SHOPPING CENTRE
COUNCIL OF AUSTRALIA

PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES INQUIRY INTO THE FRANCHISING CODE OF CONDUCT

Submission by the Shopping Centre Council of Australia, September 2008

1. Executive Summary

This submission by the Shopping Centre Council of Australia (SCCA) relates specifically to the following aspects of the Committee's terms of reference:

1. the nature of the franchising industry, including the rights of both franchisors and franchisees;

2. whether an obligation for franchisors, franchisees and prospective franchisees to act in good faith should be explicitly incorporated into the Code (having regard to its presence as an element in paragraph 51AC(4)(k) of the Trade Practices Act 1974); and

3. interaction between the Code and Part IVA and Part V Division 1 of the *Trade Practices Act 1974*, particularly with regard to the obligations in section 51 AC of the Act.

For the reasons set out in detail in this submission, the SCCA's key conclusions and recommendations are:

- To avoid an excessive compliance and administrative cost burden for business and governments, any further regulation of the franchising industry should only be introduced to address clearly established problems and even then should be the minimum necessary.

- Section 51AC provides small business with effective remedies against unconscionable conduct in their dealings with big business. In stating this it should be acknowledged that "unconscionable conduct is concerned with an inability to protect one's interests, not simply an inability to get what one wants".

- The success of section 51AC should not be judged by the number of 'scalps' hanging from the ACCC's belt. The true measure of a law is its success in changing behaviour so that scalps are not necessary. No reputable franchisor (or shopping centre owner) wants to be accused of, or found guilty of, acting unconscionably.

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- The fact that there are relatively few successful cases under section 51AC is the result of a much improved and better informed market. In addition, the wide availability of relief for breach of contract, misleading and deceptive conduct (section 52) and for failure to disclose (Part 2 of the Code) are also important since these matters typically form part of the matrix of an unconscionable conduct claim.

- In accordance with good legal practice it is not surprising, and is to be encouraged, that legal practitioners (and the Courts) are relying instead on these other causes of action and that 'unconscionable conduct' is used as a catch all where the particular conduct does not fall within a more easily defined and limited cause of action.

- As a catch all provision the strength and effectiveness of section 51AC is that it takes into account all the circumstances and not just a specific set of predetermined circumstances; yet it is easily recognisable by the Courts.

- To further amend section 51AC by seeking to redefine the concept by other necessarily vague terms is to risk this latter attribute and thus certainty. If the Parliament defines 'unconscionable conduct' with specificity it will lose its broader appeal and remit.

- If, contrary to the above, the Committee considers recommending the amendment of section 51AC this should be the subject of wider consultation since it has business ramifications that extend well beyond the franchisor-franchisee relationship.

- Part 3 of the Code should not be amended to address the so-called 'problem' that franchise agreements often do not address the entitlement by the franchisee to goodwill on termination or expiry of the franchise agreement.

- An obligation to act in good faith should not be explicitly incorporated into the Code. 'Good faith' describes a principle which is used in the construction and/or implication of contractual terms and is not a legal standard suitable for insertion as a statutory provision.

- A statutory duty of good faith is impossible to define and would add unnecessary uncertainty to the already complex franchise relationship. Further, unless and until widespread problems are clearly proved to exist in the industry, such a broad remedy is not warranted and, in accordance with good principles for regulation, should not be introduced.

- As the law currently stands, there is no general contractual term, implied in law, requiring parties to act in good faith when negotiating a contract or in its performance. A duty to act in good faith may be implied in specific contexts. Moreover, in many contexts, terms implied in fact or law or by construction will serve the same functions in particular fact situations as an implied obligation to act in good faith.

- Where an obligation of good faith is implied in a franchise arrangement, the content and import of that implied obligation depends on the express terms of the contract, the factual matrix and the parties involved and so on. It cannot

stand on its own. There must first be an agreement with an objectively ascertainable common purpose(s) with respect to which the parties must be 'faithful' and with which the implied term(s) must be consistent.

- 'Good faith' need not require 'fairness' or regard to the other party's interests, rather it "allows a self-interested approach, so long as it is loyal and consistent with the contract's objectives and spirit."

- The principle of 'good faith' being applied by the Courts to fill in the gaps of contractual provisions is consistent with preserving the sanctity of contract.

- Those who describe 'good faith' as something different and suggest that the concept "would be one to make explicit the underlying ethical standards of the industry as a whole" are really talking about 'fairness' and about interfering with sanctity of contract.

- The inclusion of 'fairness' as a legal standard in business-to-business transactions (rather than as a desirable guiding principle) has been thoroughly examined on many occasions and has been rejected because it would be so open to a variety of different interpretations that it would be inimical to the development of a coherent and clear body of law. Commercial parties need certainty.

2 Principles for the regulation of franchising

The SCCA believes it is necessary to identify the relevant "design principles" for the assessment of regulation and legislation (and proposed regulation and legislation) which impacts (or may impact) upon the franchising industry.

In adopting this approach the SCCA is following the lead of the Productivity Commission in the report of its inquiry into *The Market for Retail Tenancy Leases in Australia* (No. 43, 31 March 2008) and, in particular, chapter 5 of that report.

The Productivity Commission noted: "Despite more than two decades of extensive legislative activity affecting retail tenancies . . . and the development of dispute resolution systems . . . imbalances in bargaining power between small retailers and large landlords continues to be raised as an issue of concern. What this suggests is that specific retail tenancy legislation, introduced to redress concerns about bargaining power, has not been entirely successful in delivering the results expected by some. Whether this is a result of inadequacies in regulation or unrealistic expectations is an important question". (p.81.) In our view those reasons seem equally applicable (and possibly more applicable) to the current inquiry into franchising.

In settling on the "design principles" listed below the SCCA has had particular regard to the key principles of the Regulation Task Force (*Rethinking Regulation*: *Report of the Taskforce on Reducing Regulatory Burdens on Business*, January 2006), including that good process for developing and administering regulation requires:

- "Governments should not act to address "problems" unless a case for action has been clearly established. This should include evaluating and explaining why existing measures are not sufficient to deal with the issue";

- "A range of feasible options need to be identified and their benefits and costs, including compliance costs, assessed within an appropriate framework"; and

- "Only the option that generates the greatest net benefit for the community, taking into account all the impacts, should be adopted."

The SCCA's suggested design principles are as follows:

> ***Principles for assessing the regulation of franchises***
>
> *To ensure the efficient and fair operation of the franchise market and facilitate commerce, regulations should:*
>
> *- be clear and certain in their expression and operation;*
>
> *- be based on principles of equity, fairness and justice whilst yet being justiciable and sufficiently certain;*
>
> *- not extend or overlap with current laws governing all commercial transactions (such as common law) unless there is a clear net benefit to the community;*
>
> *- only address "problems" where a case for action has been clearly established;*
>
> *- be the product of full industry consultation;*
>
> *- not restrict commercial enterprise, freedom of contract nor interfere with the sanctity of contract unless a case for action has clearly been established and in any event no more than necessary;*
>
> *- provide affordable and accessible dispute resolution and judicial processes;*
>
> *- be the minimum necessary and not unduly add to administrative and compliance costs; and*
>
> *- of the various options available, be regulations that generate the greatest net benefit to the community.*

These principles seek to recognise the fact that, as identified by the Productivity Commission, although markets are the most efficient way of allocating resources, good regulation can contribute significantly to preventing or counteracting markets working in ways that result in adverse economic and social outcomes. Inappropriate or poorly designed and implemented regulation, however, "can act as a handicap by imposing excessive costs on businesses, limiting competition, stifling efficient investment and changing business behaviour". Ultimately, the costs of poor regulation are borne by taxpayers and consumers.

As the Productivity Commission said:

"All regulation introduced should be the minimum necessary to avoid an excessive compliance and administrative cost burden for businesses and governments respectively".

Aside from drawing on good common sense, sound economics and best practice, the above design principles are considered to be consistent with a number of established legal doctrines including:

(i) Dicey's Rule of Law – which suggests that all regulation should be prospective, open, clear and fairly stable;

(ii) The Separation of Powers doctrine – which suggests that all regulation should set down clear standards which are capable of being interpreted and applied correctly and consistently by judges (ie be "justiciable) without wide judicial discretion on matters of subjective merit which require arbitrary or prerogative judgment;

(iii) The Sanctity of Contract principle – which suggests that parties of free will are bound by the terms of the contract as framed, in the circumstances that existed at the time the contract was entered into, subject to any variations that were subsequently agreed by both; and

(iv) The Freedom of Contract principle – which suggests individuals should be free to bargain among themselves without government interference.

As one legal commentator has stated:

"..the Rule of Law is intended to maximize freedom of choice by enabling the citizen to act in the confidence that her conduct is legal unless it contravenes clear and specific legal rules.

A prime advantage attributed to a precise and detailed drafting is certainty and foreseeability of outcome in the great majority of cases...A second advantage is democratic control. "To vest decision making in a non-elected judge or official by bestowing wide discretionary powers on them is undemocratic" as power is transferred from the elected legislature to an unelected executive or judiciary.[1]

The principles stated in the above table have guided the SCCA's own assessment of the current legislation and the proposed changes it is aware have been suggested by other parties to similar franchising inquiries in the past. These principles also form the basis of this submission.

