PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

INQUIRY INTO THE FRANCHISING CODE OF CONDUCT

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[redacted]

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EXECUTIVE SUMMARY

1. Introduction

1.1 The Federal Chamber of Automotive Industries (FCAI) provides the following submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry (Inquiry) into the Franchising Code of Conduct (Code).

The FCAI is the peak industry organisation representing vehicle manufacturers and importers of passenger vehicles, light commercial vehicles and motor cycles in Australia.

1.2 As a motor vehicle dealership agreement is deemed to be a franchise agreement under the Code, the FCAI has substantial interest in both the Code and the Inquiry. Accordingly, it is pleased to have the opportunity to make the following submission.

2. The Position of FCAI

2.1 The general position of the FCAI is as follows:

a) The Code provides an appropriate and suitable means by which a franchisee can make an informed decision before entering into a franchise agreement;

b) The existing laws and wide range of remedies available to a franchisee provide substantial and reasonable protection for its legitimate rights and interests under a franchise agreement. The "regulation" is achieved by a combination of Part IVB of the *Trade Practices Act*, the *Trade Practices (Industry Codes - Franchising) Regulations* and the remedies set out in Part VI of the *Trade Practices Act*. These remedies have been described recently by the High Court of Australia as follows:[1]

> *"Part VI of the Act contains a range of remedies for a contravention of s 51AD (and s 51AC). They include the grant of an injunction with respect to conduct engaged in, or which is proposed to be engaged in, which would constitute a contravention of Pt IVB (or Pt IVA) (s 80), damages (s 82), non-punitive orders (s 86C) and the range of orders laid out in s 87(2), including orders varying contracts and refusing to enforce all or any contractual provisions."*

c) If additional disclosure is considered appropriate to enhance the making of an "informed decision" in accordance with the object of the Code, that disclosure must be limited to known facts relevant and meaningful to that "informed decision" by a reasonable member of the class of prospective franchisees and should not extend to a requirement on the part of the franchisor to make statements in relation to future contingent or speculative perceived risks. Once that "informed decision" is made and independent advice is taken by the franchisee, the provisions of the franchise agreement, as a commercial contract, should prevail, with the franchisee of course having the benefit of existing laws and remedies.

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1 Master Education Services Pty Limited v Ketchell [2008] HCA 38 at [28].

2.2 The general position is supported by the following analysis of particular issues, which have been the subject of previous discussion and recommendation in the Matthews Report,[2] the Western Australian Inquiry[3] and the South Australian Inquiry[4]. Each of these Reports will be identified accordingly in this submission and collectively will be referred to as "the Reports".

a) The Nature of a Franchise Agreement

It must be recognised that a franchise agreement is a commercial contract between independent parties, which does not confer perpetual rights on the franchisee. Nor does the Code create a fiduciary relationship between the parties.

Further, as the franchise agreement is a relational contract, requiring cooperation, trust and confidence between the parties, it is essential that applicable laws and remedies are flexible to take account of the characteristics of a franchise agreement as well as the particular circumstances of each case.

See section 3 below for a more detailed analysis.

b) Term and Non-Renewal of a Franchise Agreement

It is submitted that no changes are required in relation to the term of a franchise agreement and in relation to non-renewal. Franchisees are given adequate information before entering a franchise agreement and reasonable notice of termination is required to be given. A franchisee has sufficient protection under the existing Code due to requirements that a franchise arrangement must sustain for a reasonable duration and that there be a reasonable notice period in the event of termination. Further statutory obligations surrounding termination and obligations for renewal are uncommercial and stand in opposition to the concept of freedom of contract.

Further discussion is contained in section 4 below.

c) "Goodwill" and "Exit" payments for Non Renewal

It is submitted that a franchisor makes significant investments in its branding, conduct of the franchise network, its marketing plan and general get-up. Any goodwill of the franchisee during the term of a franchise agreement should not be confused with the goodwill of the franchisor. Appropriate protection is presently afforded to franchisees by being given a reasonable period to conduct its business as a franchisee to recoup its investment and there being a reasonable notice of termination of its franchise agreement.

Please refer to paragraph 4.15 to 4.23 for further details.

d) Good Faith and Fair Dealing

It is submitted that the Code should not be supplemented with duties relating to good faith and fair dealing. Broadly stated, the common law and *Trade Practices Act* provide adequate

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2 Review of the Disclosure Provisions of the Franchising Code of Conduct - Report to the Hon Fran Bailey MP, Minister for Small Business and Tourism, October 2006.

3 Inquiry into the Operation of Franchise Businesses in Western Australia - Report to the Western Australian Minister for Small Business, April 2008.

4 Final Report - Franchises - 65th Report of the Economic and Finance Committee, 6 May 2008.

protection in this area. Further, the insertion of a statutory overlay in the Code may be overly prescriptive.

The detailed analysis is contained in section 5 below.

e) Unconscionable conduct in relation to Franchise Agreements

It is considered that the current provisions in the *Trade Practices Act* provide appropriate protection to franchisees. Any statutory definition of "unconscionability" is likely to create much uncertainty as well as numerous disputes as to its interpretation and application to franchise agreements as commercial contracts.

See section 7 for further information.

f) Unilateral Amendments by Franchisor

It is submitted that the current legal framework provides sufficient causes of action and remedies for franchisees in this area.

See section 8.

g) Proposed Introduction of Penalties for a breach of the Disclosure Requirements

It is submitted that the pecuniary penalty regime under the *Trade Practices Act* need not be further supplemented by specific statutory penalties for breaches of the disclosure requirements under the Code.

The concept of a statutory penalty attaches to contraventions of statutes, not breaches of contract for which general contractual principles (supplemented by a range of remedies contained in the *Trade Practices Act*) provide an adequate and appropriate remedy.

The pecuniary penalty regime under the *Trade Practices Act* is not compensatory but is designed to act as a deterrent to corporations, both specifically and generally. It is considered this is sufficient.

Based on the matters above, the following features of franchise agreements must be noted:

The parties to a franchise agreement are both engaged in trade or commerce and it should not be assumed that all franchisees are, or are likely to be, small business enterprises with no, or little, bargaining power. Franchisees in many sectors of commerce and industry in Australia, including motor vehicle dealers, are substantial, sophisticated, integrated and well-resourced business enterprises.

Motor vehicle dealership agreements are deemed to be franchise agreements by clause 4(2) of the Code, notwithstanding the fact that all of the four criteria set out in clause 4(1) (in particular, the criterion under paragraph (d) that the franchisee pay to the franchisor an initial capital investment fee or other prescribed fee) may well not apply under a motor vehicle dealership agreement.

There is a legitimate case for the Code to exclude franchisees who are substantial, well-resourced enterprises (in particular, listed corporations and their subsidiaries) from all requirements under the Code or those requirements that are directed towards the protection of small business franchisees.

In any event, the Code must remain flexible in its regulation of a principally commercial arrangement. A balance needs to be maintained between the commercial rights and interests of both the franchisee, whether small business or sophisticated, and the franchisor across a number of industries.

