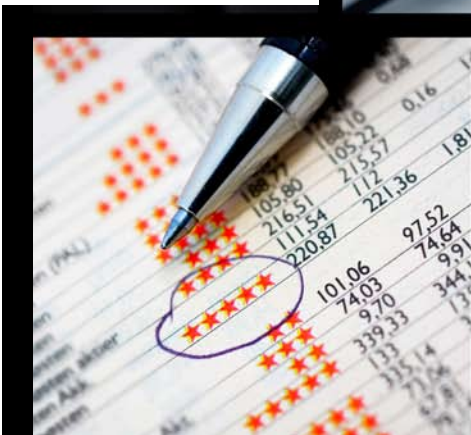




Inquiry into the Operation of Franchise Businesses in Western Australia

Report to the Western Australian Minister for Small Business

April 2008



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**Inquiry into the
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Report to the

Western Australian Minister for Small Business

April 2008

Chairman's Letter to the Minister

**The Hon Margaret Quirk MLA
Minister for Small Business**

Franchising is a robust business model that provides an entry into business ownership for many Australians. The purpose of this Inquiry is to enhance the franchising business environment in Western Australia.

Towards the end of 2007, issues relating to end of franchise agreement arrangements were brought to the attention of the Western Australian Government. Questions relating to whether patterns of unconscionable conduct in the sector were emerging and the adequacy of existing laws protecting the interests of franchisees were raised. In October 2007, the Premier of Western Australia announced the details and terms of reference of this Inquiry to examine these issues.

The terms of reference were wide ranging and the reporting time-frame relatively short. In all, the Inquiry received over 100 submissions. The quality of the submissions from franchisors, franchisees, industry service providers, peak bodies and academics were excellent and of considerable assistance to the Inquiry.

The Inquiry is firmly of the view that most franchise systems operate within the spirit and intent of the Franchising Code of Conduct. The Code serves the industry well; however, issues raised in submissions made to this Inquiry reveal that further improvements to the Australian franchising operating environment are not only desirable but also necessary.

The Inquiry was not an investigation and was unable to verify allegations made in many submissions. This does not detract from the value of the report and its recommendations. The Inquiry reports on issues to do with franchise education, disclosure and due diligence, end of agreement arrangements, dispute resolution, and enforcement of the Code and Trade Practices Act, and makes a number of recommendations to address these issues.

This discussion of the issues and the recommendations are informed by a review of existing franchising practice in other jurisdictions in Australia and overseas undertaken by the Centre for Advanced Consumer Research (CACR). This research was particularly valuable and I am grateful to the team led by Ms Eileen Webb, Co-Director CACR.

The Inquiry recognises that franchising is of national importance and deals with Australian brands. Importantly, it does not recommend separate stand alone state regulation. Consequently, the majority of the recommendations are framed in such a way that the Western Australian Government has the opportunity to provide national leadership by requesting the Commonwealth Government take a certain course of action.

The Western Australian Small Business Development Corporation (SBDC) provided the secretariat support that enabled this Inquiry to proceed and for this report to be written. I am particularly appreciative of the efforts of Martin Hasselbacher, Jennifer Collins and the team at the SBDC.

It is with pleasure that I present this report to the Minister for Small Business, the Hon Margaret Quirk MLA, and the Government of Western Australia.

A handwritten signature in black ink, appearing to read "Chris Bothams". The signature is written in a cursive style with a long horizontal stroke at the end.

Chris Bothams
April 2008

Executive Summary

The Inquiry into the Operation of Franchise Businesses in Western Australia was established to examine fairness in franchising arrangements. This followed issues being raised with the Western Australian Government to do with end of franchise agreement arrangements.

The Inquiry's terms of reference were to:

1. Review the adequacy of existing legislative provisions, both State and Federal.
2. Identify whether emerging trends in the franchising industry disclose patterns of unconscionable conduct that may not be covered under existing laws.
3. Examine whether existing remedies available to franchisees are adequate and, where appropriate, recommend changes.
4. Review existing practice in other jurisdictions, Australia and internationally, on unconscionable conduct and renewal of licences.

The Inquiry issued a Background Paper containing information about franchising in Australia including the regulatory framework, key issues and discussion points. It called for written submissions and additionally, the opportunity was provided for oral submissions to be presented at public hearings. In all, just over 100 submissions were received by the Inquiry.

The Inquiry heard from franchisors, franchisees and ex-franchisees, franchise service providers and academics from around Australia. The Inquiry heard numerous allegations of improper conduct from franchisees whose businesses had failed. Despite the seriousness of these allegations and accounts of personal loss and hardship, the Inquiry has not detected patterns of unconscionable conduct but rather instances where existing laws do not necessarily provide a desired level of protection for all franchising participants.

The Inquiry Chair and Secretariat analysed all written and oral submissions. The key issues that emerged related to franchise education, disclosure and due diligence, end of agreement arrangements, dispute resolution, and enforcement. Overall, the Inquiry believes that the franchising sector operates well; however, improvements need to be made to address the concerns raised.

While existing legislative provisions serve the franchising sector satisfactorily, there is scope for improvement to be made to the disclosure provisions of the Franchising Code of Conduct, its enforcement, and its overall understanding, particularly by prospective franchisees. Regulatory changes to the franchising sector should be undertaken by the Commonwealth Government given that franchising often involves national brands operating across Australia. There is the opportunity for the Western Australian Government to provide national leadership and direction to the Commonwealth Government by requesting that they implement all of the recommendations from this Inquiry.

The Inquiry believes that the following recommendations will improve franchise education, disclosure and due diligence, end of agreement arrangements, dispute resolution, and enforcement. If adopted, the franchising business environment will be one where participants are better informed, are more likely to be successful in their enterprises, enjoy greater equity and, should the need arise, have more timely and efficient access to justice.

1. Franchise Education

The importance of pre-entry education for franchisees cannot be underestimated. Presently, many prospective franchisees do not know what education is available nor do they understand how important this is in order to inform themselves about their rights and responsibilities under a franchise agreement. This is particularly critical in undertaking relevant due diligence when considering the risks involved in entering into a franchise arrangement.

The following recommendations seek to address issues relating to lack of awareness and reach of franchise education, as well as the desirability of franchise participants being kept informed on an ongoing basis of relevant developments in the franchising sector.

Recommendation 1.1:

The Commonwealth Government work with State and Territory Governments and the franchising sector to develop a coordinated approach to delivering targeted pre-entry education to prospective franchisees. This education should provide relevant advice on:

- **the franchise relationship;**
- **the Franchising Code of Conduct;**
- **the known business and franchising risks that franchisees should be investigating before entering into a franchise agreement;**
- **the basics of contract law as it relates to franchising; and**
- **the franchisee's rights and responsibilities under a franchise agreement.**

Recommendation 1.2:

The Commonwealth Government provide funding to State and Territory Governments to cooperatively develop an effective marketing strategy to facilitate the promotion of the information and advisory services available to both franchisees and franchisors.

Recommendation 1.3:

The Commonwealth Government regularly inform the sector about current issues, trends and key areas of concern in relation to franchising via a periodical publication. A component of this publication should provide information that is specifically focussed on educating and informing new and existing franchisees.

2. Disclosure and Due Diligence

Franchising regulation in Australia is premised on the disclosure of relevant information by franchisors to prospective and renewing franchisees. The Franchising Code of Conduct prescribes what information is required and in what format. Currently, the Code does not require franchisors to specifically disclose what franchisees' entitlements and responsibilities are at the end of an agreement. A number of other concerns regarding the current disclosure provisions have also been identified which were not addressed by the most recent changes to the Code. Compliance with the disclosure requirements also needs to be improved.

The following recommendations seek to improve the disclosure of relevant information, particularly in regards to rights at the end of an agreement, and compliance with the Code in order to improve overall transparency in the franchising sector.

Recommendation 2.1:

The Commonwealth Government amend the Franchising Code of Conduct to make it mandatory for franchisors to include, as part of its disclosure document, a clear statement that highlights the rights and responsibilities of, and risks to, the franchisee.

Recommendation 2.2:

The Commonwealth Government, through the Australian Competition and Consumer Commission, develop a standard checklist of known potential risks for prospective franchisees to investigate. The checklist is to be attached to all disclosure documents.

Recommendation 2.3:

The Commonwealth Government immediately amend the Franchising Code of Conduct to specifically require franchisors to disclose:

- the amount of rebates received from any other business for the supply of goods or services to franchisees;
- what services they will provide to franchisees in explicit terms;
- their financial position to franchisees; and
- their relevant franchising experience, qualifications and training.

Recommendation 2.4:

The Commonwealth Government review the Franchising Code of Conduct by 2010 in order to evaluate the effectiveness of changes to the disclosure provisions and any other amendments.

Recommendation 2.5:

The Commonwealth Government amend the Franchising Code of Conduct to require all franchisors to register their franchise system with the Australian Competition and Consumer Commission.

Recommendation 2.6:

The Commonwealth Government amend the Franchising Code of Conduct to require all franchise systems to lodge a copy of its current disclosure

document annually with the Australian Competition and Consumer Commission.

Recommendation 2.7:

The Commonwealth Government, through the Australian Competition and Consumer Commission, undertake a regular review of a random sample of disclosure documents to monitor compliance with the Franchising Code of Conduct and publish the results of their findings annually.

3. End of Agreement Arrangements

A particular focus of this Inquiry has been on issues relating to non-renewal of the franchise agreement and expiry of the contract. The existing regulatory framework for franchising in Australia does not specifically address end of agreement arrangements. In the interests of making an informed business decision and undertaking appropriate due diligence, prospective and renewing franchisees should have a clear understanding of what their entitlements and responsibilities are, or are not, at contract expiry prior to entering into a franchise agreement.

The following recommendations seek to improve end of agreement disclosure and transparency in contract negotiations in order to provide franchisees with greater clarity and certainty in relation to their rights and responsibilities.

Recommendation 3.1:

The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to explicitly specify, in the disclosure document, what end of agreement arrangements are in place under the franchise agreement.

Recommendation 3.2:

The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to explicitly specify, in the disclosure document, what the position is in relation to the franchisee's entitlement or lack of entitlement to goodwill or other compensation if the agreement is not renewed.

Recommendation 3.3:

The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to conduct a pre-expiry review with the franchisee at least one year prior to the expiry of the franchise agreement. The purpose of the review is to inform the franchisee of any variations between the existing and new agreement and any conditions that need to be met in order for agreement renewal.

Recommendation 3.4:

The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to specify, in the disclosure document, a reasonable period of notification in which to inform the franchisee of their intention not to renew the agreement.

4. Dispute Resolution

The Franchising Code of Conduct prescribes a mandatory process of dispute resolution through mediation. Problems associated with mediation include the difficulty in getting parties to attend and resolve their disputes in a timely fashion and the lack of enforcement of mediated outcomes. An earlier and more flexible system of intervention is required.

The following recommendations seek to improve the current mediation process in order to provide a better system to resolve disputes in the franchising sector.

Recommendation 4.1:

The Commonwealth Government, through the Australian Competition and Consumer Commission, review the current mediation processes mandated under the Franchising Code of Conduct with a view to implementing an earlier, more cost-effective and accessible dispute resolution system.

Recommendation 4.2:

The Commonwealth Government amend the Franchising Code of Conduct in relation to mediation to:

- require parties in dispute to attend mediation compulsorily;
- make mediated agreements enforceable to ensure both parties adhere to the agreed resolutions; and
- include prescribed penalties for refusing to attend mediation or refusing to make a genuine attempt to resolve the dispute.

5. Enforcement

The conduct of franchising participants is regulated by the Australian Competition and Consumer Commission. It is the role of the ACCC to monitor and enforce compliance with the Franchising Code of Conduct and the *Trade Practices Act 1974*. The ACCC currently has a formalised process to investigate breaches of the Code and allegations of misconduct. In many cases, the ACCC has not been able to respond adequately to franchisee complaints in a timely manner.

The following recommendations seek to improve the monitoring of compliance with the Code by franchising participants in order to better enforce conduct and behaviour in the franchising sector.

Recommendation 5.1:

The Commonwealth Government review its current level of funding to the Australian Competition and Consumer Commission in order to ensure adequate resourcing for the monitoring, enforcement and education of franchising participants under the Franchising Code of Conduct.

Recommendation 5.2:

The Commonwealth Government establish a dedicated franchising enforcement unit within the Australian Competition and Consumer Commission to proactively monitor and enforce compliance with the Franchising Code of Conduct and the *Trade Practices Act 1974*.

Recommendation 5.3

The Commonwealth Government amend the *Trade Practices Act 1974* to prescribe penalties for breaches of the Franchising Code of Conduct.

Recommendation 5.4

The Commonwealth Government work with the judicial system and the franchising sector to introduce a more streamlined approach to accessing compensation and recovery of costs where a particular court decision impacts on a group of franchisees.

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Chapter 1 Introduction

The purpose of this Inquiry is to examine issues to do with fairness in franchising operations and to make recommendations to enhance the franchising business environment in Western Australia.

A focus of the Inquiry has been on issues relating to non-renewal of the franchise agreement and end of contract, however, it has been necessary to take a broader perspective on franchising issues in line with the statements made in the submissions received. This report identifies some of the key issues and themes that have been brought to the Inquiry's attention in relation to the current franchising business environment in Australia and makes recommendations to remedy the situation.

Terms of Reference

On 2 November 2007, the Minister for Small Business, the Hon Margaret Quirk MLA, announced the terms of reference for the State Government Inquiry into the Operation of Franchise Businesses in Western Australia. The Inquiry is to:

1. Review the adequacy of existing legislative provisions, both State and Federal.
2. Identify whether emerging trends in the franchising industry disclose patterns of unconscionable conduct that may not be covered under existing laws.
3. Examine whether existing remedies available to franchisees are adequate and, where appropriate, recommend changes.
4. Review existing practice in other jurisdictions, Australia and internationally, on unconscionable conduct and renewal of licences.

Why the inquiry was held

As a result of a grievance raised in the Legislative Assembly on 25 October 2007, the Government of Western Australia initiated an inquiry to examine concerns about the fairness of franchise arrangements.

Specifically, the grievance revolved around the closure of the Rockingham KFC store at the end of its franchise agreement in November 2007. A further three KFC franchise agreements in Western Australia expire before the end of 2008.

The situation with the Rockingham KFC outlet raised issues to do with franchising in Australia:

[The] concern is that existing franchise arrangements in Australia may not offer sufficient protection or information to franchise operators who may find themselves in a similar situation to the one facing the owners of the Rockingham KFC franchise. It seems that the franchisor can use its right to not renew a

franchise agreement and potentially deny the franchisee the economic benefits of building a strong and successful business.¹

Whilst recognising that the matter may ultimately be for the Commonwealth Government to address under the *Trade Practices Act 1974*, the Premier was requested to “initiate an inquiry not only into whether existing legislative provisions for franchise arrangements at both the state and federal level are adequate, but also into whether state or federal legislation needs to go further to ensure a sufficient level of disclosure in franchise arrangements to prevent any unconscionable conduct in those arrangements”.²

In responding, the Premier indicated that this case had significant ramifications because “there are many franchise arrangements in our economy,” and that at “both a national and state level, governments need to ensure that small business owners are treated fairly and given fair opportunity to compete in the market place.”³

Background Paper

To facilitate community and industry engagement and encourage public submissions from a wide range of sources, a Background Paper to the Inquiry was released on 18 December 2007. The Background Paper contains information about franchising in Australia, the franchising business relationship, the Australian regulatory framework, legal remedies in case of dispute, key issues and discussion points.

Specifically, the Background Paper focuses on issues relating to the non-renewal of the franchise agreement and end of contract. Current franchise law concentrates regulatory action on the provision of relevant information to ensure that a prospective franchisee is adequately informed before entering a franchise contract – the Inquiry is interested particularly in what happens once the end of the agreement is reached.

Some of the issues identified in the Background Paper include entitlement to goodwill, franchise churn, good faith bargaining in the negotiation of franchise agreements and in mediation, and unconscionable conduct.

The Background Paper is attached at Appendix 1.

¹ Hansard, Legislative Assembly, 25 October 2007, pg. 6827

² *ibid*

³ *ibid*

Chapter 2 Process

The Background Paper and details of Public Hearings were advertised, with a call for public submissions from interested stakeholders, in community newspapers the week commencing 7 January 2008 and in *The West Australian* on Wednesday, 9 January 2008, and Saturday, 12 January 2008 (see Appendix 2).

Submissions closed 15 February 2008 and additional information provided before 13 March 2008 was also accepted for consideration by the Inquiry. In addition to providing written submissions to the Inquiry, stakeholders were given the opportunity to raise issues at Public Hearings, which were held in Perth on 4 February 2008 and Bunbury on 8 February 2008. A total of 42 people attended the hearings, representing a combination of franchisees, franchisors and industry groups.

The Inquiry received 93 written submissions and a further eight oral submissions were provided at the Public Hearings. A list of the submissions received is provided at Appendix 3. As indicated in the list, a number of people who provided a submission requested that their submissions be kept confidential.

The Inquiry also consulted with relevant stakeholders (see Appendix 4), including franchisees and ex-franchisees, industry bodies, an academic and other government representatives.

The Centre for Advanced Consumer Research at The University of Western Australia was engaged to research and advise the Inquiry on the fourth term of reference relating to existing practice in other jurisdictions, Australia and internationally, on unconscionable conduct and renewal of licences.

The Chair and Secretariat of the Inquiry conducted detailed analysis of all submissions received and identified the key issues that emerged. These issues related to franchise education, disclosure and due diligence, end of agreement arrangements, dispute resolution, and enforcement.

Issues relating to retail leasing were touched on in several submissions that highlighted the parallels between commercial tenancy and franchising issues, particularly in relation to unconscionable conduct. Given the attention to retail tenancy and leasing issues by other concurrent reports and inquiries, and the limited time-frame for this Inquiry, there has been minimal exploration of retail leasing issues.

It is from this analysis and the research carried out that the Inquiry's recommendations were developed.

A timeline of the Inquiry process is on the next page.

Timeline for the
Inquiry into the Operation of Franchise Businesses in Western Australia

25 October 2007	Grievance raised in State Parliament and the Premier announces that a government inquiry will be held
2 November 2007	The Minister for Small Business, the Hon Margaret Quirk MLA, releases the terms of reference for the Inquiry into the Operation of Franchise Businesses in Western Australia
18 December 2007	The Background Paper to the Inquiry released
7 January 2008	Advertising of “Call for Public Submissions” in Community Newspaper Group
9 & 12 January 2008	Advertising of “Call for Public Submissions” in <i>The West Australian</i>
4 February 2008	The first Public Hearing held in Perth
8 February 2008	The second Public Hearing held in Bunbury
15 February 2008	Closing date for written submissions from the public
February/March	Detailed analysis of submissions
14 April 2008	Final report of the Inquiry to the Minister for Small Business

Chapter 3 Franchising in Australia

Introduction

Franchising offers entrepreneurs the opportunity to expand their businesses in locations around the country by offering a recognised brand, a product or specific expertise relating to the good or service, with the operation of the individual business being managed by the franchisee.

Franchises are a dominant force in the retail sector, and encompass a broad range of consumer goods and services with, for example, coverage extending from fast food outlets to hardware stores, bakeries, ice-cream vendors and mobile pet grooming services. Almost any business can be conducted through a franchise arrangement.

Franchising is an important sector of the economy, employing many thousands of Australians. The great majority of the estimated 62,000 franchise businesses in the country are run by small business operators. Their contribution to the national economy was worth around \$128 billion in 2005, and growing.⁴

There has been strong growth in the sector overall, with significant increases in both the number of franchise systems (up 12.9% between 2004 and 2006) and franchise units held (up 14.6% between the same period).⁵ Business format franchise units⁶ now represent slightly less than 5% of all small businesses in Australia, indicating that there are further opportunities for growth at the unit level.

