Review of the Franchising Code of Conduct

Reviewer – Alan Wein

Response to Discussion Paper – January 2013

Competitive Foods Australia Pty Ltd

15 February 2013

Executive Summary

The Review should recommend the following:

- A well-defined duty of good faith should be included in the Code, adopting the original definition proposed in Mr Abetz' WA Bill in 2010.
- The duty of good faith should apply to all aspects of the franchising relationship, as recommended by the Ripoll Committee and stated in Mr Abetz' bill.
- An exit sale provision should be introduced into the Code to protect the property rights of franchisees, as discussed by the Ripoll Committee. This procedure should apply when a franchisor gives notice that it will not be renewing a franchise agreement at the end of the term, but wishes the franchise business to continue to operate either as a franchisor-owned outlet or under a new franchisee.
- Civil penalties should apply for all breaches of the Code, including for breach of the statutory duty of good faith.
- Some fine-tuning is required for clauses 29 and 30 of the Code to make the mediation process fairer and more effective.
- No further changes should be made to the disclosure provisions in the Code.

Franchising creates enormous economic value in Australia. The 73,000 Franchisees generate almost all of the economic activity, take most of the risk and provide most of the capital, yet they remain vulnerable to inappropriate and opportunistic conduct on the part of a small but significant proportion of Australia's 1,200 franchisors. The 2008 and 2010 amendments to the Code have done little to reduce this structural imbalance.

The implacable opposition to behavioural change by the franchisor lobby, led by the Franchise Council of Australia, has placed the franchise sector under a cloud. Banks are reluctant to provide finance for franchising, and prospective applicants are not being attracted to franchising, because of the risks associated with the industry.

For the industry to recover its credibility and realise its potential, the full suite of measures outlined above needs to be implemented to reassure banks, franchisees and the community generally that the industry operates fairly, that effort is rewarded, property rights are protected and adverse conduct is punished.

What is needed is a clear and effective conduct standard in the Code, which can be enforced when necessary by the ACCC seeking civil penalties. There is no longer any reason to delay this step. Rogue and opportunistic behaviour has been documented in report after report and it still continues.

It is now time for action and certainty, rather than further delays and continued reliance on ambiguous and uncertain concepts in relation to good faith, such as the "unwritten law". The majority of good and conscientious franchisors have nothing to fear from these changes, and everything to gain from the sector cleaning up its image through real behavioural reform.

Indeed the FCA freely admits that most franchisors currently act in good faith, and that there is a common law duty to act in good faith implied in franchise contracts. Therefore why should the inclusion of good faith in the Code be an issue?

Franchisees are in the main, small business operators. The only protection the Code currently provides franchisees from rogue behaviours on the part of franchisors is the "unwritten law" and the unconscionable conduct provisions in the ACL. Instead, what is needed is a clearly defined duty of good faith, protection of property rights and civil penalties for breach of the Code.

Set out in Table 1 is a set of drafting measures that would give effect to these submissions. These changes are supported by CFAL in its dual capacity as both a franchisor and franchisee as being essential to bring fair play back into franchising.

Table 1: List of Suggested Amendments

Good faith – replace current clause 23A of the Code and insert:

23A Good Faith

(1) In this clause –

act in good faith means to act fairly, honestly, reasonably and cooperatively.

(2) A person who proposes to be or is a party to a franchise agreement must act in good faith –

(a) in any dealing or negotiation in connection with –
(i) entering into or renewing the agreement;
(ii) the agreement; or
(iii) resolving, or attempting to resolve, a dispute relating to the agreement; and

(b) when acting under the agreement.

Exit Sale – insert the following provisions after sub-clause 20A(2) in the Code:

(3) In the notice provided to a franchisee under sub-clause (1) or (2) above, unless the franchisor decides to renew the franchise agreement or enter into a new franchise agreement with the franchisee, the franchisor must advise the franchisee if the franchisor wishes the franchised business to continue after the end of the term of the franchise agreement, in which case:

(a) the franchisee may offer the business for sale on a going concern basis to the franchisor or to a third party;

(b) the franchisor will have first right of refusal to purchase the business at market value on a going concern basis, which must be exercised within 30 days after provision of the notice referred to in this sub-clause (3);

(c) if the franchisor does not exercise the first right of refusal in paragraph (b) above, it will cooperate with the franchisee to allow the franchisee to effect a sale of the business at market value on a going concern basis to a third party prior to the expiry of the franchise agreement.

(4) Unless the court otherwise orders, the market value on a going concern basis of the business is to be determined on the basis of current year earnings of the business multiplied by a multiple of earnings commonly used in that industry for the transfer of franchises of the type being valued during the term of a franchise agreement, after allowing for all payments for royalties and other outgoings due to the franchisor.

(5) If the franchisor gives a notice under paragraphs (1) or (2) and does not state that it wishes the franchised business to continue, the franchisor may not within twelve months following the end of the term of the franchise agreement operate a business or grant a new franchise to a third party to operate a business that would have been competitive with the business of the franchisee if the franchise agreement had been renewed or a new agreement granted to that franchisee.

Civil Penalties

Amend section 51AD of the *Competition and Consumer Act* 2010 by adding a new subsection and renumbering the existing provision as sub-section (1):

(2) A contravention of sub-section (1) is not an offence.

