# SUBMISSION TO INQUIRY INTO THE OPERATION AND EFFECTIVENESS OF THE FRANCHISING CODE OF CONDUCT

By: Peter Sanfilippo
The Franchise Lawyer

4 May 2018

## 1. Terms of Reference paragraph (a)(i) - Information about likely financial performance of a franchise, and worse-case scenarios

1.1. In my experience, 'earnings information' (as it is called in the franchise disclosure document) is a highly fraught area in the franchise sector. It is the single most powerful type of information used by franchisors to sell franchises, and the type of information most relied upon by prospective buyers when buying. It is also the issue most often involved in serious franchise disputes.

1.2. However, issues relating to information about the financial performance of a business are not unique to franchising. They frequently arise in the general market for the sale of businesses. There are good reasons, in my view, why it is inappropriate to introduce a requirement for franchisors to give franchisees information on likely financial performance. Some of the reasons are obvious: franchisors cannot make predictions about the performance of a franchise with any assured level of accuracy; and not all franchisors collect information about the financial performance of their franchisees.

1.3. Introducing a requirement that franchisors provide to franchisees historical information about financial performance of a franchise, if it is held, may have unintended consequences.

1.4. On the other hand, franchisors' liability for the giving of earnings information, and requirements that apply where earnings information is given, are areas where greater specific regulation is warranted in my view.

1.5. A new version of the earnings information item in the disclosure document appeared in the Franchising Code of Conduct 2014. This clarified the meaning of "earnings information" and removed the prescription that earnings information must be based on reasonable grounds. The latter was presumably removed because that requirement already flows from the *Australian Consumer Law ("ACL")*.

1.6. This rewriting was useful, however a number of issues still remain with the approach taken towards earnings information by the Code. In my view, those issues are:

1.6.1. On the face of it, item 20 of the disclosure document only applies to earnings information that is actually attached to the disclosure document. A Federal Court interlocutory decision[1] supports this view. Even if item 20 purported to apply to information the franchisor gave that is not attached, there must be serious doubt whether it could do so with the force of law. This is because item 20 is contained in an annexure to the Code. The annexure does nothing more than to prescribe the form and content of a disclosure document. There might be an argument that the expression "may be attached" in item 20.1 contemplates application to other earnings information, but it is more likely that "may" is used because giving earnings information is optional.

1.6.2. The limited application of item 20 is a real shortcoming because where franchisors give earnings information, it is often not attached to their disclosure document. In my experience, many franchisors give earnings information directly to the franchisee without informing their lawyer, so it is not included or referred to in the disclosure document.

1.6.3. The substantive provisions of items 20 of the disclosure document are significant in offering protection to franchisees. Item 20.4 in particular offers important safeguards where the earnings information is a projection or forecast, by requiring the franchisor to give certain pertinent details with the information.

1.7. In my submission, earnings information is such a significant area in franchising that the substance of the provisions of item 20 of the disclosure document should apply regardless of the form in which earnings information is given. In my view, the legislative framework should be changed altogether so that:

1.7.1. The giving of earnings information by franchisors is specifically regulated by the *ACL*.

1.7.2. New sections in the *ACL* should mirror the definition of "earnings information" in item 20.2 of the disclosure document, and impose the requirements in item 20.4.

1.7.3. The new *ACL* sections should make clear either that:

1.7.3.1. earnings information, if given, must be attached to the disclosure document; or otherwise

[1] *Manhattan (Asia) Limited v Dymocks Franchise Systems (China) Limited* [2014] FCA 1143 at 66 – 67 per Farrell J

1.7.3.2. That any earnings information the franchisor gives to a franchisee is regulated by the *ACL* provisions, regardless of whether or not it is attached to the disclosure document.

1.7.4. A specific penalty should be introduced for contravention of the new sections of the *ACL*.

## 2. Terms of Reference Paragraph (a)(iv) – Information on the Expected Running Costs of a Franchise

2.1. In my experience, most but not all practitioners in the field of franchising have interpreted item 14.7 of the disclosure document to require information about the expected running costs of a franchise.

2.2. However, the item could provide further details of the types of costs that should be included. For example, I have seen a significant number of disclosure documents that do not contain:

2.2.1. "Cost of goods sold" figures, for a business that sells goods.

2.2.2. Staff costs.

2.3. It might also be appropriate to specify that, in the case of "cost of goods sold" figures, they should be given as a percentage of revenue, as arguably any other formula for the figures is of limited use to a prospective franchisee.