The Franchising Business Environment

While business format franchising is by and large a successful form of enterprise in Australia for many franchisors and franchisees alike, submissions made to this Inquiry have described instances of conduct that have detrimentally impacted on some franchising participants. At its worst, this behaviour has led to business failures, and with that associated costs including bankruptcy, ill health, emotional and psychological trauma, marriage and relationship breakdowns, and possibly suicide.

The Inquiry recognises that there is an inherent risk associated with any commercial arrangement, and that governments can only play a limited role in regulating business activity. However, while the principles of freedom of contract and sanctity of contract (see Background Paper at Appendix 1) need to be preserved in a market economy such as ours, there is still a governmental duty to ensure that an appropriate legal framework exists to protect the interests and rights of parties to a contract. These are the fundamentals underpinning Australia's laws regarding fair trading and trade practices.

⁴ "Franchising Australia 2006 Survey", Griffith University, 2006

⁵ Ibid

⁶ The business format franchise refers to where a franchisor develops a manner of doing business and permits the franchisee to use the entire system in a controlled way in the operation of the franchisee's independently owned business (such as fast food outlets, mobile service providers and booksellers). Business format franchising is by far the most common form of franchising in Australia.

Without adequate protections in place, the stronger party to an agreement could go ‘above and beyond’ its inherent superior bargaining position to put the weaker party in trade or commerce at a compromising disadvantage. While this power imbalance is a natural feature of contract law, and the market economy in general, a case can be made for a level of protection in franchising given the unequal contractual relationship between parties to a franchising agreement, the largely self-regulatory nature of the sector, and the potential risks and consequences associated with investing in a franchise system.

Franchising Regulation in Australia

Franchising agreements in Australia are regulated by the contractual relationship between the parties and statutory provisions including the Franchising Code of Conduct (‘the Code’).⁷ This regulatory framework has been described by the Franchise Council of Australia (‘FCA’) in its submission to the Inquiry as “world’s best practice”.

The contractual relationship

The terms of the contract carve out the parties’ respective rights and obligations. However, common law⁸ and equitable⁹ principles may, in appropriate circumstances, intervene to restrain unfettered exercise of contractual rights, and/or related business conduct, where the behaviour under consideration does not meet certain standards. In this respect, the pivotal considerations are the doctrine of unconscionable dealing and the implied duty of good faith.

Franchising Code of Conduct

In response to the concerns raised in the Reid Committee’s 1997 report on the review of fair trading in Australia,¹⁰ the Federal Government introduced the Code which applies to any franchise agreement entered into after 1 October 1998. The Code provides for disclosure of materially relevant facts and information, a ‘cooling-off’ period, procedural safeguards for franchise terminations and a dispute resolution mechanism.

The Code is mandatory under s51AE of the *Trade Practices Act 1974* (TPA) and is administered by the Australian Competition and Consumer Commission (ACCC). The mandatory nature of the Code means that all players in the franchising industry are subject to its provisions.

The Code is further strengthened by its relationship with the TPA. Failure to comply with the Code may lead to a breach of the TPA through:

- the operation of s51AD [invoking remedies of injunction (s80), damages (s82), enforceable undertakings (s87B), corrective advertising (s86C) and other orders (s87)¹¹]; and/or

⁷ *Trade Practices (Industry Codes – Franchising) Regulations 1998*

⁸ For example, economic duress, fraud and misrepresentation.

⁹ For example, unconscionable conduct, undue influence and estoppel.

¹⁰ House of Representatives Standing Committee, *Finding a Balance: Towards Fair Trading in Australia*, 1997, APH, para 6.73

¹¹ There are no criminal sanctions for a breach of s51AD.

- a finding of unconscionable conduct pursuant to s51AC.

Pursuant to s51AD, contravention of an industry code contravenes the TPA. Section 51AC proscribes unconscionable conduct in certain dealings between corporations and small business persons, including franchisees. The court may consider failure to adhere to relevant industry codes when determining whether conduct is unconscionable under s51AC(1) or (2).

Unconscionable Conduct

(i) The equitable doctrine of unconscionable dealing

In equity, the doctrine of unconscionable dealing empowers a court to set aside a contract resulting from the knowing, unconscionable exploitation by one party of the special disadvantage of another. The special disadvantage must be such that it renders the weaker party unable to make a judgment as to his or her best interests.¹²

A franchisee, being a commercial party, is unlikely to demonstrate the requisite ‘special’ disadvantage required by the equitable doctrine. Although there have been some musings in the courts regarding a recognition of ‘situational’ disadvantage, particularly with regard to reliant, personal relationships,¹³ it seems the present High Court will be resistant to broader interpretations.¹⁴ A situational disadvantage arises from particular legal or financial circumstances, such as a sitting tenant at the end of a lease, which is in contrast to a purely constitutional disadvantage (that is, emotional dependence and vulnerability).

(ii) Statutory intervention relevant to unconscionable conduct

Section 51AA TPA

Section 51AA states: “(1) A corporation must not in trade or commerce engage in conduct that is unconscionable within the meaning of the unwritten law from time to time of the states and territories.” This provision has generally been interpreted narrowly, in compliance with the equitable doctrine. Some courts and commentators have argued for recognition of ‘situational’ disadvantage and/or a ‘wide’ view of s51AA, which, rather than confining itself to the equitable doctrine, encompasses all doctrines of which unconscionability is an element. At present, there seems little possibility of these suggestions being acted upon.¹⁵

The High Court considered s51AA in a retail leasing context in *ACCC v C.G. Berbatis (Holdings) Pty Ltd*.¹⁶ In that case, the ACCC unsuccessfully alleged that a shopping centre landlord had engaged in unconscionable conduct pursuant to s51AA of the TPA by

¹² Per Mason CJ in *Commercial Bank of Australia Limited v Amadio* (1983) 151 CLR 447 at 461-462

¹³ *Louth v Diprose* (1992) 175 CLR 621

¹⁴ *Tanwar Enterprises Pty Ltd v Cauchi* (2004) 217 CLR 315

¹⁵ Indeed, superior courts seem to be requiring a more onerous standard; for example, the High Court in *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd* (2003) 214 CLR 51 (2003) and *Tanwar Enterprises Pty Ltd v Cauchi* (2004) 217 CLR 315. Similar views can be noted in the New South Wales Court of Appeal *Australia and New Zealand Banking Group v Karam* (2005) 64 NSWLR 149.

¹⁶ (2003) 214 CLR 51

refusing to grant a new lease to certain tenants unless those tenants agreed to discontinue legal proceedings against the landlord.

The circumstances of the case involved, among other things, a significant vulnerability affecting the tenants in that their lease was close to expiring, there was no option to renew and the business had been sold. Failure to grant the new lease would have resulted in the loss of the sale. The ACCC focussed their arguments on s51AA reflecting the narrow view of unconscionable conduct pursuant to the equitable doctrine. Therefore, it was necessary to establish the tenant was under a special disadvantage.

The majority of the High Court held that the tenant was not under any special disadvantage, indeed, there was nothing ‘special’ about the predicament of a sitting tenant at the end of their lease, and that the landlord’s conduct in imposing a condition upon the grant of the new lease was not unconscionable. This was illustrated by the judgement of Chief Justice Gleeson, who noted:¹⁷

In the present case, there was neither a special disadvantage on the part of the lessees, nor unconscientious conduct on the part of the lessors. All the people involved in the transaction were business people, concerned to advance or protect their own financial interests. The critical disadvantage from which the lessees suffered was that they had no legal entitlement to a renewal or extension of their lease; and they depended upon the lessors’ willingness to grant such an extension or renewal for their capacity to sell the goodwill of their business for a substantial price. They were thus compelled to approach the lessors, seeking their agreement to such an extension or renewal, against a background of current claims and litigation in which they were involved. They were at a distinct disadvantage, but there was nothing “special” about it. They had two forms of financial interest at stake: their claims, and the sale of their business. The second was large; as things turned out, the first was shown to be relatively small. They had the benefit of legal advice. They made a rational decision, and took the course of preferring the second interest. They suffered from no lack of ability to judge or protect their financial interests. What they lacked was the commercial ability to pursue them both at the same time.

This reveals that s51AA has had limited impact on regulating unconscionable conduct in commercial transactions.

Section 51AC TPA

Section 51AC addresses unconscionable conduct in business transactions, the value of which does not exceed \$10 million. A list of factors which the court may take into account in determining whether a corporation or person has engaged in unconscionable conduct in relation to the supply of goods or services is contained under s51AC(3).

¹⁷ Gleeson CJ also noted: “Parties to commercial negotiations frequently use their bargaining power to ‘extract’ concessions from other parties. That is the stuff of ordinary commercial dealing. What is relevant to a commercial negotiation is whatever one party to the negotiation chooses to make relevant.” Indeed, David Clough has made the following observations as to the utility of s51AA: “...One is left wondering what possible commercial disadvantages could ever give rise to the necessary disabling conditions or circumstances.” Clough D, *Coexistence of Fairness and Competition under the Trade Practices Act 1974 (Cth)*, (2005) 33 ABLR 99 at 107.

The scope and diversity of the considerations suggest that unconscionable conduct pursuant to s51AC is, potentially, a much broader concept than that recognised under the general law.¹⁸ However, there have been few decided cases where a finding of unconscionable conduct has been made under s51AC. While conduct may be, in some cases, harsh, unfair or even oppressive, the unconscionability threshold, it seems, is rarely satisfied.

In cases involving s51AC, it must be determined whether the particular misconduct or behaviour is sufficiently pejorative in the context of the particular business relationship under consideration. As the court's starting point for such an inquiry is an aversion to setting aside bargains, and the model against which conduct is judged is steeped in the classical model of contract theory, where hard bargaining is the accepted norm, it seems the instances where unfair business conduct will be regarded as unconscionable will remain few. To date, classical notions of the business relationship generally override considerations as to the nature of the relationship between small and large business.

Section 51AC was enacted following the report of the Reid Committee to assist small businesses to deal with more powerful entities, although it was clearly never intended that the scales be tipped completely in the small businessperson's favour. While the standard recommended by the Reid Committee was 'unfairness', the legislature chose to utilise the term 'unconscionable' which has obtained a particular connotation, and required a more onerous standard of conduct, than unfairness.

Decided cases involving s51AC therefore generally suggest a strict and guarded interpretation of the provision such that only the most malevolent conduct will be regarded as sufficiently 'unconscionable'. The crux of the issue seems to be that, as s51AC involves commercial transactions, the 'stronger' party is within their rights to protect, and act in, their own interests and pursue their own agenda, even where this has a disadvantageous effect on the other party.

Good Faith

The implied duty of good faith is another concept relevant to this discussion on the franchising relationship in the context of Australian contract law.

(i) The recognition of an implied duty of good faith in Australia

A number of recent cases¹⁹ have looked favourably on the implication of a duty of good faith into a variety of contracts, including franchising agreements. While some doubts remain as to whether Australian law has unequivocally accepted a duty of good faith in the performance and enforcement of contracts generally,²⁰ and the High Court has not

¹⁸ *Australian Securities and Investment Commission v National Exchange Pty Ltd* (2005) 148 FCR 132; *ACCC v CG Berbatis Holdings Pty Ltd* [2000] FCA 1376 per French J; *Auto Masters Australia Pty Ltd v Bruness Pty Ltd* [2002] WASC 286; (2003) ATPR 46-229 per Hasluck J.

¹⁹ *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151, (1997) 146 ALR 1; but compare *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84, 117 ALR 393 *Burger King Corporation v Hungry Jacks Corporation* (2001) NSWCA 187.

²⁰ *South Sydney District Rugby League Football Club Ltd v News Ltd* [2000] FCA 1541 at para 393 3

reached a binding conclusion on the issue, there has been an acceptance of the duty as an implied legal incident in particular classes of contract, for example, franchise agreements, commercial leases and tenders.

Despite earlier concerns as to how good faith could be defined, and fears of such a principle undermining certainty in contract law, some courts have indicated their preparedness to utilise good faith principles in Australian law.

In *Royal Botanic Gardens and Domain Trust v South Sydney City Council*,²¹ High Court Justice Kirby pondered the breadth of the implied duty of good faith, particularly “the extent to which, if such were to be the law, a duty of good faith might deny a party an opportunistic or commercial exercise of an otherwise lawful commercial right.”

Recently, in *J F Keir Pty Ltd v Priority Management Systems Pty Ltd (administrators appointed)*,²² Acting Justice Rein accepted submissions made by a franchisee that when the franchisor exercised its powers under the franchise agreement, the implied duty of good faith required the franchisor to act:

- (i) reasonably and honestly;
- (ii) objectively;
- (iii) without simply relying on information provided by third parties or ‘wilfully shutting (ones) eyes’ or refraining from making inquiries, but exercising the degree of ‘caution and diligence to be expected of an honest person of ordinary prudence’;
- (iv) without some ulterior motive;
- (v) with recognition and regard to the legitimate interests of both parties in the enjoyment of the fruits of the contract; and
- (vi) to avoid action rendering the plaintiff’s interests under the agreement ‘nugatory, worthless, or... seriously undermined’.

Franchisors in Australia are free to pursue their legitimate business interests but may offend the implied good faith principles through the pursuit of some extraneous purpose.²³ Importantly, an implied covenant will only aid and further the explicit terms of the agreement and will never impose an obligation which would be inconsistent with other terms of the contractual relationship.²⁴

(ii) References to good faith in Australian legislation

Trade Practices Act

Section 51AC(3)(k) of the TPA invites the court to consider the good faith of the parties when determining whether conduct is unconscionable. Several cases, including cases dealing with franchise or dealership terminations, have examined good faith in the context of s51AC (for a discussion of relevant cases, refer to Appendix 5). Australian franchise

²¹ (2002) 186 ALR 289

²² [2007] NSWSC 789. Judgment date: 24 July 2007.

²³ *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* [2006] VSC 223 (21 June 2006)

²⁴ In *Central Exchange Ltd v Anaconda Nickel Ltd* (2001) WASC 128 (25 May 2001), the Western Australian Court of Appeal accepted that the principles of good faith could not block the use of terms that actually appear in the contract.

cases often equate a failure to act in good faith with unconscionable conduct. Whether this is correct is the subject of considerable debate.

Good faith is not defined in the TPA and therefore recourse could be made to the common law authorities. Interestingly, as the reference in s51AC is to conduct rather than to a contract, the potential operation for good faith in the s51AC context would seem to be broader than the common law position.

Franchising Code of Conduct

In 2006, the Australian Government conducted a review of the current operation of *Part 2 – Disclosure* of the Code. The review committee (the ‘Matthews Committee’)²⁵ examined the notion of including an obligation for franchisors, franchisees and prospective franchisees to deal with each other fairly and in good faith. The Commonwealth Government did not support this recommendation because, in the government’s view, existing law adequately covered such an obligation.

Other protections in the TPA

The remainder of the TPA is fundamentally concerned with preventing anti-competitive conduct (fair trading) and providing appropriate safeguards for consumers. However, sections 52 and 53, as they pertain to the franchising sector, are worthy of a brief discussion.

Section 52 relates to misleading and deceptive conduct and its broad scope deals with issues relating to franchisor conduct during the formation of a contract and during the course of the franchise agreement. Section 52 can be applied to prohibit franchisors from making misleading statements with regard to, among other things, projected turnover or profitability. Failure to observe the standard of conduct required by s52 has consequences under Part VI of the TPA (enforcement and remedies). These include both remedies available at common law (such as injunctions and damages) and other compensatory remedies under s87, which apply when loss or damage is likely to be suffered by a franchisee (for example, orders declaring the franchise agreement void or varied).

Section 53 is also relevant in the context of franchising as it prohibits false or misleading representations made in relation to the supply of goods and services. For example, it prohibits a franchisor from making a false or misleading representation in relation to the price of goods or services and their origin.

State legislation relating to franchising

State and territory governments have not added any regulation specific to franchising to their legislation. Franchising is regulated by the Code and the contractual relationship between parties.

Several provisions from the TPA that govern relationships between traders have been reflected by the states in their respective Fair Trading Acts, thereby increasing access to a

²⁵ Recommendation 25, “Review of the Disclosure Provisions of the Franchising Code of Conduct – Report to the Hon Fran Bailey MP Minister for Small Business and Tourism”, Franchising Code Review Committee, October 2006, pg. 46

greater number of courts in which matters can be heard. The Western Australian *Fair Trading Act 1987* (the 'FTA') incorporates the relevant trade practices provisions of the TPA regarding unconscionable conduct, misleading and deceptive conduct, and false and misleading representations in commercial transactions.

Chapter 4 Issues in Franchising

Franchising in Australia is regulated by the Franchising Code of Conduct. The TPA also regulates the conduct of parties in relation to unconscionable conduct, misleading and deceptive conduct, restrictive trade practices, and false and misleading representations among others.

The Inquiry has not detected any patterns of widespread misconduct within the franchising sector in Australia. The Inquiry did, however, receive numerous submissions that made allegations of improper franchisor conduct, and in several of these cases, this conduct was alleged to be systemic across the franchise system. More than one franchisee, or former franchisee, from four franchise systems made allegations of misconduct by their franchisor.

It is important to note that this Inquiry was not an investigation and was therefore unable to determine whether such allegations were systemic within franchise systems. Many of the allegations put to the Inquiry were serious and examples of the personal financial and family costs were devastating to the individuals involved. Allegations included:

- Misrepresentation, particularly as to future earnings and amount of work involved.
- Franchise churn, whereby a franchisor repeatedly sells a franchise outlet in circumstances where it would reasonably understand that the outlet is unlikely to operate successfully.
- Collusion with banks and other financial lenders, particularly in the financing and liquidation of franchise businesses.
- Capricious and vexatious notices of dispute and termination.
- Collusion with suppliers, especially in marking-up the cost of supplies and hidden rebates and other paybacks.
- Bullying, intimidation and threats against franchisees.
- Defamation and breaches of privacy, particularly against franchisees that are considered 'recalcitrant'.
- Refusal to enter into mediation.
- Failing to adhere to the resolutions agreed to at mediation.
- Lack of disclosure, in particular relating to a specific site/store.
- Non-disclosure of materially relevant information.
- Franchisor encroachment on franchisee-exclusive territories.
- Withholding of payments, reservations or accounts.
- Abuse and misuse of advertising and other cooperative funds.
- Different and preferential treatment of company-owned stores.

No emerging trends that disclose patterns of unconscionable behaviour, which may not be covered under existing laws, as outlined in the Inquiry's second term of reference, were identified. A number of allegations were made to the Inquiry that the practice of franchise churn occurred in Australia. The Inquiry notes that the Chairman of the

ACCC, Graeme Samuel, has publicly stated that churning did exist in some cases, however, the FCA denies that this practice takes place.²⁶

The Inquiry has identified a number of significant issues which need to be addressed to further improve the franchising business environment for all participants. These issues relate to franchise education, disclosure and due diligence, end of agreement arrangements, dispute resolution, and enforcement.

1. Franchise Education

The importance of pre-entry education

The risk of business failure will always exist. This risk can be reduced by undertaking thorough business feasibility assessment and planning *prior* to entering into any commercial arrangement. Implicit in this process is that prospective parties to an agreement *understand* the intended and unintended consequences of their business decisions, actions and reactions.

It has come to the Inquiry's attention that numerous franchising disputes and business failures could have been averted had the new franchisee, prior to entering into the franchise agreement, better understood:

- basic business principles and the nature of the contractual relationship;
- the extent of their rights and responsibilities under the Code and the TPA; and
- the implications of the information provided to them in the disclosure document in order to conduct appropriate due diligence.²⁷

The importance of pre-entry education for franchisees has emerged as a key issue. In its submission to the Inquiry, the Franchise Advisory Centre claims, "pre-entry education for people prior to buying a franchise will vastly assist their understanding of the disclosure information made available to them." It has been reported anecdotally that in many cases, prospective franchisees do not educate themselves prior to entering into a franchise arrangement.

Pre-entry education is currently available through a number of avenues, including the ACCC, state and territory governments, the FCA and various industry bodies. This education is provided in a variety of forms including workshops, information sessions, accredited training, networking events, information exchange forums and conferences. These generally offer information and guidance in relation to the franchising relationship, the rights and responsibilities of franchising participants under the Code, and general business practices.

