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Paper abstract (100 words):

2007 has been a busy year for the world of franchising in Australia. There have been two significant events in particular. The first is the release of the much anticipated amendments to the Franchising Code of Conduct. The second is a very important decision by the New South Wales Court of Appeal which held that a Franchising Agreement was illegal and unenforceable because it contravened one of the clauses of the Franchising Code of Conduct. This paper deals in more detail with these two significant events.

Keywords:

Australia, Franchising Code of Conduct, foreign franchisors, general waivers, other amendments, Ketchell, illegal, unenforceable.

AUSTRALIAN FRANCHISING IN THE PACIFIC RIM

UPDATE FROM AUSTRALIA

1. Introduction

The Australian franchising industry is a highly successful AUS$130 billion[1] industry creating jobs for more than 600,000 Australians.

2007 has been a busy year for the world of franchising in Australia. In particular, there have been two significant events:

1. The release of the much anticipated amendments to the *Franchising Code of Conduct*.
2. A New South Wales Court of Appeal decision that held that a franchising agreement was illegal because it contravened clause 11(1) of the *Franchising Code of Conduct*.

2. Significant Changes to the Franchising Code of Conduct

2.1 Background to the Code

The *Franchising Code of Conduct* was introduced to Australia in 1998. It is the first, and to date only, mandatory industry code under the Australian Trade Practices Act. It sought to bring more balance to the franchising relationships in favour of the mums and dads franchisees. It operates in three ways:

(a) it requires certain provisions to be included in the franchising agreement (eg, cooling off period, termination provisions and mediation provisions);

(b) it prohibits certain provisions from a franchising agreement (eg, general disclaimers and certain termination provisions);

(c) a disclosure document regime.

During the last 15 months a detailed review of the *Franchising Code of Conduct* took place, resulting in a report to the government suggesting a number of changes. Following the release of this report there was an opportunity for industry input. The Government issued its own response to the report following input from industry. The net result was the Trade Practices (Industry Codes – Franchising) Amendment Regulations 2007 (No 1). These regulations were issued on 7 August 2007 and are effective from 1 March 2008.

The report to the government on the Code made 34 recommendations. Many, but not all, of the recommendations were in fact accepted and implemented to varying degrees. I wish

[1] This figure is based on sales turnover and includes the $30 billion motor vehicle industry and $31 billion retail fuel industry. This represents 14% of Australia's gross domestic product.

to review the more important of these, particularly those more relevant to the international franchise community.

2.2 Foreign Franchisor

Presently the Code does not apply to a franchise agreement where the franchisor is based outside Australia and grants only one franchise into Australia. However, under the amendments, foreign franchisors with only one franchisee in Australia will no longer be exempt.

As a result, foreign franchisors who are currently not required to comply with the Code will need to review their arrangements – both as to the terms of their master franchise agreements and in terms of disclosure obligations.

2.3 Prohibition on General Waivers of Representations

Currently, a fairly standard provision in franchise agreements is that any oral or written representation made by a franchisor to a franchisee prior to the agreement is regarded as having no effect. In other words, the parties agree that the written franchise agreement is the entire agreement between them.

The amendment prohibits any waiver of any verbal or written representations made by a franchisor. It seems that the prohibition will apply retrospectively. In other words, it will apply to any existing franchise agreements entered into after 1 October 1998.

Even if it does not have retrospective effect, any franchise agreement entered into after 1 March 2008 (and this will include any existing franchise agreement that is transferred, renewed or extended from that date) must not include one of these general waivers.

The consequence of this change is that franchisors need to be very careful in their approach to prospective franchisees from day one. Many franchisors already take sensible care - to avoid engaging in unlawful misleading and deceptive conduct under other aspects of the Trade Practices Act. However this is a direct prohibition and will presumably be given more prominence by the courts than the existing protection under the Trade Practices Act.

2.4 Documentary Requirements

Under the new regulations, franchisors will need to supply prospective franchisees with:

- a full copy of the proposed franchise agreement;
- a copy of the Code;
- copies of all associated agreements and contracts (eg, leases, indemnities, guarantees, confidentiality agreements).

If any documentation is not available, it has to be provided as soon as it becomes available.

2.5 Disclosure of Materially Relevant Facts

Presently, clause 18 of the Code requires certain franchisor information to be continuously disclosed to franchisees (within 60 days of it changing or becoming known). These are known as "materially relevant facts".

These include:

- change in majority ownership or control;
- judgment against the franchisor;
- material changes to a franchise system's intellectual property (or ownership of it).
- proceedings against the franchisor alleging breach of franchise agreement, contravention of Trade Practices laws, contravention of the Corporations Act, unconscionable conduct, misconduct and dishonesty.

Under the new regulations, nothing changes in terms of the substance of required disclosure of materially relevant facts, with the exception of contraventions of the Corporations Act (discussed below). However the time line has been reduced dramatically, from 60 days down to 14 days.

This will require clear and speedy lines of communication internally in monitoring this continual disclosure obligation.

2.6 Extension of Scope of Franchise Agreement

There has long been a debate in Australia as to whether an "extension" of a franchise agreement meant an extension of term and/or an extension in scope (eg, territory, additional sites etc), for the purposes of the Code.

