Law Council of Australia Trade Practices Committee, Business Law Section

Submission to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into the Franchising Code of Conduct

1 Introduction

The Trade Practices Committee, Business Law Section of the Law Council of Australia ("**Committee**") would like to thank the Parliamentary Joint Committee on Corporations and Financial Services for the opportunity to comment on the Franchising Code of Conduct (the "**Code**").

The Committee believes that it is unnecessary and undesirable to:

- include an obligation on franchisees and franchisors to act in good faith under the Code. An implied duty to act in good faith is already required under both the common law and section 51AC of the *Trade Practices Act* 1974 (the "**Act**");
- change disclosure obligations so as to require franchisors to provide franchisees with a risk statement or risk checklist;
- change the notion of what is "unconscionable" under the Act; or
- amend the procedures relating to dispute resolution.

Recent cases on section 51AC including *Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No 2)* [2008] FCA 810 and *Australian Competition and Consumer Commission v Simply No-Knead (Franchising) Pty Ltd* (2000) 104 FCR 253 demonstrate that the section is working as intended in the context of franchise arrangements.

Moreover, the Australian Competition and Consumer Commission ("**ACCC**") has not complained that section 51AC is unworkable. Rather, the register of franchise investigations initiated by the ACCC last year indicates that the ACCC has been vigorously investigating and prosecuting breaches of the Code (including in relation to unconscionable conduct).

The Committee's more detailed comments on the Code, in the context of the Parliamentary Joint Committee's current Inquiry are set out below.

2 Submission

2.1 It is not necessary to include an obligation on franchisees and franchisors to act in good faith under the Code as an implied duty to act in good faith is already required under both the common law and section 51AC of the Act

Australian Courts have recognised that a franchise agreement includes an implied term requiring parties to act in good faith and reasonably, and not to act capriciously or for some extraneous purpose.[1]

Courts have been clear that this implied duty of good faith does not require parties in a franchising situation, or otherwise, to act against their legitimate business interests which are consistent with the terms of the particular franchise agreement.[2] Whether an express obligation to act in good faith would be interpreted in the same manner is unknown.

An implied term of good faith has been applied in cases such as *Burger King Corporation v Hungry Jack's Pty Ltd* [2001] NSWCA 187 (***"Burger King"***) and *Bamco Villa Pty Ltd v Montedeen Pty Ltd; Delta Car Rentals Aust Pty Ltd v Mabco Villa Pty Ltd [2001] VSC 192* (***"Bamcom Villa"***) to protect the franchisees' enjoyment of rights under a franchise agreement. In both the *Burger King* and *Bamcom Villa* cases, the Court found in favour of franchisees in circumstances where the franchisors had purported to terminate the franchise agreement even though the franchisor had contributed to the franchisee's breach of the agreement.

In *Garry Rodgers Motors (Aus) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ¶41-703, *Far Horizons Pty Ltd v McDonalds Australia Limited* [2000] VSC 310 and *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* [2006] VSC 222, the Court has also recognised the implied duty of good faith. However, in those cases, the Court found that the franchisors were acting in accordance with legitimate business interests, consistently with the terms of the franchising agreement, and had not breached their duty of good faith.

The remedies available for a breach of the implied duty of good faith are adequate, and comprise:

- injunctions preventing the purported termination of the contract (sought in *Garry Rodgers Case)*; and
- damages (for example, considerable damages were awarded in *Burger King*).

Further, by virtue of section 51AC(4)(k) of the Act, the extent to which an acquirer or small business supplier has acted in good faith is already a factor which the Court may have regard to when considering whether there has been any unconscionable conduct in breach of section 51AC of the Act.

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[1] *Garry Rodgers Motors (Aus) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ¶41-703; see also *Burger King Corporation v Hungry Jack's Pty Ltd* [2001] NSWCA 187 at [159] and *Far Horizons Pty Ltd v McDonalds Australia Limited* [2000] VSC 310 at [120].

[2] See for example *Far Horizons Pty Ltd v McDonalds Australia Limited* [2000] VSC 310; *Garry Rodgers Motors (Aus) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ¶41-703 and *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* [2006] VSC 222.

2.2 It is not necessary to amend the notion of "unconscionable" in section 51AC of the *Trade Practices Act*

The existing regulatory framework for franchising is strengthened by the application of general provisions within Part IVA and Part V Division 1 of the Act to franchising agreements.