²⁶ Radio 2UE 954, Glenn Wheeler Weekend Show, 9 February 2008

²⁷ Due diligence refers to the care that a prudent person might be expected to exercise in the examination and evaluation of risks affecting a business transaction (from www.dictionary.com).

Lack of awareness

Whilst pre-entry education is readily available from a number of sources, the Inquiry believes that there is a general lack of awareness among prospective franchisees of not only what is available but also the importance of this information, especially in assisting with pre-business feasibility planning and due diligence.

While the ACCC has a key role in providing information and guidance to the franchising sector, it has been put to the Inquiry that franchise education needs to be better targeted and more effectively promoted by the regulator. An ex-franchisee commented that, “The ACCC has committed itself to educating potential and current franchisees about the Code and their rights and obligations. They do not attempt to ensure that potential franchisees know how to conduct relevant due diligence.” Appropriate due diligence is an essential critical step in evaluating any contractual arrangement, especially where large, long-term investments, with considerable risks, are at stake.

The Inquiry believes that there is merit in providing prospective franchisees with clear information on the known potential risks of the franchise business arrangement before entering into an agreement. Prospective franchisees need to understand the inherent risks associated with any franchise agreement and in particular, what their rights and responsibilities are before, during and at expiry of the contract.

Lack of reach

An option to improve franchisee knowledge of their rights and responsibilities would be to make it mandatory under the Code for first-time franchisees to attend pre-entry education. The Inquiry decided that this would be a too heavy-handed approach and has the potential to act as a barrier to entry and would be too difficult to enforce.

The Inquiry instead believes that pre-entry education needs to be better promoted in order to more effectively reach and inform prospective franchisees. There is no point in developing a comprehensive pre-entry education campaign if the intended audience is not aware that such information and guidance is available to them or do not understand and appreciate the relevance of this education to their commercial dealings.

A commitment from relevant bodies, both public and private, is required to fund a dedicated and ongoing marketing campaign. The campaign should focus on promoting the benefits and relevance of pre-entry education in order to better inform prospective franchisees about their rights, responsibilities and risks before they sign a franchise agreement. This information is essential to equip people with the relevant knowledge to enable informed business decisions to be made.

Ongoing education

The Inquiry believes that all franchising participants should be kept abreast of developments in the sector, including in relation to new regulatory requirements, good practice, emerging trends and issues, and the outcomes of relevant legal proceedings and prosecutions. This process of providing ongoing education and information would ensure that franchisors, franchisees and associated third parties are readily informed

about the current state of franchising in Australia and should be a priority of governments and industry bodies alike.

2. Disclosure and Due Diligence

Disclosure requirements under the Code

The key feature of the franchising regulatory framework is information disclosure. Specifically, the Code “ensures that franchisees are informed of all relevant facts when starting their business... by requiring franchisors to disclose specific facts to franchisees.”²⁸

Part 2 of the Code requires franchisors to create a disclosure document in accordance with Annexure 1. The disclosure document includes the mandatory disclosure of 23 categories of information, including:

- information about the franchise site or territory;
- information about the supply of goods or services to and from a franchisee;
- information about marketing or cooperative funds to which the franchisee may be required to contribute;
- payments that will have to be made by the franchisee in relation to the franchise; and
- current and past proceedings (including litigation and arbitration) against the franchisor and directors of the franchisor.

Clause 17.1 of Annexure 1 of the Code requires franchisors to provide a *summary* of ‘other relevant conditions’ of the franchise agreement, including matters dealing with:

- the term of the franchise agreement;
- variations to the franchise agreement;
- renewal or extension of the franchise agreement;
- conditions the franchisee must meet to renew or extend the franchise agreement;
- termination by the franchisor;
- termination by the franchisee;
- the franchisee’s goodwill, if any, on termination or expiry;
- the franchisee’s obligations when a franchise agreement is terminated, expires or is not renewed;
- the franchisor’s rights to sell its business;
- transfer of a franchise;
- mediation; and
- the option or right of first refusal, if any, for the franchisor to buy the franchised business.

The disclosure document and a current copy of the Code must be provided to prospective franchisees and franchisees proposing to renew or extend an existing franchise agreement. This must be done at least 14 days before the franchisee enters

²⁸ ACCC website (www.accc.gov.au)

into, renews or extends the relevant franchise agreement or makes a non-refundable payment to the franchisor or an associate of the franchisor in connection with the proposed franchise agreement.

The FCA, in its submission to the Inquiry, argues that “A disclosure document prepared in accordance with the comprehensive requirements of the Franchising Code of Conduct provides sufficient information to assist a prospective franchisee to make an informed decision in relation to the franchise.”

Effectiveness of disclosure

A number of submissions to the Inquiry have questioned the effectiveness of the current disclosure requirements. According to Assistant Professor of Law at Bond University, Elizabeth Spencer, in her submission to the Inquiry, disclosure has been described as a ‘blunt and unfocused instrument’ which has the capacity to generate problems if it: “provides inaccurate or incomplete information; fails to identify actual, existing concerns; promotes unjustified fears; produces a false sense of security; perpetuates misinformation; and/or promotes under or over-reaction.”

Despite its wide use, Assistant Professor Spencer argues that “There are limitations on the efficacy of disclosure with respect to the reliability, accessibility and useability of the disclosed information.” Specifically, she raises two salient points: is the current level of disclosure relevant, and how is compliance with the disclosure requirements ensured?

Concerns regarding relevance

In his submission to the Inquiry, Associate Professor Frank Zumbo from the Australian School of Business, University of NSW, claims that “A strategic targeting of information is critical, and not simply scattered through the process of disclosure. The more you disclose, the less they may read. So, the disclosure has to be relevant, it has to be meaningful, and it has to be clear and succinct.” Simply providing more information upfront may not be the panacea.

Ongoing concerns about the efficacy of disclosure led to the review of the Code’s disclosure provisions by the Matthews Committee in 2006. The Commonwealth Government supported 31 of the 34 Committee recommendations, and these have subsequently become law (effective since 1 March 2008).²⁹ These changes to the Code have increased “the transparency, quality and timeliness of disclosure to existing and prospective franchisees.”³⁰

A number of submissions to the Inquiry have been critical of the restrictive nature of the Matthews Committee review, arguing that the limited terms of reference missed an opportunity to comprehensively review the parts of the Code dealing with dispute resolution and conditions of a franchise agreement.

²⁹ Trade Practices (Industry Codes – Franchising) Amendment Regulations 2007 (No.1)

³⁰ Explanatory Statement, Select Legislative Instrument 2007 No.240, Trade Practices (Industry Codes – Franchising) Amendment Regulations 2007 (No.1)

Informational regulation can be effective only if recipients have the ability to understand and use the information. Suggestions have been put to the Inquiry to make the information in the disclosure document more strategically valuable and relevant.

Improving disclosure: rights at the end of an agreement

The required disclosure does not presently clarify certain matters relevant to a prospective franchisee's business feasibility and due diligence, principally regarding what happens at the end of a franchise agreement and the rights and responsibilities of both parties at that time. Clause 17.1 of the Code requires franchisors to provide a *summary* of 'other relevant conditions', including rights at the end of an agreement, however, there is no obligation to provide specific information about what these conditions are or mean. Franchisors do not currently have to explicitly state what franchisees are entitled to at the end of the term of their franchise agreement, particularly in relation to their rights to renewal or goodwill and compensation.

The Inquiry believes that improved disclosure of the franchisees' rights at the end of the agreement would provide a fuller, more informed picture prior to entering a franchise arrangement and assist in undertaking due diligence. It is imperative that prospective franchisees know and understand what they will be entitled to, if anything, at the conclusion of their franchise term to enable them to assess their likely return on investment.

The FCA argues in its submission to the Inquiry that there is "no demonstrable need for further disclosure of the respective rights of the parties to a franchise agreement either in relation to renewal or extension of a franchise agreement, or generally", citing that any requirement for further disclosure would add an additional compliance burden on franchisors. The FCA instead suggests that the current disclosure regime may be improved by including "a specific warning on the front of the disclosure document" about the rights (or otherwise) of the franchisee at the end of the agreement. The FCA, however, "sees little likely benefit in such a warning particularly given that existing warnings as to obtaining advice, attending courses and generally conducting appropriate due diligence are often ignored by prospective franchisees."

The Inquiry believes that information disclosed upfront empowers the prospective franchisee to decide whether or not to act on it. The high costs associated with business failure, individually and across a franchise system, would outweigh any additional impost on the franchisor.

Improving disclosure: other concerns

Submissions to the Inquiry have raised a number of other concerns regarding deficiencies in disclosure. These relate specifically to the following:

- While franchisors are now required to disclose any rebates from any other business for the supply of goods or services to the franchisee, the recent changes to the Code fail to expressly require that the amount of rebates be disclosed.
- While franchisors are required to provide a summary of their obligations to franchisees, this does not state clearly what services, such as training and

marketing, the franchisor will actually provide or any indication as to their quality and quantity.

- While franchisors require franchisees to disclose their financial position, there is no requirement for the franchisor to disclose its financial position to franchisees, in particular ongoing financial viability.
- While franchisors are required to disclose their general business experience, there is no specific requirement for the franchisor to disclose its relevant franchising experience, qualifications and training.

The FCA submission commented on the recent changes to the Code that came into effect on 1 March 2008 and the fact that it has not yet been possible to assess their impact on franchising business practice. The Commonwealth Government should undertake to review the Code before 2010 in order to assess the impact of these changes.

Concerns regarding compliance

The other principal concern with disclosure relates to the monitoring and enforcement of compliance with the Code. The Inquiry believes that some of the issues raised in the submissions could have been overcome had there been an improved level of franchisor compliance with the disclosure provisions of the Code.

The Matthews Committee recommended that the ACCC introduce a system of registering franchisors and a process for reviewing disclosure documents to address this issue:

The Committee considers that franchisors should be required to register with the ACCC and annually provide the most current disclosure document and other minimum prescribed information (to be determined by the ACCC). The ACCC should be tasked with performing representative sample audits of disclosure documents each year and addressing any failures to comply with the disclosure provisions of the Code. .. The ACCC should also be tasked to perform an active enforcement role including vetting disclosure documents and addressing failure to comply with the Code.³¹

The Commonwealth Government did not support this recommendation at the time, claiming that apart from the compliance burden on franchisors and the ACCC, “Registration of the franchisors and their disclosure documents could be seen as providing credibility to their claims and ACCC endorsement.”³²

This Inquiry believes that the monitoring of franchise systems and disclosure documents is needed to improve overall transparency in franchising. The registration of disclosure documents could be, for example, as simple as the ACCC introducing an electronic system that is capable of requesting, via an automatically-generated email, all registered

³¹ Recommendation 23, “Review of the Disclosure Provisions of the Franchising Code of Conduct – Report to the Hon Fran Bailey MP Minister for Small Business and Tourism”, Franchising Code Review Committee, October 2006, pg.45-46

³² Australian Government Response to the Review of the Disclosure Provisions of the Franchising Code of Conduct, February 2007, pg.8

franchise systems to submit an electronic copy of their most up-to-date disclosure document annually. Making this a mandatory requirement under the Code circumvents the issue of credibility and ACCC endorsement, as it would be standard for all franchise systems.

The registration of franchisors and disclosure documents would provide an easily accessible reference for prospective franchisees and enable, if the database was publicly available, searches of and comparisons with other systems and disclosure documents to be undertaken. Such a system would also enable the ACCC to more effectively monitor many aspects of franchising practices in Australia, as well as provide further information on the industry for academic and policy research.

A strong case has been made to the Inquiry that the additional levels of protection provided to prospective franchisees by a franchise registration system would be more beneficial than any additional costs incurred. The Inquiry recognises that the introduction of such a registration system would impact on the ACCC, and therefore an appropriate level of resourcing for the regulator would be required.

3. End of Agreement Arrangements

Rights at the end of an agreement

A particular focus of this Inquiry has been on issues relating to end of contract and nonrenewal of the franchise agreement. Specifically, it has been put to the Inquiry that certain rights be enshrined in law regarding the franchisee's entitlement to have the agreement renewed or to receive compensation instead. A number of submissions to the Inquiry have also called for the explicit introduction of 'good faith' bargaining in the execution of franchise agreements and in mediation.

However, there are competing views relating to the parties' respective positions at the end of the franchise agreement. One view is that at the end of an agreement, where no options for renewal or further renewal exist under the contract, that there are no further rights to renewal or compensation, particularly in terms of the perceived goodwill of the franchisee. This view accords with principles of freedom of contract and sanctity of contract. In contrast, there is a belief that at the end of the agreement there should be an entitlement to either a right of renewal or compensation on the basis of the goodwill that has been built up during the term of the franchise agreement.

The rate of non-renewal of franchise agreements during the period 2003-05 was between 1.5% and 3.7% per year.³³ This does not include agreements terminated by the franchisor. The low rate of non-renewal suggests that the majority of franchise agreements are renewed on expiry.

³³ "Franchising Australia 2006 Survey", Griffith University, 2006, pg.62-63

Non-renewal of agreements

Franchise agreements operate for a set term. Many include provision for the renewal of the same term often under similar conditions. Prospective franchisees should base their business decisions only on the understanding that they can conduct their business for the term of the agreement. 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.

This situation may disadvantage franchisees in that they are vulnerable to shifts in the franchisor's commercial strategy. While decisions not to renew a franchise agreement are, for the most part, made for legitimate commercial reasons, some disquiet has been expressed to the Inquiry about franchisees' lack of legal options in such circumstances. Concerns about this practice have been referred to as 'franchisor opportunism'.

The Retail Traders' Association of Western Australia, in its submission to the Inquiry, described the issue of franchisor opportunism as follows:

Here, the franchisor by not renewing the franchise agreement, forces the franchisee out of business, purely and simply to set up its own business at the same location and thus profit exclusively from the goodwill built up by the former franchisee without having to pay anything for it. Even with this threat in hand, the franchisor can exploit the franchisee in the acquisition of the franchisee's business or assets at significantly below market value.

There has been no evidence presented to the Inquiry that such a practice is commonplace in Australia. It does, however, underline the problem of identifying when a hard commercial decision tips into the realm of unconscionable conduct.

The Matthews Committee review³⁴ also identified the potential risks to franchisees upon termination, expiry or non-renewal of a franchise contract (see Recommendation 3). The Matthews Committee recommended regulating this aspect of the franchising relationship by ensuring that the franchisee is given adequate warning of such issues that may arise at termination, expiry or non-renewal (see Recommendation 20).

The Commonwealth Government rejected these recommendations, indicating that it would instead ask the ACCC to refer to the risks to the franchisee on termination, expiry or non-renewal of the franchise agreement in its educational material.

Protecting end of agreement rights

Existing legislation and the common law currently deal with early termination of the franchise agreement.³⁵ However, the present franchising regime in Australia provides little protection for the interests of a franchisee at the expiry of a franchise agreement. This 'gap' exists because:

³⁴ Matthews Committee report, "Review of the Disclosure Provisions of the Franchising Code of Conduct", pgs. 33-34, 44

³⁵ Whereby the franchisee can sue for breach of the Code, or for breach of the implied contractual duty to act reasonably and in good faith, or for breach of the unconscionability provisions of the TPA.

- Pursuant to contract law, when the term of an agreement expires, there is no obligation to renew. While theoretically it is possible for the common law and equity to intervene, this rarely occurs.
- There is no legislation specifically addressing renewal issues at a Commonwealth, State or Territory level.
- The Code addresses termination but not renewal of franchise agreements.
- The restrained interpretation of the unfair business conduct provisions of the TPA,³⁶ particularly s51AC, makes it unlikely that a franchisor's refusal to renew a franchise would contravene the legislation.

Equity could in theory intervene to ease the rigidity of the common law through the equitable doctrine of unconscionable dealing. However, a franchisee, as a commercial party, is unlikely to demonstrate the requisite 'special' disadvantage required by the equitable doctrine. Given the interpretation of the implied duty of good faith in Australia to date, and ss51AA and AC of the TPA, it is unlikely a court will – except in the most extreme circumstances – interfere with legitimate, albeit harsh, commercial conduct.

The FCA contends that introducing rights of renewal to franchisees would interfere with the current commercial environment:

The parties to a franchise agreement should be left free to negotiate the commercial terms to bind them in their business relationship. It would be totally inappropriate, and distort many existing commercial arrangements, to provide franchisees with specific rights of renewal or other statutory entitlements at the end of a franchise agreement.

The FCA maintains that no additional requirements be set out under the Code to deal with end of agreement rights.

It has been put to the Inquiry that the TPA or the state's Fair Trading Act (FTA) could be amended to include a provision that makes a franchisor that fails or refuses to renew a franchise agreement upon expiry to be engaging in conduct that is unconscionable, unless specified exemptions applied. Advice from the Consumer Protection division of the Department of Consumer and Employment Protection ('Consumer Protection') is that such an amendment to the unconscionability provisions would be novel and would likely lead to significant difficulties in attempting to legislate exactly in what circumstances non-renewal would constitute unconscionable conduct. More particularly, unilateral action by the Western Australian Government would be contrary to both the current Council of Australian Governments (COAG) agenda and the draft report of the Productivity Commission's review of the Australian consumer policy framework, both of which are committed to removing jurisdictional differences in existing state fair trading legislation.

Unconscionability qualifies the relationship between parties based upon the parties' respective, 'individual' characteristics vis-à-vis one another. The focus of the doctrine

³⁶ And equivalent provisions in State and Territory Fair Trading Acts.

is upon contextual characteristics in a specific situation rather than upon set and defined criteria as a measure of fairness.

As noted in *Babcraft Pty Ltd v Goebel Pty Ltd*,³⁷ the equitable doctrine of unconscionability resembles an elephant in that it “is impossible of simple and exhaustive definition... [but] is nevertheless easily recognisable when presenting itself.” Conduct of one party is deemed unconscionable where it can be seen in accordance with the ordinary concepts of humanity to be so unfair and against conscience that a court would intervene.³⁸ A transaction will be set aside as being unconscionable wherever one party by reason of some condition or circumstance is placed at a special disadvantage vis-à-vis another and unfair or unconscientious advantage is then taken of the opportunity thereby created.³⁹ The special disadvantage may arise by reason of age, sex, need of assistance, language ability, illness, ignorance, inexperience, impaired faculties, or financial need. In this sense, the enacting of unconscionability provisions in the TPA and the FTA evinces a legislative intent to regulate this ‘characteristic’ based behaviour from a commercial standpoint.

Section 51AA of the TPA has also been interpreted along the limited lines of the equitable doctrine. An allegation of unconscionable conduct regarding the renewal of a retail lease was considered by the High Court in *ACCC v C.G. Berbatis (Holdings) Pty Ltd*.⁴⁰ The majority of the High Court held that the tenant was not under any special disadvantage, indeed, there was nothing ‘special’ about the predicament of a sitting tenant at the end of their lease, and that the landlord’s conduct in imposing a condition upon the grant of the new lease was not unconscionable. For example, Chief Justice Gleeson noted, “Unconscientious exploitation of another’s inability, or diminished ability, to conserve his or her own interests is not to be confused with taking advantage of a superior bargaining position...” These comments could be equally applicable to the predicament of a franchisee at expiry.

It would seem that the doctrine of unconscionability does not regulate the issue of nonrenewal of franchise agreements. Unconscionability does not aim to strike down transactions that are simply hard bargains or instances where one party was merely at a commercial disadvantage as against the other.

Any amendment to the FTA to deem certain transactions unconscionable as a method of regulating those transactions unnecessarily involves a two step process where only one is required. If the legislature considers that regulation of the expiry and renewal of franchise agreements is necessary, the preferred approach is to enact the regulating provisions as a distinct framework outlining the style of acceptable conduct. The appropriate vehicle for this type of regulatory framework in Australia is the Franchising Code of Conduct.