The SCCA invites the Committee to determine its own "design principles", having regard to the above and then objectively assess the various submissions it receives (including this submission) from interested parties (including supposedly disinterested academic commentators) against those principles. In this way it is hoped that any recommendation by the Committee, which may find its way into law, does not come at an ultimate cost to business and the general community at large.

3. The problem with franchising – an unbalanced bargain

The Franchising Code of Conduct describes the franchise relationship as one involving a franchisee relying on "a system or marketing plan substantially determined, controlled or suggested by the franchisor, or an associate of the franchisor." It involves the operation of a business by a franchisee that is

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[1] *Lisbeth Campbell, 'Drafting Styles: Fuzzy or Fussy?' Murdoch University Electronic Journal of Law 3(2) July 1996 citing FAR Bennion, Statute Law, 2nd Ed 1983, Oyez Longman at p 28)*

"substantially or materially associated with a trademark, advertising or a commercial symbol owned, used, licensed or specified by the franchisor or an associate of the franchisor". It involves the franchisee paying an entry free as well as recurring royalties and advertising fees to a franchisor in return for the rights to use the trademark or business format etc.

Under a franchise contract, which is often described as a "relational" contract, the parties are expected to perform their contractual duties continuously and in a cooperative way for the mutual benefit of both parties. As stated by the South Australian Parliament Economic and Finance Committee, in its Final Report on Franchises, in the carrying out by the franchisee of its own business "the franchisor has a vested interest in protecting [its] reputation and maintaining the quality standards developed within that system. Anything that may potentially cause a deterioration of the commercial value of the name or quality of standards represents a risk for the franchisor."[2]

This Committee is likely to hear that the "real" problem with the franchising relationship is that typically (almost necessarily) the franchisor is in a dominant position to franchisee (or prospective franchisee) which can and, it is said, not infrequently be abused. This is said to be because:

- *"Essentially, franchising arrangements result in a separation between the ownership and control of the capital assets of a business. A franchisee invests in the business and bears the majority of risk associated with the operation of a particular outlet, whilst the franchisor maintains control over the design of the overall system and the quality of the output."* [3]

- *"The relational quality of the contract means that there are many aspects of the performance that are left unspecified and therefore cannot be disclosed. The terms of relational contracts provide for flexibility by providing for discretion to the drafter, which throws the emphasis on the commercial relationship more on trust and so erodes the function of due diligence on the part of the franchisee".:"*[4]

- *"A frequent lack of business experience, unequal access to information about a particular franchise system and a disparity in economic leveraging make the franchisee the more vulnerable to the participant of the franchise arrangement."*[5]

- *"The franchisor's position as a provider of the franchise opportunity - complete with their superior access to information, business experience and capital – means a franchisee, even those with experience and capital, enter the agreement in an inferior position to their "partner".*[6]

The SCCA, like many others who will make submissions to the Committee, does not have the necessary experience to comment on whether, in fact, such an inequality of bargaining power between the franchisor and franchisee generally exists – or whether such imbalance is case specific.

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[2] *Sixty-Fifth Report of the Economic and Finance Committee of the Parliament of South Australia Franchises 20 May 2008 ("SA Franchises Report") at 14*
[3] *Explanatory Statement to the Franchising Code of Conduct*
[4] *Elizabeth C. Spencer submission to SA Inquiry, 1 January 2008, pp. 2-3*
[5] *SA Franchises Report at 16*
[6] *SA Franchises Report at 16; see also Scott Cooper submission to SA Inquiry, 24 January 2008, p. 2*

The Committee should not rely merely on rhetoric but rather should investigate whether in fact the franchise relationship is not infrequently being abused. Certainly the franchise relationship is quite unique and prone to contention[7]. The SCCA suspects that there is now, with the advent of the Code, no such universal inequality with good franchisees now being hard to come by and much sought after by many competing franchisors. That said, as in all markets, in some cases and at some stages of the business cycle, the franchisor will be in a substantially superior bargain position to the franchisee.

In this submission the SCCA seeks to identify the means by which the law currently addresses (or is suggested may in the future address) this imbalance of bargaining power. We also comment on these laws and on various criticisms and recommendations which have been made to previous inquiries and which are likely to be made to the Committee.

4. Education and disclosure – evening out the imbalance

It is generally agreed that the best way to redress imbalances in bargaining power is through education and accurate disclosure, since inadequate information, knowledge and understanding are often key contributors to the imbalance.

The SCCA certainly supports moves to provide and promote proper education to prospective franchisees especially in assisting with pre-business feasibility planning and due diligence[8]. Better educated and better organised franchisees invariably run better businesses with resulting fewer disputes with franchisors. Successful franchisees are generally good retailers and desirable tenants.

Better education and better support services, however, are non-legislative options.

The SCCA also supports reasonably timely disclosure as a key means by which legislators may “even up” the perceived imbalance in bargaining power between the franchisor and franchisee. The SCCA consequently supports the substance of the Franchising Code which in Part 2 is concerned with ensuring better disclosure by the franchisor to the franchisee and thereby enabling better business decisions on the part of the franchisee. Again better informed franchisees making better business decisions are better retailers and more desirable tenants.

The “basic rationale” for the disclosure requirements under the Code is to "facilitate private bargaining [through] improved transparency", to "provide market participants with equal access to information that helps recipients to make better informed choices among the alternatives in the market" and to "level the playing field" while striving to "promote trust and boost confidence in the market".[9]

Notwithstanding the detailed disclosure provisions of the Code the Committee is also likely to hear submissions that:

- *"Franchising remains a "trap for the unwary". In particular there's a wide chasm between what is, and what ought to be disclosed. Franchisees are often misled by the disclosure agreements which disclose very little e.g.*

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[7] *Explanatory Statement to the Franchising Code of Conduct*

[8] *See recommendations 1 & 2 of the Report to the Western Australian Minister for Small Business Inquiry into the Operation of Franchise Businesses in Western Australia April 2008 (“WA Franchises Report”) at ii - iii*

[9] *Elizabeth C. Spencer, submission to SA Inquiry, 1 January 2008, p.15*

"goodwill" is rarely discussed or disclosed, nor are "exit costs" often discussed or disclosed. Yet they too are vital."[10]

- *"Currently, the code does not require franchisors to specifically disclose what franchisees' entitlements and responsibilities are at the end of an agreement."*[11]

- *"In the interests of making an informed business decisions and undertaking appropriate due diligence, prospective and renewing franchisees should have a clear understanding of what their entitlements and responsibilities are, or are not, at contract expiry prior to entering into a franchise agreement."*[12]

- *The current disclosure documentation is too long and may not be comprehensible or have utility "to the "average franchisee".*[13]

- *"A strategic targeting of information is critical, and not simply scattered through the process of disclosure. The more you disclose the less they may read. So, the disclosure has to be relevant, it has to be meaningful, and has to be clear and succinct."*[14]

- *The Franchising Code of Conduct should be amended to require the franchisor to provide continuous and freely accessible disclosure to current and prospective franchisees.*[15]

To the extent that real life experience relayed by franchisees and franchisors confirms to the Committee that the present regime requires tweaking, the SCCA does not oppose change. From SCCA's own experience in terms of the disclosure requirements under retail tenancy legislation there are very substantial compliance costs associated with constant change. In addition disclosure statements that become too long and too comprehensive can become intimidating for prospective franchisees and therefore be counterproductive. Hence any changes should be the minimum necessary. We refer you to the SCCA's principles for assessing regulation in this regard.

Further, following the Matthews Committee in 2006, 31 recommended changes to the Code were given effect to by the *Trade Practices (Industry Codes - Franchising) Amendment Regulations 2007 (No.1)*. Those amendments are described as intended to increase the Franchising Code's "transparency, quality and timeliness of disclosure to existing and prospective franchisees" and only came into effect on 1 March 2008. In the circumstances, this Inquiry should be very reluctant to suggest further changes until the effectiveness of these most recent amendments can be adequately assessed.

Specifically if the Committee receives submissions identifying franchise 'churn' as an issue - which occurs when a franchisor repeatedly sells a franchise outlet in circumstances where it would reasonably expect that the outlet is unlikely to operate successfully, regardless of the individual franchisee's business skills – the Committee should be aware that the recent amendments were intended to address that very issue.

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[10] *Franchisees Association of Australia Incorporated, submission to SA Inquiry, 13 March 2008, p. 2.*
[11] *WA Franchises Report at iii*
[12] *WA Franchises Report at iv*
[13] *See Elizabeth C. Spencer, submission to SA Inquiry, 1 January 2008, p.18; SA Franchises Report at 24*
[14] *Committee Hansard (SA), 20 February 2008 at 76*
[15] *SA Franchises Report at 35*

In addition it is likely that the Committee will hear submissions that there is a need to introduce some form of disclosure document monitoring process so as "to ensure access to and the reliability of disclosed material"[16]. Such monitoring, it will likely be suggested, should be undertaken by the Australian Competition and Consumer Commission and should involve the placing of both "the disclosure document and the franchise agreement on the public record"[17].

