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INQUIRY INTO FRANCHISING CODE OF CONDUCT

Submission to the Parliamentary Joint Committee on Corporations and Financial Services

by

Brendan Bailey [1]

The Circumstances surrounding the Making of the Mandatory Franchising Code of Conduct

1. I realise that the Parliamentary Joint Committee on Corporations and Financial Services is likely to be familiar with the points made in the following comments. I think, however, it is worth outlining them in this submission to emphasise the importance of recognising the regulatory approach taken in the existing Franchising Code of Conduct. A useful starting point for understanding the circumstances under which the mandatory Franchising Code of Conduct came into statutory law is found in the *Explanatory Statement* to the Trade Practices (Industry Codes – Franchising) Regulations 1998 No. 162. The *Explanatory Statement* is a public document and it is readily available on the website www.austlii.edu.au under the "Commonwealth" legislation tag. A short selection of quotes from the *Explanatory Statement* (and accompanying Regulation Impact Statement)[2] provides an outline of the problems that the industry faced and the then Government's response in the late 1990s:

> The operation of the franchising sector has been of concern for Government for many years.

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> ...a voluntary Franchising Code of Practice was introduced on 1 February 1993 for a two year trial period ...

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> ...Despite increased resources, the coverage of the Voluntary code extended to around only 65% of industry participants.

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[1] The author of this submission is a former Commonwealth Officer and is now a retiree. The views expressed in the submission are purely personal observations. The observations that are made are submitted to recognise the contribution made by a number of dedicated individuals who have provided advice and support to the franchising industry over a number of years.

[2] Available at http://www.austlii.edu.au/au/legis/cth/num_reg_es/tpcr19981998n162545.html as the *Explanatory Statement* to the Trade Practices (Industry Codes – Franchising) Regulations 1998 No. 162.

...

> The franchising sector is characterised by high dispute levels ...Around 13% of franchisors have litigation with a franchisee and a further 12% claim to have a major dispute with a franchisee.

...

> The [Voluntary] code's effectiveness was hampered by the lack of sanctions for breach of the code including the inability of the administering body to name those that breached the code for fear of defamation action. This led to a large percentage of franchisors operating outside the [Voluntary] code and effectively reduced its market impact.

2. The Regulation Impact Statement to the *Explanatory Statement* of 1998 includes the following regulatory objective in its conclusion to support the Government's response of a mandatory code of conduct:

> **The [Mandatory] Code deals with the major issues of concern raised by industry participants and represents the median road between the views of franchisors and franchisees. It is "light touch" regulation as it focuses on disclosure rather than prohibition.** *[Emphasis added]*

3. Following its introduction in 1998, the mandatory Franchising Code of Conduct has been largely successful – it actually works - even if it has its critics and some grey areas. Like all forms of regulation it can be improved and it should have regular reviews. What is unacceptable, in my view, is to expect the existing mandatory Franchising Code of Conduct to provide solutions to complex legal issues that it was never designed to address and which, in some cases, go well beyond the franchising industry (further discussed below). The Franchising Code of Conduct establishes a minimum mandatory standard on an industry-wide basis. If the time has come to introduce tougher measures promoted by some in the franchising industry, then so be it. Those suggested tougher measures, however, must be subjected to rigorous prior assessment before they are introduced.

4. In saying that the existing Franchising Code of Conduct "works", I do not discount the genuine distress encountered by some franchisees who have encountered difficulties in franchising. Small business is hard work and there is an imbalance in bargaining strength between most franchisees and their franchisor. It would be good if regulation could provide the perfect environment for business but that is yet to be achieved.