The distinction is important. An "extension" of a franchise agreement is regarded as a franchise agreement in itself, and triggers, amongst other things, the disclosure obligations.

Whatever might have been the case, it is clear under the new regulations that an extension includes an extension to scope as well as term of the franchise agreement. This means that a disclosure document and the new franchise agreement will have to be provided at least 14 days before any extension to a franchisee's sites or territory.

2.7 New Disclosures

There are certain new disclosures required including:

(a) any contraventions of the Corporations Act, rather than merely 'serious offences', for both franchisor companies and their directors;

(b) the names and contact details of past franchisees (rather than just numbers of past franchises which may have transferred or ceased operation);

2.8 Proposed Prohibition

Although not included in the recent amendments, the Federal Government has flagged its concern about provisions in franchise agreements that allow unilateral changes to the

agreement by a franchisor.[2] The foreshadowed response is a recommended tightening up of Section 51AC of the *Trade Practices Act* (which deals with unconscionable conduct). If any change results, it is likely to expressly refer to this type of unilateral power as a factor for the courts to take into account in determining whether or not there has been unconscionable conduct.

3. The Ketchell Decision

The other landmark event on the Australian horizon was a decision in July by the New South Wales Court of Appeal. Overruling some previous decisions, the Court of Appeal held that a franchising agreement will be unenforceable and illegal if, in contravention of Clause 11(1) of the Code, a franchisor fails to obtain from a proposed franchisee the required written statement that the franchisee has received, read and had a reasonable opportunity to understand the Code.

The facts were simple. The respondent sued the appellant in the local court for money due under a franchise agreement executed on 11 February 2000. The appellant claimed in defence that the franchisor had failed to comply with clause 11. The question was, did this contravention render the contract unenforceable for statutory illegality.

In the proceedings below the Court of Appeal, it was found that while the franchisor did not comply with clause 11(1), it did not render the receipt of the non-refundable payment illegal. This result was consistent with a line of authority to this effect.

The Court of Appeal undertook a very careful analysis of the history of the Code, the Trade Practices Act as a whole (including Part 6 which contains a number of remedies), and clause 11(1) of the Code.

Clause 11(1) states:

> (1) The franchisor must not:
>
> (a) enter into, renew or extend a franchise agreement; or
>
> (b) enter into an agreement to enter into, renew or extend a franchise agreement; or
>
> (c) receive a non-refundable payment (whether of money or of other valuable consideration) under a franchise agreement or an agreement to enter into a franchise agreement;
>
> unless the franchisor has received from the franchisee or prospective franchisee a written statement that the franchisee or prospective franchisee has received, read and had a reasonable opportunity to understand the disclosure document and this code.

The Court of Appeal preferred the general rule that if the legislature prohibits the making of a contract, the making of the contract does not give rise to an enforceable right or

[2] A unilateral change where the franchisor can impose, without consent or consultation, amendments to the franchise agreement, can manifest itself in a number of ways. It might be an amendment to the franchise agreement itself. It might be an amendment to an Operating Manual (or some other manual) that is by reference incorporated into and forms part of the franchise agreement.

obligation. Here, clause 11(1) of the Code expressly prohibits entering into, renewing or extending a franchise agreement unless certain things have been done. A contract made in breach of this prohibition is illegal and unenforceable unless the statute provides otherwise. The Court held that there were no words in clause 11(1) to displace the presumption of illegality and unenforceability.

What is not so clear is whether contraventions of other provisions of the Code will lead to franchising agreements being struck down. Indeed, this was left open expressly by the President of the Court of Appeal. Great weight had been placed on the words "*must not enter the franchise agreement*" in clause 11.

For example, clauses 6(1)[3] and 10[4] of the Code are among the regulations that create obligations for the franchisor before it enters a franchising agreement. Clause 6(1) states that a franchisor "*must, before entering into a franchise agreement, and within 3 months after the end of each financial year after entering into a franchise agreement, create a [disclosure document] …*"

Clause 10 requires a franchisor to give a copy of the Code and a disclosure document to a prospective franchise at least 14 days before the prospective franchisee enters into a franchise agreement.

How the courts deal with these questions remains to be seen.

The *Ketchell* decision is currently on appeal to the Australian High Court. The very clear message however is that, for so long as Ketchell remains good law, franchisors must be extremely careful to ensure compliance with clause 11 and perhaps clauses 6 and 10 of the Code in terms of fulfilling their disclosure requirements.

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3 September 2007

[3] Clause 6(1) states: A franchisor must, before entering into a franchise agreement, and within 3 months after the end of each financial year after entering into a franchise agreement, create a document (a ***disclosure document***) for the franchise in accordance with this Division.

[4] Clauses 10 states: A franchisor must give a copy of this code and a disclosure document:

(a) to prospective franchisee at least 14 days before the prospective franchisee:

  (i) enters into a franchise agreement or an agreement to enter into a franchise agreement; or

  (ii) makes a non-refundable payment (whether of money or of other valuable consideration) to the franchisor or an associate of the franchisor in connection with the proposed franchise agreement; or

(b) to a franchisee at least 14 days before renewal or extension of the franchise agreement.