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RESPONSE TO 2023 FRANCHISE CODE REVIEW - CONSULTATION PAPER

I congratulate Dr Michael Schaper as an excellent appointment to review the Code.

My Experience

- 40 years' experience in franchising and the law and advice to various State and Federal Government and federal and State Small Business Ombudsman and Commissioners.
- 2013 appointed Reviewer of the Franchise Code
- 2015 appointed as co-Reviewer of the Horticulture Code
- Various Law Council and Law Institute committees
- Unfair Contracts Terms consultative roundtable with Federal Small Business Minister
- 2018-2022 appointed as one of the three Federal Government Cabinet appointed Consumer Directors of the newly legislated Australian Financial Complaints Authority (AFCA)
- 2019 named in the prestigious Doyle's list of top Lawyer/ Mediators
- July 2020 appointed as the Chair of the Victorian Governments Covid-19 CTRS Administration Committee administering the Commercial Tenancies Relief Scheme (CTRS).
- In 2022 awarded as the exclusive winner of this year's highly competitive area of Mediation within the Australia jurisdiction LEXOLOGY Client Choice Awards by peers in the law.

Dr Schaper identified five broad themes for the Review Consultation Paper:

- A. The scope of regulation
- B. Before entering into a franchise agreement
- C. Enduring obligations in franchise relationships
- D. The end of a franchise relationship
- E. Enforcement and dispute resolution

Subject to some redrafting changes for inconsistencies and ambiguity, the Code adequately deals with disclosure, unilateral contract terms amendments¹ and capital expenditures² required to be incurred by the Franchisee, therefore I don't intend to make comment on these issues and intend to comment on only matters I consider to be sensitive and relevant for the stakeholders and the Reviewer.

¹ Clause 31A

² Clause 30A and Item 14 of Annexure 1.

The ACCC will be aware of drafting inconsistencies in the Code that should be adequately addressed by other contributors to the Review, and I don't intend to duplicate these.

I believe that the Code and the supporting Regulations, have become cumbersome and complex and frustrate many unsophisticated and poorly resourced stakeholders to enter, engage and comply. The Disclosure Document requires lengthy and expensive preparation and updating by Franchisors and a largely difficult task for Franchisees to understand and react appropriately to. If the Code Review can simplify the administrative burdens for pre-contract disclosure for all stakeholders, without diminishing the developed legal definitions and obligations on the parties, it would be welcomed by many.

For me there are three fundamental matters that the Code must cover:

1. Clear and transparent information provided by Franchisors that enables Franchisee applicants and existing Franchisees to make informed and considered decisions with regard to the franchise business and investment therein - Disclosure.
2. A process for transfer of a franchise and end of term protocols and obligations.
3. Satisfactory dispute resolution formats and process.

Franchising is both a commercial and property relationship between two parties usually for a defined period of time. The intertwining of contractual and property issues in a franchise relationship creates issues that must be considered and understood in any regulatory or statutory intervention by government.

The foundation of good legislation and regulation is based upon solid established legal principles, that have been developed through precedent over many centuries of Common Law and Equity and legislation reflecting the attitudes and mores of society at a point in time. Good law as with good legislation and regulation, cannot and must not be based upon improbable or tenuous bases. The modus operandi of legislation and regulation is to give greater effect and specificity to common law principles based upon the attitudes in society and not disrupt them to any substantial degree, that reflect the current attitudes, beliefs and mores of the community. The Code Reviews conducted over the last few decades have seen interactions of changes in how the franchise relationship must operate and the implications for failing to do so. Substantially the current Code effectively deals with the function and process issues. The issues currently before the Review seem to be issues arising out of termination or failure of a franchise, rather than administrative procedural issues.

The tightness of the economy, in the post Covid world, together with substantial advances in technology involving online sales and consumer acceptance and security of online selling have impacted retail trader of which franchises form a key part of. In any period of economic stress, conflict between parties in a commercial relationship tends to increase due to poor financial performance or unrealised expectations and failure to comply with obligations under agreements. It is not unusual for parties to genuinely believe in the cause of their issues being due to the other party and constructing a dispute that belief. Legislation and regulations cannot provide for every contrived issue or claim, nor should it.