As franchising operates across state borders, there would be significant policy ramifications if the Western Australian Government enacted state-based non-renewal

³⁷ [2003] VCAT 1700 at [87]

³⁸ *Zoneff v Elcom Credit Union Ltd* (1990) 94 ALR 445

³⁹ *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447

⁴⁰ *ACCC v Berbatis* (2003) 214 CLR 51

legislation, particularly if those provisions were incorporated with unconscionable conduct provisions.

Options at the end of agreement

The use of unconscionability, 'good faith' or equivalent standard to regulate franchise renewal is unlikely to be effective where the franchisor's conduct simply involves the exercise of a legal right. The right to compensation upon non-renewal, however, may be worthy of further investigation. A franchisor's decision at expiry could remain unfettered but the franchisee would receive compensation for the resulting loss of its business and goodwill.

Entitlement to compensation for non-renewal has legal precedent internationally (as discussed in Chapter 5). While there is no consistency among the 50 states of the United States in relation to the regulation of the franchise relationship, for the most part a 'good cause' standard, or variation thereof, for non-renewal is imposed. Notice requirements, opportunity to cure and compensation appear in some but not all statutes. Some states offer compensation only; in such cases, the non-renewal can proceed without cause but compensation must be paid by the franchisor.

The Inquiry believes there is merit in further examining the US approach to end of agreement arrangements, including:

- Upfront disclosure of a franchisee's rights at the end of agreement;
- Upfront disclosure of a franchisee's entitlement, or otherwise, to goodwill or compensation;
- Pre-expiry reviews between the franchisor and franchisee, particularly in relation to variations between the existing and new agreement and what conditions need to be met for renewal; and
- Early notification of the franchisor's intention to not renew the franchise agreement.

While not advocating that franchisees should automatically be entitled to a renewal of the contract, or compensation in its place, the Inquiry believes that improved disclosure of the franchisee's rights at the end of the agreement would provide a more informed picture prior to entering a franchise arrangement. The upfront disclosure of all end of agreement conditions and entitlements would ensure that prospective franchisees are not misled or false expectations created. Franchisees would be afforded clarity and certainty, and the future behaviour of franchisors would be regulated. Entitlement to goodwill or compensation, where it is offered, could also act as a selling point for franchise systems.

Importantly, the uniform approach to franchising in Australia through the Code, underpinned by the TPA, should be maintained and any developments in relation to non-renewal should be through amendment to the Code.

4. Dispute Resolution

Mediation under the Code

The Code sets out a mandatory process of dispute resolution through mediation. Mediation is an informal negotiation where the independent and neutral mediator assists the parties to identify and explore options for settlement. A mediator does not hand down a decision like a judge, but helps the parties reach their own agreement.⁴¹

The Commonwealth Government established the Office of the Mediation Adviser (OMA) in 1998 when the Code was introduced. The role of the OMA is to appoint mediators (within 14 days of a written request) to assist franchisors and franchisees to resolve their disputes without going to court. The OMA maintains a specialist panel of mediators across Australia but does not provide legal advice.⁴²

If either party requests mediation, it is mandatory under the Code for both parties to attend the mediation and to try to resolve the dispute. It is a breach of the Code (and thereby the TPA) to refuse to attend the mediation or to refuse to make a genuine attempt to resolve the dispute.

Outcomes of mediation

The purpose of mediation is to produce agreement between the parties in dispute. The mediator assists the parties to document this and once finalised, the written record usually becomes a binding contract. This is where the role of the OMA ends. There is no mechanism under the Code for mediated agreements to be enforced and no follow-up to ensure that both parties adhere to the mediated outcomes. This is a flaw in the Code's prescribed dispute resolution system.

The OMA informed the Inquiry that it has received 3005 enquiries about franchising disputes since 1998. Of these, a mediator was appointed in 933 matters, though some matters were resolved prior to mediation. Over the past decade, the settlement success rate has varied, averaging 75-76% for each reporting period. The OMA noted that of those matters that do not settle at mediation, many are resolved in the few weeks after mediation.

While three quarters of all disputes that go before the OMA result in a settlement that both parties are prepared to embrace, the level of satisfaction with the agreed outcomes varies considerably.

Problems with mediation

Though claiming to offer both parties a chance to equally attempt to resolve their disputes, mediation nonetheless generally reinforces the power imbalance between the parties. It was put to the Inquiry by an ex-franchisee that:

⁴¹ Office of the Mediation Adviser, www.mediationadviser.com.au

⁴² *ibid*

Whilst mediation is often reported to be a more cost effective and arguably more successful means of alternative dispute resolution, it can only be as effective as the respective parties allow it to be. For many franchisees it is the only possible means of being heard given the cost of lawyers and litigation. .. In practice, mediation only provides the franchisor with another opportunity to assert their dominance, but under a shield of confidentiality.

As an example, it is within the power of one party to baulk at attending mediation, in an attempt to stall the dispute resolution process and outlast the other party. This scenario typically favours the stronger party and is exacerbated by the lack of prescribed penalties under the Code for contravening its provisions. Without fear of penalty, there is less of a deterrent for parties to a franchising dispute to refuse to attend mediation or to attempt to positively resolve the matter, however minor it may be.

According to the website of the OMA,⁴³ if one party does not want to attend mediation, then the other party would most likely have to commence court action. However, this is generally acknowledged as not being a viable option for many due to the costs and time involved in pursuing such matters through the courts. Additionally, the OMA acknowledges that mediation is not suitable in cases requiring urgent injunctive relief (i.e. a court order to stop someone from doing something) or where there is criminal conduct.

As an alternative to following private action, the OMA recommends that the party in dispute contact the ACCC to request an investigation into the matter and take action. However, the low number of ACCC-led court actions may be indicative of a general reluctance by the regulator to pursue cases on behalf of a franchising party (which is generally franchisees). In order to be able to effectively monitor and enforce the Code, the regulator has to be adequately resourced and the laws have to be sufficiently clear and established for contraventions to be successfully prosecuted.

Without effective mediation or ACCC intervention, there is often no option left for the disaffected party – apart from mounting expensive and time-consuming private litigation – other than to acquiesce and either just live with the problem or if the situation is particularly bleak, count its losses and exit the franchise system.

Earlier intervention

An earlier system of intervention to bring both parties together in a timely fashion to resolve the matter before the dispute escalates into court action is a preferred alternative. Such a system should have the power to enforce any agreed outcome to ensure that the dispute is accordingly resolved in the interests of both parties.

Various alternative dispute resolution processes have been suggested to the Inquiry. These include the introduction of peer counselling or a peer review panel, the establishment of a national tribunal system or low-cost arbitration system, and the appointment of a national franchising Ombudsman or Commissioner (with similar powers as appropriate, for example, to the newly appointed national Fuel

⁴³ Office of the Mediation Adviser, www.mediationadviser.com.au

Commissioner). Another option could be for the Commonwealth Government to appoint, where relevant, a state-based arbitration system to address franchising disputes.

Given the size of the franchising sector, the Inquiry believes that the establishment of a separate franchising arbitration system is justified. At a minimum, this system should offer free or low cost assistance, be able to respond to matters in a timely fashion, and have the power to make and enforce decisions. Associate Professor Frank Zumbo summed up in his submission to the Inquiry, “there needs to be low cost binding dispute resolution processes to build on the good work already being done by mediation.” This would provide a quicker and simpler mechanism for disputes to be resolved before they intensify, business relationships sour and livelihoods suffer.

Need for greater flexibility

The dispute resolution process must be flexible and be able to meet the needs of both parties. Presently,

If one party would like the mediation to be held in their city, then it is common for that party to pay half the travel costs of the other party to travel to that city. If such an agreement is not reached, the OMA will appoint a mediator located somewhere between where the parties reside and each party will pay their own travel costs to attend.⁴⁴

The Inquiry heard anecdotally that there have been instances where there is no guarantee that both parties would actually attend the mediation, particularly when they are located in different cities. The costs associated with travelling to another location impact disproportionately upon the less resourced party. Even then, it is never assured that both parties will attend the mediation. With the size and remoteness of Western Australia, and the fact that many national franchise systems are based on the East Coast, the cost of attending mediation can be significant, with no guaranteed resolution nor any guarantee that even if there is an agreed outcome that it will be adhered to.

The Inquiry believes that the Commonwealth Government should consider introducing more cost-effective and flexible options for mediation, or some alternate dispute resolution process, to take place. Such technological solutions as videoconferencing and webcasting should be made more widely available in cases where distances between parties are costly or timely agreement is needed.

5. Enforcement

Role of the ACCC

It is the role of the ACCC to regulate the conduct of franchising participants. The ACCC ensures compliance by informing franchisors and franchisees of their rights and obligations under the Code and enforcing it where necessary.

⁴⁴ Office of the Mediation Adviser, www.mediationadviser.com.au

The ACCC informed the Inquiry that its enforcement activities are as follows:

- From 1 June 2004 to 31 December 2007, 1757 enquiries and 1916 complaints relating to franchising were received.
- Since 1998, the ACCC has undertaken 175 in-depth investigations relating to franchising matters and:
 - 84 of these included allegations of breaches of the Code;
 - 158 of these included allegations of breaches of s51AC of the TPA (unconscionable conduct); and
 - 112 of these included allegations of breaches of s52 of the TPA (misleading and deceptive conduct).

Of the 175 investigations conducted since 1998:

- 108 were not pursued (i.e. a breach of the TPA could not be substantiated);
- 27 were referred to mediation or another agency;
- 2 were resolved by 87B undertakings;⁴⁵
- 11 progressed to litigation; and
- 12 are continuing.

Of the 11 matters that the ACCC has commenced litigation since 1998, six have settled, five were decided at first instance, and one went on appeal to the full Federal Court (who upheld their earlier decision).

Many of the complaints received by the ACCC regarding franchising⁴⁶ relate to:

- franchising agreements and other contractual arrangements that do not fall under the Code – these matters have to be resolved privately by the complainant or by use of the mediation procedure provided under the Code; or
- issues that are not related to the TPA – these matters are referred to the appropriate government or industry organisation.

Investigating breaches

Where there is a potential breach of the Code and/or the TPA, a three-stage process is instituted by the ACCC to investigate complaints.⁴⁷ This involves:

- An *initial assessment* which includes interviewing the complainant to verify general information. If the complaint is assessed as substantive, it is progressed to the next stage. In some instances, however, the matter may be best addressed through dispute resolution (i.e. mediation via the OMA).
- An *initial investigation* whereby an ACCC enforcement officer generally seeks further information and substantiation of the allegations from the complainant

⁴⁵ Section 87B of the TPA gives the ACCC power to accept written undertakings and enables these undertakings to be enforced by the Federal Court. In many settlements under s87B, the ACCC will require the company to undertake a program to improve its overall compliance with the TPA. Section 87B is an important compliance tool for when a breach or potential breach of the TPA that might otherwise justify court action is evident. The ACCC keeps a public register of these undertakings.

⁴⁶ Australian Competition and Consumer Commission, www.accc.gov.au

⁴⁷ Ibid

and the franchisor. This may involve interviews, obtaining and examining documents pertaining to the alleged conduct and careful application of the law to the known facts.

- Additional evidence is collected as part of the *in-depth investigation* and the matter is reviewed and analysed by senior enforcement staff. If reliable evidence can substantiate the allegations, the matter is generally referred to the ACCC's Enforcement Committee for consideration. With responsibility for deciding on the most appropriate course of action, the committee has regard to the impact that the action may have on the ongoing business relationship, the national market, the relief available to affected parties and the value of precedent. The committee may elect to pursue the matter through litigation or resolve it by an administrative settlement.

Further, priority is given by the ACCC to matters in which:

- there appears to be blatant disregard of the law;
- the conduct involves significant public detriment;
- successful enforcement will have a significant deterrent or educational effort;
- new and important issues are involved; or
- there is a detriment to disadvantaged individuals or groups.

Need for greater flexibility

While there is a need for alleged misconduct to be thoroughly investigated in serious cases, the three-stage process and priority allocation described above is too reactive and formalised to respond to more minor, yet still damaging, indiscretions. This view was shared in a number of submissions, as the following highlights:

Unfortunately the ACCC is not set up to investigate everyday complaints against a franchisor; they cannot assist a franchisee if a franchisor ignores the Code. The ACCC can only investigate a franchisor after the fact, and only after evidence has been provided of a breach. By then it is too late for many former franchisees, who have been left devastated both financially and emotionally.

The situation was made worse by the time it takes to get investigations underway and the months needed by the ACCC to go through their own processes. This point was reiterated by the franchisor of a national brand, which stated in its submission that "the current process whereby the ACCC investigates franchisee complaints many months or years after the event, does not provide a satisfactory outcome to either franchisees or franchisors."

In circumstances where there are less complex breaches of the Code and/or TPA involved, a less formalised intermediary approach may be more desirable. The intermediary should at the very least have the power to advise franchising participants of their rights and bring parties together in an attempt to resolve the issue within a short space of time. This would be particularly useful in situations involving capricious and vexatious notices of dispute and termination, bullying and intimidating behaviour, breaches of privacy, etc.

Many jurisdictions apply such an intermediary approach to consumer protection. For example, Consumer Protection provides a conciliation process to assist consumers to get a fair result when they have a dispute with a trader. This can be activated if the consumer has attempted to resolve the dispute without success.

Resourcing for monitoring and enforcement

Numerous franchisees and ex-franchisees expressed their disillusionment and disappointment to the Inquiry about the lack of investigation of their complaints by the ACCC. They alleged that the apparent inadequate enforcement, together with the protracted investigation process, is unlikely to discourage attempts to engage in unconscionable conduct. This was enunciated in the submission from the Franchise Advisory Centre, which stated:

We are supportive of the ACCC in its work to administer the Code, but are critical of its lack of resources to apply to franchising, and the length of time required for it to adequately respond to complaints or conclude investigations. .. We believe existing remedies are adequate, but not delivered in a sufficiently timely manner to satisfy disaffected franchisees.

The point was reiterated in several submissions to the Inquiry that the ACCC is not properly equipped to deal with the magnitude of policing the Code. This apparent lack of monitoring and enforcement of franchising behaviour by the ACCC is especially concerning considering the significant contribution that franchising makes to the national economy and the increasing growth of the sector in recent years.

The Matthews Committee also recommended that the Commonwealth Government “appraise the ACCC of concerns expressed to the Committee about the level and extent of action by the ACCC in dealing with claims of breaches of the Code by franchisors.”⁴⁸ The Commonwealth Government agreed with the recommendation, noting that the ACCC had worked cooperatively with the Matthews Committee and had been briefed on the concerns raised. However, no further specific commitment to additional funding or resourcing of the ACCC for monitoring and enforcement of the Code was made.

The evidence presented to this Inquiry reinforces the need for the resourcing of the regulator to be reviewed in light of what is required to effectively monitor and enforce franchising behaviour.

Improving enforcement activities

The Inquiry believes that enforcement activities need to be improved in order to deal with those in the sector who disregard the Code before their conduct threatens the operation of the franchising business environment in such a way that the reputation of franchising as a sound business model is damaged. A number of suggestions to improve Code enforcement were put to the Inquiry. These included the setting up of a dedicated and focused franchising unit within the ACCC, the appointment of a

⁴⁸ Recommendation 24, Matthews Committee report, “Review of the Disclosure Provisions of the Franchising Code of Conduct”, pg. 46

Franchising Ombudsman or Advocate, and the establishment of an independent Franchising Authority to administer the Code and franchise agreements.

Transparency and enforcement would be improved if a system of registering franchise systems and disclosure documents were introduced. This would enable the regulator to respond more quickly to emerging issues and ongoing concerns about franchising conduct. The Matthews Committee made a similar recommendation.⁴⁹

There is merit in licensing franchisors, which is now a requirement in some countries. Franchisors should be made to demonstrate that they have a viable, profitable and equitable franchise system before it can be offered for public sale. It was put to the Inquiry that in other sectors, such as the stock market and real estate, agents are required to be licensed to sell their products. The licensing of Directors, Officers and persons concerned with the management of franchise systems has the potential to render individuals liable for misrepresentation, along the lines of the regulatory regime covering public disclosure for a newly listed company. The well established regulatory system in the Australian Securities and Investment Commission (ASIC) could be adopted to the franchising sector.

While the Code contains a plethora of provisions, no penalties are explicitly stipulated. The Inquiry believes that compliance with Code requirements would be further improved if strong penalties, including penal terms for criminal offences, were prescribed under the Code and committed to by the regulator.

Loss recovery

A compelling case was put to the Inquiry to consider some form of class compensation for multiple disputes in a franchise system. The inability of franchisees to recover losses from breaches of the TPA in a timely and cost-effective manner is a deficiency with the current arrangements. While the ACCC has successfully prosecuted breaches of the TPA, franchisees affected by the conduct often find it difficult to recover their losses.

The ACCC gives priority to pursuing matters where there appears to be blatant disregard of the law and there is a detriment to disadvantaged individuals or groups. In cases where the ACCC is successful, the Inquiry is seeking that an effective way be found to enable the benefits of court decisions which affect a particular group of franchisees to be accessed without each individual franchisee being required to commence separate legal action.

One suggestion put to the Inquiry was the concept of introducing a ‘class compensation order’.⁵⁰ The Inquiry recognises that the introduction of such an order would have significant ramifications on commercial arrangements and is a substantial shift in the current judicial system that could produce unintended outcomes. Nevertheless, the

⁴⁹ Recommendation 23, Matthews Committee report, “Review of the Disclosure Provisions of the Franchising Code of Conduct”, pgs. 45-46

⁵⁰ A class compensation order would involve giving the Courts the power to, following a finding that there had been a breach of the TPA, order the franchisor to compensate all affected franchisees who notify a court appointed assessor of their loss or other claim within a specified period of time.

Inquiry believes there is merit in introducing a more streamlined approach to accessing compensation and recovery of costs where a court decision impacts on a group of franchisees. The Commonwealth Government should therefore work closely with the judicial system and franchising sector to investigate the introduction of streamlined access to compensation and cost recovery for franchisees.

Chapter 5 Review of Existing Practice in Other Jurisdictions

The Inquiry was tasked with reviewing existing practice in other jurisdictions, Australia and internationally, on unconscionable conduct and renewal of licences. This was undertaken to examine whether legal precedents in existence elsewhere could address issues to do with unconscionable conduct and end of agreement arrangements in franchising in Australia. The pivotal issue is the adequacy, or otherwise, of the legal avenues available to franchisees that are desirous of renewing their franchise agreements upon expiry.

The Inquiry contends that the current Australian legal regime applicable to franchise renewal is vulnerable to unfair business practices. The research examined common law and, where applicable, statute addressing unconscionable conduct and franchise renewal in:

- Australia;
- The United States;
- Common law nations – the United Kingdom, New Zealand and Canada;
- The European Union; and
- Asia.

Where relevant, reference was also made to international conventions.

Part A: Unconscionable Conduct and 'Fair Dealing' Principles

UNITED STATES OF AMERICA

Common law

(i) Fiduciary duty

A fiduciary duty is imposed on relationships where there is a legal responsibility to act wisely on behalf of another. In the United States of America (US), it is generally accepted that it is inappropriate to classify franchises as fiduciary relationships because of the commercial nature of the relationship.

(ii) Unconscionable Conduct

In the US context, unconscionability has been described as an absence of a meaningful choice on the part of one of the parties to a contract combined with contract terms that are unreasonably favourable to the other.⁵¹ A mere inequality of bargaining power will not suffice.⁵² Duress, incapacity, fraud, misrepresentation, bad faith, oppression, unfair

⁵¹ Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.C. Cir. 1965).

⁵² Witmer v. Exxon Corp., 434 A.2d 1222 (Pa. 1981).

surprise and undue influence have been held to be indicators of unconscionability.⁵³ Nevertheless, the assessment is highly case specific.

As in Australia, the unconscionability doctrine is ill-suited to deal with fairness issues in the ongoing franchise relationship. Generally, the commercial nature of the franchise will tell against a finding of unconscionable conduct in a franchising context.

