Law Council
OF AUSTRALIA
Business Law Section

Ms Chloe Spear
Competition Section, Small Business Division
Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education
By email: chloe.spear@innovation.gov.au 9 July 2013

Dear Ms Spear,

REVIEW OF FRANCHISING CODE OF CONDUCT

I refer to the Business Law Section of the Law Council of Australia's response of 2 July 2013 which set out the views of its SME Business Law Committee ("the Committee") which were responding to the targeted consultation process as set out in your email of 18 June 2013.

The Committee now takes the opportunity to respond in a more general way to the Consultation Paper.

In the Committee's submissions made to the Franchising Code Review Secretariat dated 22 February 2013 (which are enclosed) they were confined to the following:

- **Part 1** – The Impact of Insolvency or Franchise Failure;
- **Part 3** – Good Faith in Franchising; and
- **Part 5** – Dispute Resolution in Franchising.

The Committee's response set out in this letter are similarly confined to those three parts.

The Committee has also included its comments with respect to **Recommendation 6(b)** set out in its letter to you of 2 July 2013 which, for convenience, are again repeated in this submission.

Part 2 – Franchisor Failure

Recommendation 6(a): The Code be amended to:

a. Provide franchisees and franchisors with a right to terminate the franchise agreement in the event that any administrator of the other party does not turn

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the business around, or a new buyer is not found for the franchise system, within a reasonable time (for example 60 days) after the appointment of an administrator. It should be made possible for the courts to make an order extending this timeframe in appropriate cases. It should also be clear that the parties can negotiate a right to terminate at an earlier stage.

With respect it is the Committee's view that this recommendation does not go far enough. Presently, a franchisor pursuant to clause 23 of the Franchising Code of Conduct ("the Code") and likely pursuant to a Franchise Agreement, can without notice terminate a franchise if the franchisee becomes "insolvent under administration or an external-administered body corporate". The Committee proposes that in the event of the insolvency of a franchisee that the franchisor be prohibited from unilaterally terminating without reasonable notice to the Administrator (say up to 30 days) or with the administrators consent or a court order. The administrator of a franchisee should have the protection for a reasonable period of time to turn the franchise around with a restructure pursuant to a Deed of Company Arrangement under Part 5.3 of the Corporations Act or, alternatively, a sale or transfer of the franchise. As the law presently stands, in many instances a franchisor can effectively receive a windfall gain by unilaterally terminating an insolvent franchisee and then going into possession of its business and continue to run it itself or sell it to a third party. In those circumstances none of the proceeds from the sale would go to the franchisee or its creditors. The only unintended consequence of precluding a franchisor from automatically terminating upon the insolvency of a franchisee may be ongoing cost and possibly losses the franchisor may suffer from having to continue to support an insolvent franchisee. The protection for the franchisor in these circumstances would be to seek the consent of administrator to a mutual termination or an order from the court.

The Committee does not recommend that there be any prohibition against an administrator of a franchisor or franchisee terminating a franchise. This is consistent with the administrator's right to disclaim such contracts (and leases) under the Corporations Act. If the administrator can trade the business in the short term with a view to sell the business then he or she is likely to do so. If the business is not profitable there should be no constraints on the administrator from terminating the franchise because if they do trade on they are liable for trading losses and other costs.

Recommendation 6(b): The Code be amended to:

b. Ensure the franchisees can be made unsecured creditors of the franchisor by notionally apportioning the franchise fee across the term of the franchise agreement, so that any amount referrable to the unexpired portion of the franchise agreement would become a debt in the event the franchise agreement ended due to the franchisor's failure.

1. If a franchise model does not require the franchisee to pay an upfront franchise fee, the franchisee is still likely to be an unsecured creditor should a franchisor go into external administration. It is more than likely that in these circumstances a franchisee would have incurred trading liabilities such as employee wages, rent, goods and services, which it is unlikely to recover in full in the event of a franchisor being placed into external administration, particularly in circumstances where the administrator may cease to operate the franchisor's business. In these circumstances the franchisee would most likely have a claim in damages against the franchisor. The claim would be an unliquidated one, just the same as a franchisee

claiming back part of an upfront franchise fee would also be an unliquidated claim. The operation of the Corporations Act makes sufficient provision for creditors who have unliquidated claims (as referred to above) to prove in a voluntary administration or liquidation. Invariably, it is the practice of administrators and liquidators to admit creditors with unliquidated claims for at least $1 so they can vote. If there is to be a dividend paid to creditors then a franchisee, like any other creditor with a claim for unliquidated damages, would need to have that claim assessed by the administrator or liquidator and if there was any disagreement about the value of the assessment the Corporations Act provides for a process to have that unliquidated claim assessed by the Court. In the Committee's experience, if a franchisor becomes insolvent, provided that the administrator can effectively sell the franchisor's business then the most common outcome for the franchisee would be an assignment of the franchise to the new owner rather than a novation occurring.