Amend s.76 of the Act by inserting the following paragraph in sub-section 76(1)(a):

(ii) section 51AD in relation to the Franchising Code of Conduct;

Insert the following paragraph in sub-section 76(1A) of the Act:

(ca) for each act or omission to which this section applies that relates to section 51AD in relation to the Franchising Code of Conduct - $100,000;

Insert the following paragraph in sub-section 76(1B) of the Act:

(aa) for each act or omission to which this section applies that relates to section 51AD in relation to the Franchising Code of Conduct - $10,000;

Insert the words "section 51AD in relation to the Franchising Code of Conduct or" before the words "section 95AZN" where appearing in sub-section 76A(2) of the Act.

Dispute Resolution

Insert a new sub-clause 29(1A) in the Code:

(1A) Within 14 days after receipt of a notice of dispute under sub-clause (1), the respondent must tell the claimant in writing:

(a) The respondent's statement of the dispute;
(b) What outcome the respondent wants; and
(c) What action the respondent thinks will settle the dispute.

Insert the words "act in good faith" in sub-clause 29(6) as underlined:

29 (6) The parties must attend the mediation and act in good faith to try to resolve the dispute.

Delete the words "doing any of the following" in sub-clause 29(8).

Amend the words in sub-clause 30A(1) as underlined:

(a) at least 30 days have elapsed after the appointment of a mediator for the dispute;

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CFAL RESPONSE TO THE DISCUSSION PAPER

Part One: CFAL

1. CFAL is one of Australia's largest private companies, with over 15,000 employees and a turnover in excess of $1bn per annum and it operates as both a franchisor and franchisee.
2. It was founded in 1969 by Jack Cowin, with the opening of the first KFC franchise in Western Australia. Subsequently, Mr Cowin and CFAL opened their first Hungry Jack's restaurant in 1972. The original KFC restaurant opened by Mr Cowin at Melville in Perth was funded by moneys borrowed by Mr Cowin, and in this respect Mr Cowin's story and that of CFAL illustrate the potential for entrepreneurship that franchising represents. Indeed Mr Cowin's achievements in franchising have been recognised by his admission to the Australian Franchising Hall of Fame.
3. During the past 44 years, CFAL has had many issues and disputes with its US franchisors, Burger King and currently Yum! Brands Inc. The company is therefore very familiar with what can go wrong in a franchising relationship, and understands the challenges of both court proceedings and mediation in relation to these disputes.
4. Under a Master Franchise Agreement with Burger King in Australia (ie. the Hungry Jack's brand), CFAL is both a franchisee in relation to the 290 Hungry Jack's restaurants which CFAL owns, and a franchisor in relation to 65 Hungry Jack's restaurants operated by approximately 36 individual franchisees.
5. CFAL has been an active advocate for reform in the franchising debates and inquiries since 2007. Unlike the FCA, which only speaks for the franchisors and service providers – or a select group of them – CFAL is one of the few participants which has a financial interest in both sides of the debate and is willing to abide by the changes which have been proposed to the Code.
6. The draft amendments in Table 1 are therefore based on CFAL's view as both a franchisor and franchisee. Having regard to this dual perspective, CFAL believes that these amendments will benefit the industry by re-establishing a sense of fair play, and penalising opportunistic and rogue behaviour.

Part Two – Disclosure

Overview

7. CFAL submits that there should be no change to the disclosure regime. It has delivered significant value to the industry, but it doesn't address the behavioural or ***conduct*** problems. There are diminishing returns in terms of further changes to the disclosure requirements, and there are compliance costs associated with making any significant changes to standard form disclosure documents.
8. Secondly, the fundamental problem with disclosure is that it is limited to historical information or existing practices. The remedies for misleading and deceptive conduct do not assist in dealing with situations where market conditions or franchisor practices change over time.
9. Thirdly, the Expert Panel recommendations were appropriate within the terms of reference they were given – namely to look for options which did not involve adopting a duty of good faith. As such they do not solve the ***conduct*** issues in the industry. This matter is addressed more fully in relation to the good faith and end of term issues in Parts Three and Four below.
10. CFAL has no submissions to make in relation to questions 1, 2, 11 or 12 and only limited submissions to make in relation to the other questions, as set out below.

Discussion Questions

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?
4. Does the sector have any concerns regarding the operation of these amendments?

11. Financial disclosure and transparency has improved, and should continue to do so. The main area that could be considered for further reform is the disclosure of details about rebates received by franchisors relating to goods or services that franchisees are compelled to procure. This is an area of contention for many franchisees in circumstances where the goods or services are clearly above market value as a consequence of the additional cost of the franchisor's rebates.

5. Have the amendments regarding unilateral variation, transfer and novation been effective in addressing concerns about franchisors' ability to make changes to franchise agreements? Why or why not?
6. Does the sector have any concerns regarding the operation of these amendments

12. These amendments have not stopped rogue and opportunistic behaviour by franchisors, because they are ***disclosure*** not ***conduct*** obligations.
13. An example in the Quick Service Restaurant industry of where franchisors can and do make unilateral variations is in relation to franchisor Operations Manuals, which are addendums to the franchise agreements and therefore can be amended at will with material implications for

franchisee profitability. Franchisees have no option other than to comply, irrespective of whether those changes add value to their businesses or the system as a whole, or not.

14. Disclosure about what happened in the past, or even the franchisor's current practices, provides no protection for franchisees in relation to adverse conduct by the franchisor at some later time. The only effective solution is to introduce a general good faith obligation as recommended in Part Three below.

