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

BY EMAIL: franchisingcodereview@innovation.gov.au

Dear Sirs/ Mesdames, 26 March, 2013

RE: FEEDBACK AND COMMENTS ON FRANCHISING CODE REVIEW

BACKGROUND

I have been practising as a solicitor in New South Wales since 1989 and since around 2001 my practice has focused on franchise law. In my capacity as Principal of The Franchise Lawyer, I now undertake franchising work exclusively.

To date, I have personally transacted many hundreds of franchise matters in Australia for both franchisees and franchisors and also provided advice to representative bodies of franchisees. My work has included all aspects of franchise transactions from advising prospective franchisees about franchise opportunities to helping to establish franchise systems (I have helped establish more than 100 franchise systems in Australia). I represent numerous franchisors around Australia. These tend to be at the smaller end of the scale, with less than 20 franchise outlets.

In the last decade, I have also participated in numerous legal seminars and discussions concerning franchising and have given a number of presentations about franchise law.

In the course of my work, I have had the opportunity to consider the legal and practical effect of a good many of the provisions of the Franchising Code of Conduct at one time or another and to form views about the clarity and efficacy of some of them. For the purposes of this inquiry, I would like to share some of my experiences and views, in the hope that they may be of relevance.

This submission is divided into 2 sections, the first dealing with matters which might be considered to fall within the ambit of the Terms of Reference of the inquiry, and the second dealing with matters which are outside it but which I would nonetheless like to raise in the general context of the operation of the Code.

References to 'discussion questions' in this submission are to the Discussion Paper dated January 2013.

Most of the case studies referred to in these submissions are drawn from matters in which I have been involved.

SUBMISSIONS RELEVANT TO THE TERMS OF REFERENCE

1. Disclosure of third party payments

> Discussion question 3: "Have amendments to the Franchising Code improved the transparency of financial information for franchisees? If not, why not? If so, what benefit is this having for franchisees?"

In my view, amendments to the Code relating to the disclosure of financial information have improved the transparency of financial information for franchisees. Before the 2010 amendments, an obligation to provide, in particular, estimated operating expenses for a franchised business was conspicuously absent (the obligation now follows from the duty to disclose third-party payments). Operating expenses are clearly of great import for a franchisee when considering the financial viability of the prospective business, particularly in the case of a start-up business but also for an existing business, where such information may provide a benchmark against which the prospective franchisee can measure the actual financial performance of the business. In my experience, most franchisors have actual information about the expense of operating a business in the nature of the franchised business, either in the form of copies of profit and loss statements from their own franchisees, or in relation to the franchisor's own businesses.

The duty to disclose operating expenses also has an incidental benefit for franchisors, in that it fosters the analysis by franchisors of the performance of franchised businesses, and this can have flow-on benefits for both franchisors and franchisees. In some cases, this kind of analysis has led to the reappraisal by the franchisor of the fee structure under a franchise agreement.

> *Case study: a new franchise system is being established based on a restaurant business that the franchisor has been operating for 12 months. The franchisor sets fees (both initial and ongoing) under the franchise agreement by reference to franchise sector benchmarks or averages, as reported in the Franchising Australia Survey. Following an analysis of the performance of the existing business as a result of the duty to provide estimated operating expenses to franchisees, the franchisor becomes aware that the application of benchmark fees may mean that the franchised business will not be viable. The franchisor revises its fee structure.*

2. Provision of the franchise agreement "in the form in which it is to be executed"

> Discussion question 14: "Is the extra onus on franchisors justified by the benefit this disclosure is providing to franchisees?"

As a result of the amendments to the Franchising Code which took effect in 2008, the obligation under clause 10 to provide disclosure at least 14 days before the prospective franchisee enters into a franchise agreement was widened so that, with the disclosure document, a copy of the franchise agreement was to be provided "***in the form in which it is to be executed***".

This amendment is desirable in principle, in my view. As enacted, however, I think it is capable of

different interpretations, and the issue is of significant practical importance in the day to day business of granting franchises.