These provisions include the prohibition of unconscionable conduct under section 51AC of the Act which, in tandem with the long-standing and broad prohibition of misleading and deceptive conduct under section 52 of the Act, confers significant protection on franchisees. Together, these provisions impose a clear standard of ethical business conduct in the franchising context.

The Committee understands that some commentators and State-based Parliamentary Committees have recommended that section 51AC of the Act be amended to include a statutory definition of unconscionable conduct, or by replacing the non-exhaustive list of statutory factors in section 51AC(3) and (4) with a statutory list of examples of the types of conduct that would ordinarily give rise to unconscionable conduct in the franchise relationship.

Proponents argue that these two proposals are intended to address problems currently experienced with section 51AC, including that the provision has failed to provide a clear set of standards of ethical conduct, and that the Courts have adopted an overly onerous interpretation of the concept of "unconscionable" conduct which, in turn, has meant that the provision has little room to operate.

The Committee submits that the recommendations of those commentators and State-based Parliamentary Committees not be followed. Section 51AC, as it is currently drafted and interpreted, provides a set of clear and high standards of ethical conduct for franchising relationships. Unconscionability is not an express statutory obligation, capable of precise definition, but a norm of conduct of general application - similar to acting "unreasonably" or in "good faith". It follows that any attempt to define the term - even through the use of "examples" - will lead to significant problems, including the loss of flexibility in interpretation of the provision as circumstances inevitably change and the loss of guidance on the norm provided by established legal precedent.

Further, section 51AC has a positive impact in relation to all aspects of the franchising relationship - from conduct in pre-contractual negotiations to the negotiation and entry into of written agreements, to conduct within the continuing relationship and in respect of termination. Currently, a breach of the standards of conduct prescribed by the Code is explicitly included as one of the factors that the Court may consider when determining whether there has been a breach of section 51AC. This allows section 51AC to operate effectively within the franchising context. The incorporation of an overly broad definition of unconscionability, as suggested by some commentators, would have damaging implications for franchising as well as for other industries.

2.3 Inserting a statutory definition of "unconscionable conduct"

Proponents of change to the existing Act contend that the insertion of a statutory definition of "unconscionable" conduct in section 51AC would provide clear statutory guidance as to what is meant by the term for the

purpose of section 51AC. They reason that it would provide a benchmark for assessing conduct to determine whether or not it amounts to unconscionable conduct. One commentator has proposed that the following definition of "unconscionable conduct" be inserted in section 51AC in a submission to the Parliament of South Australia's Economic and Finance Committee's Inquiry into Franchises:

> *"For the purposes of this section "unconscionable conduct" includes any action in relation to a contract or to the terms of a contract that is unfair, unreasonable, harsh or oppressive, or is contrary to the concepts of fair dealing, fair-trading, fair play, good faith and good conscience."* (13)

The Committee submits that inserting such a statutory definition of "unconscionable conduct" is unnecessary and undesirable.

Notwithstanding the absence of a statutory definition, the Courts have been able to interpret section 51AC in such a way so as to provide concrete guidance about what is unconscionable.

There is a developing body of sound Australian jurisprudence in the area which should be allowed to continue to develop without further intervention.

The developing body of jurisprudence requires the Courts to be satisfied that there has been "serious misconduct or something clearly unfair or unreasonable" before a finding of unconscionability under section 51AC may be made.

One important case that has been decided under section 51AC is *Australian Competition and Consumer Commission v Simply No-Knead (Franchising) Pty Ltd* (2000) 104 FCR 253, which involved a franchise system. In that case, Sundberg J of the Federal Court accepted a broad meaning of unconscionable conduct in the context of considering whether there had been a contravention of section 51AC, and also found that the Court is not confined to equitable principles when determining whether conduct is unconscionable for the purposes of the section: FCR at [13]-[14].

Importantly, in that case, Sundberg J found that the franchisor had engaged in unconscionable conduct in breach of section 51AC. His Honour found that the franchisor's conduct disclosed "...an overwhelming case of unreasonable, unfair, bullying and thuggish behaviour in relation to each franchisee that amounts to unconscionable conduct..."

Consistently, Beaumont J of the Federal Court in *Cameron v Qantas Airways Ltd* (1994) 55 FCR 147 at 179 has noted that "...there is no statutory definition of 'unconscionability'. But it appears that, to qualify, serious misconduct, something clearly unfair or unreasonable, must be demonstrated".