(iii) Good faith and fair dealing

In the US, there is a general obligation to act in good faith in the performance and enforcement of contracts. Academic viewpoints in the US differ as to the meaning of good faith at common law. The views range from whatever is not bad faith to acting within a contemplated range of motives or acting reasonably or honestly in the performance of a contract.

Courts in the US have consistently held that the implied covenant of good faith and fair dealing that exists in commercial contracts also applies to franchise agreements.

Statute

Several provisions of the Uniform Commercial Code (UCC) are relevant to the conduct of the parties in a franchise relationship, and it is relevant to consider the codifications of the doctrine of unconscionability and the duty of good faith into the UCC. The operation of either or both doctrines may preclude the franchisor from engaging in conduct which is otherwise authorised by the terms of the franchise agreement or an established practice of the franchisor.

However, the UCC's applicability will depend on whether the dominant feature of the business is the sale of goods or the provision of services; as the UCC applies to the sale of goods, it will be applicable to product distribution franchises but not service franchises.

(i) Unconscionable conduct under the UCC

Article 2.302(1) of the UCC provides that a court may refuse to enforce an unconscionable contract or clause if the court finds it to have been unconscionable at the time it was made. Unconscionability in this context is not defined⁵⁴ but Official Comment 1 notes:

‘the basic test [of unconscionability] is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract.’ The Comment also confirms that the ‘principle is one of the prevention of oppression and unfair surprise [citation omitted] and not of disturbance of allocation of risks because of superior bargaining power.’

⁵³ Shell Oil Co. v. Hennessy, 639 F. Supp. 626 (D. Mass. 1986).

⁵⁴ The Franchise and Dealership Termination Handbook, op cit 39

(ii) General unconscionability legislation

Some states have general unconscionability laws which could be applicable to franchises. For example, Texas, which does not have franchise 'relationship' laws, has introduced the *Deceptive Trade Practices Act*⁵⁵ where, it seems, a terminated franchisee can claim the franchisor took advantage of the franchisee's powerlessness to prevent termination.⁵⁶ 'Relationship' laws are those dealing with an ongoing relationship between parties.

(iii) Good Faith

UCC 1-304 states: "Every contract or duty in [the Uniform Commercial Code] imposes honesty in fact and the observance of reasonable commercial standards of fair dealing."

'Honesty in fact' requires actions to be without malice, deceit or ulterior motive.⁵⁷ It has been noted that the elements of the provision contain both a subjective and objective element; subjective good faith and objective fair dealing and commercial reasonableness.⁵⁸ It should be stressed the provisions apply only to performance and enforcement. Notions of good faith are therefore not an issue, at least so far as the statute is concerned, with the negotiation process.

Further, some states have codified a duty of good faith or fairness in their franchise statutes.⁵⁹ For example, the Iowa Code specifically provides that the covenant of good faith is part of every franchise relationship. According to the FCA, major adverse economic impacts have been experienced in states such as Iowa that have sought to introduce relationship laws in franchising.

(iv) Automobile and petroleum industries

At the federal level, franchise relationship legislation has been introduced which affects the automobile and petroleum industries. The Federal Trade Commission (FTC) has provided guidance through an FTC Rule but this statute deals primarily with disclosure and does not affect the parties' substantive relationship. While the franchise specific Rule does not refer to principles of good faith and/or fair dealing,⁶⁰ s5 of the FTC Act prohibits unfair acts and practices in trade and commerce.

In summary, an allegation of unconscionability in the US is rarely successful in a commercial context. The implied covenant of good faith and fair dealing is widely

⁵⁵ Tex Bus & Com Code Ann 17.41 – 17.63 (Vernon 1987 & Supp 1991).

⁵⁶ The issue will be whether a franchisee can come within the definition of consumer. The matter has not been finally determined.

⁵⁷ R Brownsword, N Hird, G Howells (eds) *Good faith in Contract: Concept and Context* (1999) 122

⁵⁸ Mark A. Senn, *The Covenant of Good Faith and Fair Dealing; Tenant's Implied Covenant of Continuous Operation*, SK010 ALI-ABA 723, 726, 747 (2005) citing [Carma Developers \(Cal.\) Inc. v. Marathon Dev. Cal., Inc., 2 Cal. 4th 342, 372 \(1992\)](#)), Frank J.Cavico, *The Covenant of good faith and fair dealing in the franchise business relationship*, 2006 6 Barry L. Rev. 61,66

⁵⁹ IOWA 523H.10 , S.D. Codified Laws § 37-5A-51, Wash. Rev. Code § 19.100.180, Ark. Code § 4-72-406, Conn. Gen. Stat. § 42-1331, and N.M. Stat. Ann. § 60-8A-8. This list does not include industry specific statutes such as liquor, motor vehicles and petroleum statutes.

⁶⁰ J.Cavico, *The Covenant of good faith and fair dealing in the franchise business relationship*, 2006 6 Barry L. Rev. 61,68

utilised through the common law and statute but rarely interferes with the legitimate exercise of commercial activity.

EUROPEAN UNION

Rather than unconscionable conduct, good faith is the pivotal 'fair dealing' standard in civil jurisdictions and the central principle in the context of European contract law. It is a long standing civil law principle and governs the performance and enforcement of contracts. However, each jurisdiction has its own views on the good faith standard and therefore an identical scenario in one jurisdiction may have a different result in another.

In relation to specific franchise legislation, the most important aspect of European Union (EU) law is Article 81 of the Treaty of Rome; an anti-trust provision. Although the Article prohibits several practices commonly found in franchising, a number of exemptions have been made available. To date, the EU has not developed principles governing disclosure or relationships regarding franchises but a few have addressed termination and/or renewal.

Additionally, Article 1.106 of the Principles of European Contract Law states that in exercising his rights and performing his duties, each party must act in accordance with good faith and fair dealing. Parties are forbidden from excluding or limiting this duty.

INTERNATIONAL LAW

The Convention on Contracts for the International Sale of Goods

The United Nations Convention on Contracts for the International Sale of Goods (the Vienna Sales Convention) Article 7(1) states:

In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

Unidroit

The Unidroit⁶¹ Principles of International Commercial Contracts 2004 also refer to good faith. The principles are not legally binding but are highly persuasive and state that good faith and fair dealing are to be construed in the light of the special conditions of international trade.

Good faith means honesty and fairness in mind which are subjective concepts. A person should, for instance, not be entitled to exercise a remedy if doing so is of no benefit to him and his only purpose is to harm the other party.

⁶¹ International Institute for the Unification of Private Law (Unidroit)

COMMON LAW JURISDICTIONS

UNITED KINGDOM

To date, the United Kingdom (UK) has not introduced any franchising legislation. Franchise agreements are regulated by the common law. As is the case in Australia and the US, the commercial nature of the franchise relationship in the UK will not see the parties regarded as fiduciaries nor will the equitable doctrine of unconscionable dealing be of assistance.

There has been a significant amount of judicial reluctance in the UK to recognise the implied duty of good faith in the performance and enforcement of contracts. Further, good faith in the negotiation process has been rejected by the House of Lords.⁶²

Through the UK's entry into the EU, the legal system has become exposed to principles incorporated through the adoption of EU laws. The most striking example of this is the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCR), which enacts into UK law the EU Directive on Unfair Terms in Consumer Contracts.

Unfairness is a new concept in UK contract law, as is good faith. The UTCCR legislation does not have any impact on franchising because the legislation is limited to consumer transactions. The legislation, however, has required UK courts to come to terms with good faith, at least in this context, and it is anticipated this will lead to a more receptive attitude to the implied duty.

NEW ZEALAND

New Zealand has not introduced franchise specific legislation. To date, franchising is regulated by a Code of Practice which forms part of the rules of the Franchise Association of New Zealand (FANZ). However, due to a number of recent high profile cases involving franchise systems in that country, the government has indicated that it will consider introducing legislation to regulate the sector. FANZ supports such legislation⁶³ and has proposed several recommendations, including:

- A requirement to register franchisors, sub-franchisees and advisors to the sector;
- Compulsory disclosure in accordance with FANZ's member disclosure requirements; and
- Compulsory mediation ahead of litigation, similar to the Australian model.

The common law and equitable regime discussed in relation to Australia and the UK is relevant to a discussion concerning franchise law in New Zealand.

⁶² *Walford v. Miles* [1992] 2 AC 128

⁶³ Franchise Association of New Zealand website, www.franchiseassociation.co.nz

CANADA

Common law

As is the case in the jurisdictions discussed above, except in very rare circumstances, a franchise does not establish a fiduciary duty and the equitable doctrine of unconscionable dealing does not shed light in the context of franchising under common law in Canada.

Similar to the situation in Australia, the concept of an implied duty of good faith is gaining recognition and has been considered in a number of commercial transactions, including in relation to franchises.

As in Australian and English law, there is resistance to the possibility of an implied covenant overriding the provisions of the contract.⁶⁴ However, in some circumstances, recognition of the inequality of bargaining power between the franchisor and franchisee has indicated a willingness to look behind the strict terms of the contract.⁶⁵ In such cases, the courts have been willing to find ‘special circumstances’, such as when one party is acting in bad faith, that will warrant a departure from the strict words of the contract. It has been suggested that this “will be an important consideration when applying contractual interpretation to the interpretation of a claim in an action.”⁶⁶

Statute

Four Canadian provinces – Ontario, Alberta, Prince Edward Island and New Brunswick – have adopted legislation imposing a duty of good faith and/or fair dealing on the parties to a franchise agreement. Even where the standard is just fair dealing, it seems good faith is still relevant. For example, in s3(3) of the Ontario legislation, the duty of fair dealing is said to include the duty to act in good faith in accordance with reasonable commercial standards.

Part B: Practices Relating to Renewal of Franchise Agreements

AUSTRALIA

In Australia, no Commonwealth, State and Territory legislation currently addresses franchise renewals. The Franchising Code of Conduct does not deal with the circumstances involved with the extension of franchise agreements. Once the term of the agreement has expired, there is no obligation on the franchisor to enter into a further franchise agreement.

At common law, in the absence of a contractual right to renew, a franchisor is not obliged to grant the franchisee a further term. Therefore, a franchisor has the choice of several options:

- to grant a new term to the present franchisee;

⁶⁴ *Pembroke Foodliner Ltd v Loeb, Inc.*, [1991] O.J. No 2340 (Ont. S.C.J.)

⁶⁵ Peter Snell and Larry Weinberg (Eds), *Fundamentals of Franchising* – Canada American Bar Association 281

⁶⁶ *Ibid* 281

- to close the particular outlet;
- to enter into a franchise agreement with a new franchisee; or
- to operate the premises as a company-owned enterprise.

In this way, the franchisor retains flexibility over the brand's corporate direction.

Franchisees can be considered to be at the same disadvantage upon expiry of their agreements where there is no right of renewal as that of sitting tenants (lessees). As can be seen from an examination of basic contract law and the decision in the *Berbatis* case⁶⁷, the landlord's refusal to renew, or agreement to renew on unpalatable terms, does not give rise to a 'special' disadvantage for the purpose of the equitable doctrine of unconscionable dealing and, as a result, s51AA of the *Trade Practices Act 1974* (TPA). As this view seems likely to permeate the law in relation to s51AC, similar issues facing a franchisee would most likely be assessed in the same way.

Petroleum Industry

'Unfair' practices within the petroleum industry led to the Government introducing the *Petroleum Retail Marketing Sites Act 1980* and the *Petroleum Retail Marketing Franchise Act 1980*. These Acts provided a comprehensive regime regulating the renewal of franchise agreements within the ambit of the legislation.

The Commonwealth Government repealed these Acts in 2006 and replaced them with the *Trade Practices (Industry Codes – Oilcode) Regulations 2006* (Oilcode). The purpose of the Oilcode, which is a mandatory code of conduct under s51AE of the TPA, is to regulate the conduct of suppliers, distributors and retailers in the petroleum marketing industry. The Oilcode improves transparency in wholesale pricing and access to declared petroleum products and assists industry participants to make informed decisions when entering, renewing or transferring a fuel re-selling agreement through the disclosure of specific information.

The Oilcode regulates options to renew a fuel re-selling agreement entered into before or after the commencement date of the Oilcode. An exception to this requirement is when the supplier has decided that the retail site associated with the re-selling agreement is to be disposed of, leased or otherwise used for a purpose other than the retail sale of motor fuel. When a fuel reselling agreement is renewed, the Oilcode requires that the supplier must provide the appropriate disclosure document to the retailer and any changes to the terms and conditions of the agreement must be reasonable and in good faith. Where a supplier and retailer cannot agree on the terms and conditions of the renewal of an agreement, or the supplier fails or refuses to renew an agreement, dispute resolution may take place.

⁶⁷ Per the Full Federal Court (2001) 185 ALR 555 at 571, "A distinction can be drawn between parties who adopt an opportunistic approach to strike a hard bargain and parties who act unconscionably. It cannot be said that the Roberts' wills were so overborne that they did not act independently and voluntarily. Unfortunately for the Roberts, the owners were under no obligation to renew or extend their lease. The Roberts had the choice of either maintaining their legal claims against the owners and losing the opportunity to sell their business or abandoning their claims and gaining the opportunity to sell their business. They made that choice of abandoning their claims. That may have been a hard bargain, but it was not an unconscionable one." In the High Court decision, Chief Justice Gleeson noted at [15] "The critical disadvantage from which the lessees suffered was that they had no legal entitlement to a renewal or extension of their lease; and they depended upon the lessors' willingness to grant such an extension or renewal for their capacity to sell the goodwill of their business for a substantial price."

UNITED STATES OF AMERICA

Federal

At a federal level, the only regulation of termination and renewal in franchises in the US is found in the motor and petroleum industries.

The *Automobile Dealers Day in Court Act* (ADDCA) requires automobile manufacturers to act in good faith towards automobile dealers in performing and complying with obligations under the franchise agreement and in terminating, cancelling or not renewing franchises. On the face of the statute, it would seem to provide considerable assistance to disenfranchised dealers. However, the definition of good faith has been given a restrictive meaning that is limited to circumstances of coercion and intimidation.

The primary object of the *Petroleum Marketing Practices Act* (PMPA) is to protect petroleum dealerships and service station franchisees from arbitrary or discriminatory termination or nonrenewal of their franchises. Consequently, the legislation prohibits petroleum distributors from terminating or choosing not to renew a dealer without good cause and prior written notice.

However, like the ADDCA, the PMPA provides limited protection in practice. The definition of good cause provides a comprehensive list of circumstances which can justify a franchisor's decision not to renew a franchise. Therefore, it is often not difficult for a franchisor to justify non-renewal of a franchise on the basis of good cause.

States

Renewal of franchise agreements is considered in the so-called 'relationship' statutes which deal with the ongoing liaison of the parties; issues such as franchisee associations, termination and renewal.

In the absence of federal intervention, various states proceeded to legislate to address the inequalities evident in many franchise contracts. Such contracts were often short-term and did not contain rights of renewal. Where there was an opportunity for renewal, there were instances where the renewal process was deliberately frustrated by the franchisor, enabling the franchisor to gain the benefit of the business the franchisee had fostered.⁶⁸

The resulting state franchise relationship laws are of two kinds; those which are industry specific and those which have a general application to all franchises, save those already specifically covered, in that jurisdiction. Only those with general application are discussed below.

The lack of a generally applicable federal franchise relationship law has resulted in a haphazard regulatory framework, with each state determining its own regulatory and compensation regime. While there have been several attempts to introduce uniform franchise relationship legislation in the US, this has not been achieved to date.

⁶⁸ Fundamentals of Franchising (2 ed) op cit 173

Laws regarding renewal

Specific provisions addressing non-renewal have been introduced in 17 states, the District of Columbia, Puerto Rico and the Virgin Islands.

It is important to note that the existence of a general relationship statute does not compel a franchisor to renew. Indeed, some states specifically provide that the statute will not require renewal or extension of a franchise after it concludes according to its terms. In other states, statutes operate in perpetuity and renewal can only be prevented in limited circumstances.

Renewal requirements

Renewal requirements can include prior notice, good cause and repurchase or compensation obligations. Often the requirements include a combination of two or more of these elements.

(i) Notice

Virtually all of the states with relationship laws require the franchisor to provide a period of notice informing the franchisee of the intention not to renew. The notice prior to non-renewal allows the franchisee sufficient time to order affairs, fill existing orders, settle accounts, minimise losses and generally make plans for future business activity.

Depending on the statute, the notice may range from 30 to 180 days. The requirements of the notice vary, for example, whether the notice must be in writing and/or whether the rationale for the non-renewal must be provided.

The consequences of failure to comply with the notice provisions also vary. For example, if a franchisor violates the 180-day notice requirement in California, the remedy is limited to repurchase of the franchisee's inventory.⁶⁹ By contrast, in New Jersey, a franchisee refused renewal without good cause may be awarded the actual or reasonable value of its franchise.⁷⁰

In some cases, there is also an opportunity to "cure" alleged deficiencies. Cure periods usually do not exceed 30 days.

(ii) Good cause

Good cause, or a variant, is the pivotal consideration in most of the state franchise relationship statutes.⁷¹ A good cause requirement overrides any contractual provision or oral agreement to the contrary.

⁶⁹ Sea Ray Boats, 825 F.2d at 1285

⁷⁰ Westfield Center Serv Inc v Cities Serv Oil Co 432A 2d48(NJ 1981)

⁷¹ Good cause requirements for termination need to be distinguished from good cause for non-renewal. Although nonrenewal is often treated in the same way as termination, in many states the requirements are different. For example, several states require good cause in relation to a termination, and define the term in this context, but good cause is not required in relation to non-renewal.

Most of the 17 states require “good cause” before the franchisor may not renew the franchise relationship. However, there is no uniform definition of good cause and its subjective nature makes its definition particularly difficult.⁷² In some states, the term is not defined at all.⁷³ In circumstances where there is a definition relating to non-renewal, good cause usually, but not always,⁷⁴ refers to the franchisees failure to comply with a material requirement of the franchise agreement.

When considering whether there was good cause for non-renewal, the states variously take into consideration:

- the legitimate business interests of franchisors;
- the existence of an ulterior motive that may taint a franchisor’s decision not to renew (however, in other states motive is irrelevant);
- whether a franchisee was stocking a competitor’s product;
- whether the site is to be converted to a company owned operation (for example, California and Minnesota expressly prohibit this); and
- a franchisor’s decision to withdraw from a market.

(iii) Compensation

Some relationship termination laws, including those in Connecticut, Hawaii, Michigan and Wisconsin, require the franchisor to compensate the franchisee even if the refusal to renew was based on good cause.

In Connecticut, the franchisor must pay the franchisee fair and reasonable compensation for its inventory, supplies, equipment, and furnishings.⁷⁵ In Hawaii, if the franchisor refuses to renew a franchise, in order to convert the business to one that is franchisor owned and operated, it must compensate the franchisee for loss of goodwill.⁷⁶

Michigan requires compensation for the franchisee's inventory, supplies, equipment, fixtures, and furnishings, but only if the term of the franchise is less than five years and the franchisee is bound by a non-competition agreement, or the franchisee does not receive at least six months’ advance notice of the franchisor’s intent not to renew the franchise.⁷⁷ Wisconsin grants the franchisee the option to have the franchisor repurchase all inventory sold by the franchisor to the franchisee.⁷⁸

Other states require repurchase payments only if termination is without good cause. Arkansas law requires, upon termination and failure to renew without good cause, the

⁷² Philip F. Zeidman *Franchising and other methods of distribution: Regulatory pattern and judicial trends*, January-February 2007 46th Annual Advanced Antitrust Seminar: Distribution & Marketing, Practising Law Institute Corporate Law and Practice Course Handbook Series 624

⁷³ Ibid

⁷⁴ For example, in Iowa, good cause will be said to exist provided that the refusal of the franchisor to renew is not arbitrary or capricious. Pursuant to this statute, good cause means cause based on a legitimate business reason.