Please refer to the following sections for a more detailed analysis of the issues.

DETAILED ANALYSIS OF ISSUES

3. The nature of a franchise agreement

A franchise agreement is a commercial contract.

3.1 As a commercial contract between independent parties, the necessary starting point should be as follows:[5]

> *"It should not be overlooked that to sign a document known and intended to affect legal relations is an act which itself ordinarily conveys a representation to a reasonable reader of the document. The representation is that the person who signs either has read and approved the contents of the document or is willing to take the chance at being bound by those contents ... whatever they might be."*

3.2 Accordingly, the fundamental first step is to recognise that a franchise agreement is a commercial contract under which a franchisor grants to the franchisee various contractual rights for the term of that contract. A franchise agreement as a commercial contract, does not confer perpetual rights upon a franchisee.[6]

3.3 The Code does not create a fiduciary relationship between the franchisor and the franchisee; rather, the relationship between the parties is of a commercial character.[7]

Characterisation of a franchise agreement

3.4 The characterisation of a contract as a "franchise agreement" for the purposes of the Code is determined by reference to the criteria set out in clause 4(1) of the Code, save for a "motor vehicle dealership agreement" which is taken to be a franchise agreement for the purpose of the Code (clause 4(2)).

Other than a "motor vehicle dealership agreement", unless each criterion set out in clause 4(1) is satisfied, the contract is not a franchise agreement and is not subject to the Code or Part IVB of the *Trade Practices Act*.[8]

3.5 In particular, an essential criterion for a franchise agreement under the Code is that the franchisor grants to the franchisee "the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor".[9]

3.6 A distinction should be drawn between a franchisor implementing its system or marketing plan throughout its franchise network, on the one hand, and a franchisor acting in an unconscionable manner towards a franchisee, on the other hand.

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5 Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd (2004) 79 ALJR 129 at [45].

6 See, for example, Multi-Core Aerators Ltd v Multi-Core Aerators Pty Ltd (1997) 40 IPR 462.

7 Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No. 2) [2008] FCA 810 at [387].

8 See, for example, ACCC v Kyloe Pty Ltd [2007] FCA 1522.

9 Clause 4(i)(b) of the Code.

It is of the essence of a franchise agreement that the franchisee accepts, and will conform to, the system or marketing plan of the franchisor. Absent that system or marketing plan, there is no franchise agreement.

The mere fact that the franchisor has such a system or marketing plan as an element of its business strategy and development in Australia, does not mean, of itself, that the franchisor can exercise "more power". It is nothing more than a reflection of the fact that the franchisee entered into a contract that confers upon the franchisee the right and obligation to carry on business according to that system or marketing plan.

3.7 This basic fact was reflected by Finkelstein J in *Garry Rogers Motors (Aust) Pty Limited v Subaru (Australia) Pty Limited* as follows:[10]

> *"Whilst [the Dealer] was not obliged to adopt the Six-Star Program, that is, it was not contractually obliged to do so, its failure to adopt the program and its criticism of certain aspects of the program, could reasonably be regarded by[Subaru] as an indication that [the Dealer] was not willing to act in the best interests of [Subaru] and of the dealership group as a whole. No doubt this led to a loss of confidence in [the Dealer]. That loss of confidence would not necessarily be overcome by a change in attitude on the part of [the Dealer]. Many relationships can only operate satisfactorily if there is a mutual confidence and trust. Once that confidence and trust has broken down the position is not easily restored. It is not unconscionable to terminate a relationship where that trust and confidence has been undermined."*

3.8 The fact that a franchise agreement is a "relational" contract, gives rise to concepts of mutual confidence and trust. If the franchisee does not follow the franchisor's system or marketing plan, the integrity of the franchisor's dealer or franchise network can be compromised, as recognised by Finkelstein J.

A franchise agreement as a relational contract

In the South Australian Inquiry, franchising is described as representing "a form of co-operation between independent businesses"[11] and a franchise agreement is identified as a "relational" contract under which "the parties are expected to perform their contractual duties continuously and in a cooperative way".[12]

3.9 The concept of a "relational" contract was explained in *Bobux Marketing Limited v Raynor Marketing Limited* as "requiring a deliberate measure of communication, co-operation, and predictable performance based on mutual trust and confidence" and as recognising the following characteristics:[13]

> *"In essence, relational contracts recognise the existence of a business relationship between the parties and the need to maintain that relationship; the difficulty of reducing important terms to well defined obligations; the impossibility of foretelling all the events which may impinge upon the contract; the need to adjust the relationship over time to provide for unforeseen factors or contingencies which cannot readily be provided for in advance;*

10 (1999) ATPR ¶41-704 at [46].

11 Paragraph 4.1 at page 10.

12 Paragraph 4.1 at page 11.

13 [2001] NZCA 348 at [43] and [44].

> *commitment, likely to be extensive, which one party must make to the other, including significant investment; and that they are in an economic sense likely to be incomplete in failing to allocate, or allocate optimally, the risk between the parties in the event of certain future contingencies."*

3.10 The fact that a franchise agreement is a "relational" contract indicates the necessary cooperation, trust and confidence that is required between the franchisor and the franchisee for that contractual relationship to work. Applicable laws and remedies need to be flexible to take account of the "relational" nature of a franchise agreement as well as the particular circumstances of each case.

4. The term of a franchise agreement and non-renewal

4.1 Each Report has raised concerns in relation to the expiration and non-renewal of the term of a franchise agreement. Recommendations have been made in relation to these issues.

4.2 In the Matthews Report, it was recommended that the Risk Statement "should, if significant, refer to the risks to the franchisee on termination, expiry or non-renewal of the franchise agreement".

4.3 In the Western Australian Inquiry, it was recommended that the Code be amended "to require franchisors to explicitly specify, in the disclosure document, what end of agreement arrangements are in place under the franchise agreement" and "to require franchisors to explicitly specify, in the disclosure document, what the position is in relation to the franchisee's entitlement or lack of entitlement to goodwill or other compensation if the agreement is not renewed".

4.4 A recommendation arising from the South Australian Inquiry is that the Code be amended "by inserting a provision imposing a duty to conduct renewal negotiations in accordance with good faith and fair dealing by each party".

The existing law and the term of relational contracts

4.5 The existing law recognises that a relational contract must be for a reasonable period in order to give effect to the reasonable expectations of the parties. The reasonable expectations of the parties will depend upon the particular circumstances of the proposed agreement and relationship between the parties and no "standard" arbitrary term should be prescribed.

4.6 Franchise agreements, as "relational" contracts, are most often long-term contracts that develop and continue to exist by reason of the relationship between the parties. This is necessary to allow the system or marketing plan of a franchisor to be developed and to expand at and from each particular franchise location and for the franchisee to have a reasonable period to operate the franchise.

4.7 It is a common law principle that a business arrangement similar to a franchise agreement is to continue for a reasonable period. This has been described as follows:[14]

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14 Crawford Fitting Co v Sydney Valve & Fitting Pty Ltd (1988) 14 NSWLR 438 at 447.