2. Normally, in that event no documentation is required to be signed by the franchisee, however, this will depend on the requirements of the buyer as to whether it requires franchisees to enter into some form of legal agreement with it. At law a novation is the end of the original contract and the start of a new agreement on the same terms with a substituted party. Under the Code a novation would amount to the buyer entering into a new agreement with each franchisee.

   This would require (amongst other things) consideration of issues of disclosure by the buyer to each franchisee before it entered into that franchise agreement, the application of Clause 11 of the Code to the buyer and whether there is a cooling off period applicable[1]. If novation is to occur, then the time frame for a buyer to prepare a disclosure document and give formal disclosure could delay a sale. In our experience Administrators will take the path of least resistance to ensure a transaction will occur quickly to the benefit of creditors. A novation may delay a sale considerably if it requires the cooperation of franchisees to sign documentation. It is not uncommon for franchise agreements to contain a clause allowing for either process (at the election of the franchisor). Unfortunately, the Code does not contain detailed provisions to deal with the process of sale of a franchise system (generally or specifically in an administration) other than a requirement for limited disclosure of that materially relevant fact under clause 18. Any decision to amend the Code to include provisions that deal with a sale of a franchise system needs much further consideration and consultation with stakeholders.

   However, in practical terms the more usual outcome is that the franchisee will withdraw from the franchise system to trade independently or else follow the franchisor into insolvency.

   With respect to Recommendation 6(b) applying where an up-front fee is paid, the Committee views this recommendation as confirming (or extending) that such payment is able to be claimed in the franchisor's insolvency and should not be viewed as being to the exclusion of other relevant claims. Recommendation 6(b) would be more effective if the effect was to allow a claim for the unexpired proportion of any up-front fees as a liquidated debt with priority ahead of other unsecured claims.

[1] Note clause 13(2) of the Code does not expressly exclude the cooling off period applying to a "novation". It does expressly exclude it applying to a "transfer".

In conclusion, the Committee is concerned about Recommendation 6(b) because of the likely difficulties that will arise from a commercial and legal point of view. Views from insolvency practitioners should in our view also be sought and considered.

Part 4 – Good Faith (and Confidentiality of Contract Details for ex-Franchisees

Recommendation 9: The Code be amended to include an express obligation to act in good faith. Such an obligation should:

a. extend to the negotiation of a franchisee agreement, the performance of a franchise agreement, the performance of obligations under the Code, and the resolution of any disputes between the parties whether or not there is a valid franchise agreement at the time of the dispute;

b. not be defined, instead the unwritten law relating to good faith should be incorporated in a manner similar to the unconscionable conduct prohibition set out in section 20 of the Australian Consumer Law;

c. apply to both the franchisor and franchisee or prospective franchisee and the agents of these parties;

d. not be able to be limited or excluded by any provision of the contract between the parties (such provisions should be declared void);

e. be clearly stated as not prevent a party from acting in its legitimate commercial interests; and

f. expressly exclude an argument that a franchisor has not acted in good faith because there is no term in a franchise agreement specifying a right of renewal.

The Committee refers to its submissions to the Franchising Code Review Secretariat of 22 February 2013.

The Committee remains of the view that there is no useful purpose in codifying the common law contract doctrine of "acting in good faith". The Committee agrees in part with option 5 of the Recommendation in these, namely, that the Code include the parties' obligations to comply with the common law duty of good faith and, further, that the parties are not able to contract out of this mutual obligation.

By including such a provision in the Code would bring certainty and no additional cost for the parties.

Part 6 – Dispute Resolution

Recommendation 13: The Code should be amended to provide that clause 29(8) applies to participation in any alternative dispute resolution process whether under OFMA, state small business commissioners, privately retained; court appointed or otherwise.

The Committee agrees that the code should be amended to enable the parties to agree on a privately retained mediator or the use of State Small Business Commissioners or

court appointed mediators. The proposed amendments will provide the parties with greater flexibility in implementing a dispute resolution process. The Committee is of the view that there is no need to specifically refer to parties being obliged to act in good faith in the dispute resolution process. In private mediations, most mediators have the parties commit to a mediation agreement which usually contains a provision to "negotiate in good faith".

Recommendation 14: Amend the Code to ensure that franchisors cannot:

a. attribute the legal costs of dispute resolution to a franchisee unless ordered by a court;

b. require a franchisee to litigate outside the jurisdiction in which the franchisee's business primarily operates.

The Committee agrees that the Code should be amended so that the costs of a mediation are borne by the parties equally, unless there is an order by a Court. The Committee does not agree that the Code should be amended so that disputes are only litigated within the franchisee's jurisdiction. The Committee is of the view that issues with respect to jurisdiction should be left to the common law and existing Federal and State laws.

Further Contact

The Committee would be pleased further any of the matters that are raised in this submission. If you have any questions, in the first instance, please contact the Committee's Chair, Mr Jon Clarke on (08) 8228-1111 or via email jclarke@cowellclarke.com.au.

Yours sincerely.

John Keeves
Acting Section Chairman

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