⁷⁵ Conn Gen Stat 042-133f(c)

⁷⁶ Haw Rev Stat 482E-6(3)

⁷⁷ Mich Comp laws. Note that the Michigan Franchise Investment Law does not legislatively establish the same “good cause” rights for franchisees seeking renewal of their franchises, as for franchisees in danger of termination.

⁷⁸ Wis Stat 135.045

franchisor repurchase, at the franchisee's net cost, the franchisee's inventory, supplies, equipment and furnishings purchased from the franchisor.⁷⁹

Californian law provides that on termination or non-renewal without good cause a franchisor must offer to repurchase a franchisee's resalable inventory, at the lower of its wholesale market value or the price paid by the franchisee with an offset for sums owed to the franchisor.⁸⁰

Illinois, Michigan and Washington are states where franchisors are liable to compensate franchisees for non-renewal *per se* or for not providing the required notice.

Illinois requires a franchisor to provide the franchisee with 180 days' notice of its intent not to renew the franchise; if the franchisor fails to do so, it must either waive the non-competition agreement or compensate the franchisee by repurchase or other means for the decreased value of the franchise.⁸¹

Washington does not require prior notice of a franchisor's intent not to renew; instead it requires that the franchisee be compensated for inventory, supplies, equipment and furnishings purchased from the franchisor, at fair market value, and in some cases for goodwill (goodwill is only compensable if the franchisee has been given one year's notice and the franchisor agrees not to enforce any non-compete covenant).⁸²

EUROPEAN UNION

The EU has not adopted franchise relationship laws. Franchises are regulated by the domestic law of member states. While many EU states have introduced franchise disclosure laws, very few have introduced laws which address relationship, including non-renewal. Of these jurisdictions, the approach has primarily revolved around the implied duty of good faith.

In Austria, Germany and Switzerland, compensation must be paid to franchisees upon termination and non-renewal under certain conditions.

COMMON LAW JURISDICTIONS

Neither England nor New Zealand has introduced franchise relationship laws.

CANADA

In Canada, perpetual and/or indefinite franchise terms are extremely uncommon. The average initial term is for a period of between 5-10 years.⁸³ It is common practice for the franchise agreement to provide the opportunity for the franchisee to renew for at least one term but, in the absence of such a contractual right, there is no obligation on the franchisor to renew.

⁷⁹ Ark Stat Ann 4-72-209

⁸⁰ Cal Bus and Prof Code 20-035

⁸¹ 815ILCS705/20 (Ill Rev stat ch 85-551 20)

⁸² Wash Rev Code 19.100 180(2)(1)

⁸³ Fundamentals of Franchising – Canada 100

Unlike many jurisdictions in the US, Canada has not adopted franchise relationship laws which regulate renewal. The opportunity to renew will be dictated by the terms of the franchise agreement. However, it has been suggested that the implied duty of good faith and/or fair dealing may assist a franchisee who lacks an option to renew. However, such a duty will not impose an obligation to renew where there is no such contractual right.⁸⁴

ASIA

While many Asian countries have introduced franchise disclosure legislation, very few address the relationship aspects of the franchise relationship. Malaysia is an exception; there is essentially a unilateral right for a compliant franchisee to renew.

In Vietnam, some relationship elements are considered, including limitations on the situations where a franchisor can deny approval of an assignment (transfer property rights) by a franchisee.

⁸⁴ Ibid 102

Chapter 6 Recommendations

The Inquiry has heard from a wide range of stakeholders about the current state of franchising in Australia. Many specific concerns regarding the alleged behaviour and conduct of franchise participants were raised.

The Inquiry believes that amendments to the current franchising regulatory framework in Australia are required. Given the importance of the franchising business model to the national economy, and the fact that franchise systems operate across state borders, the Inquiry does not recommend that changes be made to franchising regulation on an individual state basis.

There is a need for the Western Australian Government to take a strong leadership role by calling on the Commonwealth Government to effect change through national regulation and specific changes to the Franchising Code of Conduct to address the concerns raised by this Inquiry. With the principles of freedom of contract and sanctity of contract in mind, the Inquiry recognises that there is only so far that governments can go in order to protect the interests and rights of parties to a contract.

The Inquiry therefore makes the following recommendations to improve franchise education, disclosure and due diligence, end of agreement arrangements, dispute resolution, and enforcement. If adopted, the franchising business environment will be one where participants are better informed, are more likely to be successful in their enterprises, enjoy greater equity and, should the need arise, have more timely and efficient access to justice.

1. Franchise Education

The importance of pre-entry education for franchisees cannot be underestimated. Presently, many prospective franchisees do not know what education is available nor do they understand how important this is in order to inform themselves about their rights and responsibilities under a franchise agreement. This is particularly critical in undertaking relevant due diligence when considering the risks involved in entering into a franchise arrangement.

The following recommendations seek to address issues relating to lack of awareness and reach of franchise education, as well as the desirability of franchise participants being kept informed on an ongoing basis of relevant developments in the franchising sector.

Recommendation 1.1:

The Commonwealth Government work with State and Territory Governments and the franchising sector to develop a coordinated approach to delivering targeted pre-entry education to prospective franchisees. This education should provide relevant advice on:

- **the franchise relationship;**
- **the Franchising Code of Conduct;**
- **the known business and franchising risks that franchisees should be investigating before entering into a franchise agreement;**

- the basics of contract law as it relates to franchising; and
- the franchisee's rights and responsibilities under a franchise agreement.

Recommendation 1.2:

The Commonwealth Government provide funding to State and Territory Governments to cooperatively develop an effective marketing strategy to facilitate the promotion of the information and advisory services available to both franchisees and franchisors.

Recommendation 1.3:

The Commonwealth Government regularly inform the sector about current issues, trends and key areas of concern in relation to franchising via a periodical publication. A component of this publication should provide information that is specifically focussed on educating and informing new and existing franchisees.

2. Disclosure and Due Diligence

Franchising regulation in Australia is premised on the disclosure of relevant information by franchisors to prospective and renewing franchisees. The Franchising Code of Conduct prescribes what information is required and in what format. Currently, the Code does not require franchisors to specifically disclose what franchisees' entitlements and responsibilities are at the end of an agreement. A number of other concerns regarding the current disclosure provisions have also been identified which were not addressed by the most recent changes to the Code. Compliance with the disclosure requirements also needs to be improved.

The following recommendations seek to improve the disclosure of relevant information, particularly in regards to rights at the end of an agreement, and compliance with the Code in order to improve overall transparency in the franchising sector.

Recommendation 2.1:

The Commonwealth Government amend the Franchising Code of Conduct to make it mandatory for franchisors to include, as part of its disclosure document, a clear statement that highlights the rights and responsibilities of, and risks to, the franchisee.

Recommendation 2.2:

The Commonwealth Government, through the Australian Competition and Consumer Commission, develop a standard checklist of known potential risks for prospective franchisees to investigate. The checklist is to be attached to all disclosure documents.

Recommendation 2.3:

The Commonwealth Government immediately amend the Franchising Code of Conduct to specifically require franchisors to disclose:

- the amount of rebates received from any other business for the supply of goods or services to franchisees;

- what services they will provide to franchisees in explicit terms;
- their financial position to franchisees; and
- their relevant franchising experience, qualifications and training.

Recommendation 2.4:

The Commonwealth Government review the Franchising Code of Conduct by 2010 in order to evaluate the effectiveness of changes to the disclosure provisions and any other amendments.

Recommendation 2.5:

The Commonwealth Government amend the Franchising Code of Conduct to require all franchisors to register their franchise system with the Australian Competition and Consumer Commission.

Recommendation 2.6:

The Commonwealth Government amend the Franchising Code of Conduct to require all franchise systems to lodge a copy of its current disclosure document annually with the Australian Competition and Consumer Commission.

Recommendation 2.7:

The Commonwealth Government, through the Australian Competition and Consumer Commission, undertake a regular review of a random sample of disclosure documents to monitor compliance with the Franchising Code of Conduct and publish the results of their findings annually.

3. End of Agreement Arrangements

A particular focus of this Inquiry has been on issues relating to non-renewal of the franchise agreement and expiry of the contract. The existing regulatory framework for franchising in Australia does not specifically address end of agreement arrangements. In the interests of making an informed business decision and undertaking appropriate due diligence, prospective and renewing franchisees should have a clear understanding of what their entitlements and responsibilities are, or are not, at contract expiry prior to entering into a franchise agreement.

The following recommendations seek to improve end of agreement disclosure and transparency in contract negotiations in order to provide franchisees with greater clarity and certainty in relation to their rights and responsibilities.

Recommendation 3.1:

The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to explicitly specify, in the disclosure document, what end of agreement arrangements are in place under the franchise agreement.

Recommendation 3.2:

The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to explicitly specify, in the disclosure document, what the position is in relation to the franchisee's entitlement or lack of

entitlement to goodwill or other compensation if the agreement is not renewed.

Recommendation 3.3:

The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to conduct a pre-expiry review with the franchisee at least one year prior to the expiry of the franchise agreement. The purpose of the review is to inform the franchisee of any variations between the existing and new agreement and any conditions that need to be met in order for agreement renewal.

Recommendation 3.4:

The Commonwealth Government amend the Franchising Code of Conduct to require franchisors to specify, in the disclosure document, a reasonable period of notification in which to inform the franchisee of their intention not to renew the agreement.

4. Dispute Resolution

The Franchising Code of Conduct prescribes a mandatory process of dispute resolution through mediation. Problems associated with mediation include the difficulty in getting parties to attend and resolve their disputes in a timely fashion and the lack of enforcement of mediated outcomes. An earlier and more flexible system of intervention is required.

The following recommendations seek to improve the current mediation process in order to provide a better system to resolve disputes in the franchising sector.

Recommendation 4.1:

The Commonwealth Government, through the Australian Competition and Consumer Commission, review the current mediation processes mandated under the Franchising Code of Conduct with a view to implementing an earlier, more cost-effective and accessible dispute resolution system.

Recommendation 4.2:

The Commonwealth Government amend the Franchising Code of Conduct in relation to mediation to:

- require parties in dispute to attend mediation compulsorily;
- make mediated agreements enforceable to ensure both parties adhere to the agreed resolutions; and
- include prescribed penalties for refusing to attend mediation or refusing to make a genuine attempt to resolve the dispute.

5. Enforcement

The conduct of franchising participants is regulated by the Australian Competition and Consumer Commission. It is the role of the ACCC to monitor and enforce compliance with the Franchising Code of Conduct and the *Trade Practices Act 1974*. The ACCC currently has a formalised process to investigate breaches of the

Code and allegations of misconduct. In many cases, the ACCC has not been able to respond adequately to franchisee complaints in a timely manner.

The following recommendations seek to improve the monitoring of compliance with the Code by franchising participants in order to better enforce conduct and behaviour in the franchising sector.

Recommendation 5.1:

The Commonwealth Government review its current level of funding to the Australian Competition and Consumer Commission in order to ensure adequate resourcing for the monitoring, enforcement and education of franchising participants under the Franchising Code of Conduct.

Recommendation 5.2:

The Commonwealth Government establish a dedicated franchising enforcement unit within the Australian Competition and Consumer Commission to proactively monitor and enforce compliance with the Franchising Code of Conduct and the *Trade Practices Act 1974*.

Recommendation 5.3

The Commonwealth Government amend the *Trade Practices Act 1974* to prescribe penalties for breaches of the Franchising Code of Conduct.

Recommendation 5.4

The Commonwealth Government work with the judicial system and the franchising sector to introduce a more streamlined approach to accessing compensation and recovery of costs where a particular court decision impacts on a group of franchisees.

List of Appendices

1. Background Paper
2. Advertising
3. List of Submissions
 - Written
 - Oral
4. Stakeholder Consultations
5. Case Law in relation to Franchising Disputes

Appendix 1: Background Paper

Inquiry into the Operation of Franchise Businesses in Western Australia

I invite you to make a submission to the Inquiry into the Operation of Franchise Businesses in Western Australia. The purpose of the Inquiry is to enhance the franchising business environment and it will examine issues to do with fairness in franchising operations.

The background paper, which is available on the Small Business Development Corporation website at www.sbdc.wa.gov.au/inquiry, outlines: the terms of reference for the Inquiry, guidelines for submissions, and details on how to register interest in order to be informed of the details of the public hearings.

The background paper contains information about the franchising business relationship, the regulatory framework, legal remedies in case of dispute, key issues and discussion points. As its title suggests, the paper is intended to assist by way of background and is not intended to limit or direct the content of submissions.

I welcome and look forward to your submission.

Chris Bothams

Chairperson, Inquiry into the Operation of Franchise Businesses in Western Australia

18 December 2007

BACKGROUND PAPER ON THE INQUIRY INTO THE OPERATION OF FRANCHISE BUSINESSES IN WESTERN AUSTRALIA

BACKGROUND

The State Government has called an Inquiry into the Operation of Franchise Businesses in Western Australia to examine fairness in franchise arrangements.

Over the past decade, there have been significant improvements in the manner in which franchising is conducted in Australia. However, the Western Australian Government has recently been made aware of issues surrounding non-renewal of franchising contracts. As such, it is keen to ensure that the policy settings in place both at State and Federal levels are appropriate for the business requirements of the modern economy.

Given the recent Australian Government review of the disclosure provisions of the Franchising Code of Conduct (the "Code") carried out by Mr Graeme Matthews during 2006, which recommended several significant changes to the Code, the Western Australian Government does not intend to replicate the work of the Matthews Committee. Rather, this Inquiry is an opportunity for the State Government to speedily identify any other concerns in the franchising industry and ascertain whether there is a fair and competitive environment for franchised businesses to operate in.

The Inquiry has been referred to the Minister for Small Business, the Hon Margaret Quirk MLA.

INQUIRY TERMS OF REFERENCE

On 2 November 2007, Minister Quirk announced the terms of reference for the Inquiry, which are to:

- 1) Review the adequacy of existing legislative provisions, both State and Federal.
- 2) Identify whether emerging trends in the franchising industry disclose patterns of unconscionable conduct that may not be covered under existing laws.
- 3) Examine whether existing remedies available to franchisees are adequate and, where appropriate, recommend changes.
- 4) Review existing practice in other jurisdictions, Australia and internationally, on unconscionable conduct and renewal of licences.

The Inquiry is chaired by Mr Chris Bothams, Manager of the South East Metro Small Business Centre. Mr Bothams has been an accomplished and respected franchisee who has twice been awarded the Western Australian Franchisee of the Year, as well as the National Franchisee of the Year in 2002.

A report will be provided by Mr Bothams to the Small Business Minister by 31 March 2008.

SUBMISSION GUIDELINES

You are invited to make a written submission to this Inquiry. This Background Paper provides information about franchising in Australia and identifies a number of issues in relation to the franchising business environment.

The Background Paper is being distributed for the purposes of facilitating community and industry engagement about the operation of the franchising industry in Western Australia. By undertaking this consultation process, the Government hopes to receive comment from a wide range of sources.

The Small Business Development Corporation (SBDC) is providing secretariat services to the Inquiry. Information about public hearings and making submissions will be posted on the SBDC website at www.sbdc.wa.gov.au/inquiry. Persons wishing to register their interest in the Inquiry should contact Ms Lauren Stone at the SBDC on (08) 9220 0260.

Public Hearings

Public hearings will be conducted in early 2008. Those who register their interest in the Inquiry will be directly advised of the hearing dates and locations. Information about the hearings will also be posted on the SBDC website as it becomes available.

How to make a submission

The Inquiry welcomes submissions from the public on any of the issues raised, as well as any other relevant concerns.

Submissions should be made in writing and either mailed, faxed or e-mailed to the SBDC at the following:

Inquiry into the Operation of Franchise Businesses in Western Australia
Small Business Development Corporation

By mail:
GPO Box C111
PERTH WA 6001

E-mail: franchiseinquiry@sbdc.wa.gov.au

Contact details:
Phone: (08) 9220 0260
Fax: (08) 9325 3981
www.sbdc.wa.gov.au

The closing date for submissions is **5:00pm, 15 February 2008.**

Tips on making a submission:

- Respondents may comment on any matter considered relevant to the Inquiry.
- There is no set structure for submissions. They may range from a short letter outlining the respondent's views on a particular topic to a much more substantial document covering a range of issues. Where possible, evidence should be provided, such as data and documentation, in support of the views expressed.
- Please note that submissions will become public documents that can be viewed by others and may be quoted for the purposes of this Inquiry. If you do not want your submission to be made public or to be quoted, please advise the SBDC accordingly in a covering letter. Please be aware that under the *Freedom of Information Act 1992 (WA)*, the right of third parties to access the documents of most government agencies results in the SBDC being unable to guarantee the confidentiality of submissions.
- It is preferred that submissions made in electronic format be in a text document (.txt, .rtf), a Microsoft Word document (.doc) or similar text format, rather than Adobe Portable Document File (.pdf) format.

INTRODUCTION

Franchising in Australia⁸⁵

Franchising, one of the fastest growing sectors in the national economy, was worth \$128 billion in 2005.

It was estimated that there were 960 business format franchise systems operating in Australia in 2006, and of these, 93% are Australian-based franchise systems. In total, there are over 62,000 franchises in the country, which is three times as many per capita as the United States.

Franchising contributes 14% to Australia's Gross Domestic Product (GDP) and employs more than 420,000 people.

The franchise business relationship⁸⁶

Franchising is essentially a contractual relationship between two independent business proprietors – a franchisor and a franchisee – who work collaboratively for mutual benefit under a common brand and system. Under a typical franchise agreement, the franchisor sells the right (the franchise) to the use of the intellectual property, usually a trademark, tradename and/or business system, for a fixed period of time. At the end of the term, the business reverts to the franchisor.⁸⁷

Franchise owners pay an entry fee as well as recurring royalties and advertising fees to a franchisor in return for the right to use the trademark or business format as well as services provided by the franchisor (such as legal advice, advertising, training, etc).⁸⁸

In this Background Paper, the term franchising refers to all aspects of the relationship between franchisor and franchisee.

Contractual nature of the franchisor/franchisee relationship

The relationship between a franchisor and a franchisee is regulated by the contract between them. Importantly, the franchise contract is not a one-off bilateral contract; it is a “relational” contract involving a working, ongoing relationship with mutual obligations and cooperation to benefit both franchisor and franchisee.

Two theoretical contract principles are particularly relevant to the debate regarding the degree of regulation in the franchising agreement. These principles are:

1. **Freedom of contract** – the idea that individuals should be free to bargain among themselves the terms of their own contracts, without government interference. The practical result of this principle is that once a contract expires, a party such as a landlord or franchisor cannot be compelled to enter into a new contract.

⁸⁵ “Franchising Australia 2006 Survey”, Griffith University, 2006

⁸⁶ See generally: Latimer *Australian Business Law* 26th ed, para [9-985], CCH; also the website of the Franchise Council of Australia at www.franchise.org.au.

⁸⁷ Nathan, G “Profitable Partnerships” 2nd Edition, Nathan Corporate Psychology, Brisbane, 2000

⁸⁸ Grunhagen M. & Dorsch, M.J. “Does the franchisor provide value to franchisees? Past, current, and future value assessments of two franchisee types”, *Journal of Small Business Management*, vol.41(4), 2003, pgs.366-384

2. **Sanctity of contract** – parties are bound by the terms of the contract as framed, in the circumstances that existed at the time that the contract was entered, subject to any variations that were subsequently agreed by both parties. This principle assumes that contracts are complete in terms of addressing all possible future contingencies and specifying the performance required of the parties in each situation.

It is argued that the franchisor/franchisee relationship produces two significant imbalances between the parties that may require particular aspects of these theoretical principles to be addressed – an **information imbalance** and a **power imbalance**:

- The **information imbalance** flows from the franchisor’s monopoly of much of the information that would be useful or necessary to the prospective franchisee in making an informed decision to enter into the franchise agreement.
- The **power imbalance** follows from the fact that it is “inherent in most franchise relationships that the franchisor has a significant capacity to control the activities of the franchisee in great detail”.⁸⁹

The presence of these imbalances underpins the regulatory action in the franchising sector.