> *"The implication of a term that a distributorship or agency should continue for a reasonable period gives effect to the reasonable expectations of the parties. The distributor is frequently obliged to invest his own or borrowed money in the establishment or development of the business, in purchasing stock and plant, and in employing workers. He has no hope of recouping his initial expenditure or effort if the manufacturer can terminate the agreement at will or by a period of notice sufficient only to enable the distributor to deploy his labour and equipment elsewhere. ...*
>
> *Accordingly, if a person in the initial stages of a business arrangement expends money or effort in developing the business, it provides a ground for implying a term that the business is to continue for a reasonable period. If, for example, in addition to agreeing to sell a product, a distributor furnishes additional consideration by setting up or developing a distribution system at his own expense, there will usually be an implied term that the distributorship will continue for a reasonable period ... . There will be a case for such an implication even where the initial effort or expenditure is of a kind that will recur throughout the agreement. For it is not to be presumed that the parties intended that the agreement could be put to an end before the person incurring the expenditure or effort has had an opportunity to recoup his initial expenditure or effort."*

4.8 If a franchise agreement is a fixed term contract, it will need to be of a sufficient duration to meet the common law principles set out above. Established common law principles together with statutory rights such as section 52 of the *Trade Practices Act* are sufficient to protect the franchisee.

4.9 If a franchise agreement is not a fixed term contract:

(a) the above common law principles will apply to enable the franchisee to recoup any extraordinary expenditure or effort; and

(b) it could be only terminated on reasonable notice, the period of notice being "sufficiently long to enable the recipient to deploy his labour and equipment in alternative employment, to carry out his commitments, to bring current negotiations to fruition and to wind up the association in a businesslike manner".[15]

Non-renewal

4.10 If a franchisee has been given the opportunity to make an informed decision before entering into a franchise agreement (including in relation to the term of the franchise agreement and the position of the franchisor in relation to renewal), and has had a reasonable period to operate under that franchise agreement, (including the flexibility to transfer the business conducted by the franchisee during the term of that agreement), the underlying policy of that franchise agreement has been satisfied. Basically, the franchisee has been given the opportunity to recoup expenditure and to earn and retain income and profits throughout the term of the franchise agreement.

4.11 Suggestions that a franchisor should be required to renew the franchise agreement on expiry unless the franchisor had a good faith reason not to do so, or that an obligation should be imposed on the franchisor to undertake renewal discussions in good faith (regardless of the express terms of the agreement), overlook the underlying nature of a franchise agreement.

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15 Ibid at 444.

In essence, it is a contract under which the franchisee has the right to carry on a separate and independent business (and to retain absolutely financial benefits of conducting that business) for a specified reasonable period. During the term of the franchise agreement, the franchisee is entitled to sell its business (including its own goodwill in that business) and the franchisor must not unreasonably refuse consent to the transfer of the franchise agreement.

4.12 A franchisee, with the protection of the Code and the remedies under the *Trade Practices Act*, enters into a franchise agreement fully aware of these rights and it would not be fair or reasonable for a statutory provision to distort established principles of freedom of contract, to facilitate a contractual relationship on a perpetual basis or to create a mechanism that may frustrate or compromise the legitimate rights and interests of the franchisor. A contract is consensual and a franchise agreement is based on mutual trust and confidence. Any obligation in relation to renewal imposed on a franchisor would be contrary to these fundamental principles.

The proper presumption in a commercial contract (including a relational contract) is that it is capable of termination even if it contains no provision for such termination, by giving reasonable notice.[16] The existing obligation to give reasonable notice is the proper protection available to a franchisee.

4.13 A potential analogy could be drawn with the provisions of the *Retail Leases Act 2003 (Vic)*. For example, section 64 requires the landlord to give not less than 6 months notice before the expiration of the lease term informing the tenant whether the lease is to be renewed. However, there is no obligation to grant a renewal (in the absence of an option) or to negotiate a renewal in "good faith".

4.14 Although the Oilcode has been referred to in the Reports and comparisons with the Code have been made,[17] the Oilcode is a specialist code for the benefit of small business fuel retailers and particular characteristics of retail fuel sales. It should be construed accordingly and not be assumed to have broader application. In fact, in its submission to the Department of Resources, Energy and Tourism in relation to the review of the Oilcode (April 2008), the Motor Trades Association of Australia observed that "in the retail petroleum sector, franchisees, commission agents, lessees and independents (where leasing from third parties), cannot be classified as anything other than small businesses".[18]

In any event, even clause 32(6) of the Oilcode, which relates to renewal of fuel re-selling agreements and which has been referred to in submissions to the Reports, applies *only* to a retail site that is owned or leased by the supplier. It has no application where the retailer owns the retail site or leases it from an independent lessor.

The Oilcode represents no form of relevant "precedent" for the purposes of the Code.

Goodwill and franchisees

4.15 A related issue is whether a franchisee should be entitled to any form of "goodwill" or "exit" payment if the franchise agreement is not renewed.

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16 See, for example, Multi-Core Aerators Ltd v Multi-Core Aerators Pty Ltd (1997) 40 IPR 462.

17 See, for example, at page 68 of the South Australian Inquiry.

18 Motor Trades Association of Australia - Submission to the Department of Resources, Energy and Tourism - Review of the Oilcode, April 2008 at p.2.

4.16 A recommendation arising from the Western Australian Inquiry was that the Code should be amended to require a franchisor to specify "what the position is relation to the franchisee's entitlement or lack of entitlement to goodwill or other compensation if the agreement is not renewed".

The recommendation arising from the South Australian Inquiry goes further; it recommends that the Code be amended to include:

> *"A provision mandating that franchise agreements must include the basis on which termination payments or goodwill or other such exit payments will be paid at the end of the agreement".*

4.17 As discussed above, the underlying policy of any relational contract is for the dealer, distributor or franchisee to be given a reasonable opportunity to recoup expenditure and derive income and profits during the term of the contract from the use of the supplier's brand and business system and sale of the supplier's products.

4.18 A franchisee under a franchise agreement is given the contractual right to adopt and apply a system or marketing plan owned by the franchisor together with a contractual licence to use trade marks and "get up" also owned by the franchisor. The franchisee cannot acquire any proprietary interest in such rights.

It is by the use of those proprietary rights of the franchisor that the franchisee has the opportunity to derive an income and recoup expenditure over the term of the franchise agreement.

4.19 Notwithstanding the proper classification of rights of a franchisee under a franchise agreement, the word "goodwill" is often used inappropriately in the context of franchise agreements.

However, the High Court has enunciated the following principles in relation to goodwill which must be borne in mind in the context of franchise agreements:[19]

(a) The goodwill of a business is the product of combining and using the tangible, intangible and human assets of a business for such purposes and in such ways that custom is drawn to it.

(b) Goodwill is a quality or attribute that derives from using or applying other assets of the business and care must be taken to distinguish the sources of the goodwill of the business from the goodwill itself.