7. Have the changes to the Franchising Code led to improved franchisee knowledge about franchisors and their conduct before they enter into franchise agreements? Why or Why not?
8. Is the information being provided useful to franchisees?
9. What effect has the requirement to provide this additional information had on franchisors?
10. Does the sector have any concerns regarding the operation of the new provisions?

15. The short answer to these questions is that the additional disclosure may be beneficial, but not in the way implied by the questions. That is, disclosure of past conduct will force prospective franchisees, or their advisers, to think about the potential problem areas and do some further investigations.

16. In other words, the additional disclosure acts as a signal to potential franchisees about what sort of due diligence they should be doing. In itself, this is a good reason to keep the additional disclosure. However, as stated above, this disclosure will not stop adverse franchisor conduct in the future.

17. Secondly, the question makes the assumption that more disclosure actually impacts upon decisions to invest. Real world experience is that most franchisees make the emotional decision to invest based on trust and their impression of the brand, and franchisors encourage this "trust me" attitude. It is often only their lawyers, accountants and business advisers who read the disclosure material in detail, after the franchisee has made the emotional commitment to invest, but before entering a franchise agreement.

13. On the whole, do the 2008 and 2010 disclosure requirements ensure franchisees are provided with adequate information?
14. Is the extra onus on franchisors justified by the benefit this disclosure is providing to franchisees?

18. The short answer is that the 2008 and 2010 disclosure requirements are beneficial, so far as they go, and should be retained.

19. The only people who would benefit by changing the disclosure requirements are franchisor lawyers, because they get to rewrite their disclosure precedents yet again and then charge franchisor clients money to meet with them and adapt their precedents to each franchisors system. Even though the amount might be relatively small per franchisor, it is an additional business cost which cannot be justified.

Part Three – Good Faith

Overview

20. The Discussion Paper is not entirely correct in its opening statement that "from time to time calls have been made for an overarching standard of conduct – such as an obligation of good faith – to be imposed on the franchising relationship by law."

21. In fact, there has been a consistent series of recommendations for the introduction of a good faith obligation in franchising since the 2006 Matthews Report, including:

    - Dr Craig Emerson in 2007, as part of the Labor Party's platform going into the 2007 election, called for the introduction of a "well defined duty of good faith";
    - The South Australian Parliamentary Inquiry in 2008, which recommended the introduction of a good faith obligation in franchising;
    - The Ripoll Committee in 2008, which recommended the introduction of a good faith obligation in franchising.

    These recommendations have been consistently supported by franchisees, a broad cross-section of parliamentarians and other parties like CFAL that are concerned about improving behaviour in the industry.

22. On the other hand, the franchisor lobby, led by the FCA, has consistently opposed the introduction of a good faith obligation, using a range of contradictory and opportunistic arguments, depending upon the occasion:

    - Sometimes they argued that good faith does not exist as a common law duty and therefore shouldn't be introduced into franchising, on the basis that the High Court has never approved such a term;
    - Other times they argued that good faith is already part of franchising law, and so there is no need to put a good faith obligation in the Code, because it already exists at common law;
    - Sometimes they said that good faith should not be introduced in the Code because it is too ambiguous and uncertain, and that it needs to be defined;
    - Other times they said that definitions, such as those proposed in Mr Abetz' Bill, are too restrictive, and that the common law should be allowed to develop through the case law rather than be restricted by statute.
    - They also always put as an argument of last resort an undefined allegation of "unintended consequences", which is clearly a catch all threat and an amorphous excuse to do nothing.

23. In essence the franchisor lobby, and their lawyers, have tried to preserve a status quo which allows adverse and opportunistic behaviour to continue without any effective ***conduct*** remedy. In CFAL's submission, a simple, clear duty of good faith should now be introduced into the Code, without further delay, and CFAL supports the definition proposed in Mr Abetz' WA Bill.

24. The term good faith is well understood within the wider community. It appears in over 160 Commonwealth Acts, including legislation such as the Native Title Act 1992, the Fair Work Act 2009; the Insurance Contracts Act 1984 and the Corporations Act 2001.

Responses to Discussion Questions

15. How effective were the targeted amendments in 2010 to the Franchising Code in addressing specific issues, instead of inserting an overarching obligation to act in good faith?

25. The targeted amendments recommended by the Expert Panel were not effective in removing the risks of bullying and opportunistic ***conduct***, because they were ***disclosure*** requirements. As CFAL has repeatedly said, ***disclosure*** requirements do not resolve ***conduct*** issues.

26. There are plenty of examples since 2010, which are well known in the industry, to show that bullying and opportunism is alive and thriving. It may only be a small proportion of franchisors that engage in these undesirable behaviours, but their behaviour is symptomatic of a systemic problem that needs to be fixed and can only be fixed by a general ***conduct*** standard – ie. a well-defined duty of good faith.

16. How effective is section 23A of the Franchising Code, which provides that nothing in the common law limits the obligation to act in good faith?

27. Although the intention of the question is clear, the wording of this question appears to be back to front. Clause 23A of the Code states:

> *Nothing in this code limits any obligation imposed by the common law, applicable in a State or Territory, on the parties to a franchise agreement to act in good faith.*

That is, the common law obligation is assumed by clause 23A (correctly) to exist, and the clause simply confirms that the Code in its present form does not override that duty.

28. One positive consequence of clause 23A is that the reference to "*the obligation to act in good faith*" has changed the general culture within franchising, to the point where many franchisors and franchisees readily accept that good faith is a fundamental part of the franchising relationship. The language of good faith is common place in mediations and other discussions, and good faith duties were conceded by Senior Counsel for the franchisor and in the recent decision of the NSW Supreme Court in *AMC Commercial Cleaning (NSW) Pty Ltd v Coade* [2010] NSWSC 832 at [7].

