



Law  
Institute  
Victoria

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# **Discussion Paper: Review of the Franchising Code of Conduct**

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## **Submission to the Franchising Code Review Secretariat, Parliament of Australia**

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## **1. Introduction**

On 4 January 2013, the Minister for Small Business announced a review into the Franchising Code of Conduct (**Franchising Code**). Following amendments to the Franchising Code in 2008 and 2010, the Government announced a further review would be undertaken in 2013.

The Law Institute of Victoria (**LIV**) welcomes the opportunity to provide comment on the Discussion Paper – Review of the Franchising Code of Conduct (the **Discussion Paper**).

The LIV restricts its comments to those contained herein, and welcomes the opportunity to be involved with any further consultation.

## **2. Disclosure under the Franchising Code of Conduct**

### **1. Has the additional disclosure requirement regarding the potential for franchisor failure effectively addressed concerns about franchisees entering into franchise agreements without considering the risk of franchisor failure?**

The LIV does not consider that additional disclosure requirements regarding potential for franchisor failure adequately highlights risks to franchisees.

The LIV believes there is a general lack of understanding amongst many franchisees as to the impact the potential failure of the franchisor may have on the franchisee and the franchise system. In particular, many franchisees seem to be of the opinion that in the event the franchisor goes into liquidation or other form of administration, the franchisee will be released from their obligations under the Franchise Agreement (**Agreement**), which is generally not the case.

Further, the LIV believes that there may be a lack of understanding regarding the consequences in the event that the franchise business fails.

### **2. Does the sector have any concerns regarding the operation of this requirement?**

The LIV is of the opinion that greater emphasis should be placed on the binding nature of the agreement and the fact that a franchisee will generally be bound by the terms of the Agreement for the whole term regardless of the success of the franchisee's business or the business of the franchisor.

The LIV is concerned that many prospective franchisees will not be in a position to assess the liabilities and consequences in the event of franchisor failure. Accordingly, a more comprehensive warning that gives specific examples of the problems that franchisees may face would better serve prospective franchisees and help to guide their due diligence processes.

Such a warning is also more likely to be heeded than the prevailing one, which is susceptible to being overlooked because of its general, noncommittal phrasing and placement within a large block of text.

The LIV considers the danger of inducing a belief among franchisees that they are only exposed to the risks listed in the warning noted by the government may be addressed by a disclaimer that the risks listed in the warning are not exclusive.

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## **2.1 Expenditure and other payments**

### **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?**

Provided that independent advice is received, the LIV considers financial information included in the Disclosure Document is useful for franchisees. This is particularly so in relation to information regarding the lease arrangements and attribution of legal costs, which allow for a better assessment of risk.

However, the LIV believes that franchisees' financial projections cannot take into account the unforeseen significant capital investment obligations that may be imposed by franchisors.

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

The LIV has some concerns regarding the operation of the Franchising Code. In many cases the range of figures provided by Franchisors is so broad that it is of little practical assistance. Additionally, the LIV believes that disclosures made in respect of the timing and amounts of unforeseen capital expenditure are also typically broad or non-existent and do little to mitigate the risk that must be borne by franchisees.

The financial statements provided by franchisors in respect of the marketing fund as required under the Franchising Code also often do not provide sufficient detail to reassure franchisees that the funds they are contributing are being spent for the benefit of the system.

Furthermore, franchisors can avoid disclosing their own financial statements by simply substituting this with a signed statement by an independent auditor stating that the franchisor is solvent. Given the severe consequences of franchisor failure to the franchisee, the LIV suggests it may be preferable for the latter to be provided with the financial statements in all cases. This information would allow franchisees to form a more nuanced view as to the franchisor's financial health than is facilitated by a bare statement of solvency by an independent auditor.

## **2.2 Contract variation, transfer and novation**

### **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?**

The LIV considers these amendments to be effective in assisting franchisees detect if unilateral variations have been made, or whether franchisors have the capability to unilaterally vary agreements.

However, the LIV considers that there may be times when disclosing past unilateral variations ultimately do little to alleviate franchisee risk and the inherent inequity of allowing the franchisor to unilaterally vary terms. The LIV considers that the new disclosure requirements appear to legitimise franchisors' power to impose what are arguably unfair contract terms and pre-empt further debate on or reform of this complex and unresolved issue.

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

The LIV recommends an addition to the Disclosure Document highlighting to franchisees that although the franchisor may not have unilaterally varied the terms of the actual Franchise Agreement, variations to the operations manual or other related documents may also have a significant impact on the franchisee's business.

### **2.3 Disclosure regarding franchisor conduct**

**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?**

Yes. The LIV believes that the information required in the Disclosure Document is sufficient to allow the franchisee to make informed decisions regarding the system and allows franchisees to seek further details where information is lacking.

**8. Is the information being provided useful to franchisees?**

The LIV considers the information being provided is useful to franchisees. This is particularly the case in relation to contact details for previous franchisees.

**9. What effect has the requirement to provide this additional information had on franchisors?**

Franchisors are conscious of the impact of providing details of ex-franchisees to prospective franchisees as they may well have a negative opinion of the system.

**10. Does the sector have any concerns regarding the operation of the new provisions?**

The LIV considers that many franchisors may circumvent the requirement to provide details of ex-franchisees by including a written request that such details be omitted from the Disclosure Document. The LIV is concerned that comprehensive confidentiality obligations are also imposed on franchisees which limits the useful information that can be gleaned from them.