(c) The sale of an asset of a business does not involve any sale of goodwill unless the sale of the asset is accompanied by or carries with it the right to conduct the business. That is, goodwill has no existence independently of the conduct of a business and goodwill cannot be severed from the business which created it. The following example of an owner of shop premises who rents the premises to a person who then commences a business at the site is a relevant analogy:[20]

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19 Commissioner of Taxation (Cth) v Murry (1998) 193 CLR 605.

20 Ibid at [59].

> *"While the shop business exists, the goodwill of the business belongs to the shop proprietor. If the lease expires and is not renewed and the business ceases to exist, the goodwill comes to an end. A new lease to a person commencing a similar business from the premises may command a premium, but no part of the premium is paid for goodwill."*

4.20 Accordingly, the basic and established general principle is that unless a business is transferred to the person to whom an asset of the business is transferred, the transfer of the asset does not transfer any part of the goodwill of the business.
There is no reason why this general principle should not apply to a franchise business conducted by a franchisee during the term of the franchise agreement.

4.21 The very nature of a franchise agreement and any other "relational" contract is that the parties have a mutual interest in the development and expansion of the business during the term of the agreement. During the term of the agreement, the franchisee has an expectation that the relationship will continue until the expiration of the term of the agreement and that expectation has a value. Accordingly, if the franchisee sells the franchise business as a going concern during the term of the franchise agreement, that business will have an intangible value the source of which is the remaining contractual rights under the franchisee agreement and the assets of the franchise used to carry on that business.
However, upon expiry of the term, a transfer by the franchisee of the several assets that were used to conduct the business would not involve the transfer of any goodwill as there is no underlying franchise business to sell.

4.22 The goodwill attaching to the franchisor's trademarks, its system or marketing plan, its general get-up and presentation and its own business of conducting a franchise network, must be and remain the sole property of the franchisor. Any goodwill of the franchisee during the term of a franchise agreement is not to be confused with the goodwill of the franchisor.
Further, a franchisor will make a significant investment in a franchisee and the goodwill of the franchisor across its franchise network can be damaged by the conduct or underperformance of a franchisee.

If a franchisee is successful, it is likely that its contractual relationship with the franchisor will be long-term and that success will be reflected in significant returns in the form of income and profits to that franchisee potentially over a long period.

It is during the term of the franchise agreement (and not at the time of its termination or expiration) that the franchisee is conducting the franchise business and will have a separate goodwill in relation to the conduct of that franchise business for so long as the franchise agreement continues. The franchisee does not have any goodwill in the franchise business upon termination or expiration of the franchise agreement.

Submissions to and recommendations in the Reports in relation to "goodwill" or "exit" payments to a franchisee, have not attempted to classify the legal, accounting or tax nature or character of any such payment. Clearly, it could not be a payment for "goodwill".

4.23 Accordingly, the proper and legitimate expectation of a franchisee is that it will have a reasonable period to conduct its business as a franchisee and that it will be given reasonable notice of termination of its franchise agreement. If the franchisee transfers the business during the term of the agreement, the transferee may pay a premium in recognition of the transfer of the business as a going concern (subject always to the express terms of the

franchise agreement, including the date of expiry and rights of termination). This cannot translate to either:

(a) an obligation being imposed upon the franchisor to renew the term of the franchise agreement or to negotiate any renewal in good faith; or

(b) an obligation on the franchisor to pay some form of "compensation" to the franchisee upon expiry of the term if it is not to be renewed.

5. Good faith and fair dealing

5.1. A recommendation arising from the South Australian Inquiry is that the Code should be amended to insert a provision "imposing a duty to act in accordance with good faith and fair dealing by each party of the franchise relationship".

The efficacy of common law principles

5.2. It is submitted that to introduce a statutory concept of "good faith and fair dealing" into the Code is unnecessary and would not add any certainty or clarity to the rights of franchisors or franchisees.

5.3. In particular, insufficient regard has been given to the efficacy of implied terms in the context of "relational" contracts. The question of whether such a term should be implied should be determined by reference to common law principles. In *Garry Rogers Motors (Aust) Pty Limited v Subaru (Australia) Pty Limited*, Finkelstein J made the following observation in the context of a franchise agreement:[21]

> *"Recent cases make it clear that in appropriate contracts, perhaps in all commercial contracts, such a term will ordinarily be implied; (not as an ad hoc term based on the presumed intention of the party) but as a legal incident of the relationship ....*
>
> *If such a term is implied it will require a contracting party to act in good faith and fairly, not only in relation to the performance of a contractual obligation, but also in the exercise of a power conferred by the contract."*

While recognising the implication of a term of good faith, his Honour concluded that there had been no improper exercise of a contractual power as there was a good reason to terminate the franchise agreement. In addition, reasonable notice of termination had been given permitting the dealer to organise its affairs.

This case represents a good example of implication of such a term according to common law principles and how such a term, if implied, should be applied.

5.4. In *Bobux*, a case dealing with "relational" contracts, the following observation was made:[22]

> *"Good faith is required to ensure that the requisite communication, co-operation and predictable performance occurs for the advantage of both parties. In short, the obligation seeks to hold the parties to the promise implicit in a continuing, relational commercial transaction."*

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21 (1999) ATPR ¶41-703 at [10] - [11].

22 [2001] NZCA 348 at [44].

In that case, it was the franchisee, not the franchisor, against whom the question of a lack of good faith was raised.

5.5. It has been accepted in New South Wales that "an additional term implied by law into commercial contracts is a term requiring the exercise of good faith in the performance of a contract" and it was upon New South Wales authorities that Finkelstein J proceeded in the *Garry Rogers case*.[23]

In Victoria, recent authorities have preferred an "ad hoc implication meeting the tests laid down in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings*" rather than "implication as a matter of law creating a legal incident of contracts of a certain type".[24]

Under either approach, it is clear that a term of "good faith" will be implied in appropriate contracts. Indeed, in 1999, the *Garry Rogers* case proceeded on the basis that there was an implied term of good faith and fair dealing.[25]

5.6. In *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* (Receiver and Manager Appointed)[26], the Court of Appeal in Victoria accepted that there has been a clear recognition of the doctrine of good faith, but was not prepared to accept that a term of good faith would be implied as a legal incident of the relationship between parties to a commercial contract. Warren CJ observed that "the interests of certainty in contractual activity should be interfered with only when the relationship between the parties is unbalanced and one party is at a substantial disadvantage, or is particularly vulnerable in the prevailing context" and added that "where commercial leviathans are contractually engaged, it is difficult to see that a duty of good faith will arise, leaving aside duties it might arise in a fiduciary relationship".[27]

5.7. In the South Australian Inquiry, reference was made to the Esso case and the following observation was made:[28]

> *"For the relative position of the parties militates against it being a 'contractual engagement of commercial leviathans' able to act at arm's length, and indeed its construction as an incomplete, relational agreement - with significant discretions on the part of a franchisor often built-in - means that by conventional standards the contract would not qualify as 'fair', even though the seemingly 'maligned' party (most often the franchisee) enters voluntarily."*

However, the reference by Warren CJ in *Esso* to "commercial leviathans" must not be taken out of context or misconstrued. That case did involve "commercial leviathans". However, Warren CJ was merely distinguishing "commercial leviathans" from a relationship that is "unbalanced and one party is at a substantial disadvantage". In the case of such a relationship, it is clear that it would be appropriate, according to the existing common law in

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23 Burger King Corp v Hungry Jack's Pty Ltd [2001] NSWCA 187; Overlook Management BV v Foxtel Management Pty Ltd [2002] NSWSC 17.

