

REGULATING THE BARREL TO STOP THE BAD APPLES

04 April 2019 | Australia

Legal Briefings - By **Amalia Stone and Tess Mierendorff**

Franchisors and investors in them are the subject of criticism in the latest Australian Parliamentary Joint Committee on Corporations and Financial Services 'Fairness in Franchising' report, and should expect some serious changes to the Australian Franchising Code of Conduct.

IN BRIEF

- The recent Australian Parliamentary Joint Committee on Corporations and Financial Services 'Fairness in Franchising' report contains more than twenty recommendations, including changes to the Australian Franchising Code of Conduct and the establishment of an inter-agency Franchising Taskforce.
- Listed franchisors, and investors in franchisors, are singled out as having allegedly driven serious and systemic non compliant behaviour in search of profits for shareholders.
- Franchisors should brace for further regulation, including an increase in the breadth, and increased maximum amount, of penalty provisions under the FCC.

The report has focussed on some of the franchisor behaviours that may not be immediately apparent to a prospective franchisee, including:

- supplier deals where the upside is kept for the franchisor through rebate arrangements, or where costing of goods and services means that the margin realised by the franchisee is likely to be low;

- lack of meaningful specific disclosure by franchisors about key financial issues including past franchise earnings, and franchisor plans that may impact on individual franchisees, including 'churning' behaviours; and
- the ability of franchisors to make changes to aspects of the franchise system – for instance the franchise manual – that significantly impact on franchisees.

CHANGES TO THE AUSTRALIAN FRANCHISING CODE OF CONDUCT

The Committee recommends a wide range of changes be made to the Australian Franchising Code of Conduct (**FCC**), and some further changes be made to the Australian Consumer Law (**ACL**), including:

- **electronic disclosure and financial disclosure:** franchisors will need to make electronic disclosure of franchise agreements and disclosure documents, together with two years of Business Activity Statements, P&Ls, balance sheets and assessment of labour costs for the particular franchise, or an equivalent franchise if the information is not available for the relevant franchise site;
- **franchisors to train franchisees on the FCC:** a duty on franchisors to provide franchisees with training on the requirements of the FCC, including a reasonable estimate of the personal workload that the franchisee (or their manager) will need to undertake to run the franchise;
- **all marketing fees regulated:** regulation of all requirements on franchisees to pay marketing fees, not only those going into a marketing fund;
- **disclosure of supplier rebates:** not only the amount to be disclosed, but also as a percentage of the purchase price of goods and services sold by the franchisor to franchisees;
- **further crackdown on unilateral variations:** variations to franchise agreements will only be permitted with the agreement of the majority of franchisees;
- **collective bargaining by franchisees:** that the ACCC's proposal for a class exemption to allow franchisees to collectively bargain should be implemented;
- **disputes now to potentially result in arbitration:** that the dispute resolution process be enhanced to include the option of binding arbitration, if mediation is unsuccessful; and
- **termination:** delays to be built into the franchisor's rights to terminate for special

circumstances.

The committee also recommends that:

- the Oil Code be aligned with the revised form of the FCC.
- the Department of the Treasury and the Department of Jobs and Small Business give further consideration to how to better deal with capital intensive stock required to be held by automotive dealers, when dealerships are not renewed, including a proposal that 12 months' notice of non renewal be given, and certain buy back arrangements for some vehicle parts. While the committee considered establishing a separate automotive industry code, it did not recommend it.

Finally, the committee recommends amending s51ADD of the Competition and Consumer Act to provide civil penalties for non compliance with a s51ADD notice - which relevantly includes a notice to provide information required to be kept under the FCC.

All of these changes appear to be aimed at addressing the informational and power balance between franchisor and franchisee or prospective franchisee. Many of the changes will simply result in franchisors who are already well behaved towards franchisees introducing further compliance mechanisms, and incurring additional compliance costs.