29. Even Norton Rose, the FCA's principal lawyers, and the FCA have publicly stated that good faith is now a recognised part of a franchisor's obligations in Australia. This is a major step forward in the debate since 2008.

30. However, the problem with clause 23A is that it does not spell out the duty and make it an enforceable duty under the Code. This causes two problems that need to be rectified:

- First, it creates a "*lawyers picnic*" (to borrow an FCA phrase), because the lack of a definition means that franchisors and franchisees have to consult lawyers to understand what the common law means in relation to good faith. This is resolved by having a clear, simple, plain English definition as put forward by Mr Abetz;
- Second, to be effective, the duty must be capable of being enforced by the ACCC through the use of civil penalties in appropriate cases to rein in rogue franchisors or

franchisees. For that reason, the duty needs to be included in the Code and clearly defined – again this is resolved by adopting the Abetz definition.

31. It is important to appreciate that this definition does not stop a franchisor from acting in its own best interests, but ensures that it takes account of the legitimate interests of the franchisee in making its decisions. As the South Australian Committee said in relation to the duty (at p.55):

> *The judicial interpretation of the doctrine argues that the recognition of the duty of good faith and fair dealing does not go against the pursuit of parties' self-interest or disregard of one's own commercial interest or enjoyment of rights nor does it necessitate "altruism, subjugation of self-interest or disregard o one's own commercial aims". While an abstract formulation of a generalised concept of good faith may be indistinct, the courts have demonstrated that they are able to know it when they see it, or more properly, they know a breach of it when they see it.*

32. Further, good faith is a duty that may have a particular application in franchising, irrespective of how it develops in other situations, because franchising a special form of "business partnership", as the FCA acknowledged in its submissions to the South Australian enquiry.

33. In academic circles, franchise contracts are referred to as "relational contracts". This means that the duties owed by franchisors and franchisees evolve over time, depending upon the circumstances of the business and the market. This is why franchisors are given considerable discretions, including for example the power to make unilateral variations to the operating manual, to meet changing market conditions and circumstances. A duty of good faith ensures that parties exercise these discretions properly and consistently with the intention of the "business partnership" that exists between the parties.

17. What specific issues would be remedied by inserting an obligation to act in good faith into the Franchising Code which would not otherwise be addressed under the unwritten law or by the ACL?

34. There are two parts to this question, which require different answers:

- First, a duty of good faith, whether part of the unwritten law or in the Code, fills a gap that exists in the ACL;
- Secondly, inserting a good faith obligation into the Code would remove the uncertainty and ambiguity that exists by having only a passing reference in clause 23A of the Code to the unwritten or common law duty.

35. In relation to the first issue, the franchisor lobby has repeatedly tried to confuse the relationship between good faith and existing obligations under the ACL, to argue that there is no need for a good faith duty. This is incorrect. There are three separate issues here:

- Misleading and deceptive conduct under s.18 of the ACL applies to representations, and creates obligations about ***disclosure***. That is, in simple terms, whether the disclosure by the franchisor in its disclosure document was accurate and complete. As set out in Part Two, ***disclosure*** obligations do not regulate future ***conduct*** – they are about the past not the future, except in the limited case where a party makes a statement about the future where it has no reasonable basis for doing so.

  To give an example, a franchisor says that its current practice in relation to X is A. That can be a correct statement at the time it is made. Provided the franchisor did not have any intention at that time to change its practice, it will not breach any misleading and

deceptive obligation. Five years later if it decides to change its practice to B, there is no breach of its misleading and deceptive obligation.

- Unconscionable conduct under s.21 of the ACL applies to all business relationships, not just franchising. It has been heavily criticised for lacking in clarity and certainty. Litigation about unconscionable conduct is expensive and time-consuming, and relatively few cases have been run by the ACCC or by individuals to enforce these provisions.

  Given its general application to all business relationships, it is not an option to modify the unconscionable conduct provision for franchising. What is needed is a specific ***conduct*** obligation that responds to the special circumstances of franchising – namely the use of "relational contracts", the recognition that franchising is a distinct form of "business partnership" without being a legal partnership, and the existence of multiple discretions that create opportunities for opportunistic and rogue behaviour.

- The duty of good faith, whether under the unwritten law or in the Code, fills a gap in the ACL between misleading and deceptive obligations, and the unconscionable conduct obligation. As previously noted it creates a ***conduct*** standard that responds to the specific needs of the franchising industry. This point was made by the former Commonwealth Attorney-General and leading West Australian barrister, the Hon Daryl Williams QC, in his Opinion tabled in relation to the Abetz Bill as follows (a copy of the Opinion is Attachment 1 to this submission):

  > *In our opinion the Bill fills a gap in the Franchising Code of Conduct by affording a measure of protection to franchisees and thereby addressing the disparity in power between franchisors and franchisees as well as providing specific forms of relief appropriate to the franchising industry. The Bill requires both franchisor and franchisee to deal with each other in good faith.*

36. In relation to the second issue, the question needs to be turned around. If, as CFAL submits, it is now widely accepted that a duty of good faith exists, then the question is why shouldn't it be stated expressly in the Code? Putting an express obligation of good faith in the Code would put an end to the uncertainty and ambiguity that exists by forcing franchise parties to guess about, or to incur lawyers' fees to understand, the meaning of the "unwritten law".