24 Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL (Receiver and Manager Appointed) [2004] VSC 477 at [25]; Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd [2006] VSC 223.

25 Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd (1999) ATPR ¶ 41-703 at [34].

26 [2004] VSC 477.

27 Ibid at [4].

28 South Australian Inquiry at page 56.

Victoria, for a term of good faith to be implied. Similarly, Buchanan JA made the following observations:[29]

> *"I am reluctant to conclude the commercial contracts are a class of contracts carrying an implied term of good faith as a legal incident, so that an obligation of good faith applies in discriminately to all the rights and power conferred by a commercial contract. It may, however, be appropriate in a particular case to import such an obligation to protect a vulnerable party from exploitive conduct which subverts the original purpose for which the contract was made. Implication in this fashion is perhaps ad hoc implication ... rather than implication as a matter of law creating a legal incident of contracts of a certain type."*

5.8. The above extract from the South Australian Inquiry infers that the existing law is inadequate to address an imbalance between a franchisor and a franchisee and the reference to Esso appears to have been used to support that inference. However, no such inference should be drawn from Esso as the above observations by Warren CJ and Buchanan JA make clear.

5.9. In any event, even if "commercial leviathans" are the contracting parties, it does not follow necessarily that a term of "good faith" will not be implied:[30]

> *"The force of these observations [the observations of Warren CJ in Esso] in the commercial context is undoubted, however it seems to me that even when 'commercial leviathans are contractually engaged', it will depend on the nature of the obligations in the contract as to whether a duty to act reasonably and in good faith is to be implied. Commercial contracts are not a class of contracts that have an implied obligation of good faith."*

5.10. It must be also taken into account that as a general rule, each party to a contract agrees, by implication, to do all such things as are necessary on its part to enable the other party to have the benefit of the contract.[31]
Similarly, the law also implies a negative covenant not to hinder or prevent the fulfilment of the purpose of the express promises made in a contract.

In *Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No. 2),*[32] an implied term that each party agrees to do all that is necessary on its part to enable the other party to have the benefit of the contract was sufficient to make the relevant finding in favour of the franchisee. It was not necessary to rely upon an implied term of good faith.[33]

5.11. Accordingly, whether as a matter of ad hoc implication or implication as a matter of law creating a legal incident of contracts of a certain type, a term of "good faith" is capable of being implied into franchise agreements (and all other kinds of "relational contracts") without any need for an express provision to that effect in the Code.

Whether a term of good faith is to be implied will be determined by the nature of the obligations in the contract and the relationship between the parties to the contract. In other words, all relevant circumstances of each case will be taken into account. This is a fair and reasonable approach rather than an arbitrary imposition of a statutory term of good faith to

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29 [2005] VSCA 228 at [25].

30 Maitland Main Collieries Pty Ltd v Xstrata Mt Owen Pty Ltd [2006] NSWSC 1235 at [56].

31 Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd (1979) 144 CLR 596 at 607 - 608; Peters (WA) Ltd v Petersville Ltd (2001) 75 ALJR 1385.

32 [2008] FCA 810 at [313].

33 Ibid at [317].

all franchise agreements, including franchise agreements where the franchisee is a substantial well-resourced corporation in relation to whom there is no imbalance or substantial disadvantage.

5.12. It must be recognised that a term of "good faith", whether implied or express, is a concept that has been explored on many occasions at common law. It has been equated with reasonableness; a requirement of a party "not to act capriciously" and in contrast to "bad faith". It involves an obligation on the parties to co-operate in achieving the contractual objects, compliance with honest standards of conduct and compliance with standards of conduct that are reasonable having regard to the interests of the parties. It has been expressed as follows:[34]

> *"... the implied obligation of good faith underwrites the spirit of the contract and supports the integrity of its character. A party is precluded from cynical resort to the black letter. But no party is fixed with a duty to subordinate self-interest entirely which is the lot of the fiduciary .... 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 regards to the legitimate interests of both the parties in the enjoyment of the fruits of the contract as delineated by its terms."*

For example, acting in good faith has been described as meaning "that a party to a contract should not pretend to rely upon breaches of no importance to him or her to achieve a collateral but desired result of bringing the contractual relationship to an end".[35]

No need for a statutory overlay

5.13. There has been no difficulty in courts applying these principles in appropriate contracts and a statutory overlay will provide no meaningful benefit. In particular, even if the Code were to contain an express provision by which both the franchisor and the franchisee must act in good faith, the ultimate question would always be whether the franchisor or the franchisee (as the case may be) has engaged in conduct that breached an obligation of "good faith". The answer to that question will be determined by reference to the principles that are applied now by the courts.

5.14. In applying those principles, it must not be assumed that there will be necessarily a finding in favour of the franchisee. For example, in *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd*,[36] it was concluded that the franchisor's conduct was not unreasonable, harsh, unfair, dishonest, exploitative or actuated by any ulterior purpose and that the general principles illustrated in *Crawford* were followed; namely, for the franchisee "kept the franchisees informed, gave them timely notice of its intention to effect change in the future and allowed ample time for the franchisees to negotiate and arrange their affairs".

That is the proper basis upon which a term of good faith, if it is to be implied, is to be applied.

5.15. Typically, complex issues and facts arise in disputes in relation to franchise agreements. As a result, the question of whether a party has acted in good faith will not be easy to determine. Further, an obligation to act in good faith is owed mutually and "if both parties to the subject

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34 Overlook Management BV v Foxtel Management Pty Ltd [2002] NSWSC 17 at [67].

35 Mangrove Mountain Quarries Pty Limited v Barlow [2007] NSWSC 492 at [28].

36 [2006] VSC 223 at [215] - [222].

contract breached such duty, neither should be able to rely on an alleged breach of duty of good faith."[37]

In *Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No. 2)*, it was noted that "rarely do people act from a single motive, particularly where they have been involved in a long-term relationship with the other party or parties" and that "in a contractual context, relationships can give rise to a complex set of considerations which one party may apply to the other".[38] In addition, the following observations were made:[39]

> *"In a long term relationship such as that between Hoy Mobile and Allphones, it can be expected that the parties will develop personality differences, as well as commercial differences of approach to particular aspects of their relationship. Courts must be cautious in characterising or giving undue weight to particular aspects of or incidents in such a relationship when arriving at a decision that some action has been taken otherwise than in good faith."*

This provides further support for the view that the question of whether a term of good faith should be implied into a franchise agreement and, if so, whether a party has acted in good faith, should be determined by reference to the nature of the contract and the parties and all relevant facts and circumstances relating to the particular relationship between the parties and the conduct in question.

