



Law Council  
OF AUSTRALIA

*Business Law Section*

2 July 2013

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](mailto:chloe.spear@innovation.gov.au)

Dear Ms Spear,

## REVIEW OF FRANCHISING CODE OF CONDUCT

The SME Business Law Committee of the Business Law Section of the Law Council of Australia (“the Committee”) made a submission to the Department of Industry, Innovation, Climate Change, Science, Research and Tertiary Education (“the Department”) on 22 February 2013 which was referred to in part in the review of the Franchising Code of Conduct conducted by Mr Alan Wein in his report of 30 April 2013.

The Department has requested the Committee, as part of a targeted consultation process, to express its views with respect to a number of questions set out in an email to Committee of 18 June 2013.

In relation to each of those questions raised by the Department, the Committee responds as follows:

### 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 referable 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

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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<sup>1</sup>. 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.

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<sup>1</sup> 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.

**Recommendation 7: The Code be amended to prohibit franchisors from imposing unreasonable significant unforeseen capital expenditure. 'Unreasonable' and 'significant' should be defined, with a view to a franchisor being able to demonstrate a business case for capital investment in the franchised business.**

3. The Committee does not consider that 'unreasonable' should be defined if the intention (as we interpret the whole of the Recommendation) is to make the issue relevant to the circumstances of individual franchisees. In this regard we have some concerns that the ability of a franchisor to maintain uniformity of its systems, brand and processes which is likely to become subject to available resources and cash flow of each franchisee.

If the intention is, alternatively, to create a threshold for the franchisor to require further capital expenditure without direct reference to the circumstances of each individual franchisee then perhaps 'unreasonable' could be expressed or defined relative to a percentage of turnover or a percentage of the initial capital investment.

The Committee would prefer to clarify whether such prohibition is limited to a franchise term under way at the time or if it extends to any extension/renewal. We can foresee significant sector resistance if the prohibition prevented a franchisor from re-branding or upgrading its system for the full term of a franchise including extensions. Most likely the current trend (just being now observed) for franchisors not to grant options to extend would accelerate; this is a neutral outcome neither good nor bad but does represent a shift from the 'traditional' franchise model and would increase the scrutiny of Recommendation 12 (see below).

Similarly 'significant' could best be defined as a proportion of initial expenditure or turnover. However this will not necessarily address the mischief underpinning the Recommendation which is the franchisor requiring further undisclosed capital expenditure from the franchisees under threat of terminating the agreement for non-compliance.

An alternative approach may be to prohibit the franchisor from terminating the agreement for non-compliance with undisclosed unreasonable or significant capital expenditure during the immediate franchise term where the franchisee can demonstrate that the expenditure will render the franchised business unviable or that the franchisee is unable to obtain or service the capital contribution requested.

The problem with capital expenditure (upgrades) being required as a pre-condition of renewal or transfer remains, and the Recommendation needs to be clarified with respect to this issue – specifically whether the prohibition extends for the entire term including renewals. In other words, can a franchisor refuse a renewal on the basis of a franchisee refusing or being unable to make a further capital contribution?

4. With respect to the franchisor having to demonstrate a business case for the capital expenditure, the costs of compliance would be significant and unreasonable. The circumstances of each franchisee would be required to be considered for each business case study. It is entirely possible that an upgrade that works for certain

franchisees would not be suitable for other franchisees depending upon their location, experience, business acumen, the size of their operation and overheads.

Even should the franchisor be able to demonstrate a 'business case' – which we interpret as a justification of the cost when compared to the benefit obtained (not necessarily the return generated) – this will not have any relevance to whether the franchisee can afford such an expense or the potential impact upon profitability.

The Committee is reluctant to endorse this Recommendation without further clarification of its intended operation. If the conduct being targeted is to prevent unforeseen capital expenditure being imposed upon a franchisee during their then current term then such an outcome could be achieved by simply prohibiting such cost by reference to a percentage of the initial expenditure. This might also address the ongoing confusion about Item 13A of the Disclosure Document by obviating the need to make a guess about what expenditure may be relevant.

**Recommendation 8: The Code be amended with respect to the administration of marketing funds based on the following principles:**

- a. a franchisor should separately account for marketing and advertising costs;**
  - b. contributions to marketing funds from individual franchisees should be held on trust for franchisees generally, with the franchisor to have wide discretion as to how to expend the funds (subject to principle 'e' below);**
  - c. company-owned units must be required to contribute to the marketing and advertising fund on the same basis as franchised units;**
  - d. the marketing and advertising fund should only be used for expenses which are clearly disclosed to franchisees by way of the disclosure document, and which are legitimate marketing and advertising expenses;**
  - e. a once yearly independent audit should be conducted on marketing funds over a certain threshold value, with no capacity for franchisees to vote against such an audit; and**
  - f. the results of the audit (where applicable) and other detailed information about the expenditure of marketing and advertising funds should be made available to franchisees yearly.**
5. There are significant and onerous obligations to hold a marketing fund in a trust account and the legal consequences are likely to result in a fundamental change in how marketing funds are managed by franchisors. The matter will become even more onerous for franchisors if, as Recommendation 8 suggests, separate trust account ledgers are to be held for each franchisee. Initial feedback from Committee members' franchisor clients indicates that if such a change were introduced they would seriously consider eliminating their marketing funds altogether and re-cast the amount as a fee payable so that the franchisor will not incur any trust account obligations.