A Tribunal at the Commonwealth level has Limited Powers

5. The Economic and Finance Committee of the South Australian Parliament issued its report *Franchises* in May 2008. That report contains a discussion about what it calls the "two-tiered" approach to dispute resolution in the mandatory Franchising Code of Conduct (i.e. mediation or litigation). The South Australian Committee makes recommendations that include the consideration of a Franchise Tribunal.[3] Although well

[3] Parliament of South Australia, Final Report of the Economic and Finance Committee, *Franchises*, May 2008: p. 54.

intentioned, this aspect of the South Australian report warrants comment. The powers of a tribunal at the Commonwealth level are limited by wording in the Australian Constitution. A Commonwealth tribunal may make an assessment of the rights between parties but it is unable to enforce its own order because enforcement is a judicial function – a matter for the courts (*Brandy v Human Rights & Equal Opportunity Commission*[4]). The High Court in *Brandy* touched upon contract law in the following comments:

> Thus, it has always been accepted that the punishment of criminal offences and the trial of actions for breach of contract and for wrongs are inalienable exercises of judicial power (36 Federal Commissioner of Taxation v. Munro [1926] HCA 58; (1926) 38 CLR 153 at 175 per IsaacsJ). The validity of that proposition rests not only on history and precedent but also on the principle that the process of the trial results in a binding and authoritative judicial determination which ascertains the rights of the parties (37 Reg. v. Davison (1954) 90 CLR at 368-370 per Dixon CJ and McTiernan J) . So, when A alleges that he or she has suffered loss or damage as a result of B's unlawful conduct and a court determines that B is to pay a sum of money to A by way of compensation, there is an exercise of judicial power.[5]

6. Mediation is a valuable mechanism to assist in dispute resolution, particularly when it is assumed that the parties look to continue a working relationship. It follows when any internal dispute resolution has not resolved an issue. To that extent the Franchise Code of Conduct is a "three-tiered" process with the "third tier" being litigation in the courts. Mediation is not an exercise in making a binding determination that can be enforced by the mediator – it never is. That does not mean that mediation is not valuable. Litigation is expensive but the Franchising Code of Conduct should not be found lacking simply because it pays due regard to the limitations imposed under the Commonwealth Constitution and offers a relatively low cost dispute resolution mechanism, such as mediation, that will not be undone by a finding of constitutional invalidity. Perhaps with creative skill and complex legislation it may be possible to introduce a form of "franchising tribunal' at the Commonwealth level but if the suggestion is to approximate State-based tribunals such as those that deal with tenancy matters then it must be recognised that such tribunals may possibly gravitate to a court-like system in terms of cost and formality over time.

7. The complexities in dealing with the exercise of "judicial power" under the Commonwealth Constitution go well beyond franchising and it is unhelpful to look to what is light touch regulation (the Franchising Code of Conduct) and expect it to provide mechanisms that go beyond its constitutional scope.

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[4] *Brandy V Human Rights & Equal Opportunity Commission* [1995] HCA 10.

[5] Ibid: paragraph 22 of the judgment (per Mason CJ, Brennan and Toohey JJ).

Commercial Arbitration: Resolution of Disputes by Considerations of General Justice and Fairness (*Ex Aequo et Bono*)

8. The South Australian Committee report, *Franchises*, identified suggestions of a low-cost arbitration system as additional to the existing dispute resolutions mechanisms already specified in the Franchising Code of Conduct. The South Australian Committee's recommendations included consideration of a specific Franchise Arbitration Unit.[6]

9. Conventional commercial arbitration is a useful process for parties in a contractual relationship but it can be expensive and usually involves agreeing to apply the laws of a specified jurisdiction. Franchisees would be disadvantaged if the jurisdiction was the home State of the franchisor based on the other side of the country. This issue would have to be addressed in any expansion of the dispute resolution provisions of the Franchising Code of Conduct.

10. From what I have read, I note that commercial arbitration may take more than one form and this includes the process known as *Ex Aequo et Bono*, or resolution of disputes by considerations of general justice and fairness by an expert adjudicator – rather than strict application of the rules of law. Loosely described, this process is sometimes viewed as stepping "outside" the law to achieve an expedient resolution of a dispute. A commentary on *Ex Aequo et Bono* states:

> It is ideally suited to resolving disputes between parties who are engaged in complex and long-term relationship or in emerging fields in which the law is either inadequately developed or unsuitable to resolve complex disputes.[7]