5.16. A term of good faith, whether implied or express, does not, and should not, mean that a franchisee would have rights and benefits beyond the term or scope of the contract or that the franchisor must always act in the perceived interests of the franchisee; it is not a duty to prefer the interests of the other contracting party, but rather to have due regard to the interests of both parties and the benefits afforded by the contract.

United States Laws

5.17. Various references have been made to the concept of good faith and fair dealing under the laws of the United States in connection with franchise agreements in Australia.

5.18. The first observation to make is that Federal and State laws in the United States diverge significantly in relation to franchise agreements and good faith and that "caution is required in translating United States judgments, which place glosses upon the text of the United States antitrust laws, to the interpretation of the Australian law"[40]

5.19. The second observation is that the application of the concept of good faith and fair dealing to a contract in the United States does not confer rights that are significantly or relevantly different from the rights available to franchisees in Australia under existing laws. For example:

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37 Esso at [2].

38 [2008] FCA 810 at [395].

39 Ibid at [397].

40 Eastern Express Pty Limited -v- General Newspapers Pty Limited (1992) ATPR ¶41-167 at 40,306.

(a) Even if a party breaches an implied covenant of good faith and fair dealing by withholdings its plans to terminate a contract while encouraging the plaintiff to expand its facilities, the implied covenant of good faith and fair dealing would be satisfied by giving to the other party reasonable notice of termination.[41]

> This is consistent with the application of the principles set out in *Crawford* as discussed in paragraphs 4.7 to 4.9 of this submission.

(b) A party to a contract may breach an implied covenant of good faith and fair dealing in performing its obligations even when it exercises an express and unconditional right to terminate; for example, conduct destroying a party's reasonable expectations and right to receive the fruits of the contract[42].

> A similar result would follow in Australia if a term of good faith were to be implied in a contract, by the application of the implied term that a party will do all such things as are necessary on its part to enable the other party to have the benefit of the contract or by reference to Section 51AC of the *Trade Practices Act*.
>
> Further, in *Garry Rogers*, Finkelstein J made it clear that an implied term of good faith can restrict the exercise of an express right of termination in a contract:[43]
>
> *"If such term is implied it will require a contracting party to act in good faith and fairly, not only in relation to the performance of a contractual obligation, but also in the exercise of a power conferred by the contract. 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."*

5.20. The third observation is that the application of the concept of good faith and fair dealing to a contract in the United States is not some form of open ended right and remedy. For example:

(a) The failure to act in good faith in the performance of contracts governed by the Uniform Commercial Code does not create an independent claim for which relief may be granted. General allegations of breach of the implied duty of good faith and fair dealing not tied to a specific contract provision are not actionable.[44]

(b) The obligation of good faith extends only to the "performance or enforcement" of the relevant contract. Accordingly, in the context of a termination of a franchise agreement, the good faith requirement applies only in the context of an attempt on the part of a franchisor to terminate its relationship with the franchisee and it is inapplicable to negotiations for renewal in the case where the relevant contract does not incorporate any provision in relation to renewal.[45]

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41 Bak-A-Lum Corp -v- Alcoa Building Products Inc 69 NJ 123,351 A.2d 349 (1976).

42 Sons of Thunder Inc -v- Borden Inc 148 NJ 396,690 A.2d 575 (1997).

43 (1999) ATPR ¶41-703 at [35].

44 See, for example, American Casual Dining LP -v- Moe's South West Grill LLC 426 F.Supp.2d 1356 (2006).

45 See, for example, Barn-Chestnut, Inc -v- CFM Development Corporation 457 S.E.2d 502 (1995)

(c) The Federal *Automobile Dealer's Day in Court Act* provides a dealer with a Federal cause of action against an automobile manufacturer who has failed to act in good faith regarding a franchise. However, "good faith" under that Act has been held to have a "narrow, restricted meaning". The dealer must demonstrate that the automobile manufacturer coerced, intimidated or threatened the dealer and that such coercion or intimidation was designed to achieve an improper or wrongful objective.

> A lack of good faith does not mean simply unfairness or breach of a franchise agreement and if the automobile manufacturer has an objectively valid reason for its actions, the dealer cannot prevail without evidence of an ulterior motive.[46]

6. Unconscionability

6.1. The concept of "unconscionability" should not be permitted to dissipate contractual terms upon which both parties to the contract rely:[47]

> *"Unconscionability is not a slight matter, and behaviour is only unconscionable where there is some real and substantial ground based on conscience for preventing a person from relying on what are, in terms of the general law, that person's legal rights."*

6.2. It is a recommendation of the South Australian Inquiry that section 51AC of the *Trade Practices Act* be amended to include a statutory definition of "unconscionability" or the insertion of "a prescribed list of examples of the types of conduct that would ordinarily be considered to be unconscionable".

6.3. The immediate reaction to this recommendation is that it does not identify how "unconscionability" should be defined or what would be included in the "prescribed list of examples".

Any statutory definition of "unconscionability" is very likely to be the subject of numerous disputes at to its interpretation or application. In other words, it will not solve any perceived issue in any event.

An inclusive list of "examples of the types of conduct that would ordinarily be considered to be unconscionable" would be meaningless for the reason that unconscionable conduct must be determined by reference to all relevant circumstances (including the nature of the parties to the contract) and can only be determined as a question of fact on a case by case basis. No statutory presumptions should be made against either party.

Accordingly, the approach adopted in sections 51AC(3) and (4) is appropriate; namely, to provide that the court may have regard to certain matters without it being conclusive or presumed that such a matter is unconscionable or would be ordinarily considered to be unconscionable.

Section 51AC protects franchisees

46 See, for example, Action Nissan Inc -v- Nissan North America 454 F.Supp.2d 108 (2006) and cases referred to in the judgment.

47 Burt v Australian and New Zealand Banking Group Ltd (1994) ATPR (Digest) 46-123 at 53,598.

6.4. It is submitted that section 51AC provides a sufficient mechanism for the protection of franchisees (and, for that matter, the parties to any other form of relational contract). In particular, the following principles are established in relation to section 51AC:[48]

(a) Although section 51AA involves taking improper advantage of a person at a disadvantage in circumstances where equity would intervene, it is clear that the ambit of section 51AC is wider than that of section 51AA.

(b) Section 51AC is not limited to equitable doctrines or common law principles of unconscionability. The section was intended to build on, and not be constrained by, the common law.[49]

(c) The categories of unconscionable conduct under section 51AC are not closed.

(d) Unconscionable conduct involves "serious misconduct or something clearly unfair or unreasonable"[50].

> Other descriptions of unconscionable conduct include "doing what should not be done in good conscience"[51], conduct involving "a high level of moral obloquy"[52] and conduct that clearly offends "against basic notions of good conscience and fair play".[53]
>
> These broad descriptions of unconscionable conduct are quite capable of addressing perceived isolated issues or concerns in relation to franchise agreements.

