Hon Judi Moylan MP
Member for Pearce

13 February 2013

Franchising Code Review Secretariat
Department of Industry, Innovation, Science, Research and Tertiary Education
Small Business Division
GPO Box 9839
Canberra ACT 2601

Via email: franchisingcodereview@innovation.gov.au

Dear Secretariat,

Please find attached my submission to the Franchising Code review 2013.

Yours sincerely,

HON. JUDI MOYLAN MP

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Parliament of Australia
House of Representatives

Submission to the 2013 Review of the Franchising Code of Conduct

by the Hon Judi Moylan MP, Member for Pearce

14 February 2013

Overview

Franchising agreements exist within a unique legal setting that often fall short of adequately expressing the true relationship between the parties. Franchising is a symbiotic endeavour, with both parties reliant on one another to ensure the success of their individual businesses. But both parties do not come to the agreement with equal bargaining power.

Often franchisors draft contracts that cement their strong bargaining position. Whilst this is understandable so that franchisors can protect the overall brand for their benefit, as well as the benefit of other franchisees, that imbalance can result in individual franchisees being left in a position that is, by any objective assessment, unfair.

Key examples include an absence of good faith, non-compensation for the creation of goodwill by the franchisee and difficulty in resolving disputes.

Resolving the tension between two businesses' freedom to contract and the protection of individuals, often newcomers to business, is regularly portrayed as trying to enjoin entirely different principles together. But far from being mutually exclusive, an efficient balance can be struck.

That balance should be achieved through legislation to ensure that neither party can create an excessive advantage over the other and to ensure clarity of rights and responsibilities between the parties.

The Case for Change

The *Franchising Australia 2012* report prepared by Griffith University and sponsored by the Franchising Council of Australia shows that **18%** of franchisors have been in disputes with franchisees over the last twelve months.[1] The report outlines a significant overlap of issues causing those disputes, with system compliance representing **46%** of disputes, franchise fees **39%** and misrepresentation at **31%**.[2]

These sources of disputes are alarming. As the core of the franchise agreement is to "provide the tools and training"[3] for the franchise to succeed, it is logical to conclude that if a dispute were to

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[1] Frazer L, Weaven S & Bodey K, *Franchising Australia 2012* report by Griffith Business School, Griffith University available at: http://www.franchise.edu.au/franchising-australia-2012-report.html Pg 57

[2] *Franchising Australia, ibid.* pg57

[3] Startupsmart "What are my responsibilities as a franchisor?" available at: http://www.startupsmart.com.au/franchising/what-are-my-responsibilities-as-a-franchisor/20100829169.html

arise, this would be the principle area of contention. But marketing issues and concern about training represent only **15%** and **8%** of disputes respectively.

It is indicative of the fundamental flaws in existing franchise agreements, which have been highlighted for over a decade by successive reviews, that nearly one-fifth of all franchisors are in dispute with their franchisees.

System compliance remains a contentious issue for franchisees as "there is little contained in a franchise agreement which is designed to protect a franchisee"[4] and "franchising agreements are generally viewed as non-negotiable".[5] Prospective franchisees are therefore faced with a take-it-or-leave-it agreement that contains few rights for them. But franchisors retain specific controlling rights[6] that when exercised, can cause a franchisee to be in breach of its system obligations. Such a situation grants excessive power to the franchisor, particularly as an unconscionable exercise of those rights can easily be clothed as reasonable under the circumstances or contract.

For example, a franchisee may be required to undertake local advertising, but the franchisor may retain the absolute right to veto any advertising material. If the franchisor continues to exercise its legitimate contractual right of veto and prevents any advertising from occurring, it can cause the franchisee to breach its advertising obligation. The rationale for allowing such a result is difficult to understand, let alone defend.

Franchise fees and alleged misrepresentation are sources of conflict as franchisees can become unhappy about paying disproportionately for goodwill. Franchisees often wonder what their fees 'buy' when it is they who are driving business, but the goodwill is presumed or explicitly noted under the agreement to be "generated by the brand or business system"[7]. Franchisees rightly feel aggrieved that after working for years to build good customer and community relations and contributing to local advertising, franchisors can financially reap the whole value of the goodwill that they only partly contributed to.