On appeal Davies J in the Full Federal Court (*Qantas Airways Ltd v Cameron* (1996) 66 FCR 246 at 262) found that the term "unconscionable" carries the meaning given by the Shorter Oxford English Dictionary, namely, "actions showing no regard for conscience, or that are irreconcilable with what is right or reasonable".

The ACCC in its guide *Do you supply goods or services to major retail chains? Unconscionable conduct* (published 30 September 2001) states that it considers the following conduct would be unconscionable conduct:

- being unreasonable;
- acting harshly;
- being oppressive;
- lacking good faith;
- bullying; and (at worst)
- being thuggish.

These examples of conduct are consistent with those identified by the Courts. Therefore, it is clear that despite the absence of a statutory definition, the Courts and the ACCC have not placed unduly high hurdles in the way of findings of "unconscionable conduct". It is clear that the scope of unconscionable conduct in section 51AC may already be articulated by Courts with precision.

Further, like section 51AC, section 52 of the Act does not contain a definition of misleading and deceptive conduct. Whether particular conduct is misleading or deceptive under section 52 is a question of fact to be determined in the context of the evidence as to the alleged conduct and to the relevant surrounding facts and circumstances. The strength of the generality of the terms of section 52 is illustrated in its broad application as a guiding norm for commercial conduct. The Honourable Mr Bill Morrison, the Minister for Science, in the House of Representatives debate on 24 July 1974, following the second reading speech on the introduction of the Act, observed as follows:

> *"The Bill prohibits a wide range of specific practices which have come under notice, including false representations, bait advertising, referral selling, pyramid selling and the assertion of a right to payment for unsolicited goods. It is not possible however to specify in advance the nature of all undesirable practices, as sharp operators continually evolve new schemes for duping the public. For this reason the broad prohibition of misleading or deceptive conduct in clause 52 is of great importance... The courts will be able under that provision to take action against conduct which may not fall within the more specific terms of other provisions. This will provide the flexibility necessary if legislation of this kind is to be able to deal with evolving market practices without the constant need for legislative action to catch up, often after much damage has already been done, with new practices that are harmful to consumers."* (575-576)

Section 51AC similarly lays down a guiding norm for commercial conduct of general application. The generality of the terms of section 51AC is necessarily part of the strength of the section.

It is, therefore, clear that the current and developing approach of the Courts to the interpretation and application of section 51AC does not require intervention by Parliament.

2.4 Replacing the statutory list of factors in section 51AC(3) and (4) with a statutory list of examples of unconscionable conduct

An alternative proposal has been made to recast the non-exhaustive list of factors which may be taken into account when consideration is given to whether conduct is unconscionable within the meaning of sub-sections 51AC(3) and 51AC(4) into examples of conduct that would ordinarily be considered to be "unconscionable".

Proponents of this proposal contend that the current list of non-mandatory and non-exclusive factors is capable of being disregarded at the Court's discretion. They consider that recasting the list of factors into examples would provide the Courts with clearer statutory guidance when assessing conduct under section 51AC. It is suggested that the following examples be inserted in the Act to comprise, in and of themselves, instances of unconscionable conduct:

- the supplier and the business consumer did not have similar strength in bargaining positions;
- the business consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the supplier;
- the supplier took advantage of the business consumer's inability to understand any documents relating to the supply or possible supply of the goods or services;
- the supplier exerted undue influence or pressure on, or used unfair tactics against, the business consumer or a person acting on behalf of the business consumer;
- the supplier's conduct towards the business consumer was inconsistent with the supplier's conduct in similar transactions between the supplier and other like business consumers;
- the supplier failed to comply with the requirements of any applicable industry code;
- the supplier unreasonably failed to disclose to the business consumer any intended conduct of the supplier that might affect the interests of the business consumer, or any risks to the business consumer arising from the supplier's intended conduct;
- the supplier was unwilling to negotiate the terms and conditions of any contract for supply of the goods or services with the business consumer;
- the supplier exercised a contractual right to vary unilaterally a term or condition of a contract between the supplier and the business consumer for the supply of the goods or services in a manner that was materially detrimental to the business consumer; and
- the supplier acted in bad faith towards the business consumer.

The Committee submits that amending section 51AC in this way would be unnecessary and undesirable. The non-exhaustive list of factors in sub-sections 51AC(3) and (4) provide sufficient statutory guidance to the Courts about what unconscionability entails.

In fact, the current non-exhaustive list of factors in sub-sections 51AC(3) and 51AC(4) give the Courts greater flexibility than would a list of examples, which are highly likely to be confined to specific sets of facts. Further, it would be impossible to describe by way of example all the situations in which conduct might be unconscionable.