(e) The question of whether a person engages in unconscionable conduct for the purposes of section 51AC is directed to the time at which the relevant conduct occurs, it is not limited to the time when the contract is made.[54]

6.5. The recent decision of *Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No.2)*[55] represents a good example of the effective application of section 51AC in circumstances where equity would not have intervened, it being noted that section 51AC "authorises the Court to look more broadly at the whole of the relationship and to assess the corporation's conduct in that broader context".[56]

Even after acknowledging that "the commercial relationship of the parties is dysfunctional", it was held that it would be "unconscientious" for the purposes of section 51AC for the franchisor "to insist upon its strict legal rights to force an immediate termination in all the

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48 See Pacific National (ACT) Ltd v Queensland Rail (2006) ATPR (Digest) ¶46-268 at [914] - [921].

49 Australian Securities and Investments Commission v National Exchange Pty Ltd (2005) 148 FCR 132 at [30].

50 Hurley v McDonald's Australia Ltd (2000) ATPR ¶41-741 at [21] - [22].

51 Australian Securities and Investments Commission v National Exchange Pty Ltd at [33].

52 Attorney General (NSW) v World Best Holdings Ltd (2005) 63 NSWLR 557 at [121].

53 Australian Securities and Investments Commission v National Exchange Pty Ltd at [44]; Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No. 2) [2008] FCA 810 at [412].

54 CIT Credit Pty Ltd v Blayn Norman Keable [2006] NSWCA 130 at [66]. Compare section 7(1) of the Contracts Review Act 1980 (NSW) which determines whether a contract is unjust at the time it is made.

55 [2008] FCA 810.

56 Ibid [419].

circumstances where the performance of its own obligations under the franchise agreement has been lamentably and dishonestly short of the standards that it ought to have followed".[57]

Significantly, this conclusion was reached notwithstanding that it was also held that the franchisor had acted in good faith in exercising the power to terminate.[58]

7. The uncertainty of statutory definitions

7.1. Although the South Australian Inquiry recommends that statutory definitions of phrases such as "unconscionable conduct" and "good faith" should be introduced into the Code, the recommendations do not attempt to specify such a statutory definition. Further, submissions that supported such statutory definitions fell short of providing suggested drafting for them.[59]

7.2. Other complications would arise if there were attempts to define phrases such as "unconscionable conduct" and "good faith" in the Code:

(a) As soon as any expression, or definition for an expression, is incorporated into a statute, complex questions of construction, interpretation and application arise. Inevitably, this leads to dispute and expensive litigation over questions of statutory interpretation that otherwise would not arise. In particular, if there were a statutory overlay it would raise complex questions of the interpretation of statutory expressions in the light of a developed body of common law.

(b) A matter for the court to take into account in determining whether a corporation engages in unconscionable conduct for the purposes of section 51AC of the *Trade Practices Act* is the extent to which the supplier and business consumer acted in good faith (section 51AC(3)(k)).

> If "good faith" were to become an express part of, and defined within, the Code, complex questions of the relationship between the provisions of the Code and section 51AC(3)(k) would arise.

(c) As the common law description of expressions such as "good faith" indicate, any attempt to define such phrase in the Code would have the potential to create unnecessary (and most uncertain) distinctions between concepts of "reasonableness", "good faith", "unfair" and "unconscionable conduct".

Statutory interpretation of an "unfair term"

7.3. This is illustrated by Part 2B of the *Fair Trading Act 1999 (Vic)* which deals with unfair terms in consumer contracts.

"Unfair term" is defined in section 32W as follows:

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57 Ibid at [427].

58 Ibid at [400].

59 South Australian Inquiry at pages 45 and 57.

> *"A term in a consumer contract is to be regarded as unfair if, contrary to the requirements of good faith and in all the circumstances, it causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of the consumer."*

Section 32X sets out an inclusive list of matters that may be taken into account.

The complexity involved in the interpretation of the definition of an "unfair term", including the overlapping nature of expressions used, is illustrated in *Director of Consumer Affairs v AAPT Ltd (Civil Claims)*.[60]

Significantly, common law principles in relation to the concept of "good faith" were referred to, emphasising the difficulty of interpreting a particular statutory provision by reference partially to common law principles. In addition, the difficulty of the statutory definition was recognised in that it was stated that "there is a large area of overlap between the concepts of good faith and significant imbalance" and that "the definition of an unfair term might be thought to be circular, as it is impossible to avoid the notion of fairness in determining whether a term causes a significant imbalance in the parties' rights and obligations".[61]

Accordingly, any statutory definition of concepts such as "good faith", "unconscionable conduct" or "unfairness" is very likely to lead to the complex analysis that was necessary in *AAPT*.

Statutory interpretation of an "unfair contract"

7.4. Another example of how broad concepts of statutory "unfairness" can cause significant confusion and uncertainty and in no way alleviate the complexity of statutory interpretation to be undertaken by the courts, is found in sections 105 and 106 of the *Industrial Relations Act 1996* (NSW).

Section 106(1) provides that the Industrial Relations Commission "may make an order declaring wholly or partly void, or varying, any contract whereby a person performs work in an industry if the Commission finds that the contract is an unfair contract".

An "unfair contract" is defined in section 105 as meaning, the extent relevant in the context of this submission, a contract that is "unfair, harsh or unconscionable".

7.5. It has been stated that unfairness for the purposes of section 106 "is determined by the commonsense of a juryman and that it is a moral and not a legal issue" 62 and that "the nature and degree of the unfairness ... relates to ordinary standards of fairness by directing attention to the particular circumstances of the individual contract or arrangement concerned."[63]

In *Kavacuitti v XTMCA Ltd (Toyota Motor Corporation Australia Pty Ltd)*, the following test of unfairness was applied:[64]

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60 [2006] VCAT 1493.

61 Ibid at [43] and [44].

62 A & M Thompson Pty Ltd v Total Australia Limited [1980] 2NSWLR1 at 13.

63 Port Macquarie Golf Club Limited v Stead (1995) 64 IR 53 at 59.

64 [2002] NSWIRComm 117 at [61].

> *"In determining whether there is an unfair arrangement for the purposes of proceedings brought under section 106 ... the Court is required to exercise a value judgment reflecting contemporary community values derived from the commonsense approach characteristic of the ordinary, reasonable, hypothetical 'standard' member of the community. The value judgment must obviously take into account the totality of the circumstances of the relationship between the parties and the totality of the interests of each of the parties."*

7.6. These judicial descriptions of "unfairness" illustrate how uncertain statutory expressions can become by reason of broad references to vague notions such as "moral issues" and "value judgments". This amounts to uncertainty in judicial interpretation and description being applied to, and compounding, existing uncertainty in statutory expressions or definitions.

Risk in applying statutory definitions to commercial contracts

7.7. As discussed in this submission, a franchise agreement is a commercial contract between independent parties. Further, many franchisees in Australia are substantial, sophisticated, integrated and well-resourced business enterprises (including listed corporations and their subsidiaries).