In addition, United States data indicates that there is a trend towards franchisees owning multiple units.¹ Anecdotally, this is common in the automotive dealer sector in Australia. Multi-units have the advantage of providing more stability and success by spreading risk over multiple locations, greater cost efficiency, and franchisors are likely to offer reduced fees and royalty breaks for multi-units. What this means is that although each individual franchise site may be a 'small business' at a disadvantage in negotiations, in fact the multi-unit franchisee is in a powerful position to negotiate. Those multi-unit franchisees however will still be treated as if they needed those additional protections that a small business needs.

FRANCHISING TASKFORCE TO BE ESTABLISHED

These are not the only potential amendments on the way. The committee also recommended establishing a Franchising Taskforce to consider how to address a number of the more complex issues identified by the committee, including:

- **franchisees to be represented on franchisor board:** if it is appropriate for a

franchisee representative to be a voting member of the franchisor's board;

- **disclosure of cost structures:** how to amend the FCC to require new disclosure as to the cost structure and rebate arrangements relevant to goods and services for the franchise, including an obligation to disclose:
 - for the previous 2 year period, circumstances where the maximum resale price of items have been below the franchisee's cost price, the margin between purchase price paid by franchisee and the maximum or recommended resale price for the top five products; and
 - what proportion of supplier rebates would be retained by the franchisor, and what directed to franchisees, including through direct payment, free or subsidised training, advertising and marketing, subsidised goods and services or administration expenses.

This includes looking at whether conflicts of interest arise in connection with supplier rebates and third line forcing, and whether franchisees suffer as a result. It also includes looking at terms that allow the franchisor to decide the volume and frequency of orders for goods and services relevant to the franchise;

- **online register:** investigating options for an online public franchise register to be operated by the ACCC, and a requirement to provide updated disclosure documents and template franchise agreements annually, with civil penalties for non compliance;
- **significant capital expenditure:** how to amend the FCC to more clearly define 'significant capital expenditure' and put appropriate constraints on how franchisees are required to contribute, and how they must be compensated. Separately, the taskforce is to consider the extent to which franchise systems involve sufficient co-investment and risk sharing such that they should be regulated as a financial product;
- **prohibiting unfair contract terms:** whether to amend the ACL to prohibit unfair contract terms in franchise agreements, including civil pecuniary penalties and infringement notices where such terms are included, and to amend the *Competition and Consumer Act, 2010 (Cth) (CCA)* to ensure the ACCC can give s155 notices to obtain evidence about whether a standard form contract contains an unfair contract term.

Currently there are only penalties associated with unfair terms if a party seeks to rely on an unfair term after a court has held that term to be unfair.

- **further crackdown on unilateral variations to manuals:** whether the FCC should be amended to restrict how subsidiary documents, like franchise manuals or policies be amended, including that amendments can only be made with the agreement of the majority of franchisees, which is an approach that a number of franchise systems have already adopted or are considering;
- **civil penalties for all breaches, and increase in amount of penalties:** if the CCA and the FCC should be amended to implement civil penalties for all breaches of the FCC, and an increase in the size of the penalties to provide more meaningful deterrence, including that the penalties would be prescribed so that the limit on penalties under codes would not apply.

Penalties under the ACL were recently increased for companies to the greater of \$10 million, three times the benefit received (or if that cannot be calculated, 10% of annual turnover for the preceding 12 months), and for individuals to \$500,000 per breach. In the recent UltraTune decision,² the court held that separate civil penalties may be awarded for multiple instances of the same contravention, with UltraTune receiving civil penalties of \$1,204,000 (out of a total award of \$2.6 million) including for failure to provide disclosure documents and marketing fund statements to multiple franchisees across its network.

Civil penalties for breach of the FCC are currently capped at 300 penalty units (\$63,000) per infringement. However, franchisors should be aware that if there is an increase in the maximum amount of the civil penalty available, instances of multiple breaches in the same course of conduct (eg, by not providing franchisees with marketing fund statements) could rapidly become very expensive.

- **protection of lease:** where the franchisor takes the head lease and sub-leases premises to the franchisee, how to amend the FCC to ensure that rent for premises paid by the franchisee is passed properly through to the lessor; and
- **termination:** how to amend the FCC to give franchisees rights to terminate in special circumstances, for instance where the franchisor becomes insolvent or bankrupt.