With the proportion of franchises in dispute in Australia equating to less than 4% in total[18], and with two recent inquiries having "not detected any patterns of widespread misconduct" and having found "overall" "that the franchising sector operates well"[19], this suggestion seems particularly ill-conceived and merely likely to drastically overburden the ACCC with little if any reward.

With thousands of franchising agreements entered into every year the Commission would be swamped by such a procedure and would not be able to properly vet the documents provided. The Commission should be left to do what it does best – to advise upon and enforce the law – rather than utilising its resources proof-reading disclosure documents.

Such an approach would also be commercially impractical, requiring every amendment to such a document to also be 'vetted', adding months and possibly years to a negotiation process. Franchise agreements are on foot 24 hours a day, seven days a week, usually for a period of five years or more. Vetting a franchise agreement at the outset cannot possibly cover all eventualities over the period of the agreement. Delays in finalising franchising agreements can often lead to delays in or the hampering of leasing, which the SCCA is keen to avoid.

As an alternative it is suggested that, in the event that an individual franchisor is brought to the attention of the Commission as guilty of non-complying disclosure, and their re-offending is considered a real concern, the Commission may then, as part of any undertakings it requires of that franchisor pursuant to 87B of the Act, require that particular franchisor to vet their future disclosure documents with the Commission (should it deem such a course appropriate).

5. Section 52 – ensuring disclosure is accurate

It is important to have disclosure but it needs to be useful and accurate. It is therefore relevant that the conduct of parties involved in a franchise is subject to the application of the general provisions of the *Trade Practices Act 1974* - in particular, the provisions prohibiting misleading or deceptive conduct (section 52), making false or misleading representations (section 53) and false or misleading representations concerning the profitability or risk or any other material aspect of any business activity (section 59). Similar provisions are enacted in State and Territory Fair Trading Acts.

The common law also offers a number of remedies and courses of action.

These laws ensure that the disclosure requirements of the Code result in the accurate disclosure of relevant information and material.

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[16] *SA Franchises Report at 31*
[17] *SA Franchises Report at 31*
[18] *WA Franchises Report at 59*
[19] *See WA Franchises Report at 13*

Most parties would agree that section 52, in particular, is already well suited to address criticisms such as the claim that "the inherent intangible risks associated with franchising [are] frequently obscured by the aura of achievable, if not guaranteed, prosperity the industry's proponents had managed to project".[20]

No change is suggested nor warranted here.

6. Unconscionable conduct – addressing abuses of the imbalance

In addition to disclosure requirements and section 52, the law relating to unconscionable conduct is also relevant as it is specifically directed to dealing with abuses of imbalance. Section 51AC is specifically referred to in the terms of reference to the Inquiry but section 51AA is also relevant. Section 51AA(1) of the *Trade Practices Act 1974* provides:

"A corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the underwritten law, from time to time, of the States and Territories."

In Australia in *Louth v Diprose* (1992) 175 CLR 621 at 637, Deane J conveniently summarised the requirements of the unwritten law to obtain relief against unconscionable conduct as follows:

"(i) a party to a transaction was under a special disability in dealing with the other party to the transaction with the consequence that there was an absence of any reasonable degree of equality between them and (ii) that special disability was sufficiently evident to the other party to make it prima facie unfair or "unconscionable" that the other party procure, accept or retain the benefit of, the disadvantaged party's assent to the impugned transaction in the circumstances in which he or she procured or accepted it.

In terms of what constitutes a special disability the seminal statement of the law is that of Fullagher J in *Bromley v Ryan* as follows:

"The circumstances adversely affecting a party, which may induce a court of equity either to refuse its aid or set a transaction aside, are of great variety and can hardly be satisfactorily classified. Among them are poverty or need of any kind, sickness, age, sex, infirmity of body or mind, drunkenness, illiteracy or lack of education, lack of assistance or explanation where assistance or explanation is necessary. The common characteristic seems to be that they have the effect of placing one party at a serious disadvantage vis-à-vis the other."

In equity (and s 51AA), however, something more "special" is required than merely taking advantage of a superior bargaining position. In *ACCC v CG Berbatis Holdings Pty Ltd* [2003] HCA 18; (2003) 214 CLR 51; 77 ALJR 926; 197 ALR 153; ATPR 41-916 Gleeson CJ said:

"Unconscientious exploitation of another's inability, or diminished ability, to conserve his or her own interests is not to be confused with taking advantage of a superior bargaining position. There may be cases where both elements are involved, but, in such cases, it is the first, not the second, element that is of legal consequence. It is neither the purpose nor the effect of s 51AA to treat people

[20] *SA Franchises Report at 18*

generally, when they deal with others in a stronger position, as though they were all expectant heirs in the nineteenth century, dealing with a usurer."

As a result of the above this Committee is likely to be told, correctly, that: "The franchisee, being a commercial party, is unlikely to demonstrate the requisite 'special disadvantage' required by the equitable doctrine."

That said, section 51 AC of the *Trade Practices Act* was introduced in 1998 to address this very "problem of small businesses facing power imbalances while dealing with larger commercial entities."[21]

Section 51AC(1) of the *Trade Practices Act 1974* provides:

A corporation must not, in trade or commerce, in connection with:

(a) the supply or possible supply of goods or services to a person (other than a listed public company); …

engage in conduct that is, in all the circumstances, unconscionable.

It is now generally accepted that the term "unconscionable" in s 51AC is to be interpreted more broadly than the interpretation developed by the courts of equity: *ASIC v National Exchange Pty Ltd* [2005] FCAFC 226; (2005) 148 FCR 132; *ACCC v CG Berbatis Holdings Pty Ltd* [2000] FCA 1376 per French J; *Auto Masters Australia Pty Ltd v Bruness Pty Ltd* [2002] WASC 286; (2003) ATPR 46-229 per Hasluck J.

Given that the legislative aim of section 51AC was to provide small business with effective remedies against unconscionable conduct in their dealings with "big business" and that there is specific reference in section 51AC(3) to "the relative strengths of the bargaining positions of the supplier and the business consumer", it is clear that franchisors might be caught by s 51AC not only when dealing with someone under an inherent disadvantage because of something personal like lack of education, drunkenness or illness (as covered by the equitable doctrine) but also when dealing with someone in a weaker commercial position because of the legal and financial situation which they find themselves.

That said a definite principle emerging from the decisions on s 51AC is that the mere use of superior bargaining power to drive a hard bargain is unlikely *of itself* to be unconscionable conduct. "Conduct will only be considered unconscionable when it goes beyond the mere 'cut and thrust' of everyday business so that it is harsh or oppressive. Conduct which is merely 'unfair' will generally not be sufficient to establish that unconscionable conduct has occurred." [22]

The issue then becomes what more is required to constitute unconscionable conduct. This is an issue with which the Courts are continuing to grapple. Unlike the equitable doctrine where any taking advantage of old age, infirmity of mind, physical disability, illiteracy etc can readily be appreciated as "unconscionable", under s 51AC the mere taking advantage of a better bargaining power is the stuff of ordinary robust commerce and does not similarly, of itself, bespeak unconscionable conduct.

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[21] *Philip Tucker, "Unconscionability: The hegemony of the narrow doctrine under the Trade Practices Act" (2003) 11 Trade Practices Law Journal 78 as cited in SA Franchises Report at 42*
[22] *A small business guide to unconscionable conduct, ACCC, May 2005*

In the SCCA's view, "unconscionable conduct [in s 51AC] is concerned with an inability to protect one's interests, not simply an inability to get what one wants". *ACCC v CG Berbatis Holdings Pty Ltd*. As the ACCC has said:

"It is unlikely that simply having a stronger bargaining position will make conduct unconscionable. It appears that how the party in the stronger bargaining position uses that advantage will be the deciding factor. Therefore, the strength of the bargaining position may be examined in combination with other factors listed in section 51AC(3)(b)-(k). If it is the strength of one party's bargaining position that allows that party to behave in an oppressive fashion this may evidence unconscionable conduct.

The concept of unconscionability in section 51AC looks to the conduct of the stronger party in attempting to take advantage of a disadvantaged person in circumstances where it would be inconsistent with equity or good conscience that he or she should do so.

As the cases establish, whether conduct is "unconscionable" , under section 51AC, is to be judged in all the circumstances and significant guidance is given by the relevant factors listed in subsection 51AC(3) which themselves are indicative but necessarily not determinative.

