and certainty of industry practice. A suggested list of provisions and possible changes is set out in Appendix D: Technical or minor changes to the drafting of provisions of the Franchising Code.

Comment:

I agree that minor and technical amendments should be addressed in the revision of the code. Clearly this is the time to undertake this exercise and it would be a shame not to take the opportunity to do so.