2021 CHANGES TO THE CODE

The 2021 amendments to the Franchising Code focus on fairness and transparency. Several key matters were addressed - some of the amendments provide:

- (a) Franchisors are now required to provide additional disclosure³ to an applicant at least 14 days before the franchisee signs a franchise agreement including:
 - a copy of the lease of the premises or a summary of the commercial terms of the lease;
 - previous franchisee disputes over the last financial year;
 - details around rebates and other financial benefits that franchisors receive from suppliers; and
 - right to any goodwill generated by the franchisee.
 - *Key facts sheet*⁴
- (b) Franchisors are no longer allowed to pass on certain legal costs to the franchisee:⁵
- (c) Provisions relating to the termination of franchise agreements:
 - the cooling off period after entering into a franchise agreement has been extended from 7 days to 14 days;
 - a franchisee can propose (not insist) an early termination of a franchise agreement and the franchisor must reply in writing within 28 days; ⁶ Immediate termination is replaced with a notice show cause type provision:⁷
 - a franchisee can terminate the franchise agreement within 14 days after receiving the terms of the proposed lease, and a further 14-day cooling off period applies if the final terms of the lease are not substantially identical to the proposed terms. ⁸
- (d) Restraint of trade provisions in a franchise agreement will now only be effective if a franchisee has committed a **serious breach** of the franchise agreement rather than a trivial immaterial breach. ⁹

³ Clause 17

⁴ Clause 9A

⁵ Clause 19A

⁶ Clause 26B

⁷ Clause 29

⁸ Clause 26

⁹ Clause 23

The 2023 Amendments to the **Australian Consumer Law's** Unfair Contracts Act (UCT)¹⁰ will have an impact on franchising. Depending on the type of contract, unfair terms are prohibited under the Australian Consumer Law and also the Australian Securities and Investments Commission Act 2001 (Cth) ("the ASIC Act"). Under the UTC a contract may be determined to be a 'standard form contract', despite there being an opportunity for:

- a party to negotiate minor or insubstantial changes
- a party to select a term from a range of options for such term, or
- the parties to meaningfully negotiate the terms of another contract but not meaningfully negotiate the terms of the contract in question.

Section 23 of the UCT provides that a term of a consumer contract or small business contract is void if it is unfair and contained in a standard form contract. Section 24 of the UCT explains when a consumer contract is unfair.

Section 24 of the ACL defines a term of a consumer contract or small business contract is 'unfair' if it:

- would cause a significant imbalance in the parties' rights and obligations arising under the contract, and
- is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term, and
- would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

Some aspects of the Code and UCT restrict the flexibility of franchises to quickly adapt and change where the market conditions or circumstances dictate such as competition, technology or economic conditions. The *raison d'être* for tougher requirements upon franchisors in these two areas, must be balanced with the need for change that may be best for both franchisees and the master franchisor, such as AI, online sales and social networking platforms.

¹⁰ The Amending Act amends the unfair contract terms (UCT) provisions of the Competition and Consumer Act 2010 (Cth) (CCA) and the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act). Amendments to the UCT provisions of the CCA and ASIC Act

¹¹ The UCT laws apply to terms which are found to be unfair in contracts which are, (1) either a consumer contract or small business contract, and (2) in a standard form.

PRE- AGREEMENT AND DISCLOSURE

Disclosure Document

There should be no disguising the fact that a franchise relationship is at heart a commercial one. As such both parties should enter into the relationship with an understanding of the rights, duties and obligations each party has and the operational functions to be performed by both parties. Such assessment involves some but not all of the following matters:

- (a) Risk assessment
- (b) Capability of performing the required functions
- (c) Financial suitability
- (d) Legal obligations

The current Code as developed, provides a comprehensive Pre-Disclosure process which I believe is somewhat cumbersome, but satisfactory. Informed decision making is the key to mitigating conflict. The well-known franchise lawyers in the sector will no doubt provide the Review with a comprehensive and well-articulated list of practical administrative suggestions with regard to Disclosure and the large volume of documents required. Therefore, I will not duplicate what others will provide the Review, other than to say that the Disclosure process must properly inform in a manner than a lay person with limited education and language, can understand and make decisions concerning.

Franchise Disclosure Register

As part of the 2021 Code amendments a Franchise Disclosure Register¹² was mandated and then watered down due to Franchisor concerns regarding privacy and confidentiality.

Franchisors were required, at a minimum, to create a profile on the Franchise Disclosure Register however not required to, upload their disclosure document, franchise agreement and key facts sheet.

Based on the current IT platform of the register and that only a small minority of franchisors have provided information that could be regarded as relevant, it would appear that the Registry is useless. The Registry is not well supported and fails to deliver upon the intended policy. Further there is limited support for a mandatory requirement of appropriate information to be provided in a Register. I do not support a mandatory requirement. It would

¹² Competition and Consumer (Industry Codes – Franchising) Amendment (Franchise Disclosure Register) Regulations 2022 ('Regulations') to insert a new clause 53. Clauses 53A to 53J

also appear that Treasury time, interest and resources in maintaining the Register are limited and the Registry process should be substantially reworked or removed from the Code.