Again as the Commission has said:

"It is also important to note that the court will determine whether a business has engaged in unconscionable conduct by considering all of the circumstances. In isolation, each of these factors may not amount to unconscionable conduct. However, when considered together the court may consider that the conduct was unconscionable."[23]

The Committee is likely to hear criticism of section 51AC that:

- *"The problem with section 51 AC… is that the section has not been effective despite its broader remit."*[24]

- *"… there have been few decided cases were a finding of unconscionable conduct has been made under section 51 AC. While conduct may be, in some cases, harsh, unfair or even oppressive, the unconscionability threshold, it seems, is rarely satisfied."*[25]

- *"As the court's starting point for such inquiry is an aversion to setting aside bargains ….where hard bargaining is the accepted norm, it seems the instances where unfair business conduct will be regarded as unconscionable will remain few."*[26]

- *"One of the reasons for the problem with unconscionability is that we do not really know what it means."*[27]

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[23] *A small business guide to unconscionable conduct, ACCC, May 2005*
[24] *SA Franchises Report at 43; see Frank Zumbo, "Promoting Fairer franchise agreements: A way forward?" (2006) 14 Competition and Consumer Law Journal 127-145*
[25] *WA Franchises Report at 9*
[26] *WA Franchises Report at 9*
[27] *Professor Terry, Committee Hansard (SA), 12 March 2008, pp. 109-110*

- *"[The] uncertainty surrounding the meaning of unconscionability makes litigators and lawyers very reluctant to rely on section 51 AC as a chosen cause of action."*[28]

- *"..the principle of unconscionable conduct "is one of the prevention of oppression and unfair surprise and not of disturbance of allocation of risk because of superior bargaining power."*[29]

It is also likely to be suggested to the Committee that "section 51 AC of the Trade Practices Act 1974 be amended by the inclusion of a statutory definition of unconscionability or alternatively by the insertion in the Act of a prescribed list of examples of the type of conduct that would ordinarily be considered to be unconscionable".[30]

Associate Professor Frank Zumbo, in particular, has asserted that the insertion of a statutory definition will:

"send a clear parliamentary signal to the Courts that the concept is not only broader than the equitable concept, but that section 51 AC is intended to promote ethical business conduct. Such a definition would set out a non-exhaustive benchmark for assessing conduct to determine whether or not it goes beyond what is reasonably necessary to protect the legitimate interests of the parties involved. This would not in any way interfere with the driving of a "hard" bargain, but rather would provide clear statutory guidance as to what is considered unethical."[31]

He has further asserted that a prescribed list of examples would "give all parties a very clear legislative indication of where they would ordinarily stand in relation to particular types of conduct".[32]

The SCCA believes the Committee should be very reluctant to endorse these criticisms or follow these recommendations. Certainly the Committee should undertake its own critical analysis in accordance with the principles it identifies for regulation as suggested at the outset of this submission.

The success of section 51AC should not be judged on the basis of the number of 'scalps' hanging from the ACCC's belt. The true success of a law is its success in changing behaviour so that 'scalps' are not necessary. Major shopping centre owners, managers, franchisors and other businesses now spend significant resources on education and compliance courses for their staff in order to ensure that their staff are aware of their legal and ethical obligations in dealing with tenants, franchisees and other parties. No reputable franchisor or shopping centre owner or other businessmen want to be accused of acting unconscionably or to be found to have acted unconscionably.

As the Productivity Commission has noted: "while there is a relatively limited case history pertaining to unconscionable conduct claims, threat of action under

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[28] *SA Franchises Report at 44*
[29] *Official Comment 1 to Article 2.302(1) (unconscionable contracts) of the Uniform Commercial Code (United Stated of America)*
[30] *Frank Zumbo submission to the SA Inquiry, 3 March 2008, p. 14*
[31] *Frank Zumbo submission to the SA Inquiry, 3 March 2008, p. 13*
[32] *Frank Zumbo submission to the SA Inquiry, 3 March 2008, p. 14*

unconscionable conduct provisions appears to have had an influence on market conduct." [33]

Further, even while limited in number, franchising decisions such as *ACCC v Simply No-Knead (Franchising) Pty Ltd* and *Automasters Australia Pty Ltd v Bruness Pty Ltd*[34] have still provided significant guidance to the industry as to what is unacceptable behaviour.

The fact that there are few successful cases under section 51AC is the result of a much improved and better informed market and, perhaps more importantly, the wide availability of relief for breach of contract, misleading and deceptive conduct (s52) and for failure to disclose (Part 2 of the Code). These types of failings typically constitute part of the matrix which constitute what might be regarded as "unconscionable conduct" but are simpler to prove.

In accordance with good legal practice it is not surprising, and is to be encouraged, that legal practitioners (and the Courts) are first relying on these other causes of action and that "unconscionable conduct" is used as a catch all where the particular conduct does not readily fall within one of these more easily defined and limited causes of action. This is the "supplementary" role that s51AC was intended to play and should play.

As the Commission said in its submission to the Productivity Commission[35]:

"…"[Unconscionable conduct] generally presents as a complex web of interlinking accusations and claims (i.e. misleading and deceptive conduct, harassment and coercion, misrepresentations) and personal grievances that require intensive, time consuming investigations to untangle the legally relevant facts.

The fact that there have been a number of claims of unconscionable conduct, but few successful prosecutions is also not surprising and certainly not a bad thing. As one commentator said:

"The review of authorities tends to suggest that allegations under the section are being used as a type of safety net or catch-all way of describing the conduct of a lessor over a range of spectra, some lawful conduct and some not. As shall be seen, the plea of unconscionability by retail lessees in most cases failed. In many instances, it appeared to be a last ditch effort to preserve the rights of lessees who were otherwise in breach of their own respective obligations or an attempt to resurrect rights (for example, option rights) which no longer existed." [36]

Further, as the Commission has said:

"Unconscionable conduct provisions seek to prohibit actions that are unreasonable and offending of good conscience in the circumstances. Such behaviour is frequently listed as a source of dispute between tenant and landlord. However, once the facts of the case become evident, the dispute typically relates to a more straightforward matter such as rent arrears, maintenance or lease renewal.

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[33] *Productivity Commission Inquiry – Retail Tenancy Market; Submission by Shopping Centre Council of Australia p.178*
[34] *(2003) ATPR (Digest) 46-229*
[35] *Productivity Commission Inquiry – Retail Tenancy Market; Submission by Shopping Centre Council of Australia*
[36] *Unconscionability in commercial leasing – Distinguishing a hard bargain from unfair tactics? by Sharon Christensen and WD Duncan*

Disputes involving unconscionable conduct are not widespread and rarely proceed to court." [37]

As a catch all provision the strength and effectiveness of s51AC, like Part IVA of the Income Tax Act (Cth), is its breadth and the fact, as the Court stated in *Babcroft Pty Ltd v Goebel Pty Ltd*, the doctrine of unconscionable conduct resembles an elephant in that it "is impossible of simple or exhaustive definition . [but] is nevertheless easily recognizable when presenting itself."

The SCCA submits that s51AC should not be further amended. If there are franchise specific issues which are raised by this Inquiry which need redress, that redress should be directed to that particular issue and contained as a separate provision in Part 3 of the Code.

Further, before making any such recommendation, the Committee should be wary of the fact that regulation "is never able to shield small businesses from errors in decision-making and the negative consequences of commercial risk-taking."[38]

If, however, the Committee was to consider recommending Section 51AC be amended then in accordance with good principles for assessing regulation it would need to be the subject of wider consultation, to allow the broader business community to provide its input.

7. Part 3 of the Code – confining the bargain

It has been argued that even with education, proper disclosure and laws that cover unconscionable abuses of bargaining power, the power dynamic in favour of the franchisor is such as to be "reflected in the terms of the contract, with the franchisor reserving various discretions and maintaining a heightened level of control over the operations of individual franchises"[39].

Franchise agreements, the Committee is likely to hear, are "usually being offered on a 'take it or leave it' basis, reducing or extinguishing the opportunity for pre-contractual negotiations"[40].

These "observations" will be undoubtedly be cited to the Committee as reasons for abandoning established principles of contract law, such as freedom of contract and the sanctity of contracts, because it will be said:

"the basic premise on which the principles of freedom of contract and sanctity of contract rest is that contracts are negotiated at arm's length by equally positioned participants in the bargaining process …. that condition is not met in the typical franchise arrangement."[41]

The Committee is also likely to be told that "real fairness" can only be guaranteed in franchise agreements "by legislative intervention which overrules traditional notions of freedom of contract and the sanctity of contract to impose norms of acceptable conduct."[42] Similarly, "a long-term strategy to address the imbalance of bargaining power between the franchisee and franchisor would be the statutory

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[37] *The Market for Retail Tenancy Leases in Australia – Productivity Commission Draft Report (2007)*
[38] *SA Franchises Report at 25*
[39] *SA Franchises Report at 16; see Scott Cooper submission to SA Inquiry, 24 January 2008, p. 2.*
[40] *SA Franchises Report at 16*
[41] *SA Franchises Report at 17*
[42] *SA Franchises Report at 56*

endorsement of the 'standard provisions of the franchise agreement' which could be supplemented by specific conditions reflecting the arrangements between the specific franchisee and franchisor."[43]

Such general comments should be treated with great caution and restraint. Again, in accordance with good principles for regulation, rhetoric should be ignored and actual, clearly established, problems should be identified. Further, real attempts should be made to ensure established doctrines such as sanctity of contract (which is in fact based on a freedom of will not equal bargaining power) are not trampled. Such respected doctrines (which provide for certainty of contract and the ability to plan and invest in business) should weigh heavily in the assessment of whether a particular identified option, of a range of feasible options available, has the greatest net benefit to the community.

A net benefit test in the current circumstances should also take into account the facts that the vast majority of franchisees do very well out of business – even if dealing with large franchisors and the relationship is such that the franchisor needs to have wide powers for the benefit of franchisees as a collective whole.

