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REPLY TO DANDENONG OFFICE

15 February 2013

Attention: Mr Alan Wein
Franchising Code Review Secretariat
Business Conditions Branch
Department of Industry, Innovation, Science,
Research and Tertiary Education
GPO Box 9839
CANBERRA ACT 2601

By email: franchisingcodereview@innovation.gov.au
Confirmation to follow by mail

Dear Mr Wein,

REVIEW OF THE FRANCHISING CODE OF CONDUCT

M+K Lawyers has acted for Franchisors and Franchisees (especially motor dealers) since well before the introduction of the 2008 amendments. In fact, M+K Lawyers made submissions in relation to the Review of the Franchising Code of Conduct that took place from December 1999 until May 2000. On this basis, we are well positioned to comment on some of the questions posed in the current Discussion Paper: Review of the Franchising Code of Conduct.

We hope the following comments are useful in the preparation of your report:

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?**

   From what we have seen, the inclusion of a note to the effect that franchising is a business and could fail during the franchising term does not address these concerns. We have not seen improved due diligence or an increase in the number of franchisees obtaining legal and accounting advice. In fact, we regularly see franchisees who have entered into franchise agreements without obtaining professional advice or undertaking prudent checks. In our experience, franchisees largely rely on representations made by franchisors.

   In our view, the additional disclosure requirement is so general that it does not have any impact. If the Code is to address the above concerns, specific guidance to franchisees about how to adequately investigate and consider these risks should be included. As it stands, such emphasis is placed on disclosure that franchisees rightly rely heavily on the information provided.

However, franchisor failure can take place for a myriad of reasons that could not have been foreseen based on the disclosure. For example, whilst the financials provided may give a snapshot that confirms a franchisor's solvency, subsequent litigation may cause the franchisor to become insolvent (*Australian Competition & Consumer Commission v Simply No-Knead (Franchising) Pty Ltd* [2000] FCA 1365). Other forces such as heightened competition may also arise during a franchise term.

Notwithstanding the above, we do not recommend that any further changes are required. As with any business purchaser, it is up to the franchisee to undertake necessary due diligence and obtain appropriate and relevant advice. We doubt if the general warnings in the disclosure documents is the place to reinforce this need.

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?

We have not seen anything to suggest that Section 23A has made any improvement for franchisees or franchisors. People generally perceive the common law as unclear and somewhat unhelpful. We therefore question whether this statement is given any weight by parties.

In the franchising industry, the obligation of good faith does not tend to be relied on in practice, unlike certain legislative provisions. Whilst there are examples of franchising cases which involve an alleged breach of the obligation of good faith (*Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310), we expect that they are infrequent. We have not been involved in any franchising disputes where good faith has played a large, if any, part. The only times good faith has been raised to any real extent is in disputes where a clause imposing "good faith" was contained in the franchise agreement.

The Small Business, Franchising and Industry Codes Half Year Report July-December 2012 indicated that there were 454 complaints about competition and consumer issues from the franchising sector in this period. The highest number of these complaints related to misleading conduct and false representations. The second highest number related to issues around disclosure, followed by complaints about unconscionable conduct.

On this basis, it could be argued that the industry is adequately aware of their rights under competition and consumer laws. However, we presume that in many instances legal advice was sought before the complaint was made.

We submit that the inclusion of a section referencing applicable legislative provisions, such as those relating to misleading conduct and unconscionable conduct, would be more effective as a reminder of the rights and obligations of 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?

One of the reasons put forward by franchisee activist groups, such as the National Franchisee Coalition, in support of an obligation to act in good faith is to avoid unfairness at the end of a franchise relationship. An example of what can happen at the end of a franchise agreement is as follows:

A franchisee invests considerable time and money building the goodwill of a business within a territory. The franchisor may provide little or substantial training and support. The franchisee is successful and profitable and the term is renewed for the renewal period. However, at the end of the renewal period, the franchisor decides not to enter into another franchise agreement with the franchisee. The franchisor is named on the lease and can take back the premises. The franchisee has no rights to the business and is bound by confidentiality obligations and restraints. Therefore, for a period of time they cannot even use their industry specific skills in another business. The franchisor sells the business or grants a new franchise for a large sum.

We question whether an express obligation to act in good faith would be any more effective than Section 23A in combating this type of unfairness. However, we think this is best dealt with by a first right of refusal - see our comments below in response to question 23.