The KEY ISSUES at this stage in the relationship involves both parties' assessment of suitability. The Franchisor must properly determine whether the application franchisee, (despite having adequate financial resources) is a suitable candidate for the proposed site and franchise business. Such assessment is equally important for a Franchisor, as it is for an applicant Franchisee. If a Franchisor can be shown to have accepted a Franchisee applicant without a proper basis or examination, it may open itself up for a litigation. I won't set out a pleading, however my colleagues will be able to articulate a Statement of Claim in a more comprehensive way. Situations where a site is available for franchise and there are limited poor candidates, the acceptance of a poor candidate, rather than lose the site by the Franchisor could result in a problem site that leads to dispute. A Franchisor must either do the site itself as a corporate site or pass on the site if no suitable candidate is found. There is a time to walk away from a site that is available!

The fundamental starting point in engaging in any franchise relationship is that it involves appreciation of risk. Merely because the franchise fails, does not follow that someone is to blame and bares the consequences of failure. Consequences of failure should only flow in the event that there has been a breach of the Code, the Franchise Agreement or the law.

A primary issue of dispute involves matters that could have and should have been addressed in the due diligence process prior to the entering into the franchise agreement. Far too often have I seen parties arguing about matters that would have been addressed had the proper process of investigation and advice been obtained. The 2013 Franchise Code Review recommended that an independent legal advice certificate prior to entering into the franchise agreement. Such advice certificate would also include financial advice that would be undertaken as to the financial information provided and the borrowing commitments of the franchisee. This recommendation was not accepted on the basis that a Franchisee should not be required to incur greater costs. I suggest that the costs of not obtaining advice have costs both Franchisees and Franchisors millions of dollars of losses incurred in failed franchises, in addition to the emotional and psychological stresses of such failure.

I suggest that the mandatory obtaining of a proper **Legal / Financial Advice Certificate** (similar to a mortgage advice certificate) would be essential in this Code Review.

GOODWILL AND END OF TERM

The issues of goodwill and compensation for a Franchisee have been complex and vexed questions for some time. As previously stated, a franchise is in part a contractual and part property relationship. The current position at law is clear that all the proprietary interest in the franchise goodwill vest with the Franchisor. Under contract the Franchisee licences the proprietary rights in the Franchisors IP for a period of time and is granted the opportunity (not guaranteed) to profit generated from that grant of licence. At the expiration of the term of the agreement (including options if any) the Franchisee must return all the IP to the Franchisor and must desist from using the Franchisors IP. There is no right to compensation on the end of the term or upon early termination consequent on a breach of the franchise agreement.

The 2013 Franchise Code Review was asked to examine the question in detail and was provided strong representation for both sides of the issue with regard to an amendment providing for compensation to a Franchisee upon the end of term, that was not going to be renewed.

The Recommendation was that NO compensation should be granted as such a requirement would represent a fundamental change in the law that would significantly change established principles of property law established over many centuries at common law. Goodwill resides solely in the Franchisor. The Review provided that compensation may apply upon an early termination without proper cause. The Review also provided a practical compromise that allowed a Franchisee at the end of a term that was not renewed, to not be restrained¹³ from conducting a business of a similar type as the franchise, but in a different name and not using the Franchisors IP.

The 2021 amendments to the Code provided further protections and guidance on termination and compensation. The Code has expressly allowed a franchisee to request early termination (see clause 26B). If a franchisee makes such a request, it must provide reasons for the request and a franchisor must respond to the proposal within 28 days. If the franchisor does not agree with the franchisee's proposal relating to termination, it must provide reasons for the refusal.

The recent decision in **AHG WA (2015) Pty Ltd v Mercedes-Benz Australia/Pacific Pty Ltd**¹⁴, which involved a myriad of issues including non-renewal and issues of whether there

¹³ Clause 23A Franchise Code sets out a series of circumstances in which a restraint of trade clause contained in a franchise agreement has no effect after the franchise agreement expires.