As Professor Andrew Terry, of the University of New South Wales, explained:

"The franchisor must have the right and power to get rid of non-performing franchisees, because a non-performing franchisee risks not only the intellectual property of the franchisor but also the investment of every other franchisee. If you have had a bad experience and one particular franchise outlet, you're going to take it out against that franchise system…. not only that, the franchisor must have the power to respond, to introduce new menu items, new shop fits, or new whatever."[44]

And Jeannie Marie Paterson said:

"The general rationale behind the franchisor's power to terminate the franchise agreement is the protection of the integrity and viability of the particular franchise system as a whole".[45]

From the shopping centre industry's perspective it is important that franchisors have wide powers to deal with "free riders". Free riding "is characterised by a franchisee seeking to maximise returns from their business by reducing the cost, especially those related to maintaining the integrity and standards of the franchised brand. In doing this the franchisee degrades the currency of the trademark in which the franchisor has invested."[46] Shopping centre owners decide upon a certain tenancy mix and agree to lease to particular franchisor on the basis that the franchisee (whom the owner may not know) will be required to run the business to a particular known quality or standard.

Part 3 of the Code already acts to impose standard terms in franchise arrangements by giving the franchisee a 7 day cooling off period; provides for continuing disclosure by the franchisor, after entering into a franchise agreement;

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[43] *Ms Buchan Committee Hansard (SA), 19 March 2008, p. 112 as cited in SA Franchises Report at 60*
[44] *Professor Terry Committee Hansard (SA), 12 March 2007, pp. 102 - 3*
[45] *Jeannie Marie Paterson, "Good Faith in Commercial Contracts? A Franchising Case Study" (2001) 29 Australian Business Law Review 284 as cited in SA Franchises Report at 69*
[46] *Bill Dixon, "What is the content of the common law obligation of good faith in commercial franchises" (2005) 33 Australian Business Law Review 209 as cited in SA Franchises Report at 15*

and also has express provisions governing the transfer of the franchise and termination of the franchise.

The issue is what more (if anything) is required and why?

7.1 The end of franchise 'problem'

We suspect that the inquiry will hear that the standard terms in Part 3 of the Code are insufficient because there continue to exist "issues relating to end of contract and non renewal of the franchise agreement"[47] and because "the present franchising regime in Australia provides little protection for the interests of the franchisee at the expiry of a franchise agreement."[48]

We are not aware of any other concerns in respect of which it is suggested that statutory terms be imposed to address.

In relation to this alleged 'problem' it is likely to be said that the problem relates to goodwill and the "*fact*" that:

"… franchise agreements often do not address the entitlement by the franchisee to goodwill on termination or expiry of the franchise agreement. If it is referred to, it is usually to deny the franchisee any rights. In either case the benefit of any goodwill reverts to the franchisor."[49]

The "problem" is said to be that:

- *"Over the length of the agreement, franchisees' financial and personal effort contributes to the brand. Presently, this input does not entitle franchisees to compensation or legal recourse unless it is stated in the franchise agreement."*[50]

- *"…most agreements are entered into for a term that is not sufficient to allow return on the initial investment."* [51]

As a result, in theory:

A "franchisor by not renewing the franchise agreement", may force "the franchisee out of business, purely and simply to set up its own business at the same location and thus profit exclusively from the goodwill built up by the former franchisee without having to pay anything for it. Even with this threat in hand, the franchisor can exploit franchisee in the acquisition of the franchisee's business or assets at significantly below market value."[52]

A franchisor "may seek to buy out a franchisee at the completion of a contract for a price that does not reflect the value of the business and constitutes an effective

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[47] *WA Franchises Report at 63*
[48] *WA Franchises Report at 21*
[49] *Andrew Terry and P D Giugni, "Freedom of Contract, Business Format Franchising and the Problem of Goodwill", Australian Business Law Reform, Volume 23, August 1995, pg.245 as cited in WA Franchises Report at 63*
[50] *WA Franchises Report at 21*
[51] *See Franchisees Association of Australia Incorporated Committee Hansard (SA), 2 April 2008, p.138; SA Franchises Report at 63*
[52] *Retail Traders' Association of Western Australia submission to the WA Franchise Inquiry as cited in WA Franchises Report at 34*

loss for the franchisee; a refusal to sell on those terms, however, means a franchisee may see their contract simply lapse at its completion of the loss of their entire investment."[53]

The current law, it has been asserted, may not cover this issue as:

- *"Franchisees can be considered to be at the same disadvantage upon expiry of their agreements where there is no right of renewal as that of sitting tenants (lessees) as can be seen from an examination of basic contract law and the decision in the Berbatis case, the landlord's refusal to renew, or agreement to renew on comparable terms, does not give rise to a "special" disadvantage for the purpose of the equitable doctrine of unconscionable dealing."*[54]

- *"The use of unconscionability, good faith or equivalent standard to regulate franchise renewal is unlikely to be effective where the franchisor's conduct simply involves the exercise of a legal right."*[55]

The Committee is likely to be told, as a solution, that "at the end of the [franchise] agreement there should be an entitlement to the renewal or compensation on the basis of the goodwill that has been built up during the term of the franchise agreement"[56]. Alternatively it could be suggested that "a statement obligating franchisors, franchisees and prospective franchisees to act towards each other fairly and in good faith"[57] should be inserted in the Code (or the TPA more generally). It might even be suggested that section 51 AC be amended "to suggest that a franchise that fails or refuses to renew a franchise agreement on expiry engages in conduct that is unconscionable, unless specified exemptions apply".[58]

Again we advise caution against the Committee relying upon or acting upon on such claims. We understand that "[t]he rate of non renewal of franchise agreements, during the period of 2003- 2005, was between 1.5% and 3.7% per year. This does not include agreements terminated by the franchisor." [59] The low rate of non renewal therefore suggests that the vast majority of franchise agreements are renewed on expiry and that the theoretical problem above does not generally exist and is not "clearly established".

Further the Committee should investigate and form its own view whether the said 'goodwill' of the franchisee is indeed 'goodwill' of the particular franchisee rather than the franchisor or existing franchisees generally. Finally the Committee should consider the available options for addressing the problem (if it indeed exists) and seek the regulation that does the "minimum necessary" to address the problem and yet has the greatest net benefit. This last comment is particularly relevant to the suggested imposition of an overriding duty of 'good faith'.

7.2 Personal Goodwill?

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[53] *SA Franchises Report at 65*
[54] *WA Franchises Report at 39*
[55] *WA Franchises Report at 24*
[56] *WA Franchises Report at 63*
[57] *Review of the Disclosure Provisions of the Franchising Code of Conduct, Report to the Hon Fran Bailey MP, Minister for Small Business and Tourism (SA), October 2006, p 13*
[58] *WA Franchises Report at 22*
[59] *WA Franchises Report at 20*

In support of the assertion that there is something identifiable as a franchisee's "goodwill" it is likely that it will be submitted to the Committee that:

"In legal terms there are three types of goodwill: business goodwill, site goodwill and personal goodwill. The franchisee pays for business goodwill and possibly site goodwill when buying into a franchise system. Personal goodwill is added by the franchisee."[60]

It is also likely to be submitted that:

"..the initial goodwill of the franchise business obviously reflects the franchisor's concept, intellectual property, established reputation and investment. However, the investment and entrepreneurial activities of franchisee, together with the usual contributions to systems promotion and advertising levies, clearly enhance the goodwill correct franchise system and would not be unreasonable to expect that the franchisee should be compensated for her or his contribution to the enhance goodwill of the system."[61]

The 'problem' then will be said to be that:

"Conventionally goodwill in its entirety belongs to the franchisor as the owner of the business, while the franchisee is seen as being only in that business for the period of time defined in the franchise contract…. in the absence of a contractual provision providing for compensation for goodwill on expiry or termination the franchisee forfeits the goodwill".[62]

It has been further suggested, as a solution, that "the interdependence of the relationship, with a franchisor and franchisee, sharing an interest in the viability and success of the business" should "be reflected in a shared entitlement to any goodwill."[63]

We disagree with the above summation.

If the franchisee is, for example, buying into, say, a McDonald's franchise a customer, regardless of the operator would stop at McDonald's, buy a burger and drive off. The actual franchisee and its identity does not matter a jot[64]. In that circumstance the franchisee has no goodwill. In other circumstances where the franchised businesses "are very, very dependent on the operator and which are less dependent on perhaps a supplier of branded product - and that might be someone who cleans your swimming pool" the franchisee may have some so-called 'personal goodwill'.[65] The measure of that 'goodwill', however, will be limited to the customers the franchisee can keep, notwithstanding the loss of the site and the loss of the franchisor's branding.