37. Apart from lining the pockets of lawyers to opine on the unwritten law, there is simply no justification for leaving the duty of good faith out of the Code. There is no need to rehash the countless examples and evidence presented to inquiry after inquiry about opportunistic and rogue franchisor behaviour, which has resulted in numerous findings of the need for good faith. This behaviour occurs at all stages of the franchising relationship, which is why a general duty of good faith is required.

38. To the extent the question about "specific issues" is asking about particular types of conduct, CFAL submits that a piece-meal approach to good faith would satisfy no-one, would add complexity to the law when simplicity is required, and would not solve the industry's image with financiers and potential franchisees as a high risk proposition.

18. If an explicit obligation of good faith is introduced, should 'good faith' be defined? If so how should it be defined?

39. Good faith should be defined in the Code, and Mr Abetz' definition should be used. This definition solves all the problems of ambiguity and uncertainty using simple, clear, everyday

words that franchisors and franchisees can easily relate to, without needing to consult lawyers. All that parties need to do is look up the Code on-line and apply their common sense:

> *act in good faith means to act fairly, honestly, reasonably and cooperatively.*

40. In order to address the opposition being put forward in WA by the FCA and its allies about this definition, the Hon. Daryl Williams QC confirmed that the Courts would give these words their ordinary, everyday meaning:

> *The requirement to act in good faith is defined in clause 11(1) of the Bill to mean that a party is required to "act fairly, honestly, reasonably and cooperatively". These words are well known to the common law and lawyers, and, broadly speaking they are non-technical terms which will be interpreted in accordance with their ordinary meaning. It is to the meaning of the quoted words that the courts will turn to determine what the duty to act in good faith requires in the circumstances of the particular case.*

41. There is nothing revolutionary in the words adopted in Mr Abetz' definition. They reflect existing common law concepts, as summarised by Justice Rein in *AMC Cleaning v Coade* (see above):

> *There was no dispute as to the legal principles relevant to franchises. In J F Keir Pty Ltd v Priority Management Systems Pty Ltd (administrators appointed) [2007] NSWSC 789, I summarised the submissions made on behalf of the franchisee in that matter, which I accepted as to the content of the duty of good faith. In short, and relevantly, the franchisor is required to act reasonably and honestly (to an objective standard), not to act for an ulterior motive, to recognise and have regard to the legitimate interest of both parties in the enjoyment of the fruits of the contact, and to avoid rendering the franchisee's interest under the agreement nugatory or worthless or seriously undermining it: see Burger King Corp v Hungry Jack's Pty Ltd [2001] NSWCA 187; (2001) 69 NSWLR 558; Alcatel v Scarcella (1998) 44 NSWLR 349; Far Horizons Pty Ltd v McDonald's Australia Ltd [2000] VSC 310; Gary Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd [1999] FCA 903; (1999) ATPR 41-703; Automasters Australia Pty Ltd v Bruness Pty Ltd [2002] WASC 286; (2003) ATPR (Digest) 46-229.*

42. One of the furphies spread by the franchisor lobby is that the definition in the Abetz' Bill should not be used, because the common law should be allowed to develop on its own. This is really shorthand for saying that franchisor lawyers want to have the flexibility to think up clever arguments to limit the scope of good faith to attempt to protect rogue and opportunistic conduct by their clients. It would exacerbate the adverse conduct because it would allow these franchisors to bully franchisees at mediation, because the alternative for franchisees would be the prospect of expensive and time-consuming litigation arguing legal points, potentially all the way to the High Court.

43. From another perspective, the lack of a definition creates an informational disadvantage which favours franchisors over franchisees, because the assistance of lawyers is required to interpret the unwritten or common law. Franchisors are much more likely to have the resources and ability to consult lawyers, thus reinforcing the franchisee's disadvantage.

44. CFAL notes that Mr Abetz' definition post-dates both the South Australian Inquiry and the Ripoll Inquiry. If, contrary to the submissions put forward above, this Review recommends the inclusion of a duty but leaving the duty undefined, CFAL submits that the undefined duty should be included in the Code as per the Ripoll recommendations. This would at least remove some of the existing ambiguity and allow the ACCC to take enforcement action. It would be a second-best solution, but it is better than doing nothing.

19. If an explicit obligation to act in good faith is introduced, what should its scope be? That is: should it extend to: the negotiation of a franchise agreement, and/or the execution of a franchise agreement, and/or the ending of a franchise agreement, and/or dispute resolution in franchising?

45. The scope of the duty should apply to all aspects of the franchise relationship. As stated above, the franchise relationship is a "commercial partnership" from start to finish. Franchisor discretions and opportunities for abuse exist throughout the relationship, meaning that a general duty of good faith should apply to all aspects of the franchising relationship.

46. CFAL supports the adoption of the scope of the duty set out in Mr Abetz' Bill. This is precisely what the Ripoll Committee recommended in 2008, as did the South Australian Committee preceding it. Mr Abetz' Bill stated:

> *A person who proposes to be or is a party to a ... franchise agreement must act in good faith –*
>
> *(a) in any dealing or negotiation in connection with –*
>
> *(i) entering into or renewing the agreement;*
>
> *(ii) the agreement; or*
>
> *(iii) resolving, or attempting to resolve, a dispute relating to the agreement; and*
>
> *(b) when acting under the agreement.*

47. Good faith is ultimately about ensuring that the trust and cooperation that led a franchisee to enter a franchise system, or a franchisor to take on a particular franchisee, continues throughout the life of the franchise relationship. Trust and fair dealing cannot be sliced and diced into compartments, where sometimes it applies and sometimes it doesn't. There is no disadvantage in applying the duty generally – good and honest franchisors will not be affected, because this is how they do business anyway.