### **2.4 Disclosure exemption for foreign franchisors**

**11. What impact has the removal of the foreign franchisor exemption had on the sector? Has the removal of the exemption caused any issues?**

The LIV believes the removal of the foreign franchisor exemption may have the effect of discouraging foreign franchisors from entering the Australian market. However, as a leading economy of the world, Australia is still an attractive market in many ways to foreign franchisors.

### **2.5 Efficacy of the disclosure amendments as a whole**

**12. On the whole, do the 2008 and 2010 disclosure amendments ensure franchisees are provided with adequate information?**

Overall, the LIV considers that the information provided to franchisees in the Disclosure Document should be sufficient to allow franchisees to make informed

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decisions about whether or not the system is appropriate for them.

However, the major areas affecting franchisees' business viability are still full of risks and uncertainties. The typical power imbalance sees franchisors able to unilaterally vary franchise agreement terms or impose significant capital expenditure at any time during the term. The resulting problems for franchisees, which arise from unfair contract terms and the resulting inadequacy of information, are not really addressed by such disclosure as is currently mandated.

**13. Is the extra onus on franchisors justified by the benefit this disclosure is providing to franchisees?**

Yes. Once a franchisor has a Disclosure Document prepared, the requirement to keep it up to date is not overly onerous.

### **3. Good faith in franchising**

**14. 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?**

The LIV believes the 2010 amendments were effective in that they addressed specific areas of concern such as end of term arrangements. In the LIV's view, it is more important to address the areas of particular concern specifically, rather than imposing an overarching obligation of good faith, on the basis that to do so would likely result in more disputes and uncertainty as to what actually constitutes "bad faith".

**15. 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?**

The LIV's members are not able to comment on the effectiveness of specific sections of the Franchising Code.

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

While there is an argument that imposing explicit obligations to act in good faith may be useful, the LIV considers that some members may see little benefit in inserting a specific obligation to act in good faith in the Code because a common law duty of faith is already implied into most franchise agreements, and is included in relation to mediation, and is also already a factor in relation to unconscionable conduct.

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

If an explicit obligation of good faith is introduced the LIV suggests good faith be defined as "good faith within the meaning of the unwritten law". Alternatively, an approach similar to "unconscionability" could be taken in that both an express and unwritten legal definition can be used.

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- 18. 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?**

If an explicit obligation of good faith is introduced, the LIV believes it should apply to both franchisees and franchisors and their conduct generally in relation to the franchise relationship. To limit the scope to particular areas such as entering into or ending a franchise agreement suggests that acting in "bad faith" in relation to other aspects is acceptable to some degree.

- 19. If 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?**

The LIV considers that the range of potential breaches is so broad that it is not within the scope of this submission to suggest an appropriate penalty. However, the LIV believes that the appropriate consequences would be contingent upon the specifics on each individual case, including the quantum of loss.

- 20. If 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?**

The LIV does not consider that there would be any conflict between an obligation to act in good faith and the behavior prescribed by the ACL, such as misleading conduct and deceptive conduct, especially as the former is likely already imposed under the common law in the form of an implied term in most franchise agreements. Rather, these obligations are consistent and cumulative.

Likewise, the obligation to act in good faith is not thought to be inconsistent with the content or nature of industry codes. It is a duty rather than merely an 'aim or ideal' and while its scope may be difficult to define across a multiplicity of factual situations, it imposes core requirements (e.g. not to act in bad faith) that are clear, readily understood and of use in regulating the behavior of the parties to a franchising agreement.

- 21. 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?**

Further analysis on this question beyond the scope of this submission may be required.

#### **4. End of term arrangements for franchise agreements**

- 22. 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?**

The LIV believes the additional information required in section 17C of the Disclosure Document is effective in that it brings the issue of end of term arrangements to the attention of the franchisee. Again, whether or not a franchisee has a proper

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understanding of the consequences of those arrangements will depend on the professional advice they receive prior to entering into the Agreement.

## **5. Dispute resolution in franchising**

- 23. Has conduct and behavior 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?**

The LIV is unable to assess whether or not parties are approaching mediation in more of a reconciliatory manner since the introduction of the changes. However, on a whole the dispute resolution process set out in the Code as a whole seems to be effective and the obligation on parties to approach mediation in this manner may be assisting in this regard.

## **6. Enforcement of the Franchising Code**

- 24. Is the current enforcement framework adequate to deal with the conduct in the franchising industry?**

The LIV does not believe the current framework adequately deals with conduct in the industry due to a lack of consequences for franchisors who fail to comply.

- 25. How can compliance with the Franchising Code be improved?**

The LIV believes compliance with the Code could be improved by imposing penalties for clear breaches of the Code, such as failing to provide a disclosure document or have the marketing fund audited in accordance with the requirements of the Code.

- 26. What additional enforcement options, if any, should be considered in response to breaches of the Franchising Code?**

The LIV believes that the Franchising Code should impose reasonable and appropriate penalties for specific and blatant breaches.

- 27. What options are available to businesses to address breaches of the Franchising Code, or any other adverse conduct in the franchising industry?**

In practice, it appears to the LIV that franchisees may be restricted in the action they can take against franchisors. The options appear to be either activating the dispute resolution procedure under the Code or reporting the matter to the Australian Competition and Consumer Commission.