11. Although arbitration by way of *Ex Aequo et Bono* can be an informal and prompt process there are some issues that may present discomfort for franchisees in particular. For example, this form of arbitration is seen as "outside" the law and it is difficult, therefore, to envisage an appeal to a court because there may be no readily identifiable "question of law" involved. Also, such a dispute resolution provision in a contract is sometimes seen as a "waiver clause" and it is treated warily. An experienced judge has noted that this process of arbitration may raise concerns when there is an inequality of bargaining power between the parties.[8] The experienced judge was mainly discussing international commercial arbitration but noted that reservations about such a process of arbitration may change when it is considered that it may be preferred by

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[6] Parliament of South Australia, Final Report of the Economic and Finance Committee, *Franchises*, May 2008: p. 54.

[7] See Trackman, Leon, *Ex Aequo et Bono: De-mystifying an Ancient Concept* [2007] UNSWLRS 39.

[8] See Lord Cooke of Thorndon (Lord of Appeal in the United Kingdom), *Party Autonomy*, [1999] VUWL Rev 37.

business and may also avoid "the clogging of court lists" – thus offering a public benefit.[9]

12. What I am suggesting is that this may be an area where the franchising industry can look after itself i.e. where the parties agree to place their dispute before an expert adjudicator for assessment. It may be argued that resolving disputes by reference to an independent industry expert (or panel) for assessment is confirmation that the industry can facilitate an additional option in dispute resolution itself. Such an option must not, however, displace the right of any party to decline this form of arbitration and to rely on conventional mediation or litigation. There must be no scope for what could be viewed as pressure to follow a particular option.

Penalties for breaches of the Franchising Code of Conduct

13. The South Australian Committee report, *Franchises*, recommends "…that the Franchising Code of Conduct be amended to introduce specific penalties for breaches of the disclosure requirements under the Code"[10]. I assume that the South Australian report uses the word "penalties" to mean what might loosely be called a "fine". This recommendation warrants a comment particularly in light of the recent High Court decision in *Master Education Services Pty Limited v Ketchell* [2008] HCA 38. The High Court explained that a Regulation (the mandatory Franchising Code of Conduct is a Regulation under the *Trade Practices Act 1974*) must be placed in its statutory context and be consistent with the legislation under which it is made. The High Court in rejecting the imposition of a common law sanction that would have rendered a franchise agreement unenforceable held that provisions dealing with the consequences of non-compliance with the Franchising Code of Conduct are found in the *Trade Practices Act 1974* itself. I acknowledge that to apply the provisions under the *Trade Practices Act 1974* involves litigation but, for the reasons outlined above, that is the nature of the Commonwealth scheme.

14. I suggest that it is important to any understanding of the *Trade Practices Act 1974* and its Regulations to appreciate how the legislative provisions are designed to operate. It is necessary to assess whether the specific provisions impose a norm of conduct or whether, where a breach has been established, they may lead to a liability such as a "fine". The High Court in *Ketchell* said of the 1998 legislative provisions which introduced the Franchising Code of Conduct (and other provisions):

> At the time of the additions to the legislation which were made by the 1998 Act, the significance for the operation of the Act, as a whole, of the imposition of norms of conduct such as those in s 51AD (and s 51AC) was well understood from the authorities dealing with s 52 of the Act.[11]

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[9] Ibid.

[10] Parliament of South Australia, Final Report of the Economic and Finance Committee, *Franchises*, May 2008: p. 42.

[11] *Master Education Services Pty Limited v Ketchell* [2008] HCA 38: paragraph 31.

[Section 51AD basically says a breach of an industry code is a breach of the Trade Practices Act 1974. Section 52 relates to misleading and deceptive conduct – an allegation that may arise in franchising disputes.]