REGULATORY FRAMEWORK IN AUSTRALIA

Franchising regulation in Australia

Introduced to Australia in the early 1970s, business format franchising has been subjected to a series of inquiries and reviews. This has progressed in various stages from no regulation except under the general law (pre-1981), to quasi-regulation under the prescribed interest/investment security/managed investment provisions of the Corporations Law (1981-87), to deregulation (1987-93), to self-regulation pursuant to a voluntary Franchising Code of Practice (1993-96), to deregulation (1997-98), to the current mandatory Franchising Code of Conduct (1998-now).

Need for a Franchising Code of Conduct

In 1997, a review of fair trading in Australia was undertaken by the House of Representatives Committee on Industry, Science and Technology (the “Reid Committee”). The review identified a number of small business concerns with the franchising system, including:⁹⁰

- unfair contract terms arising from a refusal of big business to negotiate the terms and conditions of contracts;
- complexity of documentation;
- lack of pre-contract disclosure, resulting in an inability to make informed decisions about the viability of an enterprise;
- the inadequacy of advice and education for small business; and
- the prohibitive costs of, and the long delays involved in, legal action.

⁸⁹ Brown, *Franchising: Trap for the Trusting*, (1969), p.41.

⁹⁰ “Review of the Disclosure Provisions of the Franchising Code of Conduct – Report to the Hon Fran Bailey MP Minister for Small Business and Tourism”, Franchising Code Review Committee, October 2006, pg.19

The Reid Committee's report, "Finding a Balance", recommended the development of specific franchising legislation based on the provision of adequate disclosure documentation, the establishment of appropriate independent code administration bodies and dispute resolution procedures.

Franchising Code of Conduct

In September 1997, the Australian Government announced the introduction of the mandatory Franchising Code of Conduct (the Code)⁹¹, prescribed under the *Trade Practices Act 1974* (the "TPA").

The Code was enacted through the *Trade Practices (Industry Codes – Franchising) Regulations 1998* and came into operation on 1 July 1998. In addition, the Office of the Mediation Adviser (OMA) was established in 1998 to support the dispute resolution aspects of the Code.

The Code regulates the conduct of participants in the franchising industry towards other participants in franchising.⁹² The Code principally provides for the disclosure by the franchisor of materially relevant information to prospective or renewing franchisees. It also provides a framework for dispute resolution – through negotiation or mediation – that is relatively fast and inexpensive.

Part 1 of the Code sets out the name and purpose of the Code as well as its application. It also sets out all definitions, including the meaning of a "franchise agreement".

Part 2 of the Code requires franchisors to create and maintain a *disclosure document* in accordance with either Annexure 1 (long form) or Annexure 2 (short form).

The long form disclosure document (which is most commonly used by franchisors) includes the mandatory disclosure of 23 categories of information, including:

- information about the franchise site or territory;
- information about the supply of goods or services to and from a franchisee;
- information about marketing or cooperative funds to which the franchisee may be required to contribute;
- payments that will have to be made by the franchisee in relation to the franchise;
- current and past proceedings (including litigation and arbitration) against the franchisor and directors of the franchisor; and
- financial details of the franchisor.

The short form disclosure document, which only contains 11 categories of prescribed information that must be disclosed, can only be used if the expected annual turnover of the franchised business is less than \$50,000.

Annexure 1 (see Clause 17.1 of the Code) also requires franchisors to disclose a *summary* of other conditions of the franchise agreement, including matters dealing with:

⁹¹ Available at <http://scaleplus.law.gov.au/html/pastereg/2/1466/pdf/TradePracIndCodeFran1998.pdf>

⁹² Explanatory Statement, Select Legislative Instrument 2007 No. 240, "Trade Practices (Industry Codes – Franchising) Amendment Regulations 2007 (No.1)

- the term of the franchise agreement;
- variations to the franchise agreement;
- renewal or extension of the franchise agreement;
- conditions the franchisee must meet to renew or extend the franchise agreement;
- termination by the franchisor;
- termination by the franchisee;
- the franchisee's goodwill, if any, on termination or expiry;
- the franchisee's obligations when a franchise agreement is terminated, expires or is not renewed;
- the franchisor's rights to sell its business;
- transfer of a franchise;
- mediation; and
- the option or right of first refusal, if any, for the franchisor to buy the franchised business.

Together with a current copy of the Code, the appropriate disclosure document must be provided to prospective franchisees and to franchisees proposing to renew or extend an existing franchise agreement at least 14 days before the prospective franchisee enters into, renews or extends the relevant franchise agreement *or* makes a non-refundable payment to the franchisor or an associate of the franchisor in connection with the proposed franchise agreement.

Part 3 of the Code provides for a number of other measures to be followed, including the regulation of how and when termination of the franchise agreement is permitted. Under this part, if the franchisee breaches the franchise agreement and the franchisor intends to terminate it as a result, the franchisor must notify the franchisee and allow a reasonable time for the franchisee to remedy the breach.

Part 4 of the Code mandates various aspects of resolving disputes, including definitions, the appointment of a mediation adviser and procedures to be followed (including the inclusion of particular dispute resolution processes in franchise agreements). Generally, franchisees also have access to the remedies and sanctions available under the TPA for any disputes with their franchisor (see "Legal Remedies" section below).

While the requirement for the preparation of a current disclosure document adds to the compliance burden of franchisors, it is generally acknowledged that regulation in some form is both necessary and desirable.

Dispute handling and resolution

All franchise agreements entered into after 1 October 1998 must contain a dispute resolution clause that complies with *Part 4 – Resolving Disputes* of the Code.⁹³ This clause should provide something similar to the following:

⁹³ See OMA website at www.mediationadviser.com.au

1. If a dispute arises the complainant must tell the respondent in writing:
 - (a) the nature of the dispute; and
 - (b) what outcome the complainant wants; and
 - (c) what action the complainant thinks will settle the dispute.
2. The parties should then try to agree about how to resolve the dispute.
3. If the parties cannot agree about how to resolve the dispute, then either party can refer the matter to a mediator, or ask the OMA to appoint a mediator from its national panel of mediators.
4. Both parties must attend the mediation and try to resolve the dispute.
5. The parties share the cost of the mediation equally unless they agree otherwise.
6. The parties pay their own costs to attend the mediation unless they agree otherwise.

Under the Code, if neither party wants to go to mediation then it is not compulsory. This would most likely mean that court action would be started, however, this generally involves considerable cost.

The role of the OMA is to appoint mediators to assist franchisors and franchisees to resolve their problems without going to court. Mediation is usually much faster and cheaper than court action. Around 75% of mediations conducted through the OMA result in a binding settlement that both parties are prepared to live with.⁹⁴

Level and nature of disputes in franchising

It has been argued that the level of reported disputes in the franchising sector remains low.⁹⁵ In 2006, substantial disputes (i.e. those referred to an external advisor for action) were experienced by 35% of franchisors in the previous 12-month period, but most disputes were with only one or two franchisees.

The proportion of franchisees in disputes in Australia equates to less than 4% in total. The most common causes of disputes were related to system compliance, communication problems and misrepresentation claims. Fewer than 2% of franchised units ceased to operate, some of which may not be related to failure or dispute, supporting the notion that franchising failure rates are low.

However, the results of franchise business failure can be devastating, particularly as franchisees often borrow funds to get into franchising. The consequences of such business failure include bankruptcy, loss of savings and/or the family home, and marriage and relationship breakdowns.

⁹⁴ Ibid

⁹⁵ "Franchising Australia 2006 Survey", Griffith University, 2006, pg.56

Mediation is being used more than twice as often as litigation as a means of resolving disputes. It could be argued that the larger proportion of disputes being resolved through mediation, rather than litigation, supports the effectiveness of the Code.⁹⁶

Nevertheless, many disputes do not get settled by mediation or litigation, often because the franchisee runs out of money and ends up walking away from the disagreement.

Reviews of the Code

The Australian Government conducted a review of the Code between December 1999 and May 2000, which resulted in a number of amendments to improve the effectiveness of the disclosure provisions. These amendments were effected by the *Trade Practices (Industry Codes – Franchising) Amendment Regulations 2001*.

Following ongoing concerns about the effectiveness of the Code's disclosure provisions, the Commonwealth Minister for Small Business and Tourism announced a review of the current operation of *Part 2 – Disclosure* of the Code on 28 June 2006.

The review Committee (the “Matthews Committee”) advertised nationally, consulted with key stakeholders and received a total of 75 submissions. The Committee was also supported by expert legal advice and took into account overseas experiences.

The Matthews Committee report, submitted to the Australian Government in October 2006, made 34 recommendations for amendments to the Code. In its response of February 2007, the Australian Government supported 31 of these recommendations.

The Australian Government's amendments were contained in the *Trade Practices (Industry Codes – Franchising) Amendment Regulations 2007 (No. 1)* (the “Regulations”), which was passed by the Federal Executive Council on 9 August 2007.

The Regulations, which come into effect on 1 March 2008, amend the Code “to increase the transparency, quality and timeliness of disclosure to existing and prospective franchisees”.⁹⁷ Among the changes, the Regulations provide for:

- foreign franchisors to no longer be exempt from the Code, as it is considered that all franchise systems operating in Australia should be subject to the same rules afforded to those dealing with foreign franchisors; and
- the details and history of the territory or site to be franchised to be provided together with the disclosure document. Currently, it is not necessary to supply this information with the disclosure document, but rather is only required to be made available for viewing.⁹⁸

Additionally – and pertinent to this Inquiry – the Matthews Committee noted that “some of the problems identified by the submissions may have been avoided if the prospective

⁹⁶ Ibid

⁹⁷ Explanatory Statement, Select Legislative Instrument 2007 No. 240, “Trade Practices (Industry Codes – Franchising) Amendment Regulations 2007 (No.1)

⁹⁸ Ibid, Attachment A, “Overview of the Proposed Trade Practices (Industry Codes – Franchising) Amendment Regulations 2007”

franchisee had a clearer understanding of the significant risks that were involved in becoming a franchisee”.⁹⁹ Among the concerns expressed by franchisees and ex-franchisees were “the consequences to them on termination, expiry or non-renewal of the franchise agreement”.¹⁰⁰

The Matthews Committee made two recommendations in relation to the parties’ respective rights at termination, expiry or nonrenewal of a franchise contract, however, these were *not adopted* by the Australian Government. They were:

- *Recommendation 3* – amend the Code to include a requirement that the franchisor include a risk statement with the disclosure document and that the Australian Competition and Consumer Commission (ACCC) be tasked with developing a prescribed risk statement with disclosure requirements. It was proposed that the risk statement, to be completed by the franchisor, would identify known risks that could have a material impact on the franchisee, including franchisee rights and obligations on termination or expiration of the franchise agreement.
- *Recommendation 20* – the risk statement should, if significant, refer to the risks to the franchisee on termination, expiry or non-renewal of the franchise agreement.

These recommendations suggest that the Matthews Committee believed that upon termination, expiry or non-renewal of a franchise agreement, there are potential risks to franchisees that should be regulated by ensuring that the franchisee be given adequate warning of their rights.

State and Federal roles in regulating franchising

Notwithstanding that the regulatory focus has been upon prior disclosure in franchise relationships so as to improve the information balance between the parties, the parties’ contractual relationship is nonetheless legislatively regulated by the TPA and State and Territory Fair Trading Act equivalents.

*Trade Practices Act 1974 (Cth)*¹⁰¹

The TPA aims to promote competition, fair trading and consumer protection in Australia. The TPA prohibits corporations from *inter alia* engaging in restrictive trade practices, unconscionable conduct, misleading and deceptive conduct, and false and misleading representations. The Act is administered by the ACCC.

Sections 51AA and 51AC of the TPA prohibit unconscionable conduct in commercial dealings, whereby corporations must not, in trade or commerce, engage in conduct that is unconscionable. While it is not defined in the TPA, unconscionable conduct deals with harsh and oppressive conduct in business transactions and is generally referred to as conduct that is so unreasonable that it goes against good conscience.

More specifically, section 51AA is a broad prohibition against unconscionable conduct within the meaning of the unwritten law (i.e. under common law), while section 51AC sets

⁹⁹ “Review of the Disclosure Provisions of the Franchising Code of Conduct – Report to the Hon Fran Bailey MP Minister for Small Business and Tourism”, Franchising Code Review Committee, October 2006, pg.33

¹⁰⁰ Ibid, pg.44

¹⁰¹ See Australian Competition and Consumer Commission website at www.accc.gov.au

out a range of factors that the court can consider when determining if conduct is unconscionable when it occurs between businesses. This applies to dealings between businesses where the value of the transaction does not exceed \$3 million.

Section 52 of the TPA contains provisions on misleading and deceptive conduct whereby, generally, sellers are required to tell the truth and refrain from giving an untruthful impression. Damages will be available to a party who can prove loss resulting from the misleading or deceptive conduct of another in trade or commerce.

Section 53 of the TPA prohibits false or misleading representations to be made in commercial transactions.

Fair Trading Act 1987 (WA)

In Western Australia, the *Fair Trading Act 1987* (the “FTA”) essentially provides a commercial code of conduct for traders and is administered by the Department for Consumer and Employment Protection.

The FTA was enacted following agreement by the State and Commonwealth Ministers for Consumer Affairs in 1983 that there be uniform consumer protection legislation throughout Australia. It was determined that uniformity should be achieved by each jurisdiction enacting legislation modelled on the consumer protection provisions contained in the TPA.

No State or Territory Fair Trading Act has departed from the substance of the unconscionable conduct provisions contained in section 51AC of the TPA.

Similarly, no State or Territory has added to the regulation of the Franchising Code in any Fair Trading legislation.

LEGAL REMEDIES

There are several legal remedies available to franchisees in addition to the rights that exist under the Code. They include:

- the prohibition on unconscionable conduct in sections 51AA and 51AC of the TPA and in the equivalent State and Territory Fair Trading Acts;
- the prohibitions on misleading and deceptive conduct and on false and misleading representations in sections 52 and 53 of the TPA and in the equivalent State and Territory Fair Trading Acts;
- the common law relating to innocent, tortious and fraudulent misrepresentations;
- the doctrine of equitable estoppel (i.e. inducing an expectation); and
- the equitable doctrine of undue influence (i.e. taking advantage of a position of power over another person).

The notion of unconscionable conduct in particular is considered an uncertain concept and the cost associated with pursuing private civil action against a better resourced competitor is a powerful deterrent to a majority of franchisees.

To date, the ACCC has not taken litigation on behalf of small businesses in “one-off” cases unless the matter is taken as a test case to establish precedents for future private action.

KEY ISSUES

While franchise law concentrates regulatory action on the provision of relevant information to ensure that a prospective franchisee is adequately informed *before* they enter a franchise contract, one focus of this Inquiry is on issues relating to end of contract and non-renewal of the franchise agreement.

In this regard, competing views exist in the franchisor/franchisee relationship relating to the parties' respective positions at the end of franchise agreement. Franchisors generally take the view (in line with the principles of freedom of contract and sanctity of contract) that at the end of agreement and where no options for renewal or further renewal exist under the contract, that there are no further rights to renewal or compensation, particularly in terms of the perceived goodwill of the franchisee. In contrast, franchisees may view that at the end of agreement they should be entitled to either a right of renewal or compensation on the basis of the goodwill they have built up during the term of the contract (see next section for discussion of goodwill).

Survey data reveal that during the period 2003-05, the rate of non-renewal of franchise agreements was between 1.5% and 3.7% per year.¹⁰²

Goodwill

An important consideration in any contract negotiation (or renegotiation) is the issue of "goodwill".

While legally recognised as a form of property, courts have found goodwill difficult to define. In Anglo-Australian jurisprudence, goodwill is variously defined as:

- The attractive force that brings in custom and adds to the value of the business; it may be site, personality, service, price or habit.¹⁰³
- Goodwill is an intangible, saleable asset, separate and distinct from the stock, fixtures, fittings, and other tangible assets of the business; it arises from the reputation and relations formed with customers of the business and the nature of its location. Goodwill has no independent existence; it must be attached to a business. It is indivisible, though its value when realised may be shared in proportions.¹⁰⁴

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".¹⁰⁵

¹⁰² "Franchising Australia 2006 Survey", Griffith University, 2006, pg.62-63

¹⁰³ *Federal Cmr of Taxation v Murry* (1998) 193 CLR 605; 155 ALR 67

¹⁰⁴ *Geraghty v Minter* (1979) 142 CLR 177; 26 ALR 141

¹⁰⁵ Andrew Terry and P D Giugni, "Freedom of Contract, Business Format Franchising and the Problem of Goodwill", Australian Business Law Reform, Volume 23, August 1995, pg.245

Franchise Churn

Another franchise industry issue is that of franchise “churn”. Churning occurs when a franchisor repeatedly sells a franchise outlet in circumstances where it would reasonably understand that the outlet is unlikely to operate successfully regardless of the individual franchisee’s business skills.

Under certain circumstances, this type of behaviour risks contravening the misleading and deceptive (section 52) and unconscionable conduct (section 51AC) provisions of the TPA. This may occur through misleading by silence if the franchisor fails to advise the potential franchisees of existing issues with the business, and it may be unconscionable conduct if the franchisor fails to advise potential franchisees of the conditions that it knows will significantly affect the operation of the franchise outlet.

Good Faith Bargaining

The Code does not expressly provide for “good faith” in the execution of franchise agreements and in mediation. The Matthews Committee noted that while a number of overseas jurisdictions “have either a general concept of good faith in commercial contracts or a specific concept of good faith applying in franchise agreements, including in the context of pre-contractual negotiations and in mediation of disputes”, there was no uniform acceptance in the Australian jurisdictions “of a coherent, separate legal concept of good faith or fair dealing in contract law”.¹⁰⁶

According to the Matthews Committee¹⁰⁷, good faith embraces three notions:

- an obligation on the parties to cooperate in achieving their contractual objects;
- compliance with honest standards of conduct; and
- compliance with standards of conduct which are reasonable having regard to the interests of the parties.

In response to the Matthews Committee’s recommendation to include in the Code a statement obligating franchisors, franchisees and prospective franchisees to act fairly and in good faith towards each other, the Australian Government concluded that a separate provision was not necessary as section 51AC of the TPA includes “good faith” as a factor that a court or tribunal may take into account when determining unconscionable conduct.

Unconscionable versus Unfair Conduct

In 1997, the Reid Committee concluded in their report that section 51AA of the TPA (unconscionable conduct) be repealed and replaced with a new provision that proscribed “unfair” conduct in commercial transactions.

To assist in interpretation, the provision was to contain a non-exhaustive list of factors the court could have regard to for the purpose of determining whether a corporation

¹⁰⁶ “Review of the Disclosure Provisions of the Franchising Code of Conduct – Report to the Hon Fran Bailey MP Minister for Small Business and Tourism”, Franchising Code Review Committee, October 2006, pg.70

¹⁰⁷ Ibid, pg.46

has engaged in unfair conduct. The committee made a conscious decision to utilise the term 'unfair' rather than 'unconscionable'. The committee was of the view that retaining the term 'unconscionable' would not provide a sufficiently clear signal to the courts that a concept broader than the traditional equitable doctrine was intended. .. After considering several examples where a 'fairness' standard had been utilised, the committee formed the view that a 'fairness' standard regulating conduct in commercial transactions could be a workable option that would not undermine 'the institution of contract' by tipping the balance in favour of small business.¹⁰⁸

The Australian Government rejected this recommendation, instead adopting "an unconscionability standard rather than an unfairness standard when determining whether business conduct offended the TPA".¹⁰⁹

¹⁰⁸ "Almost a decade on – A (Reid) report card on retail leasing", Eileen Webb, Australian Property Law Journal, (2006) 13, pgs.282-283

¹⁰⁹ Ibid, pg.283

DISCUSSION POINTS

The Inquiry is particularly interested in hearing from those involved in or representing the franchising industry. The following discussion points have been provided to assist those interested in providing comment regarding some of the issues being considered by the Inquiry. These are designed to stimulate discussion, and please note that submissions do not have to address all of the following. Evidence in support of arguments would be appreciated.