I find that many franchisor clients, as a result of the amendment, now request me to prepare the franchise agreement in the form in which it is to be executed to submit initially with the disclosure document to the franchisee, in order to trigger the start of the mandatory 14 day waiting period. This increases the cost for the franchisor at a stage when the franchisee is not yet committed to the deal. Prior to 1 July 2010, it was more often the case that the franchise agreement, although complete, would be submitted in generic form with the disclosure document.

Furthermore, in most cases in my experience, the first executable version of a franchise agreement submitted with the disclosure document will undergo further changes before it is executed. Clause 10 of the Code does not explicitly deal with the question of subsequent amendments to a franchise agreement, after it is first provided in executable form and before it is actually executed. Arguably, in my view, the effect of clause 10 is that the franchise agreement cannot be entered into until at least 14 days have elapsed from the time that the ***final*** form of executable franchise agreement is tendered to the franchisee. Such an interpretation may follow from the use of the words "***in which it is to be***" in the expression "in the form in which it is to be executed", although it seems from the Explanatory Memorandum to the 2007 amending regulations that it may only have been the intention of the legislature to mandate the attachment of a complete franchise agreement to the disclosure document when the disclosure document is first provided.

For the sake of caution, I have adopted the former, more conservative view in advising franchisor clients about the requirements of the Code. This can unfairly impact upon both parties, causing the last minute change or cancellation of scheduled opening dates, rent periods and promotional events, with possible consequential loss and inconvenience for both parties. However, if the conservative view of the legislation is the correct one, the risk in not allowing the additional 14 days is that the franchise agreement or a part of it could be declared unenforceable. From a legal practitioner's perspective, prudence would dictate, in my view, that a franchisor must be advised of this possibility.

I think the issue calls for clarification. If the intention was only for a complete franchise agreement to be attached to the disclosure document initially, it would be a relatively straightforward matter to amend clause 10 so as to confirm this.

If it is intended that the franchisee should have the ***final*** form of franchise agreement for at least 14 days before signing, then perhaps consideration ought to be given to distinguishing between different scenarios for the purposes of such a rule. For example, has the franchisee has been legally represented throughout the process of negotiation of the franchise agreement? It may be appropriate in such a case for the mandatory time period to be shortened.

3. Transfer and novation provisions

> Discussion questions 5 and 6: "Have the amendments regarding ... transfer and novation been effective in addressing concerns about franchisors' ability to make changes to

franchise agreements? Why or why not? Does the sector have any concerns regarding the operation of these amendments?"

A. Can novation now be refused?

The Discussion Paper reports that the Expert Panel was of the view that the most appropriate approach to the issue whether franchisors should be able to change the terms of the franchise agreement at the time of sale of a franchised business, was to ensure that there is adequate upfront disclosure to prospective franchisees on the processes that will apply.

The amendments actually made in 2010 with regard to this issue introduced the term "novation" in clause 3 of the Code and also modified clause 20, which formerly dealt just with 'transfer', so that it now deals equally with transfer and novation. This includes sub-clause 20 (2), which provides:

> *"A franchisor must not unreasonably withhold consent to the transfer **or novation**." (emphasis added)*

The definition of 'novation' in clause 3 is:

> *"… the termination of the franchise and entry into a new franchise with a proposed transferee on the same terms as the terminated franchise".*

In my submission, the literal effect of these amendments is not to preserve the choice of a franchisor whether to change the terms of a franchise agreement upon sale, but rather to put novation on the same footing as transfer. Importantly, this includes the fetter that the franchisor cannot unreasonably withhold consent. In other words, if the franchisee requests the franchisor, in writing, to consent to a novation of the franchise, the franchisor cannot unreasonably withhold consent and the circumstances in which it is reasonable to withhold consent include those circumstances referred to in sub-clause (3), which are the same circumstances that apply to a transfer. This implies that simply by asking the franchisor, the franchisee can gain the ability to sell its franchise upon the same terms as it was granted, and the franchisor cannot refuse consent except in accordance with conditions that would normally be considered reasonable for refusing consent to a transfer.