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[60] *Jenny Buchan, "When the Franchisor Fails: A research report prepared for CPA Australia by the University of New South Wales", January 2006, p. 23 at www.cpaaustralia.com.au/cps/rde/xbcr/SID-3F57FEDFCDC3599/cpa/200602_franchisor.pdf*

[61] *Andrew Terry and P. D. Giugni, "Freedom of Contract, Business Format Franchising and the Problem of Goodwill" 23 (1995) Australian Business Law Review 253*

[62] *Andrew Terry and P. D. Giugni, "Freedom of Contract, Business Format Franchising and the Problem of Goodwill" 23 (1995) Australian Business Law Review 245 as cited in SA Franchises Report at 71*

[63] *SA Franchises Report at at 71*

[64] *Ms Buchan Committee Hansard (SA), 19 March 2008 p. 112*

[65] *Ms Buchan Committee Hansard (SA), 19 March 2008 p. 112*

This 'personal goodwill', however, is not goodwill in the sense as commonly understood. As explained by the Productivity Commission in its report on 'The Market for Retail Tenancy Leases in Australia':

"...only one of these [three] components [of goodwill] is fully transferable on the sale of a business if location is not owned - the product/brand reputation. If goodwill is dependent on the managerial ability of the owner, it cannot (usually) be bought or sold - its lies with the individual."[66]

In the circumstances, our view is that as 'personal goodwill' cannot usually be bought or sold ("it lies with the individual") at termination that 'personal goodwill' remains with the individual and he or she should not be entitled to any compensation in relation to it.

In the franchise relationship the absence of any personal or management-based goodwill under franchise agreements is part and parcel of the franchise model and is a result of the underlying franchise rights. A franchisee simply acquires the right to participate in a business system for a term specified by the franchise agreement.[67]

Just as the work of an employee in the course of employment belongs to the employer, the goodwill accumulating to the brand through the efforts of franchisees belongs to the franchisor but it utilised by existing franchisees for their benefit for the term of their agreements. For example, in employment relationships an employer is entitled to benefit from any invention or improvement devised by an employee. Farwell J said in *Triplex Safety Glass Co v Scorah* [1938] Ch 211 at 217:

"... any invention or discovery made in the course of the employment of the employee in doing that which he was engaged and instructed to do during the time of his employment, and during working hours, and using the materials of his employers, is the property of the employers and not of the employee .... [the] employee is therefore as a trustee bound to give the benefit of any such discovery or invention to his employer."

Even where a franchisee might pay for 'site goodwill', such as by obtaining a licence to use premises or a sub-lease or assignment of lease, this 'site goodwill' the franchisee pays for is the ability to use the premises for an express term only. As the Productivity Commission found:

"The holding of a fixed-term lease in a shopping centre does not confer goodwill to the lessee beyond the period of the lease."[68]

In any event we cannot foresee franchisors, in circumstances which would not typically fall foul of the unconscionable conduct provisions, equitable estoppel etc., seeking to not renew the franchises of successful, brand-building franchisees. It simply does not make good business sense.

7.3 Possible Regulations

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[66] *Productivity Commission Inquiry Report 'The Market for Retail Tenancy Leases In Australia' No 43 31 March 2008 at 118 (Box 6.2), 225 (Table 10.1)*

[67] *Andrew Terry and P. D. Giugni, "Freedom of Contract, Business Format Franchising and the Problem of Goodwill" 23 (1995) Australian Business Law Review 241 at 242*

[68] *Productivity Commission Inquiry Report 'The Market for Retail Tenancy Leases In Australia' No 43 31 March 2008 at 120*

In terms of the suggested solutions to the alleged problem we oppose automatic renewal on the basis that such a solution would be not be commensurate with the 'problem' even if, contrary to the above, it were clearly established. For the reasons stated above franchisors need the right to terminate or allow to expire franchise agreements to take into account changed commercial circumstances and/or to ensure loyalty to and the success of their brand.

We also oppose as a suggested solution a requirement that the franchisor have a good cause for non renewal, such as legitimate business interests and no ulterior motive. If a franchisee wants a longer term he should negotiate that term from the outset and negotiate a payment arrangement appropriate for that longer term.

In accordance with good principles for regulation the Committee should not introduce a substantial area for further dispute within franchises, involving whether or not a franchisor had 'good cause' for non-renewal without the problem having been clearly established and demonstrable.

We can foresee considerable difficulties with our members own leasing task if disputes arise between retailer franchisees and franchisors about whether a franchise has in fact expired or in fact had to be renewed because the non-renewal was without cause. It is not only the directly interested parties that require certainty.

We can also foresee very complex arguments about compensation about whose goodwill it really is; how much goodwill attaches to a name; how much goodwill attaches to the fact that a restaurant was built on a prominent site; to the staff engaged, etc."[69]

As stated above we do not see any value in 'personal goodwill' which the franchisee retains in any event post-expiry and which consequently should not be the subject of compensation.

We acknowledge that the possible suggested solutions cited above to the identified (but not established 'problem') at least have the virtues that they are directed at the specific problem and could be limited to the minimum necessary by only operating where the franchisor itself, or a related company, takes over the franchise. According to the other principles for regulation, however, they should not be entertained by this Committee.

The suggested solution of a general 'duty of good faith' does not have these virtues. It is a wholly inappropriate remedy to the said problem as detailed below.

8. An Overarching Duty of Good Faith?

It is also likely to be submitted to the Committee, particularly given its terms of reference (2), that it should recommend the imposition of a general statutory duty of good faith in franchise agreements and that such a duty will fix problems including the end of franchise issues referred to above.

Some may argue to the Committee that:

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[69] *Mr Castle Committee Hansard (SA), 5 March 2008, p.86*

- *"… the introduction of a statutory duty of good faith would be one way to make explicit the underlying ethical standards expected of the industry as a whole."*[70]

- *"A statutory duty of good faith would represent a positive statement of what is considered ethical conduct within a franchising context and provides an appropriate and well accepted benchmark appropriate standards of ethical behaviour…. the ongoing success of the relationship requires that they act in a mutually respectful and cooperative manner throughout the course of the relationship. A statutory duty of good faith would set out the boundaries of acceptable conduct in a positive manner for the benefit of both franchisors and franchisees."*[71]

In support of their claim that 'good faith is an appropriate, sufficiently certain, legal test the proponents have asserted:

- *"The doctrine of good faith has been present in the Australian law some time … over recent years the Australian judiciary, especially in New South Wales and Victoria, have recognized the existence of the duty of good faith and fair dealing has an implied term in franchise contracts."*[72]

- *"A number of recent cases have looked favourably on the implication of a duty of good faith into a variety of contracts, it including franchising agreements."*[73]

- *"…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."*[74]

In particular, Associate Professor Frank Zumbo has claimed:

"Clearly, the concept of good faith has not only received strong judicial support, but now has reached a point in Australia where its nature and scope is being defined with an increasing degree of precision. Consequently, there is a ready body of law on which a statutory duty of good faith could readily and usefully draw upon in seeking to promote ethical business conduct."[75]

Whilst recognised in the Courts of Equity and at Common Law this Committee is likely to hear claims that there exists a real need for an express statutory provision as currently:

" the implied duty of good faith and fair dealing offers only limited protection to franchisees as it can be contractually excluded by inserting express terms which exclude the implicit duty of good faith or terms that are inconsistent with the implicit duty…"[76]

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[70] *See Frank Zumbo submission to SA Inquiry, 3 March 2008, p 2; SA Franchises Report at 54*
[71] *Frank Zumbo submission to SA Inquiry, 3 March 2008, p 17*
[72] *Robert McDougall, "The Implied duty of good Faith in Australian Contract Law", Australian Contract Law, Supreme Court of New South Wales, at http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/pages/SCO_mcdougall210206 (accessed on 7 April 2008) as cited in SA Franchises Report at 54*
[73] *WA Franchises Report at 9*
[74] *SA Franchises Report at 55*
[75] *Frank Zumbo submission to SA Inquiry, February 2008, p. 17*
[76] *See Frank Zumbo Committee Hansard (SA), 20 February 2008, p.73; SA Franchises Report at 59*

Finally, it has been argued that a duty of good faith has the virtue that:

"Franchisors in Australia are free to pursue their legitimate business interests but may offend the implied good faith principles through the pursuit of some extraneous purpose. Importantly, an implied covenant will only aid and further explicit terms of the agreement and will never impose an obligation which would be inconsistent with other terms of the contractual relationship."[77]

Again the Committee should be very cautious in relying on such statements. The truth is an overriding duty of good faith is impossible to define and would add unnecessary uncertainty to the already complex franchise relationship.