48. It is actually in the interests of franchisors and the industry generally that the industry embrace a general overarching duty of good faith in the Code to reduce the perceptions of risk that currently exist in relation to the industry. Any attempt to introduce a partial solution will look contrived and not be seen as a genuine attempt to put the industry back on track.

20. If such a specific obligation to act in good faith was introduced into the Franchising Code, what would be an appropriate consequence for breaching such an obligation.

49. There would be two consequences of breaching the good faith duty:

- The aggrieved party, franchisee or franchisor, would be able to seek civil remedies to compensate them for any harm suffered – damages, injunctions and other orders under the ACL;
- The ACCC would be able to take action to recover civil penalties, although these actions would require a higher standard of proof than ordinary civil actions by franchisees.

21. If such a specific obligation to act in good faith was introduced into the Franchising Code, how would such an obligation interact with the provisions of the ACL.

50. There would be no confusion or overlap, because the good faith provisions fill a gap left by the current ACL as stated in answer to question 17 above.

51. The current ACL provides a range of civil remedies to an aggrieved party for breaches of the Code, such as damages, injunctions and other orders. If a general duty of good faith is included in the Code, these remedies would be available for breach of the duty.

22. If the Franchising Code was amended to contain an explicit obligation to act in good faith, would there need to be other consequential amendments to the Franchising Code?

52. The short answer is that the only amendment required will be to clause 29, because it sets a standard for mediation conduct which is less than a good faith standard would require.

53. Clause 29 (6) only requires that "*the parties attend the mediation and try to resolve the dispute*". This is below the usually accepted standard that parties must make good faith attempts to settle disputes at mediation – see for example the Law Council of Australia's 2007 Guidelines for Lawyers in Mediations which states:

> *Lawyers and clients should act at all times, in good faith, to attempt to settle their dispute.*

54. It is clear from the deeming provision in clause 29(8) that it is a lesser standard which applies in a franchise mediation. On a literal reading of that clause, a party will discharge its obligations by "*doing any of the following*" in paragraphs (a)-(e). That is, if a franchisor simply attends and participates in meetings at reasonable times, it will discharge its obligation of trying to resolve the dispute. The franchisor doesn't actually have to put forward any constructive offers – it just has to attend and participate, it doesn't have to say or do anything constructive. This issue is addressed further in Part Five below.

55. There are other specific ***conduct*** obligations on franchisors in the Code. All of these involve specific obligations which are clearly spelt out, and are consistent with a general duty of good faith:

- The giving of notices, information or disclosure - clauses 6, 6B, 10, 11, 14, 17, 18, 19, and 20A;
- Prohibitions in relation to franchisee associations and releases – clauses 15 and 16;
- Not unreasonably withholding consent to the transfer or novation of a franchise – clause 20;
- Termination procedures – clauses 21-23.

56. As there is no inconsistency between any of these provisions and a general duty of good faith, no consequential amendment is required to these provisions, and none has ever been suggested.

Conclusion

57. The reality in 2013 is as follows:

    - As a result of clause 23A there is now a wide-spread acceptance that a good faith duty is part of franchising in Australia;
    - There is now a well-defined duty of good faith put forward in the Abetz Bill in WA, which codifies the common law in simple and easily understood terms;
    - Including a well-defined definition in the Code will remove ambiguity and uncertainty from the law, and remove the need to constantly consult lawyers about the unwritten law;
    - The introduction of that duty in the Code will enhance certainty and reduce perceptions of risk in the franchise sector.

58. Looking back at the history of the matter, it is clear that the government missed the opportunity to act on the Ripoll report recommendations, by rejecting good faith in the Department of Industry's Regulatory Impact Statement in 2010. It would appear that the Department, based on its own consultations, rejected Option 2, which was a "broad good faith obligation" on the grounds of "increased ambiguity of rights and obligations and disputation". In other words, the Department accepted the position taken being taken by the franchisor lobby at the time.

59. As a result of the RIS, the Expert Panel was asked to prepare recommendations for Option 3 in the RIS, namely specific measures to discourage specific behaviours. The Expert Panel was limited by its terms of reference for evaluating a second-best outcome in relation to ***conduct***, rather than examining good faith and formulating a definition of good faith as Mr Abetz has now done. As noted in Part Two of this Submission, the Expert Panel's recommendations for more disclosure did not and cannot address the ***conduct*** issues in franchising.

60. With the benefit of having a well-defined duty, which is clearly supported by the legal opinion of the Hon Daryl Williams QC, it is now time for the Federal Government to act and implement that duty in the Code.

Part Four – End of term renewals and property rights

Overview

61. What happens to a franchisee's investment at the end of the franchise term is a major issue for the sector. This is another reason why prospective franchisees are not entering the industry and banks are reluctant to lend money to franchisees to invest.

62. The real issue here is the recognition and protection of property rights built up by franchisees in their businesses, where the franchisor wants to continue with the business without the franchisee after the end of the franchise term. This is often referred to as "churning".

63. During the term, a franchisee's rights are protected as follows:

    - Clause 20 of the Code facilitates franchisees selling their businesses, by stating that franchisors cannot unreasonably withhold consent to transfer or novation.
    - Clause 21 of the Code prevents a franchisor from terminating a franchise agreement for breach, without giving a franchisee reasonable notice and allowing the franchisee to rectify the breach.