I do not wish to make any submission about the merits or otherwise of this position. I point it out simply because it is inconsistent with the intentions of the Expert Panel, as reported in the Discussion Paper.

Moreover, I am not the only legal practitioner practising in franchising who has adopted this interpretation of these new provisions of the Code. The matter first came to my attention in a legal seminar presented by Fiona Wallwork of Norton Rose on behalf of the University of New South Wales in August 2010, shortly after the 2010 amendments took effect. In her presentation paper, Ms Wallwork remarked:

> *"The effect of the amendments is that for franchise agreements entered into post-July 1, 2010, the franchisee has the right to request the franchisor to consent to a novation of the franchise agreement on the same terms. Standard clauses that require the transferee*

franchisee to sign the franchisor's "then current form of franchise agreement" as a condition of novation will not be effective for such franchise agreements."

If it is thought desirable to preserve a franchisor's right to make changes to a franchise agreement before the sale of the franchised business, this could be achieved by the following further amendments to the Code:

a) The reference to 'novation' could be deleted from subclause 20 (2);

b) A new clause 20 (3A) could be inserted to the effect "in the case of novation, a franchisor can withhold consent if … [reasons considered appropriate]". Perhaps an appropriate formulation for an appropriate reason for refusing consent is "if the franchisor requires amendments to the franchise agreement that are for the legitimate interests of the franchisor or the franchise system".

If it is thought desirable, instead, for the interpretation described here to be confirmed and reinforced, then the Code provisions could remain as they are, but consideration should perhaps be given to changing the wording of clause 17D of the disclosure document so that it is consistent with this interpretation of the Code.

B. Novation for a new term of years?

The definition of "novation" in the Code leaves open the question whether "on the same terms as the terminated franchise" means that the new franchise agreement must grant to the transferee a new term equivalent to the length of the full term under the original franchise agreement.

Conventionally, if a contract is novated, one or more of the parties is simply substituted by another party, and the contract continues on foot with its terms unamended. The substitution is effected by means of a deed. This type of transaction is also sometimes referred to as an assignment or 'transfer' of an agreement, although as a technical matter normally only rights can be assigned, not liabilities.

The reference in the Code definition of 'novation' to the termination of the franchise and entering into of a new franchise (which presumably means a new franchise agreement - this is reinforced by the Explanatory Memorandum) causes some confusion about whether what is intended is a transaction along the lines of the conventional legal concept of novation. If it is, this means that the transferee would only be entitled to the balance of the term under the original franchise agreement, not a new full term. If this is not the intention, then it is arguable that the definition of novation implies that a new, full term of years must be given under the new agreement, as the terms of the new agreement must be the same as the terms of the old.

My view is that, in terms of the legal rights and obligations created by the Franchising Code, the conventional approach to contract novation should be adopted. In other words, franchisees should not be given the right to insist upon a franchisor granting a new full term of years to a purchaser. If such a right were given, it may produce a "cascading" effect, whereby a franchisor would effectively be precluded from placing a finite term upon a franchise.

On any view, I would submit that this issue is of such importance that it should be dealt with in the Code, perhaps by including words in the definition of "novation" to the effect “(save that the duration of the new franchise need only be for the balance of the duration of the terminated franchise, together with any options for renewal)”.

> ***Observation****: novation (or transfer/assignment) of a franchise agreement in the conventional sense seems to happen fairly seldom in the franchising sector. In my experience, it is far more common for a new franchise agreement to be entered into upon transfer. It is not an uncommon practice for the new agreement to grant a new full term to the purchaser, even if the purchaser may not be entitled to it, although I have also seen many instances where the new agreement is only for the balance of the original term.*

4. Disclosing details of previous franchisees

> Discussion questions 9 and 10: "What effect has the requirement to provide this additional information had on franchisors? Does the sector have any concerns regarding the operation of the new provisions?"

