MEMORANDUM

DATE:	**12 September 2008**
TO:	**Secretary, Parliamentary Joint Committee on Corporations and Financial Services**
FROM:	**Peter A. Piliouras, Company Legal Officer - Peregrine Corporation**
SUBJECT:	**Inquiry into Franchising Code of Conduct**

Introduction

The Peregrine Group of Companies ("**Peregrine**")[1] welcomes the opportunity to make this submission to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into the operation of the Franchising Code of Conduct (the "**Code**").

Peregrine has reviewed the questions put forward for discussion by the Committee and provides its submissions in relation to whether an obligation to act in "good faith" should be prescribed by the Code.

Overview

Peregrine is a national retailer with its franchise operations currently based in South Australia. Together with its associates, it owns and operates over 80 businesses in several franchise systems.

Peregrine makes these submissions based on its 20-plus year history of retailing and involvement in franchise systems, from its experiences as franchisee, franchisor and master franchisor and from its general understanding and observation of the franchising industry.

[1] Peregrine corporate website: http://www.perecorp.com.au

Arbitrary Termination

Peregrine is concerned that the Code does not currently prohibit or sufficiently restrict the ability of franchisors to terminate franchise agreements in arbitrary circumstances. In its submission dated 23 February 2008 to the Inquiry into Franchising by the South Australian Economic and Finance Committee (the "**State Committee**"), Peregrine observed that:

> [w]here the Franchisee has used "reasonable endeavours" or perhaps "best endeavours" to rectify a breach of the Agreement, but not done so to the satisfaction of the Franchisor, the Franchisor should be restricted from terminating the agreement. For example, if the Franchisor gave the Franchisee reasonable opportunity to rectify 30 issues, and 29 were rectified to the satisfaction of the Franchisor, it would be unfair for the Franchisor to begin the termination process.
>
> Further some Franchise Agreements stipulate that the Franchisee from the onset is given a set number of chances. For example, if a franchisee breaches the agreement on more than 3 occasions, the Franchisor may elect to terminate, notwithstanding that the Franchisee has remedied those issues within the given notice period. This should be expressly prohibited by the Code.

In its final report, the State Committee responded to the above submission by suggesting that an obligation of good faith would assist in creating a "level playing field" in the franchising community, and would "discourage arbitrary termination while introducing an additional measure of accountability".[2]

It is Peregrine's view that whilst an obligation of good faith would no doubt assist in the manner suggested by the State Committee, such an obligation would need to be expressly defined in relation to termination rights of the franchisor. Alternatively, the Code should introduce other measures to address this issue. One such measure would be to prevent termination where the franchisee has evidenced "**due diligence**". Statutory defences of "due diligence" are becoming increasingly common. The Trade Practices Act itself already provides a defence of due diligence in relation to a number of offences.[3]

Clause 21 of the Code deals with termination by the franchisor because of a breach by the franchisee:

> **21 Termination -- breach by franchisee**
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> (1) This clause applies if:
>
> a) a franchisee breaches a franchise agreement; and
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> b) the franchisor proposes to terminate the franchise agreement; and
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> c) clause 23 does not apply.
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> (2) The franchisor must:
>
> a) give to the franchisee reasonable notice that the franchisor proposes to terminate the franchise agreement because of the breach; and
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> b) tell the franchisee what the franchisor requires to be done to remedy the breach; and
>
> c) allow the franchisee a reasonable time to remedy the breach.
>
> (3) For paragraph (2) (c), the franchisor does not have to allow more than 30 days.
>
> (4) If the breach is remedied in accordance with paragraphs (2) (b) and (c), the franchisor cannot terminate the franchise agreement because of that breach.
>
> (5) Part 4 (resolving disputes) applies in relation to a dispute arising from termination under this clause.

[2] Final Report, Franchises, Sixty-fifth Report of the Economic and Finance Committee, page 70.

[3] See e.g. section 85 of the Trade Practices Act 1974 (Cth); section 88 of the Fair Trading Act 1987 (SA); section 26 of the Food Act 2001 (SA); section 41 of the Dangerous Substances Act 1979 (SA); section 232 of the Fair Work Act 1994 (SA).

This clause affords the franchisee some protection insofar as the franchisor must allow the franchisee a reasonable opportunity to remedy the breach before terminating the franchise agreement.