Also, in our experience people tend to refer to "good faith" obligations to counter situations where the issues would be more appropriately characterised as an "unfair terms" argument. The ability of a franchisor to unilaterally vary the agreement springs to mind.

23. Have the amendments regarding end of term arrangements and renewal notices been affective in addressing concerns about inappropriate conduct at the end of the term of Franchise Agreements?

We suggest that the amendments to the Code in respect of end of term arrangements should go further to address inappropriate conduct at the end of term of franchise agreements.

The amendments regarding end of term arrangements have gone some way in setting more realistic expectations, for example, that the franchisee will not be compensated at the end of the term.

However, simply requiring disclosure as to end of term arrangements does not in itself lead to appropriate conduct. Franchisees, especially those under very large or powerful franchise groups, such as motor dealerships, have very little scope to negotiate changes. Therefore, the debate remains whether in some circumstances franchisors should provide payments to franchisees at the end of a term.

As noted above, we act for a large number of motor dealers. The automotive industry is unique for many reasons, including that the dealerships have very little scope to negotiate terms and the term of the agreements are relatively short (3-5 years). Also, they have very substantial up front premises and capital investment. For these reason, groups such as the Australian Automotive Industry Association call for an industry specific Franchising Code of Conduct. We do not intend to provide comments on that proposal here.

Using the automotive industry as an example, it would not be uncommon for a franchisee to invest in excess of $10m over the term. Often motor dealers receive minimal capital assistance from the franchisor and their success is very dependent on their own contributions. Consequently, the goodwill built up in the territory is largely created by the individual motor dealer. Regardless of the contribution of the motor dealer, at the end of the term, the motor dealer has no rights and, where the agreement is not renewed or another entered into, receives nothing. The franchisor is not constrained how it deals within the territory.

In the case of other (not motor dealer) franchisors, they often take over the territory and profit from its operations, or regrant a new franchise for a further fee.

We submit that where the franchisor is set to make a windfall gain like this, or seeks to refranchise the territory (even with no gain), franchisees should be given a first right of refusal to continue with the business. Obviously there would need to be certain conditions in circumstances where the franchisor has legitimate reasons for wanting the franchisee out of the system, such as that the franchisee must not be in breach of the franchise agreement.

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?

In our view, the requirement for the parties to act in a "reconciliatory manner" has had little impact. Prior to the changes, and since, parties tend to resolve matters based on self interest and commercial realities, not because they are obliged to act in a reconciliatory manner.

However, the requirement for both parties to attend mediation has been beneficial in order to force mediation and avoid an otherwise protracted disagreement. Mediation is an effective and proven dispute resolution tool.

26. Is the current enforcement framework adequate to deal with the conduct in the franchising industry?

We refer to the High Court decision in *Master Education Services Pty Ltd v Ketchell* [2008] HCA 38 in which technical breaches of the disclosure

requirements did not automatically render the franchise agreement unenforceable and illegal. One of the reasons given by the High Court was that there was a range of sanctions in the Trade Practices Act (now the Competition and Consumer Act) and therefore a more flexible approach could be taken rather than finding the contract illegal.

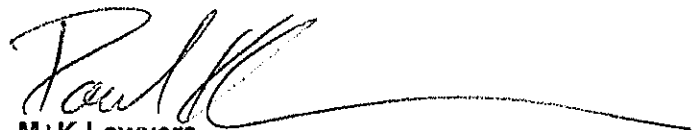
In practice, a flexible approach creates uncertainty. We do not submit that a franchise agreement should necessarily be unenforceable due to a technical breach of the Code, nor do we suggest that additional enforcement options are required. We do submit that there should be increased certainty as to what breaches attract which enforcement options.

Currently, it is difficult to provide meaningful advice to clients about the probable outcome in the event of a breach of the Code. Further, it is difficult to determine whether there is any benefit to the client in taking any action due to a breach of the Code.

This is particularly relevant where a disclosure document is not provided or contains materially misleading information. In these situations, the franchisee needs to rely upon the misleading and deceptive conduct type claims, which can be uncertain, very time consuming and expensive.

Thank you for this opportunity to comment on the issues detailed in the terms of reference. If you have any questions please contact Paul Kirton on 9794 2617.

Yours faithfully



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