The requirement for a franchisor to disclose contact details of previous franchisees pursuant to clause 6.5 of the disclosure document, a requirement introduced in 2010, is often being circumvented in my experience by means of the exception in clause 6.6 of the disclosure document, which allows the franchisor to withhold disclosure where the franchisee has requested in writing that its details not be disclosed.

Franchisors have been inserting a provision in the franchise agreement by which the franchisee specifically requests that its details not be disclosed in the event that any of the circumstances occur that are referred to in clause 6.4 of the disclosure document. I am not sure whether it was the intention of the Expert Panel to allow the franchisor to circumvent the obligation so easily.

I am also aware that some franchisors have purported to circumvent the obligation by reference to privacy laws. This has been done by putting in place, in the franchise system, privacy principles pursuant to the provisions of Federal privacy legislation. Under the privacy principles, the franchisor promises not to disclose contact details of franchisees unless they specifically authorise the disclosure. Franchisees sign a document by which they are bound by the principles enunciated in the privacy document. The franchisor does not ever seek the authorisation of franchisees to disclose their contact details.

Both the Competition and Consumer Act and the Franchising Code are silent about the interaction of Commonwealth privacy legislation with the provisions of the Franchising Code. In my view, it would be helpful for the Parliament to make some pronouncement about the intended operation of the Code where it may conflict with privacy legislation.

5. Provision of lease documents

Discussion questions 9 and 10: "What effect has the requirement to provide this additional information had on franchisors? Does the sector have any concerns regarding the operation of the new provisions?"

The new clause 18.2 in the standard long form disclosure document was introduced by the 2010 amendments and requires a franchisor to provide to the franchisee, documents that the franchisee will be required to enter into in addition to the franchise agreement. These documents include any lease or other agreement under which the franchisee will occupy premises.

The clause does not specify that the documents must be provided ***with*** the disclosure document. Rather, it specifies the time within which they must be provided.

The placing of this requirement in clause 18 of the disclosure document may have been convenient in terms of its proximity to the list of documents to which it makes reference. However, from another perspective it is a curious place to have inserted the requirement, because the disclosure document in principle seems intended to be an information document for a franchisee rather than a catalogue of obligations of a franchisor, and the only obligation imposed on a franchisor under the substantive Code provisions in connection with a disclosure document is to complete it in accordance with the appropriate form and provide it to the franchisee. There may be a legal question as to whether the content of the standard form disclosure document can operate to impose positive obligations on a franchisor that do not directly relate to the preparation and provision of the document to a franchisee.

Moreover, insofar as clause 18.2 of the disclosure document deals with premises documents, it overlaps with clause 14 of the Code proper. Clause 14 of the Code effectively provides that where the franchisor or its associate is involved in arrangements concerning premises, the franchisor or its associate must provide to the franchisee the documents evidencing the arrangement within 1 month after the documents are signed or the occupation of the premises commences.

The provisions of clause 14 are not necessarily inconsistent with clause 18.2 of the disclosure document, insofar as the latter relates to lease documents, although on some interpretations the provisions could conflict.

For the sake of consistency, in my view, clause 14 should make reference to obligations of the kind referred to in clause 18.2 of the disclosure document insofar as they relate to premises arrangements, and care should be taken to ensure that the 2 sets of obligations do not conflict. Consideration might also be given to reproducing in the Code proper, the provisions of clause 18.2 with regard to other types of documents.

6. Renewal notices

Discussion question 23: "Have the amendments regarding end of term arrangements and renewal notices been effective in addressing concerns about inappropriate conduct

at the end of the term of franchise agreements? Why or why not?"

In my experience, prior to the 2010 amendments, many franchise agreements (like property leases) required the franchisee to give notice of the exercise of an option for a further term between 6 and 3 months before the end of the initial term.

If such a notice period is retained in a franchise agreement entered into after 1 July 2010, the effect of the new clause 20A of the Code is that the franchisor will be notifying the franchisee of its decision whether or not to renew the franchise agreement before the franchisee gives formal notice of the exercise of its option.