¹⁴ [2023] FCA 1022

was goodwill and compensation entitled to the Franchisee at the end of a term and whether a Franchisor could change the nature of the relationship at the end of term that was not renewed. The Court conclude inter alia, that there was no right to a renewal and no right to compensation. The Court in fact referred to the 2013 Review in para 132.¹⁵

A decade on, I see no substantive reason to change the established fundamental principles of common law with regard to proprietary rights of goodwill. The current Code appropriately deals with the issues. In the event that the government were to accept and legislate for a compensation payment for goodwill where an expiring franchise term (without options) was not renewed or there was a justifiable legitimate early termination for breach - the established precedents in property law definitions would be turned on its head and the unintended consequences for not only franchise contracts, but also Leases, Licences, and other commercial contracts involving proprietary rights would be significant. The section 23A restraint of trade exemption is an appropriate off set for a end of term non-renewal. Again, some of the drafting issues in the Code should be addressed in order to give proper effect to the policy intent. The reference to 'extending' the term is not the same as 'non-renewal'. Item 18 in the Disclosure Document¹⁶ is inconsistent with Clause 23 and Clause 18 of the Code. Item 18 properly notes the position I support and Clause 23 should be amended to give effect to the terms of the agreement at the end of the term.

The matters that may be open for consideration and discussion are:

1. Fixed initial Term of agreement eg 5 years or 10 years where the capital investment required in a franchise exceeds \$1M (similar to most Retail Lease Acts provide).
2. Further relaxation of restrictive covenants.
3. Increased periods of notice of non-renewal.

¹⁵ Following the Wein review, amendments were made to the Franchising Code in relation to the enforceability of restraint of trade provisions where a franchise agreement is not renewed and nominal or no compensation for goodwill is given to a franchisee. But no right to compensation for goodwill, and no right to renewal, has been included in the Franchising Code. Rather, a franchisor is required to disclose "the prospective franchisee's rights relating to any goodwill generated by the franchisee (including, if the franchisee does not have a right to any goodwill, a statement to that effect)"

¹⁶ Franchising model - disclosure document Guidance 9 September 2022

AUTOMOTIVE MOTOR DEALER ARRANGEMENTS

Part 5 of the 2021 amendments to the Franchise Code provided specifically for Motor Dealers. Some of the key amendments included:

The obligation to act in good faith based on whether the terms of the agreement are fair and reasonable.

The Code¹⁷ provides that a Franchisor must not enter into a new vehicle dealership agreement unless the agreement provides for compensation in the event that a franchise agreement is terminated by the franchisor before it expires because the franchisor withdraws from the Australian market, rationalises its networks in Australia, or changes its distribution models in Australia.

The franchise agreement must also make provision for the franchisor to buy back or compensate the franchisee for new road vehicles, spare parts and special tools if the franchise agreement is not renewed and a new agreement is not entered into, or the franchise agreement is terminated before it expires because the franchisor withdraws from the Australian market, rationalises its networks in Australia, or changes its distribution models in Australia.

The Code¹⁸ provides that a franchisor must not enter into a new vehicle dealership agreement unless the agreement provides the franchisee with a reasonable opportunity to make a return, during the term of the agreement, on any investment required by the franchisor.

The key issues for franchising under a Motor Dealers or Machinery relationship include:

- (a) What and how should a return¹⁹ on investment be defined and calculated as reasonable based upon the current wording in the Code?
- (b) Should there be a minimum term granted for these types of franchises?
- (c) Does any goodwill exist in end of term franchises?
- (d) Should the current Part 5 of the Code be repealed and Motor Dealers and Machinery franchises be specifically provided in a separate regulatory framework?

¹⁷ Clause 46A

¹⁸ Clause 46B

¹⁹ Clause 46B

I have covered a number of the key issues in the comments earlier in this paper, and simply make a few observations for consideration.

The recent decision in **AHG WA (2015) Pty Ltd v Mercedes-Benz Australia/Pacific Pty Ltd**²⁰, highlighted several important outcomes:

There is no right or obligation to a renewal where there is no option and non-renewal on its face is not a breach of good faith.

On the expiration or justifiable termination of a franchise term any goodwill in that franchises also ceases to exist and no right to compensation exists.

The 2021 and 2022²¹ Part 5 amendments of the Franchise Code, together with the 2023 amendments to the Unfair Contracts Act (UCT) and the restructure of some of the Motor Dealer distribution system from franchise to agency will change the Motor Car Dealer franchises in Australia and the nature of Manufacturer and country distributor relationships as well. The Code now captures agency agreements in the definition of franchise.

Notwithstanding some of the recent changes in Part 5, there are specific and unique issues involved in the motor dealer industry and I believe a separate regulatory framework should be considered and developed for all motor vehicle dealership agreements including new vehicle dealership agreement and heavy machinery, motor bikes and trucks in Australia.