Respected academics, legal practitioners, and judges have expressed very different views about the status of any duty of good faith. Certainly Associate Professor Zumbo's opinion that good faith is well accepted and has been defined with some precision is contrary to the opinion of many qualified writers. We have cited below just some of these views:

- *"To say that the role of good faith in Australian contract law is currently unsettled and that the law is in a state of flux would be an understatement. It may be closer to the mark to say that it is in a state of utter confusion."*[78]

- *"Despite the increased use of implied and express terms of 'good faith' in contracts over the last 10 years, there is still little agreement about the exact meaning of the obligation."*[79]

- *"There is no uniformly agreed definition of 'good faith'*[80]*.*

- *"The recognition of good faith as a principle inherent in contractual relationships has caused sufficient judicial angst for its place to continue to be doubted within Anglo-Australian jurisprudence."*[81]

- *"Perhaps the most important unresolved issue in Australian contract law today is the extent to which the law recognises an implied requirement of good faith in performance and enforcement."* [82]

- *"One of the stumbling blocks is that Australian law has yet to come to terms with the concept of good faith. Firstly, it is difficult to compose a workable definition and secondly there is the issue of the standard of conduct which will amount to a breach of a duty of good faith, or simply bad faith."*[83]

Even those academics, practitioners and judges who advocate that there exists, or should exist, general overriding duties of good faith, are unable to agree, even generally, as to its content. They variously and vaguely suggest:

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[77] *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd [2006] VSC 223 (21 June 2006) as cited in WA Franchises Report at 10*
[78] *Good Faith in Australian Contract Law by JW Carter and Elisabeth Peden*
[79] *The meaning of contractual 'good faith' by Dr Elisabeth Peden*
[80] *See eg Aiton Australia Pty Ltd v Transfield Pty Ltd (2000) 16 BCL 70 at [156] per Einstein J; R Brownsword*
[81] *Too Much Concern Too Soon? Rationalising the Elements of Section 51AC of the Trade Practices Act by Philip Tucker*
[82] *Interpretation, Good Faith and the 'True Meaning' of Contracts: The Royal Botanic Decision by JW Carter and Andrew Stewart.*
[83] *Outline of the Interaction of Retail Tenancy Issues and Section 51AC*

- *"The proposition that a requirement, perhaps even a duty, of 'good faith and fair dealing' should be recognised as an inherent feature of contracts is now routinely accepted … These cases have not, however, given much content to the requirement, or even explained whether it operates as an obligation the breach of which sounds in damages."* [84]

- *"There is no uniformly agreed definition of 'good faith'*[85]*.*

- *"In most instances, the good faith requirement envisaged in the Australian cases seems to equate with the established principles that a party must act honestly, and do 'all such things as are necessary … to enable the other party to have the benefit of the contract'."* [86]

- *"This article proposes that the most appropriate meaning of 'good faith' is a requirement that regard be had of the other party's interests. This definition includes 'loyalty' to the contract and subjective honesty. However, this definition does not go so far as to require 'reasonableness' or 'unconscionability', which have been suggested as concurrent obligations with 'good faith' in some cases."* [87]

- *"'[G]ood faith' embraces three notions: an obligation on the parties to cooperate in achieving the contractual objects (loyalty to the promise itself); compliance with honest standards of conduct; and compliance with standards of conduct which are reasonable having regard to the interests of the parties."* [88]

- *"… The duty is not a duty to prefer the interests of the other contracting party. It is, rather, a duty to recognise and to have due regard to the legitimate interests of both the parties in the enjoyment of the fruits of the contract as delineated by its terms."* [89]

- *"Good faith operates to restrict a party exercising a discretion in a way that falls outside the justified expectations of the parties at the time of formation."* [90]

- *"Good faith demands that the latter party in this example not perform its obligations at less than the reasonably expected standard having regard to the parties' intentions (and the parties' corresponding reasonable and legitimate expectations) when the contract was formed, and to the subject matter of the contract."* [91]

This lack of clarity around the concept of "good faith" is not limited only to Australia:

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[84] *Interpretation, Good Faith and the 'True Meaning' of Contracts: The Royal Botanic Decision by JW Carter and Andrew Stewart.*
[85] *See eg Aiton Australia Pty Ltd v Transfield Pty Ltd (2000) 16 BCL 70 at [156] per Einstein J; R Brownsword*
[86] *Interpretation, Good Faith and the 'True Meaning' of Contracts: The Royal Botanic Decision by JW Carter and Andrew Stewart.*
[87] *The meaning of contractual 'good faith' by Dr Elisabeth Peden*
[88] *Sir Anthony Mason*
[89] *The meaning of contractual 'good faith' by Dr Elisabeth Peden*
[90] *The meaning of contractual 'good faith' by Dr Elisabeth Peden*
[91] *Too Much Concern Too Soon? Rationalising the Elements of Section 51AC of the Trade Practices Act by Philip Tucker*

- *"Academic viewpoints in the United States differ as to the meaning of good faith at common law. The views range from whatever is not bad faith to acting within a contemplated range of motives or acting reasonably or honestly in the performance of the contract."*[92]

- *"There has been a significant amount of judicial reluctance in the United Kingdom to recognize the implied duty of good faith in the performance and enforcement of contracts. Further, good faith in the negotiation process has been rejected by the House of Lords."*[93]

In Australia there is considerable debate whether the Courts that have implied a duty of good faith have in fact got it right. For instance, it has been said:

- *"… in Burger King Corp v Hungry Jack's Pty Ltd, the NSW Court of Appeal repeatedly referred to terms of 'good faith and reasonableness' … With respect, to equate an obligation of reasonableness and one of good faith is misconceived."* [94]

- *" it has been suggested that good faith may not only require honesty and a degree of co-operation, but extend beyond that to require compliance with a standard of 'reasonable' conduct. There are, potentially, two errors in this approach. "…once the parties are subjected to a general requirement of reasonableness in their performance and enforcement, virtually every aspect of that performance and enforcement is open to challenge. The reason for that is not hard to find. When viewed objectively, particularly with the benefit of hindsight, there will often look to be an element of unreasonableness (from one party's perspective) in the operation of a contract. But this is not in itself a sufficient basis for depriving a party of its contractual rights. This is an issue which those who consider that good faith should be implied as a matter of law into contracts of all description, or at least commercial contracts, must address. So far they have failed to do so."* [95]

In what the SCCA believes to be an independent "text" Halbury's Laws of Australia it is stated:

- *"As the law currently stands, there is no general contractual term, implied in law, requiring parties to act in good faith when negotiating a contract or in its performance. However, in some cases it has been made as a matter of law. Moreover, where a duty of good faith is implied, the duty may or may not be a term of the contract.*

- *Nevertheless, a duty to act in good faith may be implied in specific contexts particularly in relation to contracts for the provision of services, or to give business efficacy to a particular contract. Moreover, in many contexts, terms implied in fact or law or by construction will serve the same functions in particular fact situations as an implied obligation to act in good faith"*[96]

The High Court has not yet addressed the issue of a general overriding duty of good faith.

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[94] *The meaning of contractual 'good faith' by Dr Elisabeth Peden*

[95] *Interpretation, Good Faith and the 'True Meaning' of Contracts: The Royal Botanic Decision by JW Carter and Andrew Stewart.*

[96] *Halsbury's Laws of Australia/Contract/Terms and Parties/Implied Terms/Terms implied in Law*

In *Royal Botanic Gardens and Domain Trust v South Sydney City Council* [2002] HCA 5, whilst not determining the matter, Kirby J observed that the idea of an implied term of good faith and fair dealing "appears to conflict with fundamental notions of caveat emptor that are inherent (statutes and equitable intervention apart) in common law conceptions of economic freedom". He also stated that such an implied term "appears to be inconsistent with the law as it has developed in this country in respect of the introduction of implied terms into written contracts which the parties have omitted to include". Callinan J did not go so far, describing the arguments put by the lessee on the basis of the New South Wales Court of Appeal authorities mentioned below as "rather far-reaching".

Further, Gummow J pointed out in 1993, "[t]he implication of a term by operation of law, applicable across the whole spectrum of the law of contract, is a major step" (*Service Station Assn Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FC 84 at 97) and held that Australian law had not yet taken this step as regards an implied term of good faith and fair dealing in performance.

The SCCA's legal advisers have reviewed the key authorities on "good faith" and have concluded that 'good faith' takes on different meanings depending on its context[97] In their view this is neither surprising nor unsatisfactory given that it is really a principle or policy deriving from and guiding the implication of terms and/or the construction of existing terms rather than being itself a legal norm.

In the view of our legal advisers the exact content of any implied obligation of good faith depends on the type of contract, the factual matrix and the parties involved etc.[98] An obligation of good faith cannot stand on its own. There must first be an agreement with an objectively ascertainable common purpose(s) with respect to which the parties must be able to be 'faithful'. It makes no sense to simply say that parties must perform in good faith. Rather "[w]e must know what terms they will be performing. If we are then requiring those terms to be performed in good faith, really all we are doing is explaining the standard to which they must perform."[99] In this way the obligations of good faith fills in the gaps.

As is said in Section 205 of the 'Restatement Second of Contracts'[100] the underlying ethic in good faith performance and enforcement of a contract is a "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party"[101].

'Good faith' need not require fairness or regard to the other party's interests, "since the contract allows a self-interested approach, so long as it is loyal and consistent with the contract's objectives and spirit." [102] If, for instance, "a party makes clear that it will be seeking nothing less than the most favourable terms, the other party can only reasonably and legitimately expect that the first party will act in an

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[97] *See eg Aiton Australia Pty Ltd v Transfield Pty Ltd (2000) 16 BCL 70 at [156] per Einstein J; R Brownsword*
[98] *The meaning of contractual 'good faith' by Dr Elisabeth Peden*
[99] *Contracts: Good faith in the performance of contract law by Dr Elisabeth Peden*
[100] *Restatement of the Law of Contracts (Second reprinting) adopted and promulgated by the American Law Institute at Washington DC, May 17 1979 and published 1981 (hereafter referred to as "Restatement Second of Contracts" or "Restatement Second".*
[101] *Comment accompanying s.205.*
[102] *The meaning of contractual 'good faith' by Dr Elisabeth Peden*

entirely self-interested fashion and accordingly obligations of good faith will be minimal." [103]

It is for these reasons that 'good faith', as being applied sporadically by the Courts, is not regarded as an affront to the doctrine of sanctity of contract. It is for this reason also that 'good faith' is not suitable as a statutory duty. It describes a principle, not a legal norm, which is used to construe and/or imply contractual terms and would be poorly translated into a statutory provision.