Why current protections are not enough

Goodwill

Freedom to contact advocates will argue that most issues can be resolved by prospective franchisees insisting on protecting their rights through inserting relevant contractual clauses. This argument is correct in theory only. As previously noted, franchise agreements are generally non-negotiable, with

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[4] RIBA Business Lawyers "What clauses might you expect to see in a franchising agreement?" available at: http://www.ribalaw.com.au/what-clauses-might-you-expect-to-see-in-a-franchise-agreement/ para 2.

[5] Franchise Expo "The franchising agreement" *Franchising in Australia* see under 'What is considered negotiable in a franchise agreement?' available at: http://www.franchiseexpo.com.au/franchise-agreement-understanding.cfm para 1

[6] RIBA *ibid*. para 1

[7] Stone A (2012) "How should franchisors deal with goodwill?" Herbert Smith Freehills, reproduced in *Lexology*; see under 'Businesses using third party sources of goodwill' available at: http://www.lexology.com/library/detail.aspx?g=15ea94c1-9edf-4f63-aee9-6114cdb8aa94 para 1

the exception only of "territory rights, location and opening dates"[8]. Plus, with franchisors receiving a median of 40 franchising enquiries a year,[9] and some receiving over 3000[10] there is little need for a franchisor to engage in bargaining to secure a franchisee.

Therefore, if goodwill is not already a standard term in the franchise contract, there is almost no scope for a potential franchisee to negotiate for the inclusion of such a term.

Stakeholders, such as the Franchise Council of Australia, have been vocal in their opposition to the mandatory inclusion of such clauses, arguing that this should be left up to the parties. But it is a long standing feature of the law that where one party to an agreement suffers from an unfair disadvantage, the law will intervene to the extent of ensuring that the other party cannot take advantage of that disadvantage. This principle runs through Equity and the more recent statutory provisions of unconscionable conduct.

Considering both the significant bargaining disadvantage of franchisees and that this "limitation on a franchisee's rights regarding the goodwill of the business is often not understood by franchisees"[11] there is significant policy rationale for a mandatory provision protecting franchisee's rights. Such a suggestion is not onerous or unique as the convention in the US, home to more than 900,000 franchise units[12] is that "local goodwill belongs to the franchisee". The argument that goodwill in the Australian context is too burdensome to determine or implement is unfounded, considering that it is the norm in a franchising system ten times larger than Australia.[13] Valuing and compensating goodwill is also normal practice in Australia when a partnership is dissolved or in the sale of any business.

Good faith

On good faith, again, the Franchise Council of Australia has been vocal in its argument that the common law duty of good faith provides sufficient protection for franchisees. However, as that duty is not universally accepted in Australian jurisdictions[14]; *may* be implied on an individual basis and is not automatically implied as a matter of law[15]; and can be excluded under the contract[16], there is no certainty of the 'duty' applying. Franchisees cannot be confident of any protection as the Franchise Council argues.

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[8] Franchise Expo *ibid.* under 'What is considered negotiable in a franchise agreement? para 1
[9] Frazer L *et.al. ibid.* p54
[10] Frazer L *et.al. ibid.* p54
[11] Spencer, E (2008) "Balance of power, certainty and discretion in the franchise relationship: an analysis of contractual terms" June 2008, Bond University available at: http://epublicaitons.bond.edu.au/law_pubs/250 p28
[12] International Franchise Association "Economic impact of Franchised Businesses" Vol2 http://unstats.un.org/unsd/nationalaccount/workshops/2008/newyork/IG28.PDF pg 2
[13] Frazer L *et.al. ibid.* pg 10 (83,930 total franchise units in Australia; over 900,000 in US – see footnote12)
[14] See decision in: *Trans Petroleum (Australia) Pty Ltd v White Gum Petroleum Pty Ltd* [2012] WASCA 165
[15] *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum N L* [2005] VSCA 228
[16] *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15

The case of *Trans Petroleum (Australia) Pty Ltd v White Gum Petroleum Pty Ltd*[17] demonstrates that lack of protection. Whilst the WA Court of Appeal was prepared to accept that there may be an implied duty of good faith to reasonably exercise a clause terminating a franchise agreement, it found that such a duty would not override the express promises made by the parties. The clause, which allowed termination of the agreement for any reason and without regard to the rights and interests of the other party, was upheld and found to amount to an exclusion of any implied duty of good faith. Consequently, the clause, which vested unfettered power with the franchisor to terminate the agreement, did not have to be exercised reasonably.