64. There will be some, cases in which a franchisor has a good cause for not renewing a franchise agreement – for example, consistent poor performance by the franchisee over an extended period, or where the lease required by the business has expired and cannot be renewed, or the franchisor wishes to exit franchising all together. CFAL does not suggest any remedy is required for franchisees in these circumstances – which is more akin to contractual frustration than franchisor opportunism.

65. However, franchisees should not be exposed to the risk that they invest their time, money and effort in building up a business, only to have it taken away without compensation at the end of the term. This is contrary to the basic bargain in franchising, where the franchisee is led to believe that they are building up a business and generating wealth for themselves, not just buying a job.

66. There are two fundamental facts about franchising which are relevant to this discussion:

    - Over 90% of franchises are renewed on expiry. This is consistent with the basic franchising bargain and makes good business sense for honest franchisors – you attract good franchisees by allowing them to share in the benefits of the business they build up.
    - There is a persistent and high level of disputes in relation to renewals and expiry, because rogue and opportunistic franchisors attempt to take away the value of the business from the franchisee, by refusing to renew or imposing stringent conditions on renewal that reduce business value.

Responses to 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?

67. The amendments have not been effective, because they do not recognise property rights for the franchisee. Instead, they make franchising look like retail leasing, which it is not. In franchising

the franchisee has created a business which did not exist at the start of the agreement; in retail leasing the shop taken by the tenant at the start of the lease is the same shop that the tenant hands back to the landlord at the end of the lease.

68. There are three possible options that exist for a meaningful provision to protect the property rights of franchisees:

    - A provision requiring a renewal to be granted unless the franchisor has "just cause" not to renew. This was the approach adopted for the oil industry, to stamp out abuses in that industry, in the *Petroleum Retail Marketing Franchise Act* 1980. It is also the approach adopted in a number of key US states, as CFAL pointed out to the Ripoll Inquiry.

    - Enhanced remedies for courts to apply in the case of a breach of good faith or unconscionable conduct in relation to renewal decisions. In the original version of Mr Abetz' Bill, these orders were called "renewal orders". The availability of these orders would send a clear signal to the Courts to stop franchisors from depriving franchisees of the property rights in their businesses, by ordering a compulsory renewal if the circumstances warranted.

    - A provision allowing a franchisee to sell the business at the end of the term, which allows the franchisor or incoming franchisee to buy the business at market value ("**exit sale option**"). In other words, if the franchisor wants the business to continue, but not with the original franchisee, the franchise would be able to exit for value. This solution was put forward by CFAL to the Ripoll Inquiry.

69. Proper debate about these options has become clouded by arguments about relationship breakdown. That is, franchisors argue that they should not be forced to stay in a business relationship with a franchisee once the term expires. While superficially attractive, the claims about relationship breakdown need to be treated sceptically, particularly if both parties are making money out of the relationship – experience indicates that relationship breakdowns can be manufactured by franchisors as an excuse for not dealing properly with a franchisee and vice-versa.

70. Claims and counter-claims about who was responsible and why for a relationship breakdown involve cost and time, and are often self-fulfilling distractions for both franchisors and franchisees. For this reason CFAL submits that the exit sale option is the best course. This option is also consistent with the introduction of the good faith obligation in the Code, which will of course extend to end of term negotiations and renewals.

71. The exit sale option is not a compulsory buy-out. If the franchisor does not want to continue with the franchised business, it can close the business. This will be a very rare case, and will probably only occur if the business is worthless in any event.

72. However, if the business is to continue, then it is only fair and just that the franchisee has a property opportunity to sell the business. If the franchisor wishes to take over the business itself, it should do so and pay market value for that right. Alternatively, the franchisor and franchisee should cooperate to sell the business and allow the franchisee to recoup the business value. The Ripoll Committee clearly envisaged the attractiveness of the exit sale option: see the Report at paragraph 6.89 and Chapter 6 generally.

73. The exit sale option is simple to put into effect:

    - It only applies when the business is to continue after the end of the term. The franchisor can advise the franchisee of that decision upon giving a notice under clause 20A.

- The Code can stipulate a default sale price based on current EBITDA multiples, using current year earnings, as if the sale had taken place during the term.
- There will need to be anti-avoidance measures to stop franchisors, for example, closing one business and then granting a new franchise next door, and claiming that it is a new or different business. This can be done by a "restraint of trade" type clause that prevents a franchisor from opening up a competitive outlet within 12 months of closing the franchise business.

74. There are three key advantages of the exit sale option for the industry as a whole:
    - First, it will clean up the risk image of the industry, and give banks and prospective franchisees certainty in relation to the value of their investment;
    - Secondly, the default sale price uses a market mechanism which is easy to calculate, and achieves consistency with in-term sales;
    - Thirdly, it removes the incentives for franchisors to churn good franchisees for the wrong reasons, because there is no profit in doing so for the franchisor, and there is a risk that the new franchisee will not be as good an operator as the old franchisee.
75. The exit sale option is consistent with CFAL's experience in its own franchise dispute negotiations, and will help resolve the very serious cloud that currently hangs over franchising in Australia.

Part Five – Dispute Resolution

Overview

76. The dispute resolution statistics referred to in the Discussion Paper appear to understate the level of disputation in franchising. In a 2010 report entitled "Rogue franchisors giving a bad name to a relationship driven industry", independent research house, 10 Thousand Feet, estimated that over 58% of franchise systems recorded a dispute in the preceding 3-years.