²⁰ [2023] FCA 1022

²¹ Competition and Consumer (Industry Codes – Franchising) Amendment (Penalties and Other Matters) Regulations 2022

DISPUTE RESOLUTION

In 2021 the dispute resolution process has been expanded. The Code now provides for disputes to be handled via conciliation and voluntary binding arbitration, in addition to the existing mediation model.²² These expanded processes provide the best and most efficient pathway to resolution and prospect of improved ongoing relationship for the parties. Litigation must always be the last resort. While arbitration should provide a viable format - it is yet to be fully accepted by the sector.

I believe that the ACCC and the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) continue to be best placed to manage and support the Code.

Most commercial conflicts are rarely categorised as a clear breach event easily identifiable. In my experience most commercial contract / relationship disputes are a cry for help or a deflection of blame for actions and conduct that may have placed stress on the business, relationship and financial position of the business or relationship. We lawyers are skilful on framing a cause of complaint or a pleading. Striking first doesn't make a sound case, but it establishes a problem that may not be properly and accurately identified in the letter of demand, breach notice or pleading. Most franchise disputes relate to:

- Debt owing to Franchisor
- Breach of clear operational clause in franchise agreement or Code by either Franchisor or Franchisee such as pre-agreement representations, site suitability, disclosure issues, failure to provide services or adequate services etc.

Disputes that are characterised as follows, concern me and fail to properly deal with the best process that leads to a path to resolution:

- Unconscionable conduct
- Good faith
- Unfair terms
- Misrepresentation
- Ambit claims that fail to recognise simple commercial risk.

The Code adequately deals with early termination without cause, where a case for compensation should apply.

²² Clause 4A

The more complex issues arise where a franchise fails due to no easily identifiable cause of the Franchisor or the Franchisee. Currently all the site loss is borne by the Franchisees. While there are consequential losses to Franchisors, the overwhelming loss is to the Franchisees. The legal and jurisprudential question is who should bare the risk or should there be some cascading obligations upon the parties, in a failed franchise scenario, without fault, to mitigate or manage the loss.

The factors to consider are:

- lease and occupancy costs
- Suppliers
- Bank and hiring debt
- Wages and employees' costs
- Taxes & GST

There should be no consideration for loss of opportunity or loss of profit in this scenario.

Commercial risk must be accepted by all parties in a commercial relationship and there may be no genuine cause of complaint or action - the difficulty of having a failed franchise creates issues for all concerned. Clearly a failed franchise creates not only financial issues for the Franchisee, as the Franchisor will probably lose revenue from the site. The Franchisor will be adversely impacted from a marketing and public image. Supplier and consumer confidence will be impacted and prospective franchise applicants may be discouraged. Providing a process that equitably deals with how to deal with a failed franchise, is worthy of consideration. A retail franchise will have a leasehold interest involving a third-party landlord and complicates any resolution to such a problem site. Apart from the lease, the Franchisee will probably have debt and financial commitments having invested in the franchise and liabilities to parties other than the Franchisor. Responsible Franchisors will attempt to investigate ways of improving the site or negotiating with the landlord regarding the terms of the lease or location of the site, or changing the Franchisee (that may be the issue in poor performance) or remixing the stock range and marketing. In the end, despite a good Franchisee and marketing, a site (despite initial due diligence) can fail.

Many of the factors that give rise to a dispute could be avoided if the pre-franchise due diligence, investigation and advice were sought and provided. When parties enter into a mortgage, purchase a house or invest in some financial products or funds - there is a substantial documentary and compliance process required. While the franchise Code imposes relevant detailed disclosure obligations on the Franchisor, there is no substantial obligations on the Franchisee other than warnings and encouragement to seek advice.

Given the cost of proper advice and the fact that many franchises are sold to new immigrants or parties with limited language, legal and financial competence - without an obligation to obtain advice, it will in many cases not be sought and thereafter issues arise. The Code provides a back ended rather than a preventative approach to potential disputes, other than disclosure and registry provisions.

The Code Review should not tinker with established principles of law – that should live within superior courts and parliament. The Code should address potential areas of conflict and provide processes that mitigate conflict, without attempting to eliminate commercial business risk in the ordinary course. The imbalances will never be completely aligned - the processes that define those imbalances can be reasonably addressed in the Code Review.

MAKE THE CODE ACCESSIBLE AND EASY TO COME TO, UNDERSTAND AND COMPLY WITH. SIMPLIFY THE ADMINISTRATIVE BURDEN OF DISCLOSURE, MITIGATE RISKS AND CONFLICT BY REQUIRING PROPER DUE DILIGENCE AND DO NOT DISTURB SOUND LEGAL PRINCIPLES THAT WILL HAVE UNINTENDED CONSEQUENCES.

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