

Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into Franchising Code of Conduct

Background notes

The franchise model

In general terms, franchising describes an ongoing business relationship in which one party (the franchisor) authorises another (the franchisee) to use their business model, trademarks, marketing strategy, etc in return for an agreed fee and/or proportion of sales. A number of variations on this broad theme exist, depending on the nature of the business being conducted.

Franchising agreements involve a contractual relationship between two independent parties with continuous obligations. These 'relational' contracts are prone to adaptation as time passes and circumstances change, as well as franchisors exercising greater power over franchisees through their control of various aspects of the business. These factors can generate disputes between franchisors and franchisees over their obligations under the agreement.

Current regulatory framework

Franchising in Australia is currently regulated by the Franchising Code of Conduct (the Code), which is a mandatory industry code established under section 51AE of the Trade Practices Act 1974 (Trade Practices Act). The Code was established as a mandatory industry code in 1998. This followed the failure of an earlier voluntary code (established in 1993) to address the high levels of disputes in the sector resulting from the imbalance of power between franchisors and franchisees. Other mandatory codes established under the Trade Practices Act apply to the petroleum and horticulture industries.

Franchising agreements are also subject to the application of general provisions within the Trade Practices Act. These include:

- Section 51AC on unconscionable conduct in business transactions;
- Section 52 on misleading or deceptive conduct;
- Section 53 on false or misleading representations; and
- Section 53 on false or misleading representations about business activities.

Despite the strengthened regulatory framework, concerns remain that the problems that led to the establishment of the Code have not been adequately rectified. In 2006, a review by the Office of Small Business examined the disclosure provisions in the Code.¹ Regulations to give effect to recommendations from the review came into effect on 1 March 2008.² Two state-based inquiries have also been conducted to examine the issue more broadly and these are described as follows.

WA government inquiry

In April 2008 the WA state government undertook an inquiry into the fairness of franchise agreements. The report included recommendations to improve franchisor disclosure and end of agreement arrangements, review mediation processes for resolving disputes, and establish a dedicated franchising enforcement within the ACCC.

The report can be viewed at

<http://www.sbdc.com.au/drilldown/drilldown.asp?refid=81>.

SA parliamentary committee inquiry

In May 2008 the South Australian parliamentary Economics and Finance Committee also tabled a report on the efficacy of the laws regulating the franchisee/franchisor relationship. This adopted a stronger position on legislative reform than the WA government's report. The committee concluded that a number of improvements to the regulation of franchising are needed, including the following recommendations:

- Establishing a federal registration scheme for franchise disclosure documents;
- Amending section 51AC of the Trade Practices Act to include a statutory definition of unconscionable conduct; and
- Amending the Franchising Code of Conduct to include a requirement to act in good faith.

The South Australian committee report can be viewed at

<http://www.parliament.sa.gov.au/Committees/Standing/HA/EconomicandFinanceCommittee/CompletedInquiries/65Report-Franchises/FranchisesFinalReport.htm>.

1 A copy of the report and its recommendations can be viewed at http://www.innovation.gov.au/Section/SmallBusiness/Documents/Franchising_Code_Review_Report_2006_FINAL_06120720070205134250.pdf

2 An outline of the amendments is at <http://www.accc.gov.au/content/item.phtml?itemId=815467&nodeId=9c74905234475e10f491a278e2901a25&fn=Franchising%20Code%20of%20Conduct%20amendments.pdf>

Both reports made recommendations to improve dispute resolution processes, introduce specified penalties for breaches of the Code, and improve disclosure of rebates.

Commonwealth response - Small Business Ministerial Council

The Franchising Code of Conduct was also discussed at a Small Business Ministerial Council meeting between state and Commonwealth small business ministers in May 2008. Following this meeting Minister for Small Business, the Hon. Craig Emerson MP, indicated that the commonwealth government would consider introducing a good faith clause as part of the Code. However, he also stated that the unconscionable conduct provision of the Trade Practices Act was not discussed.³

Recent court cases – Clause 11 of the Code, disclosure obligations

A requirement of Clause 11 of the Franchising Code of Conduct is that an agreement cannot be entered into until the franchisee has provided the franchisor with written acknowledgement that the disclosure document and code have been received, read and had an opportunity to be understood. In the 2007 case *Ketchell v Master Education Services Pty Ltd*, the NSW Court of Appeal held that a franchise agreement is unlawful and unenforceable where this clause has been breached.⁴

However, in May 2008 the Federal Court's decision in *Hoy Mobile Pty Limited v Allphones* did not follow the Ketchell reasoning on the implications of a technical breach of Clause 11. The Federal Court found that the intention of the code is not to automatically invalidate any agreement in which non-compliance with the clause has occurred.⁵

Despite the Federal Court's ruling, the Franchise Council of Australia is reportedly still concerned that technical breaches of Clause 11 could place a large number of franchise agreements in jeopardy, describing it as 'the biggest single legal issue the FCA has faced in its 25-year history'.⁶ In June 2008 the High Court heard an appeal to the Court of Appeal's Ketchell decision and is still deliberating on the case.

3 Lynch, D. 'Canberra may zero in on rogue franchisors', *AFR*, 27 May 2008, p. 51; Small Business Ministerial Council Communiqué, 23 May 2008, viewed at http://www.innovation.gov.au/Consultativeforum/SmallBusinessMinisterialCouncilSBMC/Documents/SBMC_MAY_2008_Communique.pdf

4 *Ketchell v Master of Education Services Pty Ltd* [2007] NSWCA 161

5 *Hoy Mobile Pty Limited v Allphones Retail Pty Limited* [2008] FCA 810. Contributing to the different reasoning in Hoy was a 2001 amendment to the Code - the introduction of Clause 6A - that postdated the agreement in dispute in the Ketchell case.

6 Switzer, P. 'Franchisors' day of destiny arrives as Ketchell decision faces High Court test', *Australian*, 10 June 2008, p. 19