Another common argument is that 'unconscionable conduct', which applies to businesses and was clarified under the *Competition and Consumer Legislation Amendment Act 2011* as not being bound to the common law definition, provides sufficient protection to franchisees. But for conduct to be unconscionable, one party must have a disadvantage that affects their ability "to make a judgement as to their own best interest"[18] the action by the other party must be "irreconcilable with what is right or reasonable and show no regard for conscience."[19]

Franchisees faced with a termination clause such as that in *Trans Petroleum* (above) would likely fail in an argument that the unreasonable exercise of such a clause would be unconscionable. First, absent of any special circumstances, franchisors would argue that the franchisees were fully capable of assessing what was in their best interest when entering the contract, so there is no disadvantage. Second, drawing from the view in *Trans Petroleum*, far from being irreconcilable with what is right or reasonable, as the parties have agreed to such a clause, they have set the standard of what is reasonable for them.

Such an argument might seem logical legally, but the law is blind to the fact that when entering into the contract, franchisees are in reality faced with a take-it-or-leave-it bargain. So the standard, in practice, is not one agreed between the parties, but forced on the franchisee.

Dispute Resolution

The ACCC's mandate to investigate complaints regarding franchising is severely limited by its resources and the ever increasing regulatory scope of the Commission. Mr Issac Chalik of the National Franchise Coalition is reported as saying "the ACCC has admitted to me that it simply does not have the resources to follow up all the complaints. The only way [to settle disputes] is formal applications through the Supreme Court or Federal Court."[20]

Although the ACCC can refer disputes to mediation, that process can only resolve disputes though the consent of both parties. It does not address the fundamental problem of access to a cost-effective dispute resolution system that can *rule* on disputes.

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[17] *Trans Petroleum (Australia) Pty Ltd v White Gum Petroleum Pty Ltd* [2012] WASCA 165

[18] Commercial Bank of Australia v Amadio (1983) 151 CLR 447 at 462 per Mason J

[19] Kuti A & Cogswell C "ACCC to home in on unconscionable conduct" Clayton Utz insights, 29 March 2012 available at: http://www.claytonutz.com/publications/edition/29_march_2012/20120329/accc_to_home_in_on_unconscionable_conduct.page under "What is unconscionable conduct?" para2

[20] Hammond M "ACCC endorses dispute resolution service but franchise groups wary" StartupSmart, 5 July 2011 available at: http://www.startupsmart.com.au/franchising/2011-07-05/accc-endorses-dispute-resolution-service-but-franchise-groups-wary.html para 12

Opponents to the creation of a low cost quasi-judicial body argue that it duplicates existing mechanisms. Those concerns are unjustified. Mediation is an entirely separate alternative dispute resolution process to other ADR's such as arbitration. It is also common for business contracts or court systems to establish a tiered approach to dispute resolution, starting with mediation, progressing to arbitration and allowing applications to the court as a last resort.

As a lower cost entry into business, franchising often attracts newcomers who have relatively little of their own capital to contribute to the business. If a dispute then arises, they have no financial capacity to challenge their franchisor through the court system. Not only is this unfair for the franchisee, the perception of unfairness within the franchising system damages the reputation of the business model and franchisors in general.

Creating a cost-effective dispute resolution mechanism would also free up the scarce resources of the ACCC for it to focus on the most flagrant breaches of the Franchising Code or where franchisees have no ability at all to pursue a private action, such as where the franchise becomes insolvent and the franchisee has lost their home as it was security for the purchase of the franchise.

Proposals for Change

1. An explicit duty of good faith to be incorporated into the Franchising Code

As a symbiotic endeavour, there should be no question that the parties to a franchising agreement have a duty to act in good faith.