Accordingly, it would be inappropriate to draw analogies with, or inferences from, statutory definitions or other statutory provisions inserted with the object of protecting persons who are, or are likely to be, at a significant disadvantage in terms of bargaining power; in particular, consumers and employees.

7.8. Part 2B of the *Fair Trading Act* is limited to unfair terms and consumer contracts with particular emphasis upon "standard form contracts". A "consumer contract" is defined in relation to the supply of goods or services of a kind ordinarily acquired for personal, domestic or household duties or consumption.[65]

Part 2B has no application to commercial contracts.

7.9. The joint communiqué of the Ministerial Council on Consumer Affairs meeting on 15 August 2008, in identifying a proposal to provide for unfair contract terms in the proposed national consumer law, was limiting its proposed scope to transactions with consumers and "standard form (i.e. non-negotiated) contracts". It proposes a term to be unfair "when it causes a significant imbalance in the party's rights and obligations arising under the contract and it is not reasonably necessary to protect the legitimate interests of the supplier".

Again, it does not propose to have any application to commercial contracts.

7.10. The fact that a commercial contract such as a franchise agreement has been subject to analysis as an "unfair contract" under section 106 of the *Industrial Relations Act* on the basis that a franchise may "perform work in any industry", has been criticised. The Court of Appeal in New South Wales has expressed its reluctance on several occasions to franchise agreements, as a class of contract, being subject to section 106 of the *Industrial Relations Act*[66]. Further, the High Court of Australia has reviewed and modified the jurisdictional test

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65 Section 3 of the Fair Trading Act 1999.

66 See, for example, McDonald's Australia Holdings Ltd v Industrial Relations Commission of NSW [2005] NSWCA 286. Azzi v Volvo Car Australia Pty Ltd [2007] NSWSC 319 was before a single judge, but section 106 was held to have no application.

under section 106[67] and the Industrial Court itself has reflected those principles recently in the context of a franchise agreement.[68]

8. Unilateral amendments

8.1. It has been suggested that the Code be amended to control the right of a franchisor to make unilateral amendments to a franchise agreement.

In the Matthews Report, it was recommended that consideration should be given to "prohibiting unilateral changes by franchisors to arrangements with franchisees which have materially adverse effects on the franchisee without franchisee consent".

8.2. However, if a franchisor were to impose a unilateral change that would have a materially adverse effect upon the franchisee, it is submitted that existing laws provide sufficient causes of action and remedies:

(a) Section 51AC(3)(ja) of the *Trade Practices Act* provides expressly (in the context of unconscionable conduct) that a relevant matter to which a court is to have regard, is whether the "supplier has 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".

(b) A material unilateral variation to the detriment of the franchisee will be protected by provisions such as section 52 of the *Trade Practices Act* and general principles of estoppel. It is unlikely that a broad and imprecise power of unilateral variation could be exercised if the franchisee has invested in a particular course of conduct in reliance upon a particular earlier direction of the franchisor.

8.3. As a relational contract, it is clear that various commercial elements of a franchise agreement will need to be modified from time to time in order to reflect the dynamic nature of a franchise business system. The concept of "unilateral variation" could be capable of extending to changes in programs, strategies, presentation, policies, models and brands and other elements essential to the efficient operation of a franchise system. Modifications of this kind are a necessary part of the business relationship between the franchisor and the franchisee.

9. Penalties for breaching the Code

9.1. A recommendation arising from the Western Australia Inquiry is that the Code should be amended to introduce specific penalties for breaches of the disclosure requirements under the Code.

9.2. It is important for the underlying foundation of a franchise agreement to be kept in mind. The franchise agreement is a contract and rights and obligations derive from the terms of that contract (several of which are prescribed in the Code).

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67 Fish v Solution 6 Holdings Ltd (2006) 225 CLR 180.

68 Alto Artarmon Pty Ltd v BMW Australia [2007] NSWIRComm 172.

9.3. The compensatory nature of the remedies available by reason of a breach of the Code have been confirmed recently by the High Court of Australia in *Master Education Services Pty Limited v Ketchell.*[69] For example, it was observed:[70]

> *"The detailed provision by the Act for the consequences of non-compliance with an industry code, such as the Franchising Code of Conduct, does not support a conclusion that it was intended that the harsh consequences provided by the common law were to follow upon contravention of s51AD. The Act provides a more flexible approach. It allows a court to prevent entry into a franchise agreement, to vary the terms of an agreement entered into in breach of the Code, or to terminate such an agreement or provide compensation for loss and damage, if it is shown to have been caused by the contravention. In that regard the extended meaning which may be given to loss and damage by s82, which is suffered by reason of entry into contractual obligations, may assume significance."*

In addition, it was observed:[71]

> *"The operation of the Act with respect to a contravention of a provision of the Code therefore stands in marked contrast to a contravention of other statutory regimes which, beyond stating that contravention is an offence, are silent as to the remedial consequences for the relations in the civil law between the parties."*

The significance of the range of remedies available under the *Trade Practices Act* was further reinforced as follows:[72]

> *"The provision made by the Act, in Pt VI, for remedies for contraventions of Pt IVB, and the unconscionability provisions of Pt IVA, tell strongly against an intention that the common law remedy for illegality was to apply."*

Accordingly, the clear emphasis is remedial and compensatory.

9.4. The concept of a statutory penalty or fine attaches to contraventions of statutes, not breaches of contract for which general contractual principles (supplemented by the remedies under the *Trade Practices Act*) provide an adequate and appropriate remedy.

9.5. Significantly, the pecuniary penalty regime under the *Trade Practices Act* is not compensatory; it is to act as a deterrent, both specifically and generally. A pecuniary penalty should be sufficient to deter the corporation from engaging in further contraventions of the *Trade Practices Act* and to deter members of the public from engaging in similar conduct by demonstrating to the public that the contravention is a serious matter and that the burden or consequences of that contravention of the provision outweigh the cost of adopting a culture of compliance with the legislation.[73]

Clearly, the object of the Code must be to protect a franchisee to the extent necessary (taking into account the fact that it is a commercial contract) and to provide compensatory remedies for a breach of the Code.

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69 [2008] HCA 38.

70 Ibid at [38].

71 Ibid at [30].

72 Ibid at [40].

73 ACCC v Dataline.Net.AU.Pty Ltd (2007) ATPR ¶42-181 at [60].

9.6. It is one thing for a contractual provision to be rendered void by a statute or for a statute to incorporate mandatory terms into a contract. It is another thing for a statute to prescribe a penalty or fine for breach of that contract.

For example, Division 2 of Part V of the *Trade Practices Act* requires certain conditions and warranties to be incorporated into contracts with consumers. Division 2A of Part V imposes statutory obligations upon manufacturers in respect of like conditions and warranties. In neither case is a pecuniary penalty prescribed.

By way of contrast, a contravention of the statutory obligations contained in sections 53 to 59 of the *Trade Practices Act* is the subject of offences and penalties under Part VC of the *Trade Practices Act*.