The suggested recasting of the list of factors in section 51AC(3) and (4) into examples of unconscionable conduct poses a number of problems. For instance:

- while unequal bargaining power is obviously a relevant factor in deciding if a person has acted unconscionably, unequal bargaining power is common in commercial negotiations and should not, by itself, be the foundation of an allegation of unconscionable conduct;

- it is problematic to suggest that a supplier's unwillingness to negotiate the terms and conditions of any contract with the business consumer is unconscionable in and of itself, even where, for example, the business consumer has obtained legal advice on the terms and conditions of the contract, or the terms and conditions are themselves fair, necessary or reasonable to protect the legitimate interests of the supplier, or the supplier had previously negotiated the terms and conditions and is seeking to renew the existing contract on the same terms and conditions. There is also the potential for tension between this factor and sections 51AC(3)(f) and (4)(f), which touch on consistency of treatment. If a franchisor provides special treatment to a potential franchisee (thus potentially removing (j) as a factor) does it potentially risk enlivening (f)? It must be recognised that an appropriate degree of standardisation is necessary if a franchisor is to be able to operate a sustainable and consistent franchise system;

- similarly, exercising a right to unilaterally vary a franchise agreement should not, by itself, amount to unconscionable conduct. There are cases where the terms of a franchise agreement include operational documents, such as manuals, which need to be revised from time to time on a uniform basis. The fact that a franchisor exercises such a right should not, of itself, support a conclusion that the franchisor is acting unconscionably.

These matters are currently part of the factual matrix to which the Courts may have regard in determining whether or not unconscionable conduct has occurred. Removing the Court's ability to consider such matters would make the section unduly prescriptive and unreasonably impinge upon legitimate business conduct.

The Committee also submits that such a proposal may have the unintended effect of causing the Courts to adopt overly restrictive assessments of conduct in individual cases.

In contrast, the current wording of sub-sections 51AC(3) and 51AC(4) vest the Courts with substantial discretion to make a determination based on the individual facts of each case. This discretion is a guided or principled discretion, reducing judicial subjectivity and at the same time allowing flexible decision-making. The guided discretion that the Courts currently enjoy is a necessary part of the strength of section 51AC.

2.5 Enforcement of, and wide remedies for, contravention of section 51AC

Section 51AC may be enforced by private action or by the ACCC.

Private actions for contraventions of section 51AC may seek redress in the form of an injunction (section 80) and/or other orders under section 87, including:

- compensating a person for loss or damage;
- declaring a contract void in whole or in part;
- varying a contract or arrangement;
- requiring a refund of money or the return of property; and
- requiring that specific services be performed.

Further, contraventions of section 51AC may result in awards of damages under sections 87 or 82 of the Act.

As well as private actions, the ACCC may initiate administrative or Court action against a party that it considers has engaged in unconscionable conduct covered by section 51AC. The ACCC's *Guide to unconscionable conduct* states that whether the ACCC takes administrative action or court action will depend on both the criteria the ACCC uses to order its priorities generally and the nature of the particular conduct.

The administrative action that may be taken by the ACCC includes requesting that a party stop certain conduct or change particular trading practices. The ACCC may also accept an enforceable undertaking from the party concerned and make the undertaking public, under section 87B of the Act. Further, the Court can enforce an undertaking upon application by the ACCC.

If a matter cannot be resolved administratively, the ACCC may take Court action. The ACCC may seek injunctions under section 80, or other orders under section 87. It may also bring a representative action on behalf of people who have suffered, or are likely to suffer, loss or damage as a result of conduct by a person in contravention of Part IVA under section 87(1A)(b).

The ACCC can also seek a "non-punitive" order under section 86C for a contravention of section 51AC, such as community service orders, probation orders, orders for disclosure of certain information and corrective advertising. The ACCC can also apply for other orders under section 87. After it has begun proceedings, the ACCC may seek orders to prevent the dissipation of property or money under section 87A.

Therefore, there is a wide range of enforcement and remedial measures which may already be taken for unconscionable conduct. The wide range of enforcement and remedial measures is adequate.

2.6 Proposals to introduce additional disclosure requirements would be both unduly onerous and impossible for franchisors to accurately outline

When placing disclosure obligations on franchisors, it is important that the Franchising Code strikes an appropriate balance between ensuring that prospective franchisees are adequately informed about their decision to enter a franchise agreement, while at the same not placing an unreasonable compliance burden on franchisors that will ultimately be to the detriment of both franchisor and franchisee.