In order for this not to be the case, the franchisee's notice period under the agreement must be extended out beyond 6 months before the end of the term. This is the approach that has been taken by most of the franchisor clients of this practice. However, it is arguable that this is too long for the franchisee. Many franchisees may not be in a position to form a good opinion of whether or not they should renew the franchise agreement until closer to the end of term.

I have not had experience in the actual working of the renewal notice procedure at the time of this submission, as no franchise agreement entered into by a client of the practice after 1 July 2010 has reached the relevant part of the end of term.

However, I would respectfully submit that if franchisors are compelled to decide whether or not to grant a renewal hypothetically, that is, without knowing whether or not franchisees intend to exercise their right of renewal, this may be unfairly onerous for franchisors because:

a) It places an administrative burden on franchisors in circumstances where the effort may be futile;

b) It does not allow franchisors to consider conduct of franchisees subsequent to the renewal notice that may fairly be relevant to the decision whether or not to renew the franchise agreement.

In my submission, consideration ought to be given to reducing the 6 month period for notification, perhaps to 2 months. This would allow the conventional renewal exercise period of 6 to 3 months to be retained in franchise agreements, and the disadvantages referred to above to be avoided.

7. Unforeseen significant capital expenditure

I would like to raise a purely semantic point regarding the expression "unforeseen" in the new clause 13A of the standard form disclosure document. This clause was introduced by the 2010 amendments.

As a matter of plain English, if something is unforeseen it is not yet predicted, and therefore cannot be disclosed. "Unforeseen" in the heading to clause 13A obviously refers to the perspective of the franchisee, however when the word is used again in the body of clause 13A.1, it is in connection with the franchisor's obligations and is therefore at best, devoid of meaning. The franchisor cannot know

whether or not the franchisee has foreseen a certain type of significant capital expenditure, it can only know whether it will require the expenditure and whether or not it has hitherto disclosed this. For this reason, the word "unforeseen" in the body of 13A.1 should be deleted, in my submission.

8. Enforcement of the Franchising Code

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

My experience in dealing with many disputes in the franchise sector reinforces the view of the Joint Committee and subsequent South Australian and Western Australian State reports that the Franchising Code "lacks teeth". This is particularly so after the High Court in *Master of Education Services v Ketchell* supported the view that a franchise agreement will rarely be held to be unenforceable merely because of a failure to comply with the Code.

Civil pecuniary penalties for breach of the Code are desirable, in my view, for the following reasons:

a) To encourage consistency in the form of disclosure, thereby reducing the costs of due diligence for franchisees;

b) To provide for a penalty against a franchisor where it is difficult for the franchisee to satisfy the legal burden of proof to show that a particular non-compliance with the Code caused loss.

In relation to the desirability of consistency in the form of disclosure, my experience is that, by and large, franchisors' disclosure documents follow the form stipulated by the Code. However, a significant number of disclosure documents I have seen do not. Where the form of a disclosure document varies considerably from that stipulated by the Code, it can sometimes be very time consuming to review the document and check whether all the information required by the Code has been provided. In these cases, the information given is also more likely to be unclear or incomplete. This increases the cost of due diligence for prospective franchisees and can therefore act as a barrier to commerce. In my view, it is worth considering the introduction of modest pecuniary penalties for this kind of non-compliance.

Higher pecuniary penalties could be provided for in cases of more serious non-compliance. In a number of matters in this practice, for example, franchisees were not provided with a disclosure document at all before entering into an agreement for the grant of a franchise, perhaps because the franchisor was not aware that the transaction constituted a franchise. In these matters, it would not necessarily have been easy to demonstrate that the outcome for the franchisee would have been any different if a compliant disclosure document had been provided. It may be argued that if the outcome would have been no different, there is no cause to penalise the franchisor for its non-compliance. However, in my submission it is dubious wisdom to allow franchisors to breach the Code with impunity depending on a fine judgement whether or not compliance with the Code would have made any difference.