The definition of good faith should include reference to acting fairly, honestly, reasonably and co-operatively. These words represent the core issues of good faith, are easily understood and are comparable to the expression of other legal doctrines that are applied in day-to-day business activities, such as 'misleading and deceptive conduct.'

Importantly, they represent a significant limitation on the ability of franchisors to exercise their controlling rights that can cause a franchisee to be in breach of their obligations.

Also, rather than adversely affecting the franchisor's ability to protect the brand and system, a duty for all parties to act in good faith ensures that franchisees must act co-operatively and not in a manner that would be to the detriment of the franchise.

2. A requirement in the Franchising Code for franchise agreements to have a clear mechanism for the division of the value of goodwill attributable to the franchisee

Under this recommendation, the parties would be free to decide upon the most appropriate mechanism for valuing the goodwill, such as engaging a qualified individual or settling upon a recognised methodology for determining the goodwill attributable to the franchisee.

This ensures that franchisees are compensated for the value of the goodwill they generate during their time in control of the franchise.

3. **The ability for franchising disputes to be lodged directly with Australian Competition Tribunal or the creation of a low cost alternative dispute resolution system that has the ability to rule on disputes**

Whilst the Australian Competition Tribunal currently only hears applications for the review of ACCC decisions, it may provide a readymade framework for the resolution of franchise disputes.

In the alternative, a similar style body should be created that allows for franchisees to seek binding rulings on a dispute without having to either complain to the ACCC or engage in costly litigation.

Any such system should be accessible without the need to engage legal professionals and the rules of evidence and procedure should reflect this intention.

Comment on the Franchise Council of Australia's 'Good faith' recommendations

A recent briefing by the Franchise Council to its members regarding the review of the Franchising Code of Conduct recommended supporting the inclusion of good faith.[21] The wording suggested was:

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

It is encouraging that the FCA supports the inclusion of good faith in the Code. However, the construction above should not be adopted as it is confusing and contradictory.

The code applies across all Australian jurisdictions. But as noted earlier, the common law is not settled on whether a duty of good faith exists in commercial contracts. It is inherently contradictory to require compliance to the common law when there remains debate as to whether such a duty even exists.

Even where good faith has been found, different approaches have been taken across different jurisdictions. The words, "within the meaning of the unwritten law... of the States and Territories" add additional confusion as it appears to combine the divergent jurisprudence of the states and apply it across the Commonwealth. For instance, under the wording, it is unclear if the provision would require a franchise in Western Australia, whose jurisdiction has been more reluctant to find a duty of good faith, to comply with the common law of New South Wales, which has more readily found a duty of good faith in commercial contracts.

The uncertainty of the provision suggested by the Franchising Council of Australia highlights that to achieve good faith in franchising contracts, as the FCA now endorses, the most effective means is to introduce a mandatory provision in the Franchising Code. That would provide a clear and consistent application of good faith which would bring certainty to franchisors and franchisees alike.

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[21] FCA Member Briefing "The review of the Franchising Code of Conduct – Retaining the regulatory balance in the context of current threats" (PowerPoint presentation) by Stephen Giles; slide 5, bullet point 3

Conclusion

The franchise industry is worth $131 billion per annum in Australia[22] and importantly it provides many people an opportunity to start up small businesses without much business experience. But the legal framework in which franchising operates gives significant power to franchisors and provides little protection to franchisees.

The combination places franchising in a unique position of attracting many often inexperienced newcomers into a business environment where they are severely disadvantaged in terms of being able to protect or enforce what is in their best interests.

Franchisees are often forced to walk away from disputes with more powerful franchisors due to the high cost of accessing the Courts to seek a fair legal remedy.

As franchising makes such a significant contribution to the Australian economy, it is worthwhile finding a way to make contracts more transparent and fair. Contractual uncertainties are often an impediment to a franchisee obtaining financing and also result in unnecessary disputes which ultimately damage the industry.

Addressing these inherent issues would increase the attractiveness of franchising as a way of entering business and further contribute the vibrancy of this important industry.

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[22] Frazer L *et.al. ibid.*p11