In particular, it should be noted that:

- disclosure documentation is already lengthy. Mandatory disclosure only tends to be effective if disclosure documentation is concise and appropriately targeted to focus on the material information needs of the recipient only;

- preparation of disclosure documentation involves compliance costs. These may ultimately be passed on to franchisees through increased franchisee fees.

The amendments to the Franchising Code which took effect on 1 March 2008 enhanced the already considerable level of mandatory disclosure required to be made by franchisors to franchisees. In the Committee's view, the franchisor's disclosure obligations in the Code in their present form are appropriate and balanced and do not require further amendment.

It has been recommended that a number of additional disclosure requirements should be introduced. Each of these are considered below in turn.

Requiring Disclosure of Head Leases

The Committee submits that no additional disclosure requirement to this effect should be included in the Code on the basis that:

- the franchisee is not a party to the head lease;

- franchisees are able to obtain copies of registered head leases from the relevant Titles Office in many States in any case;

- head leases are unlikely to be able to be renegotiated in any event;

- it is unclear how the interest of a sub-lessee might be 'noted' in a head lease;

- if the franchisor were to default under a head lease, it would be a matter for a landlord whether it wished to enter into new tenancy arrangements directly with a franchisee. Franchisees are also commonly bound by restrictive covenants which may prevent them

from continuing to carry on a business in competition with the franchised business from the site.

Further disclosure regarding rebates

The Committee submits that no additional requirement should be added to disclose the amount of rebates. In particular, a requirement to disclose the dollar amount of rebates may prove practically difficult for a franchisor to comply with. The key material information, being the price of the goods or services supplied, is already required to be disclosed.

Requirement to audit

The Corporations Act does not require small proprietary companies to be audited. Accordingly, it does not appear to be appropriate to impose a mandatory auditing requirement on franchisors that are small proprietary companies. The costs of auditing would inevitably be passed back to franchisees in the form of higher franchise fees.

Requirement to disclose whether the franchisor has franchise specific experience

The failure to disclosure in a disclosure document any franchise specific experience would clearly indicate the absence of such experience. Accordingly, no amendment to the existing business experience disclosure requirements would appear to be necessary.

Disclosure of reasons for buying back a franchise

It would be difficult for franchisors to comply with this proposed additional disclosure requirement and the disclosure of reasons for buying back franchises would also add considerably to the length of many disclosure documents. Further, as the performance of different franchisees in different locations will vary significantly, it is difficult for a franchisee to draw any reasonable or meaningful conclusions from such information. The privacy of outgoing franchisees would also be infringed by such a mandatory disclosure requirement.

Risk checklist

It would be unduly onerous and probably impossible for a franchisor to accurately outline the risks of a franchisee. The franchisee is best placed to assess their own risks having regard to their own facts and circumstances, and the information they receive from franchisees under the existing regime for disclosure.

The Committee submits that requiring franchisors to provide prospective franchisees with a statement of risks would only be a barrier to commerce.

Further, given the amendments made to the disclosure obligations on March 31 this year, the Committee believes that those changes ought to be given time to be tested before further action is taken. Moreover, if the essential issue of concern is adequacy of disclosure, then sections 52 or 53 are more appropriate avenues for redress than section 51AC, as both provisions

continue to operate very effectively in the franchising context (as well as in other contexts).

2.7 Existing mechanisms within the Code for dispute resolution are adequate

The Committee submits that the dispute resolution processes contained in the Franchising Code are adequate in their current form and the inclusion of a new binding alternative dispute resolution process (based around expert determination by an Ombudsman or expert) is not warranted.

Franchising is a contractual business arrangement pursuant to which a franchisee is granted a right to operate a franchise business. It is appropriate that disputes regarding franchise agreements, which cannot be resolved through the mediation processes contemplated by the Code, are resolved in the manner contractually agreed by the parties to the franchise agreement. If the parties determine that disputes will ultimately be resolved by Courts, this is entirely appropriate.

The proposal to introduce new dispute resolution processes raises a number of difficult issues, including:

- the need to resolve constitutional law issues relating to judicial bodies;
- whether rules of evidence would apply;
- whether legal representation would be allowed before the expert;
- how evidence would be presented;
- how the expert would be selected; and
- avenues of appeal from decisions (at least in respect of points of law).