OTHER SUBMISSIONS

9. Termination Provisions

The Code places a number of limitations on the rights that a franchisor that would otherwise have at common law to terminate a franchise agreement. For example, immediate termination can only occur in the special circumstances mentioned in clause 23, and termination for any other breach of a franchise agreement can only occur after the notice procedure referred to in clause 21 is followed. Unlike the position at common law, a franchisor is not entitled to terminate immediately by reason of an essential breach, or by reason of conduct by a franchisee amounting to repudiation of the agreement (other than where that conduct may fall within one of the special circumstances mentioned in clause 23).

In my opinion, these limitations work satisfactorily insofar as they curtail a franchisor's ability to terminate an agreement immediately, and the breach notice procedure is, in principle, fruitful in clarifying a franchisor's expectations and fair in giving a franchisee the opportunity to remedy the situation.

However, a number of problems arise, particularly in connection with paragraph 21 (2) (b) of the notice provisions, which requires the breach notice to tell the franchisee what the franchisor requires to be done to "remedy the breach".

Paragraph 21 (2) (b) fails to distinguish between breaches of a franchise agreement that are capable of being rectified, as such, and those that are not. Many breaches of operational procedures requirements – a common type of breach in a franchise system – are not capable of being rectified: for example, failing to enter customers' details in a database; disclosing trade secrets to competitors; preparation of products or delivery of services not in accordance with the franchisor's specifications. A failure to meet minimum revenue requirements is another common example of such a breach.

If "remedy the breach" in paragraph (b) should be interpreted to mean "rectify the breach", it may follow that breaches that are not capable of being rectified cannot become the subject of a notice under sub-clause (2), and consequently the franchisor has no redress in relation to such breaches - at least none that could lead to termination of the agreement. This is notwithstanding that the breaches could be repetitive, or of a serious nature.

On the other hand, paragraph (b) refers to "what the franchisor requires to be done" to remedy the breach, which may suggest that breaches that are not capable of being rectified as such can become the subject of a breach notice, and in that case what must be done by way of remedy for the breach is within the franchisor's discretion. Such an interpretation could also apply in the case of a breach that is capable of being rectified so that, notwithstanding that a particular course of action would specifically rectify the breach in question, the franchisor can nonetheless choose another form of remedy in the breach notice.

None of these interpretations, in my opinion, produces a satisfactory result, and yet I would submit they are reasonable interpretations of paragraph 21 (2) (b).

The issue is of such importance in the franchise sector, in my submission, that amendments should

be made to the Code to address it. Amendments could be made so that:

a) A distinction is drawn between breaches of a franchise agreement that are capable of rectification and those that are not;

b) In relation to breaches that are capable of rectification, a breach notice must state that the breach must be rectified and tell the franchisee what, in the franchisor's opinion, is required to be done to rectify the breach and the specified rectification must be objectively capable of rectifying the breach;

c) In relation to breaches that are not capable of rectification, the breach notice must tell the franchisee what the franchisor requires to be done to remedy the breach, and the required remedy must have a reasonable connection with or be no more than reasonably necessary to compensate the franchisor for the breach.

*Case study 1: **a broad view of "remedy the breach"**. A franchisee fails, in the course of conducting a franchised business, to enter details of customers in a central database maintained by the franchisor. The franchisor sends a breach notice to the franchisee requiring the franchisee, by way of remedy for the breach, to engage a manager nominated by the franchisor for a 6 month period at the salary nominated by the franchisor.*

*Case study 2: **a narrow view of "remedy the breach"**. Under the franchise agreement, quarterly minimum revenue requirements apply to the franchisee. The franchisee fails to meet the requirements in a particular quarter. The franchisor sends a breach notice requiring the franchisee to meet the requirements for the next quarter (the non-compliance for the previous quarter not being capable of being rectified, as such). The franchisee does so, however in the succeeding quarter, the franchisee again fails to meet the minimum revenue requirements. The franchisor sends another, similar breach notice, and the franchisee meets the requirements for the next quarter. The franchisee has avoided termination of the agreement and the franchisor has enforced compliance with the agreement in alternate quarters, but cannot recover compensation for the shortfall in the other two quarters.*

10. Problems with the Cooling Off Period

The cooling off period under clause 13 (1) of the Code is calculated by reference to the earlier of:

a) Entering into a franchise agreement (or an agreement to enter into a franchise agreement); or

b) Making any payment under the agreement.