15. The call for imposition of penalties under the Franchising Code of Conduct may be understandable but it requires an analysis of some complexity which goes well beyond any goal of "tougher" sanctions in regulating the franchising industry. For example, the *Trade Practice Act 1974* applies to business in the broad sense and a breach of section 52 (misleading and deceptive conduct) or section 51AC (unconscionable conduct) does not attract a "fine". The remedies for a beach of section 52 or section 51AC include such remedies as damages, injunctions or a finding that part or whole of a contract is void. These remedies are set-out in another part of the Act.[12] Other conduct provisions in the *Trade Practices Act 1974* that deal with a breach of the Act attract offence provisions and "fines". As the High Court said in *Ketchell*, the *Trade Practices Act 1974* contains flexible and elaborate provisions that can deal with the consequences of breaching the Act.[13] It is accepted that in a very serious franchising dispute the conduct alleged may involve a whole range of sanctions including breaches that should attract offence provisions and "fines" or even "contempt" provisions if a remedial court order is not followed. I suggest that it is not helpful, however, just to seek penalty provisions in franchising matters without having a careful consideration as to how that sits with the elaborate provisions in the *Trade Practices Act 1974*.

Good Faith

16. There are helpful commentaries on whether the duty of "good faith" is applicable in Australian contract law.[14] It is an issue that goes well beyond franchising but, certainly, "good faith" is relevant in the franchising industry. Good faith is mentioned in section 51AC of the *Trade Practices Act 1974* as a factor that may [*nb*: not *must*] be taken into account by a court when determining whether unconscionable conduct has occurred. The *Trade Practices Act 1974* does not provide a legislative definition of "good faith". To my mind this can be an indication that the legislature considers that the concept is already well understood or it has left the doctrine to the courts to develop when interpreting the statute. I can only suggest that it is probably the latter presumably because of the apparent debate between lawyers and economic theorists over imposing a restraint on self-interest exhibited by contracting parties wanting to maximise their own side of the deal. To the credit of the Parliament - via the *Trade*

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[12] A useful guide on the *Trade Practices Act 1974* is Russell V Miller, *Miller's Annotated Trade Practices Act*, 29th Edition, Thompson Law Book Company, 2008. See for example the commentary at page 533 on section 52 and the remedies available for a breach.

[13] Op Cit: paragraph 38.

[14] See for example: Harper, Matthew, *The Implied Duty of "Good Faith" in Australian Contract Law*, [2004] MurUEJL 22.

Practices Act 1974 – it has at least "had a go" at expressly introducing the doctrine into statutory law – even if it is undefined and a factor that *may* be taken into account.

17. As discussed above, the High Court in *Ketchell* has explained that provisions dealing with non-compliance with the Franchising Code of Conduct are found in the *Trade Practices Act 1974*. However, it may assist users of the Franchising Code of Conduct if the parties were expressly reminded by a clause in the Code to observe "good faith" when complying with their obligations under the Franchising Code of Conduct. This suggestion will draw an understandable response that "good faith" (which is a complex doctrine) should be defined because it contains a number of elements such as cooperation, reasonableness, proper purpose, legitimate interest and an overall nature of acting fairly and honestly.

18. Again, what seems a simple and common sense suggestion for the Franchising Code of Conduct addresses an issue of some complexity in law and it is likely to present polarised views. However, the Franchising Code of Conduct was ground-breaking legislation when it was introduced in 1998 and it has survived – so far.

Conclusion

19. I consider it is important to have regard to how the High Court of Australia has approached its analysis of the Franchising Code of Conduct in *Ketchell*. It is important to start with an understanding of the circumstances that prevailed at the time the Franchising Code of Conduct was introduced and what was intended by making the Franchising Code of Conduct in the form that it appears. I suggest that the Franchising Code of Conduct was never intended to be punitive and draconian. It is mandatory on a national basis but it is light touch regulation that has been carefully drafted with the intention of raising standards of conduct in what is a vital sector of the Australian economy.

20. Like all legislation, the Franchising Code of Conduct should be reviewed periodically and, if necessary, modified to meet changing circumstances or pressing issues (such as provisions to deal effectively with the renewal of franchise agreements). If the consensus of opinion is that the franchising industry requires "tougher" regulation then that should not, in my opinion, be achieved by twisting the existing light-touch regulatory measure into something it was never designed to be. My suggestion is to look to a different model of regulation.

Brendan Bailey
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