In terms of the key authorities in *Alcatel Australia*, Sheller JA (Powell JA and Beazley JA agreeing) said (at p.368):

"If a contract confers power on a contracting party in terms wider than necessary for the protection of the legitimate interest of that party, the courts may interpret the power as not extending to the action proposed by the party in whom the power is vested or, alternatively, conclude that the powers are being exercised in a capricious or arbitrary manner or for an extraneous purpose, which is another [way] of saying the same thing."

The reference to good faith concepts here is a reference to concepts which guide the construction of contracts and is consistent with the modern approach of giving effect to what the parties are construed to have intended: see *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales*. No overriding duty of good faith is imported. Rather the particular wide express clause is read down to give effect to what the parties are construed to have intended.

In *Far Horizons Pty Ltd v McDonalds Australia Ltd* [2000] VSC 310 at [120], Byrne J said:

"I proceed, therefore, on the basis that there is to be implied in a franchise agreement a term of good faith and fair dealing which obliges each party to exercise the powers conferred upon it by the agreement in good faith and reasonably, and not capriciously or for some extraneous purpose. Such a term is a legal incident of such a contract."

Also in *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703 (43,008), Finkelstein J said:

"There is no reason to think, prima facie at least, that the obligation of good faith and fair dealing would not act as a restriction on a power to terminate a contract, especially if that power is in general terms."

These cases are again illustrations that an obligation of good faith may be implied to fill in the gaps where a discretion/power given to one party on its literal terms is wider than was intended (as objectively ascertained).

In *Burger King Corporation v Hungry Jack's Pty Ltd* (2001) 69 NSWLR 558, Sheller JA, Beazley JA and Stein JA said:

"For a term to be implied at law, in a new category of case [such as good faith] it must be both reasonable and necessary: see Castlemaine Tooheys and Byrne. In Byrne, McHugh J and Gummow J explained the meaning of necessity in this

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[103] *Too Much Concern Too Soon? Rationalising the Elements of Section 51AC of the Trade Practices Act by Philip Tucker*

context. They said (at 450) "Many of the terms now said to be implied by law in various categories of case reflect the concern of the courts that, unless such a term be implied, the enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless, or, perhaps, be seriously undermined. …Hence, the reference in the decisions to 'necessity'. …"

In that case the Court noted that the franchisor had been given in the agreement a "sole discretion" which, interpreted literally, would have allowed it:

"… to give or to withhold relevant approval 'at its whim' including capriciously, or with the sole intent of engineering a default of the Development Agreement, giving rise to a right to terminate".

The Court then said:

"In our opinion, applying the words used by McHugh J and Gummow J in Byrne (at 450), the 'enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless or perhaps seriously undermined' if the clause was able to operate in the matter for which Burger King Corporation contended."

The Court found:

"That being so, it reinforces our view that Burger King Corporation's contractual powers under cl4.1 are to be exercised in good faith and reasonably. That does not mean that Burger King Corporation is not entitled to have regard only to its own legitimate interest in exercising its discretion. However, it must not do so for a purpose extraneous to the contract – for example, by withholding financial or operational approval where there is no basis to do so, so as to thwart Hungry Jack's Pty Ltd's rights under the contract."

Properly understood this decision does not represent a major new development in the law, but rather is an application of established principles of interpretation and implication, which results in the particular clause 4.1's wide (literally unfettered discretion) being read down.

That this is the correct interpretation is evident from a recent decision of the New South Wales Court in *CGU Workers Compensation (NSW) Ltd (ACN 003 181 002) v Garcia* – BC200706429 per Mason P, Hodgson and Santow JJA, in which the Court said that:

- *"The worker points to decisions of this Court recognising that some commercial contracts contain terms implied as a matter of law imposing an obligation of good faith and reasonableness in the performance of contractual obligations (Alcatel Australia Ltd v Scarcella (1998) 44 NSWLR 349 at 369; Burger King Corporation v Hungry Jacks Pty Ltd [2001] NSWCA 187 at [159], [164]; Vodafone Pacific Ltd v Mobile Innovations Ltd [2004] NSWCA 15 at [125]).*

- *These cases do not establish that such an implied term is to be inserted into every contract or even into every aspect of a particular contract."*

- *"In determining whether the implication is to be drawn form a particular class of contract, courts ask range of questions that include whether the contract would be effective without it, and whether the enjoyment of the rights*

expressly conferred would or could be rendered nugatory, worthless or perhaps be seriously undermined. The central criterion is one of "necessity", a matter to be tested against any applicable statutory policy (see Byrne v Australian Airlines Ltd (1995) 185 CLR 410 at 450; Breen v Williams (1995) 186 CLR 71 at 80 102-3 and 124; Hughes Aircraft Systems International v Airservices Australia (1997) 76 FCR 151 at 193-5)."

A review of the key authorities therefore reveals that there is no overriding duty of good faith in equity or common law but rather "good faith", "reasonableness" etc are concepts which are as a matter of construction or by construction used to fill in the gaps of contractual provisions but only where it is not inconsistent with the express provision to do so – ensuring the sanctity of contract. Where you have a fixed term franchise agreement which expires on a certain date without a franchisee option you have no gap to fill and therefore no common purpose in respect of which "good faith" may operate.

Having regard to the above this Committee should appreciate that when Associate Professor Frank Zumbo describes 'good faith' as something different, and suggests that concept "would be one way to make explicit the underlying ethical standards of the industry as a whole", he is really talking about 'fairness' – a principle he has long championed[104], as a legal norm. Associate Professor Zumbo's attempts to cloak 'fairness' under the guise of 'good faith' - to suggest it is respectable, legitimate and accepted as a judiciable legal norm - should be seen for what they are.

8.1 Fairness

The inclusion as a legal norm or standard of 'fairness' (rather than a desirable guidng principle) in transactions between businesses has been thoroughly examined on many occasions and there is good reason why it has not been introduced. In Australia it was considered in 2003 by the Senate Committee examining small business protections under the *Trade Practices Act*. As was noted in the majority report of that Senate Committee: "the consequence [of amending section 51AC of the Trade Practices Act to include words such as 'harsh' or 'unfair'] would make the meaning of the section so open to a variety of different interpretations that it would be inimical to the development of a coherent and relatively clear body of law."

As one commentator has said:

"Most people would agree that it is undesirable for judges to decide that business conduct is unconscionable simply by reference to idiosyncratic or personalised notions of fairness and justice unguided by law, as some kind of misguided "individualised justice", "discretionary remedialism", or abandonment of "principle" for "pragmatism"."[105]

This is after all the Separation of Powers doctrine and underlies the Rule of Law.

Commercial parties want laws such that in any given situation both parties seeking legal advice as to their rights and obligations can expect the same clear and confident answer from their advisers and neither will be tempted to embark on long

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[104] *See submission to Reid Committee in 1997.*

[105] *The expansion of fairness-based business regulation – unconscionability, good faith and the law's informed conscience by Bryan Horrigan (2004) 32 ALBR 159*

and expensive litigation in the belief that victory depends on winning the sympathy of the court.

It is for the above reasons that, following the Reid Committee report in 1997, the Australian Government settled on an unconscionability standard rather than unfairness standard when determining whether business conduct offended the *Trade Practices Act*. "The opportunity to adopt a provision prohibiting the conduct which was unfair was deliberately avoided."[106]

In any event, applying the principles for regulation referred to above, there does not seem any need to 'experiment' with good faith or fairness in Australia, given the conclusions of recent State Franchise Inquiries that:

- *"Overall, the Inquiry believes that the franchising sector operates well; however, improvements need to be made to address the concerns raised."*

- *"The Inquiry has not detected any patterns of widespread misconduct within the franchising sector in Australia."*

If there is a specific franchise issue that the Committee is satisfied requires redress, we believe that issue should be addressed by a specific provision in the Code directed solely at that issue.

9. Shopping Centre Council of Australia Ltd

The Shopping Centre Council represents owners and managers of shopping centres. Our members are: AMP Capital Investors, Centro Properties Group, Colonial First State Property, Dexus Property Group, Eureka Funds Management, GPT Group, ISPT, Jen Retail Properties, Jones Lang LaSalle, Lend Lease Retail, Macquarie CountryWide Trust, McConaghy Group, McConaghy Properties, Mirvac, Multiplex, Perron Group, Precision Group, QIC, Savills, Stockland, Westfield Group and the Yu Feng Group.

[106] *Outline of the Interaction of Retail Tenancy Issues and Section 51AC*

10. Contact

The Shopping Centre Council would be happy to discuss any aspect of this submission. Please do not hesitate to contact:

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