Paragraph (b) is confusing, in my view, and can lead to significant problems in practice. Paragraph 13 (1) (b) is of prime relevance in a matter in which this practice was recently involved and which is now the subject of litigation.

The difficulty arises from the expression "under the agreement" in paragraph (b). By reason of the words "***the earlier of***" in subclause 13 (1), paragraph (b) cannot apply after an agreement has been entered into, only before. If no agreement has been entered into, how are the words "payment … under the agreement" to be understood?

One possible interpretation is that the payment in question is a payment referred to, or mentioned in a proposed agreement that has been submitted to the (prospective) franchisee.

This interpretation would raise further questions – for example, if a number of different versions of a proposed agreement were submitted to the franchisee, which is the relevant version? Secondly, how can it be established that the payment made by the (prospective) franchisee was by reference to the proposed agreement or was for another purpose not mentioned in the franchise agreement, for example, by way of deposit to secure the opportunity to enter into the franchise?

If the correct interpretation is that the payment in question is a payment referred to in a proposed agreement and made before the agreement is entered into, the right to terminate the agreement pursuant to subclause (1) could only be of utility in the event that the agreement is subsequently entered into within less than 7 days after the payment is made.

Further uncertainty results from the possible connection between a payment referred to in paragraph 13 (1) (b) and the concept of "non-refundable money" in the Code. Must the payment under paragraph (b), being a trigger for the cooling off period, be a payment of non-refundable money or of refundable money? Any money paid by a prospective franchisee to the franchisor must remain refundable under the Code until at least 14 days have elapsed from the provision by the franchisor of proper disclosure under the Code, and the parties cannot enter into a franchise agreement until that period has elapsed. It seems nonsensical for an entitlement to terminate an agreement to be triggered off before the agreement can be legally entered into, and so presumably the correct interpretation is that the payment must be of non-refundable money, yet the clause is silent on this distinction.

In practice, these difficulties cause real concern because it is almost invariably the custom in the franchise sector, in my experience, for franchisors to require a deposit from franchisees before providing franchise documents, and the documents may well say that the deposit will be applied towards fees payable under the franchise agreement in the event that the franchisee enters into the agreement. In some instances, prospective franchisees will pay substantial sums towards the purchase of the franchise a considerable time before a franchise agreement is entered into.

If the correct interpretation of the cooling off provisions is that such payments are caught by paragraph (b), because they are payments mentioned in a proposed agreement, then unless the agreement is entered into very shortly after the payment is made, the cooling off provisions will be of no benefit whatsoever to the prospective franchisee.

To compound these difficulties, in my experience many franchise agreements in the sector still include a clause concerning cooling off that is derived from the precedent contained in the former Butterworths *Franchising Law & Practice* Manual. The provision gives the franchisee a contractual

right to terminate the franchise agreement within 7 days after entering into the agreement, and provides for monetary refund to the franchisee in those circumstances, ***but only of the franchise fee***. Of course, many franchise agreements, especially those relating to retail franchises and involving significant fitout and equipment expenses on commencement, divide the amount payable under the franchise agreement into a number of components, of which the franchise fee may only be a minor component. In circumstances where a prospective franchisee makes a substantial payment of equipment and fitout money more than 7 days before a franchise agreement is entered into, the franchisee may well lose that money if it subsequently exercises this contractual cooling off right. In those circumstances, the cooling off right under the Code will have been lost if the correct interpretation is that the payment would fall under paragraph 13 (1) (b) of the Code.