## 3. Terms of Reference Paragraph (e) – Adequacy and Operation of Termination Provisions in the Code

3.1. The Code's termination provisions have remained largely unchanged since the introduction of the Code in 1998.

3.2. Termination is more difficult for a franchisor than it is for a party normally under a commercial contract. This is intentional[2]. It appears to have been done to guard against a number of problems arising from the imbalance of power between franchisors and franchisees, including churning of franchises and the high cost of legal actions by franchisees. In my submission, the Code's approach to termination has largely achieved its aim of adjusting the power imbalance.

3.3. However, a number of issues remain. Most of the problems seen in practice, in my experience, relate to the power of a franchisor to terminate the franchise agreement

[2] See *Trade Practices (Industry Codes – Franchising) Regulations 1998* Explanatory Statement – 1998 No. 162 – 'Problem Identification and Specification of Regulatory Activities – para. 4

after giving a notice of breach. The problems can affect both a franchisor and a franchisee's legitimate interests.

**Anomalies Concerning Termination for Breach**

3.4. Where a franchisor intends to terminate a franchise agreement because of the franchisee's breach, clause 27(2) of the Code requires the franchisor to give the franchisee a notice. Under paragraph (b), the notice must "tell the franchisee what the franchisor requires to be done to **remedy** the breach" (emphasis added). Problems arise because the meaning of "remedy", and any limitations that might apply to a remedy are not elaborated upon.

3.5. The fundamental issue here is that there is a distinction between breaches of a franchise agreement that can be rectified and those that cannot. There may be a further class of breaches that can be neither rectified nor remedied. For example:

| **Breach** | **Rectifiable?** | **Rectification/remedy** |
|---|---|---|
| Failure to pay royalties | Yes | Making payment |
| Failure to meet minimum revenue requirements for a financial quarter | No, not *post facto* | Arguably can be remedied, by making up for it in subsequent quarters |
| Engaging a sub-contractor to provide a service to a customer | No, not *post facto* | The franchisee could be required not to do it again? |
| Failure to prepare food in accordance with franchisor's recipes, leading to customer complaints | No, not *post facto* | The franchisee could be required not to do it again? It could also be asked to compensate the customers; perhaps also to pay an amount to the franchisor for damage to reputation and other expenses. |

3.6. By failing to make these distinctions, the Code provisions allow the following situations to occur (for brevity, I will refer to a breach that cannot be rectified as "unrectifiable" and a breach that can be remedied, though not rectified, as "remediable"):

3.6.1. There is some uncertainty whether a notice of breach concerning an unrectifiable (but remediable) breach can validly give rise to a right to terminate the franchise agreement.

3.6.2. For breaches that are remediable but unrectifiable, there is uncertainty around whether any fetters apply to the remedy specified by the franchisor.

3.6.3. It is unclear whether, by way of a remedy, the franchisor could simply require the franchisee not to commit the same breach again. This is arguably not a remedy, but a proscription on future breaches of the same kind.

3.7. By way of illustration, using the examples above, it is uncertain whether the following notices of breach would be valid:

| **Breach** | **Specified remedy** |
|---|---|
| Failure to meet minimum revenue requirements for a financial quarter | In the next financial quarter, from June to September, the franchisee's revenue must be $50,000 above the minimum revenue requirement. |
| Engaging a sub-contractor to provide a service to a customer | The franchisee must not engage, at any time in future during the term of the franchise agreement, any third-party contractor to provide approved services to customers. |
| Failure to prepare food in accordance with franchisor's recipes, leading to customer complaints | The franchisee must refund to the customers, the respective amounts they paid for their meal. The franchisee must also pay the sum of $1,000 to the franchisor in respect of administration expenses relating to the breach and as compensation for loss of reputation. |

**Suggested Amendments to Clause 27 Code**

3.8. In my submission, a number of paragraphs should be added after paragraph 27(2) of the Code, as follows:

*"(3) If the breach can be rectified, the remedy specified in the notice must be the rectification of the breach.*

*(4) If the breach cannot be rectified but can be remedied, the remedy specified in the notice must be no more than is reasonably necessary to:*

*(a) address the breach so as to prevent or reduce the likelihood of a re-occurrence of the same breach in future; and/or*

*(b) compensate the franchisor for any loss suffered or likely to be suffered as a result of the breach; and/or*

*(c) compensate any other parties for any loss suffered or likely to be suffered as a result of the breach.*

*(5) [current paragraph (3)].*

*(6) [current paragraph (4)].*

*(7) If the breach cannot be rectified and cannot be remedied in accordance with paragraph (4), then instead of a notice under paragraph (2), the franchisor must give to the franchisee notice in writing that if the franchisee commits the same breach of the franchise agreement on any subsequent occasion, the franchisor proposes to terminate the franchise agreement because of that breach."*