77. Depending upon survey designs and the identity of the survey respondents, it is possible that the 10 Thousand Feet survey data is more reliable than the ACCC or Griffith University. The ACCC only measures calls it receives, which may reflect only those disputes where franchisees do not have their own lawyers. In relation to the Griffith University *Survey* for 2012, their finding that the level of disputes was estimated at 18% was based on voluntary responses provided by 126 franchisors, who may or may not be representative of the sector (see p.18).

78. CFAL does however accept that most disputes are resolved through mediation. Also it supports the emphasis in Part 4 of the Code upon mediation of disputes prior to the commencement of court proceedings. CFAL's responses to these Discussion Questions proceed on this basis.

Responses to Discussion Questions

> 24. Has conduct and behaviour during mediation changed since the introduction of the 2010 amendments to the Franchising Code, including requiring parties to approach mediation in a reconciliatory manner? If so, in what ways?
>
> 25. Does the sector have any concern regarding the operation of these amendments?

79. The mediation procedures in clauses 29 and 30 are useful but need fine-tuning to avoid franchisors using the mediation procedures unfairly against franchisees. These are:

    - There should be a requirement to match clause 29(1) for respondents. That is, within 14 days of the receipt of a complaint, the respondent must provide the claimant with a statement in writing responding to each of items (a), (b) and (c) in sub-clause 29(1).
    - Sub-clauses 29(6) and (8) should be amended to require a duty to mediate in good faith, and to remove the words "doing any of the following" in sub-clause (8);
    - Sub-clause 30A(1)(a) should be amended to start the 30 day time period from the appointment of the mediator, not the "start of the mediation".

80. The first of these suggestions will ensure that the responding party (typically the franchisor) must put its cards on the table prior to the appointment of the mediator, so that the real issues and possible solutions can be identified quickly and cheaply. At present, a franchisor accused of bullying, for example, can avoid having to justify its conduct and put forward its side of the dispute until the actual mediation conference itself, which is too late.

81. The problem raised by the second suggestion has already been identified. The absence of an express duty to mediate in good faith, and the presence of the words "including doing any of the following" means that a party can pay lip-service to the mediation simply by "attending and participating in meetings at reasonable times". Again, a determined rogue franchisor can make the mediation process a mockery, which should not occur. Removing these additional words in sub-clause 29(8), and requiring parties to mediate in good faith will solve this problem.

82. The third suggestion is designed to create certainty in relation to timing. At the moment it is unclear what is meant by "the start of mediation" – is it the service of the notice of dispute (unlikely), is it the appointment of the mediator (possible) or is it the mediation conference itself (probable).

83. These three enhancements will all improve the current mediation framework. Otherwise CFAL submits that the mediation framework should remain as it is.

84. The only other suggestion that might be worth considering is a data collection function by the ACCC to receive confidential reports from mediators, in all mediations, whether an OFMA mediation or a private mediation. This data would improve transparency and take the guess-work out of what is happening on the ground in relation to disputes and resolution in the franchise industry.

Part Six – Enforcement of the Code

Overview

85. The main issue in relation to enforcement is to give the ACCC, as regulator, the power to seek civil penalties for breach of the Code. Every recent report in relation to franchising has recommended that the Code be given teeth by the introduction of civil penalties.

86. CFAL takes issue with the justifications advanced for not introducing civil penalties in response to the Ripoll Report for three reasons:

    - Franchising is a major area of economic activity in Australia. Absent civil penalties, the regulatory structure of this sector is weak, and a clear message needs to be sent to the sector that rogue conduct will no longer be tolerated.
    - The Code is largely prescriptive in relation to the issues which it covers. These are the sorts of matters that can and should be the subject of civil penalties.
    - In the absence of civil penalties, enforcement of the Code is largely left up to the resources and motivation of private parties, which means it will be inconsistently enforced at best. This is a problem in franchising where many individuals may be affected by the same conduct of the one franchisor.

87. As part of the process of cleaning up the industry's image, it would be appropriate for this Report to join with all prior reports and recommend the immediate introduction of significant civil penalties, bearing in mind that any penalty will likely be levied against an organisation rather than an individual. In its draft provisions in Table 1, CFAL has adopted, for convenience, the penalty amounts proposed in Mr Abetz' Bill.

Responses to Discussion Questions

26. Is the current enforcement framework adequate to deal with the conduct in the franchising industry?
27. How can compliance with the Code be improved?
28. What additional enforcement options, if any, should be considered in response to breaches of the Franchising Code?
29. What options are available to businesses to address breaches of the Franchising Code, or any other adverse conduct in the franchising industry.

88. The current enforcement framework is not adequate to deal with adverse conduct in the franchising industry – civil penalties are required. They are effective in addressing other potential market failure issues. They are needed in franchising to give the Code some "teeth".

89. Compliance with the Code is only as good as the Code itself. The Code should include a well-defined duty of good faith, as stated in Part Two. Civil penalties should apply to a breach of this duty. This will allow the ACCC to single out the rogues and stop them giving the industry a bad name, bearing in mind the higher degree of satisfaction about the evidence is required in civil penalty actions compared to normal civil claims.

90. Again, the absence of a strong and clear statement by Government of its intention to stamp out rogue behaviour in franchising, by the introduction of civil penalties, will ensure that the sector will continue to suffer from its image as a high risk activity to the detriment of all sector participants.