THE ACCC AND BEYOND

The Committee recommend that:

- the whistleblower protection regime be expanded to expressly cover franchisees and their employees;
- the ACCC be given an express power to intervene and prevent marketing and sales of franchises where it considers the franchisor 'churns' and 'burns';
- the ACCC be adequately resourced so that it can investigate all complaints or whistleblower reports about illegal unfair contract terms; and
- the ACCC, ASIC and ATO investigate the current and former directors and senior executives of the Retail Food Group with respect to ACL, Franchising Code of Conduct, insider trading, short selling market disclosure obligations, compliance with directors duties, audit quality, valuation of goodwill and other assets and tax avoidance.

The ACCC has been very active in the last year in relation to franchisee complaints, and we expect that they will continue to focus on poor behaviour, or the perceived potential for poor behaviour by franchisors.

WHAT DOES THIS MEAN FOR LISTED FRANCHISORS AND INVESTORS IN FRANCHISE SYSTEMS?

- If all the changes to the FCC are made, and the recommendations to be considered by the Franchising Taskforce are implemented, franchisors will need to put in place stronger systems to ensure compliance in all aspects of franchising, from onboarding prospective franchisees, tracking costing of goods and services and rebates (to allow appropriate disclosure), and in documenting they are behaving appropriately towards the franchisee in respect of all elements of the franchise. Those systems will bring with them increased costs, and require more management involvement.
- The committee has demonstrated that it thinks the ACCC should be looking at the behaviour of the investors behind franchise systems when it considers the behaviour of the franchisors involved in those systems. This is in line with comments made in recent court decisions in actions commenced by the ACCC.³ The ACCC seems to take the view

that concentration of franchise system ownership has resulted in poor behaviour, and it is possible that the ACCC may take a more active role in reviewing transactions resulting in aggregation of franchise systems to seek to control this, in addition to the proposed changes to the FCC and those to be considered by the Franchising Taskforce.

- The committee (and before it the ACCC) is not interested in whether standard form contracts and disclosure documents bring efficiencies for the franchisor. Rather, it is interested in ensuring that the outcome of the standard contract is fair. As drafting lawyers, it can be difficult to anticipate all the circumstances in which a clause can be used by the franchisor in order to determine definitively if the clause is 'fair'. While the ACCC has provided some guidance, it is not definitive or binding.⁴ If the recommendations in relation to 'unfair terms' are implemented, franchisors will need to take a much more cautious approach to their franchise agreements.

ENDNOTES

1. [Shifting Landscape: 5 Trends Changing MU Franchising.](#)
2. *Australian Competition and Consumer Commission v Ultra Tune Australia Pty Ltd* [2019] FCA 12.
3. *Ultratune, ibid, ACCC v Geowash Pty Ltd (subject to a deed of company arrangement) (No 3)* [2019] FCA 72. Geowash was found to have engaged in misleading and deceptive conduct and unconscionable conduct in breach of the ACL, and in breach of its obligations under the FCC to act in good faith. The ACCC first started investigating Geowash in 2015. See also <https://www.herbertsmithfreehills.com/latest-thinking/accc-takes-action-against-franchisors-under-franchising-code>.
4. [Determining whether a contract term is unfair, ACCC unfair terms in small business contracts.](#)

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



AMALIA STONE
SPECIAL COUNSEL,
SYDNEY

+61 2 9225 5522
Amalia.Stone@hsf.com



**TESS
MIERENDORFF**
SENIOR ASSOCIATE,
SYDNEY

+61 2 9225 5596
Tess.Mierendorff@hsf.com



KRISTIN STAMMER
PARTNER, SYDNEY

+61 2 9225 5572
Kristin.Stammer@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

© Herbert Smith Freehills 2021

**SUBSCRIBE TO STAY UP-TO-DATE WITH LATEST THINKING, BLOGS, EVENTS, AND
MORE**

Close

© HERBERT SMITH FREEHILLS LLP 2021