The protection provided by this clause is diminished in any situation involving multiple alleged breaches by the franchisee. This must be understood in the context of a situation where a franchisor might hold the franchisee to a high standard thus giving notice of several "minor" or otherwise "trivial" issues. This is prevalent in the food retail business where compliance with high presentation standards consists of many measures, each individually treated as an individual "breach".

To elaborate, this clause strictly may not provide protection against termination where the franchisee has committed several breaches (however technical or trivial they may be) but not remedied all those breaches to the satisfaction of the franchisor within the notice period.

The operation of this clause is also unclear in the case of a breach that may have been remedied, but then re-occurred, during the notice period.

To illustrate with an example — suppose a franchisor inspected a franchisee's retail operation to identify the following "breaches":

Breaches (1st Inspection):

1. there are cracks in the wall;
2. a light bulb is not working;
3. a staff member is not wearing a name badge; and
4. there are finger prints on the glass of the entrance door..

Suppose further after giving the franchisee 30 days to rectify their "non-compliance", the franchisor conducted an inspection to find the following issues and actions taken by the franchisee in relation to the previous issues:

Breaches (2nd Inspection):

1. there are still cracks in the wall;
2. a different light bulb is not working; the light bulb originally faulty was replaced;
3. a different staff member is not wearing a name badge: the staff member originally not wearing the name badge was counselled and all staff members reissued with the uniform policy; and
4. there are finger prints on the glass of the entrance door: the original finger prints were cleaned and the entrance glass added to the daily cleaning roster which is currently being followed. However, it is impossible to prevent customers from touching the entrance glass and prevent fingerprints at all times of the day.

If this were the case, the franchisor would be entitled to terminate the franchise agreement or at the very least, send the franchisee a letter threatening termination. The franchisor could terminate notwithstanding that:

- most non-compliances were remedied;
- the franchisee exercised **due diligence** to remedy all non-compliances:
- the item(s) of non-compliance is trivial;
- the outstanding non-compliance issue(s) was remedied but occurred again prior to inspection; or
- the outstanding non-compliance(s) was remedied, but not to the subjective standard of the franchisor.

The above example illustrates a potential for franchisors to terminate a franchise agreements where the franchisee has exercised all required "**due diligence**" but not fully remedied the complained breaches.

Peregrine does not believe that a franchisor would normally take every opportunity to terminate their franchise arrangements. Such conduct would not be in a franchisor's interest. However, the franchisor has the power to threaten franchisees with termination. This adds to the already unequal distribution of power between franchisees and franchisors.

The danger for franchisee also arises where franchisors operate their systems at "arms length". Under some franchise systems, the franchisor may give a notice of termination of the franchise agreement without prior notice of a breach. The termination notice includes a condition that it will be revoked only if certain breaches are remedied within, say 30 days. In that case, the notice of termination is self-executing. It is effective to terminate the franchise without any further act of the franchisor, unless the franchisor elects to revoke the termination notice prior to the termination date.

Such systems do not likely take into account any explanations or feedback proffered by the franchisee. This erodes the fundamental relationship of trust between franchisee and franchisor.

Franchisees need confidence that their franchise agreement will not be unreasonably terminated or that they won't be "held to ransom" or "threatened" with unnecessary demands of the franchisor.

The below table illustrates 3 different ways in which Peregrine believes this issue could be easily addressed:

1. Defence of Due Diligence	2. Good Faith Obligation	3. Fundamental Breach Only
➢ Franchisor cannot terminate agreement for breach by franchisee where the franchisee has displayed all necessary "**due diligence**" in remedying the breach.	➢ Introduce overriding obligation to act in good faith. ➢ Illustrate specific acts which are prima facie not "good faith" e.g. notwithstanding clause 21, terminating an agreement where it is unreasonable to do so. ➢ Preferably specify that terminating for breach by franchisee where franchisee has exercised all reasonable "**due diligence**" is not in "good faith".	➢ Only allow termination of a franchisee agreement for breach where that breach is a "fundamental breach". This consistent with the common law in regards to contracts. ➢ The Code could go further than the common law to describe what a "fundamental breach" is.

Conclusion

An obligation of “good faith”: should be imposed. The Code should be relatively proscriptive in regards to what constitutes lack of “good faith” and deal with lack of “good faith” in the context of termination by the franchisor for breach of the franchisee. In that sense, “good faith” must impart a concept of acting honestly and sincerely.

The obligation of “good faith” should be complemented by a defence of “due diligence” which the franchisee can rely on in respect of a termination by the franchisor.

Yours faithfully,
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