1. Should a franchisee be given rights at the end of a franchise agreement, and what should these rights be?
2. In relation to renewing or extending a franchise agreement, is there a need for more upfront disclosure about the respective rights of both parties?
3. Is there a need to prescribe the respective parties' rights to goodwill at the end of the franchise agreement?
4. Is there a need to include a requirement for franchise agreements to be negotiated in good faith?
5. In relation to the franchisor/franchisee relationship, do the current unconscionable conduct provisions contained within the *Trade Practices Act 1974* provide adequate protections?
6. Is there a case for including the principles of goodwill and good faith in the *Fair Trading Act 1987* (WA)?
7. Is there a need to improve the regulatory and other avenues available for dispute resolution between franchisors and franchisees?
8. In your opinion, are there any requirements on either franchisors or franchisees – both legal and nonlegal – that exist in other countries that should be adopted to improve the Australian franchising industry?
9. The Inquiry is interested in “good practice” in franchising, particularly in relation to the respective rights of parties at the end of franchise agreement. Please detail good practices that address any of the issues identified in this paper.
10. Are there any other matters relating to the terms of reference of this Inquiry into the Operation of Franchise Businesses in Western Australia that you wish to raise that are not covered in this paper?

Appendix 2: Advertising

The following advertisement appeared in community newspapers the week commencing 7 January 2008 and in *The West Australian* on Wednesday, 9 January 2008, and Saturday, 12 January 2008.



FRANCHISING INQUIRY CALL FOR PUBLIC SUBMISSIONS

The State Government is inviting written submissions from the public to its Inquiry into the Operation of Franchise Businesses in Western Australia.

The inquiry is examining fairness in franchise arrangements, particularly end of franchise agreement issues.

A Background Paper and submission guidelines have been released and are available to download from www.sbdc.wa.gov.au/inquiry.

Submissions can be lodged by email to franchiseinquiry@sbdc.wa.gov.au or by mail c/o the Small Business Development Corporation, GPO Box C111, Perth 6001, or facsimile on (08) 9325 3981.

Written submissions close **15 February 2008**.

A number of public hearings will also be conducted in early 2008, with the first to be held in Perth on 4 February. Attendance is by prior registration only. Further information about the hearings will be posted on www.sbdc.wa.gov.au.

Further enquiries: email as above or (08) 9220 0260.

Appendix 3: List of Submissions

Written submissions were received from the following stakeholders:

Number	Organisation
1	Midas ex-franchisee
2	Les Stewart Consulting
3	Ms Elizabeth Spencer, Assistant Professor of Law, Faculty of Law, Bond University
4	Bakers Delight ex-franchisees
5	Chooks Fresh & Tasty
6	Bakers Delight ex-franchisee
7	Confidential
8	Burger King ex-franchisee
9	Franchise Council of Australia
10	Lenard's ex-franchisee
11	Bakers Delight ex-franchisees
12	Lenard's ex-franchisee
13	Jim's Pool Care franchisee
14	Midas ex-franchisee
15	Party Plus
16	Bakers Delight ex-franchisee
17	Confidential
18	Bakers Delight ex-franchisee
19	Lenard's franchisee
20	Retail Traders' Association of WA Inc
21	Supplier to franchisee
22	National Pizza Association
23	Confidential
24	Supplier to franchisee
25	Track Record Consulting
26	Supplier to franchisee
27	Competitive Foods Australia Pty Ltd
28	Godfrey's franchisee
29	Supplier to franchisee
30	Supplier to franchisee
31	Supplier to franchisee
32	Supplier to franchisee
33	Godfrey's franchisee

34	Confidential
35	Franchisee
36	Supplier to franchisee
37	Supplier to franchisee
38	Supplier to franchisee
39	Supplier to franchisee
40	Supplier to franchisee
41	Chamber of Commerce and Industry of Western Australia
42	Supplier to franchisee
43	Godfrey's franchisee
44	Franchisee
45	Godfrey's franchisee
45	Godfrey's franchisee
46	Confidential
47	Avis Australia
48	Australian Franchising Systems
49	Supplier to franchisee
50	Supplier to franchisee
51	Supplier to franchisee
52	Supplier to franchisee
53	Supplier to franchisee
54	Supplier to franchisee
55	Juice Station franchisee
56	Confidential
57	WA Retailers Association
58	VIP Home Services ex-franchisee
59	Cullen Babington Hughes Lawyers
60	Barrister and Solicitor
61	Supplier to franchisee
62	Supplier to franchisee
63	Supplier to franchisee
64	Supplier to franchisee
65	Supplier to franchisee
66	Supplier to franchisee
67	Supplier to franchisee
68	Supplier to franchisee
69	Supplier to franchisee
70	Employee of franchisee

71	Confidential
72	Ms Jenny Buchan, School of Business Law and Taxation, University of New South Wales
73	Ground Transport Services franchisee
74	Automasters ex-franchisee
75	Midas ex-franchisee
76	Bakers Delight Holdings Ltd
77	Confidential
78	Hertz Rent a Car ex-franchisee
79	Confidential
80	Lenard's ex-franchisee
81	Yum! Restaurants Australia Pty Ltd
82	Australian Competition and Consumer Commission
83	Mr Tony Simpson MLA, Member for Serpentine-Jarrahdale
84	Supplier to franchisee
85	Midas ex-franchisee
86	Supplier to franchisee
87	Franchise Advisory Centre
88	Burger King ex-franchisees
89	Confidential
90	Former industry association representative
91	International Franchise Association
92	Associate Professor Frank Zumbo, School of Business Law and Taxation, University of New South Wales
93	Franchisees Association of Australia Incorporated

Oral submissions were received from the stakeholders at the Public Hearings held in Perth on 4 February 2008 and Bunbury on 8 February 2008.

Number	Received from
1	Competitive Foods Australia Ltd
2	Lenard's ex-franchisee
3	Bakers Delight ex-franchisee
4	Lenard's ex-franchisee
5	Ground Transport franchisee
6	Bakers Delight
7	Retail Traders' Association of WA Inc
8	Hertz Rent a Car ex-franchisee

Appendix 4: Stakeholder Consultations

The Chair and Secretariat of the Inquiry consulted with the following stakeholders during the Inquiry process:

- Franchise Council of Australia;
- Australian Competition and Consumer Commission;
- Competitive Foods Australia Ltd;
- Member of the Economic and Finance Committee, Parliament of South Australia;
- Franchising Academic, Australian School of Business, University of NSW;
- Midas ex-franchisee;
- Automasters ex-franchisee;
- Ground Transport franchisee;
- Lenard's ex-franchisee; and
- Lenard's ex-franchisee.

Appendix 5: Case Law in relation to Franchising Disputes

Franchising and s51AC

Franchising disputes generally arise in two circumstances; firstly, where the franchise agreement is terminated because of the franchisee's failure to comply with the franchisor's 'system', and secondly where there has been a change of operating requirements or design.¹¹⁰ To date, Australian cases considering s51AC (unconscionable conduct in commercial dealings) of the *Trade Practices Act 1974* (TPA) have focused primarily on a franchisor's decision to terminate a franchise.

It is fair to say that the cases involve the termination of a franchise agreement after a protracted dispute between the franchisor and franchisee and generally, but not always, considerable financial losses. Varying amounts of acrimony are also sometimes evident.

Below is a brief examination of relevant cases to date outlining whether the conduct was regarded as unconscionable in the circumstances, and providing some comments made by the courts regarding the scope of s51AC. It is also interesting to note the interplay between the discussions of unconscionable conduct and good faith in relation to the termination of franchise agreements.

*Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd*¹¹¹

Garry Rogers Motors (Aust) Pty Ltd ('Garry Rogers') had been, for a considerable time, an authorised dealer on behalf of Subaru (Aust) Pty Ltd ('Subaru'). The Subaru franchise agreements were of three years duration; terminable on 32 days notice. In Garry Roger's case, the agreement was not renewed after the second term but the dealership continued on the same terms and conditions as before.

The relationship between the parties deteriorated after Subaru introduced a 'revitalisation' program which sought to enhance its dealer image. Garry Rogers refused to comply with the program and soon after the franchise was terminated on one year's notice. Faced with the prospect of termination, Garry Rogers agreed to comply with the program in all respects. Nevertheless, Subaru refused to withdraw the termination.

The franchisee contended that Subaru's conduct was unconscionable pursuant to s51AC because:

- There had been a failure to provide written reasons for termination; a requirement of the Franchising Code; and
- Subaru had refused to withdraw the termination notice following the franchisee's agreement to comply.

Justice Finkelstein concluded the conduct was not, in the circumstances, unconscionable. His Honour noted:

¹¹⁰G K Hadfield, *Problematic Relations: Franchising and the law of incomplete contracts* (1990) 42 *Stanford Law Review* 927 at 928 Hadfield, Dixon at 99-100

¹¹¹ [\(1999\) ATPR 41-703](#)

... whilst [Garry Rogers] was not obliged to adopt the Six-Star Program, that is, it was not contractually obliged to do so, its failure to adopt the program and its criticism of certain aspects of the program could reasonably be regarded by the first respondent [Subaru] as an indication that the applicant was not willing to act in the best interest of the first respondent and of the dealership group as a whole. No doubt this led to a loss of confidence in the applicant. That loss of confidence would not necessarily be overcome by a change in attitude on the part of the applicant. Many relationships can only operate satisfactorily if there is mutual confidence and trust. Once that confidence has broken down the position is not easily restored. It is not unconscionable to terminate a relationship where that trust and confidence has been undermined.

The case is also significant for its discussion of good faith in the context of s51AC (3) (k) of the TPA. The franchisee claimed that Subaru had contravened the implied duty of good faith in terminating the franchise agreement in the circumstances. Justice Finkelstein¹¹² stated that the duty requires a party to act in good faith and fairly, and imposes an obligation upon that party not to act capriciously.

However, the duty would not operate so as to restrict actions designed to promote the legitimate interests of that party. Therefore, where a party who was exercising a power, including a power to terminate, acted reasonably in all the circumstances, the duty will ordinarily be satisfied. On the facts, Subaru was entitled to treat Garry Roger's refusal to comply with the revitalisation program as being contrary to its own business interests and was not in breach of the implied duty of good faith.¹¹³

Australian Competition and Consumer Commission v Simply No-Knead (Franchising) Pty Ltd¹¹⁴

Simply No-Knead (Franchising) Pty Ltd ('SNK') operated a home bread-making franchise. Although by the time of the proceedings the business had been wound up, the Australian Competition and Consumer Commission ('ACCC') pursued the managing director. In summary, the circumstances involved a litany of undesirable business practices, including *inter alia* the franchisor's refusal to:

- provide disclosure documents;
- deliver essential supplies to franchisees because they (the franchisees) had refused to pay for unordered, and over-supplied, products;
- deliver up a diary containing customer lists;
- provide stock figures; and
- meet with the franchisees to try to resolve the issues in dispute.

¹¹² After recognising that such a duty was implied as a matter of law into franchising contracts, His Honour referred to *Renard Constructions (ME) Pty Ltd v Minister for Public Works* [1992] 26 NSWLR 234; *Hughes Aircraft Systems International v Airservices Australia* (1997) 146 ALR 1; *Alcatel Australia Ltd v Scarcella* [1998] 44 NSWLR 349.

¹¹³ There was also sufficient notice (13 months) in the circumstances. The case also saw a contention that Subaru owed duties of a fiduciary character to Garry Rogers. While not deciding, Finkelstein J noted that the content of any such duty would not, in these circumstances, be different to that imposed by an obligation to act in good faith. *Chan v Zacharia* [1984] HCA 36; (1984) 154 CLR 178, *Hospital Products Ltd v United States Surgical Corporation* [1984] HCA 64; (1984) 156 CLR 41 and *United Dominions Corporation Ltd v Brian Pty Ltd* [1985] HCA 49; (1985) 157 CLR 1

¹¹⁴ (2000) 104 FCR 253.

SNK was also found to have competed with its franchisees and on-sold franchises within designated territories. There was evidence of harassment and abuse of franchisees.

Justice Sundberg held that, overall, SNK's conduct disclosed "an overwhelming case of unreasonable, unfair, bullying and thuggish behaviour in relation to each franchisee that amounts to unconscionable conduct by [SNK] for the purposes of s51AC."

His Honour continued that certain of its conduct "intended to cause the franchisees to terminate or not renew their franchise agreements" was unconscionable within the meaning of s51AC.¹¹⁵

Auto Masters Australia Pty Ltd v Bruness Pty Ltd¹¹⁶

Auto Masters Australia Pty Ltd v Bruness Pty Ltd involved the purported termination of a franchise agreement because of the franchisee's alleged failure to comply with the franchisor's document management system. Auto Masters Australia Pty Ltd ('Auto Masters') was the franchisor of a number of auto repair franchises in Western Australia. Bruness Pty Ltd ('Bruness') was franchisee of the Midland Auto Masters outlet.

The Auto Masters franchise system required the use of a "tracking system"; purpose-built computer software that recorded and processed the movement of stock and work flow in each franchise. The system also enabled the franchisor to calculate the royalties payable by individual franchisees.

Almost from the outset, Bruness experienced considerable difficulties with the software. Attempts to rectify the problems were unsuccessful and the parties met on several occasions regarding the problems experienced by Bruness. Despite these difficulties, Auto Masters served several Notices of Default and Notices to Remedy Breach which claimed that Bruness had failed to comply with the Auto Masters operations manual for document management. The relationship between the parties had become considerably strained, particularly after Bruness made a complaint to the ACCC.

In March 1999, the franchisor purported to terminate the franchise. While Bruness resisted the Notice of Termination by seeking mediation and claiming that the franchisor had not provided a working system, Auto Masters commenced court proceedings seeking an order that the franchisee cease trading and vacate the premises.

Bruness denied it had breached the franchise agreement and claimed that the agreement had, in fact, been wrongfully and unlawfully terminated by the franchisor.¹¹⁷ It was contended that the termination exceeded the legitimate business interests of the franchisor and the actions were motivated by malice. The franchisee claimed that Auto Masters was in breach of cl15.1 of the agreement pursuant to which the franchisor undertook to use its best endeavours to promote the performance and success of the franchise and would deal with the franchisee in absolute good faith. Bruness also claimed that Auto Masters had engaged in unconscionable conduct pursuant to s51AC of the TPA and had contravened the Code.

¹¹⁵ The managing director was knowingly concerned in the conduct of the franchisor under s 75B(1)(c)

¹¹⁶ [2003] ATPR (Digest) 46-229.

¹¹⁷ The franchisee therefore sought a declaration that the franchise agreement had not been terminated, damages for breach of contract and damages pursuant to the TPA.

Auto Masters disputed the allegations regarding a lack of good faith claiming that Bruness had several opportunities to comply with the system and, in the circumstances, the franchisor was entitled to terminate the franchise agreement. Crucially, for the purposes of discussions above, the franchisor contended that it was not a breach of good faith or unconscionable conduct to terminate a commercial relationship where the trust and confidence of one party had been undermined by the conduct of the other.

Justice Hasluck held that there had been a breach of the good faith obligation and that the franchisor's conduct was unconscionable. In Justice Hasluck's view, the conduct of the franchisor was capricious, unreasonable, lacked good faith and had an element of oppression to it.¹¹⁸

ACCC v 4WD Systems Pty Ltd¹¹⁹

4WD Systems Pty Ltd ('4WD') operated a business selling and fitting four-wheel drive vehicle accessories. A related corporation oversaw the operation of the business's foray into franchising. The ACCC commenced proceedings against 4WD alleging, *inter alia*, unconscionable conduct and contravention of the Code. The allegations involved representations made with regard to the quality of products, their place of origin and the standard of the services, particularly delivery services, offered by the franchise.

The ACCC was successful in establishing breaches of s52, 53(eb) and the Code. However, the conduct was held not to be unconscionable pursuant to either s51AC or 51AA of the TPA.

Justice Selway considered the evidence and concluded that the conduct even, "in all the circumstances"¹²⁰ was not unconscionable. After noting that s51AC does not operate as a general 'catch all' provision, His Honour concluded that to establish a contravention of s51AC it was necessary was to show that the conduct was so unacceptable that it could properly have been described as unconscionable. This would necessitate more than merely misleading or deceptive behaviour and, ordinarily, it would entail some moral fault or responsibility occasioned by a deliberate, or at least reckless, act.

The Silver Fox Co Pty Ltd as Trustee for the Baker Family Trust (CAN 083 629 225) v Lenard's Pty Ltd¹²¹

The Silver Fox Co Pty Ltd as Trustee for the Baker Family Trust (CAN 083 629 225) v Lenard's Pty Ltd involved the unfortunate experiences of franchisees who entered into a franchise agreement for a business in a new shopping centre. The projections made by the landlord's representative regarding the desirability of the location, anticipated turnover and profit were questionable and the business suffered financial difficulties from the outset.

When the cash flow did not reach anticipated figures, the franchisees used an inheritance and their superannuation to try, to keep the business afloat. As well as the financial loss, the situation caused the franchisees considerable psychological stress and illness.

¹¹⁸ Ibid 53-702.

¹¹⁹ (2003) 200 ALR 491.

¹²⁰ The ACCC submitted that in order to determine its claim of unconscionable conduct, it was necessary for the Court to consider "all of the circumstances" and listed some 10 pages of "circumstances" for consideration.

¹²¹ (2004) ATPR 42-024

Although the turnover of the business started to increase, the franchisor terminated the franchise agreement because of unpaid franchise and royalty fees. The franchisees alleged, *inter alia*, that the franchisor's conduct in terminating the franchise was unconscionable because the franchisor was the cause of the problems relating to turnover, and of the franchisee's resulting difficulties but chose to terminate the agreement at a time when the turnover started to increase.¹²²

While the franchisees were successful in establishing contraventions of s52, and damages were awarded for financial loss and psychological injury, the claim under s51AC was dismissed. It was held that termination of the franchise agreement was not unconscionable as the defaults under the agreement had been ongoing for many months.

Socasen Pty Ltd v Caltex Australia Petroleum Pty Ltd¹²³

Recently, *Socasen Pty Ltd v Caltex Australia Petroleum Pty Ltd* considered an application for interlocutory relief concerning the termination of a franchise. The franchisee had operated a particular Caltex service station since 2000 but had experienced difficulties with a point of sale system which, it was claimed, had led to losses on credit card and certain other transactions.

It was also claimed that Caltex had discriminated against the franchisee through the operation of a compensation scheme to assist dealers who had to lower prices to meet those of competitors. The business experienced severe financial difficulties and the franchisee commenced proceedings against Caltex. It was alleged that there had been breaches of the franchise agreement and that Caltex had engaged in unconscionable conduct pursuant to s51AC.

In addition to the matters outlined, the franchisee also claimed that Caltex had engaged in unconscionable conduct through its refusal to permit the franchisee to:

- be converted to a commission agent;
- cease 24 hour trading; and
- enjoy a rent-free arrangement over a workshop on the site.

The franchisee sought an order restraining the franchisor from taking possession of the site in reliance on the disputed Notice of Termination until a final determination was made. It had been conceded by the franchisor that there was a serious question to be tried as to the franchisee's difficulties with the point of sale system and the compensation entitlements. However, the application for further interlocutory relief failed because:

- on the information available it seemed Socasen would continue to operate an unprofitable business;
- the delay would frustrate the franchisor in its attempts to find a new franchisee for the site; and
- such an order may involve the court in a supervisory role.

¹²² It was also alleged that the franchisor made false and misleading representations in the disclosure documents contrary to s52 of the TPA, namely that the site of the shop had been carefully chosen ("the site quality representation"), that the business would be capable of producing a net operating profit associated with a weekly turnover over \$8,000 and a realistic return on investment ("the sales-profitability representation") provided that the franchisees complied with the prescribed system.

¹²³ (2007) ATPR 42-170



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