Although it seems rare in the sector for franchisees to exercise cooling off rights, it is desirable in my submission for subclause 13 (1) of the Code to be revised and amended so as to resolve these difficulties.

Case study: a prospective franchisee is an acquaintance of the franchisor manager, having known him for a number of years. The prospective franchisee agrees in principle to purchase a franchise, and pays $70,000 to the franchisor on 1 February. The proposed franchise agreement is received on 1 March and mentions $20,000 as a franchise fee and $70,000 as the fit out and equipment fee. The franchise agreement is signed on 15 March and on the same date, the franchisee commences operating the business. Payment of remaining fees under the franchise agreement is postponed. Within 4 days of commencement, the franchisee regrets the decision to purchase the franchise and seeks advice from a lawyer about terminating the franchise agreement. The lawyer advises the franchisee that, because of the payment on 1 February, it has lost the right to terminate under the Code, but can terminate under a cooling off provision in the franchise agreement. The franchise agreement provides that any part of the franchise fee of $20,000 that has been paid will be refunded in these circumstances. The franchisee terminates pursuant to the contractual right, but the franchisor refuses to refund any moneys on the basis that the franchisee had not paid any part of the franchise fee.

11. Disclosure obligations in a subfranchise

Subclause 6B (2) of the Code provides that where a subfranchisor (or master franchisee) proposes to grant a subfranchise, the franchisee must either receive separate disclosure documents in relation to the master franchise and the subfranchise respectively, or otherwise a joint disclosure document that addresses the respective obligations of the franchisor and the subfranchisor.

In relation to the option of providing a joint disclosure document that addresses the respective obligations of the franchisor and subfranchisor (paragraph (a) (ii) of 6B (2)), it is not altogether clear whether the reference to the respective obligations is to:

a) The obligations of the franchisor and subfranchisor towards the franchisee;

b) If so, whether the reference is to direct or indirect contractual obligations; or

c) If rather, so far as the franchisor's obligations are concerned, the reference is to the franchisor's obligations towards the subfranchisor, not towards the franchisee.

In the circumstances contemplated by subclause 6B (2), the franchise agreement would be directly between the subfranchisor and the franchisee, and so the franchisor would have no direct contractual obligation towards the franchisee. It therefore follows that if the correct interpretation is that "obligations" refers to direct contractual obligations towards the franchisee, a joint disclosure document would not disclose any information about the obligations of the franchisor other than the fact that it does not have any towards the franchisee.

If, on the other hand, the reference is to indirect contractual obligations, then the joint disclosure document must disclose any obligations that the franchisor, under the master franchise agreement with the subfranchisor, assumes towards the franchisee.

However, if the reference in paragraph 6B (2) (a) (i) to the provision of a separate disclosure document in relation to the master franchise simply means provision of a copy of the disclosure document that the franchisor gave (or must give) to the subfranchisor in connection with the master franchise agreement, then it may be that the reference to the franchisor's obligations in paragraph (a) (ii) is intended to be a reference to the obligations of the franchisor towards the subfranchisor, and in that case the contents of this joint disclosure document would be quite different.

In my experience, there is a great lack of consistency in the franchise sector in approaching the obligations under subclause 6B, and perhaps some of this is caused by these interpretative difficulties. In a substantial number of cases where subfranchises are involved, the only disclosure document that is forthcoming is the usual franchise unit disclosure document and the obligations under subclause 6B are overlooked altogether. In other cases, a joint disclosure document is provided but the document does not take a uniform approach towards disclosure of the franchisor's obligations, with the result that sometimes obligations towards the subfranchisor are mentioned, and at other times obligations towards the franchisee.

In my submission, it is important for a franchisee in a multi-tiered franchise system to be informed of significant overarching obligations in the system. To that end, I think the provisions of subclause 6B (2) should be clarified to avoid the ambiguities that have been described here.

Please feel free to contact me if you would like to discuss any of the issues raised in this submission.

Yours faithfully,
THE FRANCHISE LAWYER

PETER SANFILIPPO