Some of the issues that are likely to cause difficulty if a marketing fund becomes a formal trust account(s) include:

- Franchisors would have contractual obligations and separately under the Code (if amended) and the law generally to account for trust monies.
  - Compliance with the various State Trustee Acts require trust account receipts, trust account statements, reporting, audit, the indefinite keeping of trust account records and potential prosecution for non-compliance (and which may conflict with some parts of Recommendation 8);
  - Whether the contribution made by an individual franchisee is to be returned at the end of their agreement;
  - Whether the contribution made by a franchisee can only be spent in their territory or for the direct benefit of their business. We acknowledge that this is contemplated in Recommendation 8b, however, the Committee is not settled that the Code has the necessary jurisdiction to ensure this outcome;
  - Potential conflicts and difficulty arising between the franchisor's fiduciary duty to beneficiaries as trustee of the trust account, and the franchisor's commercial obligations in its own business and in respect of which those same beneficiaries are the franchisor's commercial counterparts;
  - A significant increase in the cost of compliance, including training, software, reporting, accounting fees and audit costs; and
  - How are contributions made by parties other than the franchisor and franchisees addressed (such as supplier rebates)? Would those rebates be paid into trust accounts or to the franchisor for marketing?
6. Requiring the marketing fund to only be used for legitimate marketing and advertising expenses may be too narrow unless the intention is to deliberately exclude operating, audit and management expenses (which can all genuinely be associated with the maintenance and operation of the account).

The Committee acknowledges that reform is necessary in this area and the evidence before Mr Wein appears to identify 3 main issues:

- to stop administrators/banks accessing marketing funds in insolvency;
- ensure transparency regarding the use of the marketing fund and the expenses being reimbursed; and
- prevent franchisors using the fund for their own account or purposes (whether by way of loan or otherwise).

The intention of the Recommendation seems to be moving in the direction of creating a fiduciary duty for the establishment, operation and reporting of marketing funds by the franchisors which are commercially too onerous.

We also note that Recommendation 8 does not cover circumstances where the marketing fund is administered by an associate or agent of the franchisor.

**Recommendation 12: The Code be amended to state that, if all of the following conditions are satisfied:**

- a. the franchisee wishes to have the franchise agreement renewed on substantially the same terms;**
- b. the franchisee is not in breach of the agreement;**
- c. the agreement does not contain provisions allowing a franchisee to make a claim for compensation in the event that the franchise is not renewed;**
- d. the franchisee abides by all confidentiality clauses in the agreement and does not infringe the intellectual property of the franchisor; and**
- e. the franchisor does not renew the franchise agreement;**

**any restraint of trade clauses in the franchise agreement which prevent the franchisee from carrying on a similar business in competition with the franchisor, are not enforceable by the franchisor against the franchisee.**

7-9. The formulation of the common law position is that all restraints are invalid for reasons of public policy unless the person seeking to rely upon the restraint can establish that it is reasonable to protect a legitimate interest. The time at which this 'legitimate interest' is assessed is at the time the agreement was entered into (not the circumstances at the conclusion of the contract).

Recommendation 12 is at risk of creating a unique sub-set of restraint of trade law with the attendant confusion and litigation until the position has been clarified through the Courts.

Already the Committee has seen a number of different interpretations of Recommendation 12 between various experienced lawyers. This does not bode well for its implementation into the sector generally. By way of example:

- a. a refusal by the franchisor to allow a renewal where the franchisee has exercised or has in its agreement an option or right to require a renewal;
- b. a refusal by the franchisor to enter into negotiations for a new agreement where there is no option or right to renew remaining;
- c. a refusal by the franchisor to either offer a renewal or enter into a new agreement (where there is no option to renew or right to renew remaining) on "*substantially the same terms*" as their existing agreement.

The words "renew" and "renewal" are not defined in the Code but appear in various places including in clause 20A of the Code. In particular they appear in clauses 20A(1)(a) and (2)(a). Its use in these contexts demonstrates that it is intended to apply where there is an option or right to renew whereas clauses 20A(1)(b) and 20A(2)(b) differentiate with words that relate to negotiating a new agreement. As a consequence there may be a misunderstanding as to the proposed reach of this recommendation. Consideration whether the application of the recommendation is reasonable in each of these events may differ.

We note that the relief offered by this Recommendation is limited solely to non-renewal and does capture, for example, a franchisee whose agreement is terminated mid-term by way of notice without breach.

It would be preferable to either make all restraints against franchisees unenforceable (and let the market re-price the risk and value) or continue to operate within the boundaries of the common law position (which we accept will result in no material change to the current situation). The Committee favours the later.

The Committee will be providing general responses to the Consultation Paper by 9 July 2013.

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](mailto:jclarke@cowellclarke.com.au)

Yours sincerely,

A handwritten signature in black ink, appearing to read 'John Keeves', with a long horizontal stroke extending to the right.

John Keeves  
**Acting Section Chairman**