FRANCHISING UPDATE

Date: July 2016

By: Chris Nikou, Anna Trist, Philip Vickery

Franchising is set to undergo change following the Australian Federal election. The Senate Standing Committee on Education and Employment recently recommended further amendments to the Franchising Code of Conduct to allow franchisors to immediately terminate franchisees that commit a serious breach of workplace legislation. Changes to other workplace legislation impacting on franchisors would not be unexpected and would follow global trends in this area.

K&L Gates will keep you updated in respect to any changes implemented.

In this newsletter, we include comments on:

- the role and liability of franchisors for workplace law breaches by their franchisees
- the obligation franchisors have to act in good faith and consider franchisee interests when developing business strategies – a recent case
- the impact of the unfair terms legislation on franchisor and franchise agreements
- the risks faced when false testimonials and reviews are used by franchisors or franchisees
- matters to consider in your yearly update of the disclosure document.

Quick links

- Franchisor Liability for Workplace Law Breaches
- Slicing the Profits: What are the Good Faith Obligations?
- Are you Ready for the Extension of the Unfair Contract Terms Regime to Franchise Agreements?
- False Testimonials and Reviews – Learning From One Franchisors Mistake
- Yearly Disclosure Document Update Time

FRANCHISOR LIABILITY FOR WORKPLACE LAW BREACHES

A franchisor can be penalised for the failure of its franchisees to comply with the *Fair Work Act 2009 (Cth)* (FW Act), and things may be about to get tougher.

The Fair Work Ombudsman's approach so far suggests that the more day to day involvement and control a franchisor has in the operation of the businesses of its franchisees, the more likely that it would have the requisite knowledge and involvement in contraventions of the FW Act to be liable as an "accessory" under s550.

A High Standard for Franchisors

The threshold required to satisfy the accessorial liability test is a high one. A franchisor must be *"knowingly involved in"* a contravention by a franchisee of a civil remedy provision in order to be an "accessory" to that contravention.

A franchisor (including its managers, human resources practitioners and other senior leadership personnel) is *"involved in a contravention"* if it:

- aided, abetted, counselled, procured or induced the contravention
- conspired with others to effect the contravention
- were in any way, directly or indirectly, knowingly concerned in or a party to the contravention.

The franchisor must also have actual knowledge of the essential facts that make up the contravention, or have participated itself in the contravention. Actual knowledge includes:

- being 'wilfully blind;' or
- deliberately shutting one's eyes to the facts.

Are Things About to Get Tougher? The Coalition's Policy to Protect Vulnerable Workers

The Coalition's signature workplace policy proposes to strengthen the FW Act to protect vulnerable workers engaged within franchise networks.

The Coalition's Policy to Protect Vulnerable Workers takes a tougher stance against employers, including franchisors, who ignore their workplace relations obligations. The Policy does this by:

increasing the penalties for deliberate non-compliance with record keeping obligations from a maximum of AUD27,000 per breach to AUD270,000 per breach; and

making franchisors who fail to deal with the exploitation of workers by its franchisees liable for breaches of the FW Act where:

> the franchisors should have been reasonably aware of the franchisees' breaches; and
>
> the franchisor could have reasonably taken action to prevent the breaches from occurring.

Importantly, the proposed amendments to the FW Act will exempt franchisors who have taken reasonable steps to educate their franchisees about their workplace obligations and have assurance processes in place.

Actions for Franchisors Post 2 July 2016

Now that the Coalition has been re-elected, if the proposed amendments to the FW Act are passed, franchisors will need to look at what reasonable steps can be taken to minimise the risk of being found to have failed to address non-compliance within its network.

Actions for franchisors may include:

- implementing learning and development programs for new and existing franchisees focusing on employee entitlements and workplace obligations
- providing ongoing workplace relations and human resources training to ensure all persons who have a supervising or management responsibility within the franchise network are aware of their legal obligations and the rights and entitlements of workers from a workplace, safety and migration law perspective
- reviewing franchise agreements to express the obligation for franchisees to comply with workplace laws and give the franchisor the ability to require the notification and rectification of breaches within specified timeframes
- considering available auditing methods to monitor franchisee compliance such as:
  - sample auditing of employee time sheets, pay slips and entitlements
  - external specialist random auditing of franchisees, and/ or
  - establishing a dedicated telephone hotline service for workers to report potential non-compliance with workplace laws.

This article was written by Belinda Copley, Special Counsel, in the Brisbane office

SLICING THE PROFITS: WHAT ARE THE GOOD FAITH OBLIGATIONS?

A recent decision handed down on 5 February 2016 by the Federal Court of Australia provides an interesting example of how the duty to act in good faith applies in practice.

In *Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd*[1]franchisees of Pizza Hut stores across Australia failed in their claims against the franchisor for breaches of contract, negligence and unconscionable conduct in relation to a franchise-wide pizza price reduction strategy.

The defendant, as franchisor of the Australian Pizza Hut franchise, introduced a price reduction strategy across all stores that reduced the maximum price of the Pizza Hut pizza ranges from AUD9.95 to AUD4.95 and AUD11.95 to AUD8.50, respectively (Pricing Strategy).

The plaintiff, as the representative of the Pizza Hut franchisees, argued the franchisees had suffered economic loss due to the Pricing Strategy and claimed that by introducing the Pricing Strategy, the defendant had:

1. breached an implied contractual obligation to set maximum prices that would enable a franchisee's business to be profitable
2. breached its duty of care by implementing a promotional campaign that caused economic loss to the franchisees

3. breached an implied term to act in good faith, and
4. acted unconscionably by using its powers under the agreement exclusively for its own interests.

The Federal Court found that the defendant had an implied obligation to act in good faith in conducting promotional activities. However, the plaintiff was unsuccessful for the following reasons:

- While the object of the Franchise Agreement was to provide the franchisees with the opportunity to operate a profitable business, this did not extend to a requirement to ensure that maximum prices on all products returned a profit to the franchisee. Profits could be made on ancillary goods sold and the object of the Pricing Strategy was to increase market share and customer retention.
- The franchisor was not privy to the sales information of individual franchisees and the profitability of each store hinged upon a multitude of factors.
- The Franchise Agreement contained a provision expressly excluding liability for unsuccessful promotional campaigns.
- The defendant had conducted trial programs, prepared a financial model and consulted with franchisees and its executives in relation to the Pricing Strategy.
- The failure of the Pricing Strategy was predominantly attributed to the defendant's major competitor pre-empting the Pricing Strategy and adjusting its prices accordingly.

The Court held that, in implementing the Pricing Strategy the defendant had not acted unreasonably, unfairly, dishonestly or negligently. It could not be shown that the defendant had not believed that the Pricing Strategy would benefit the future profitability of the national Pizza Hut brand.

It is important to note that the decision in this case depended greatly on the factual circumstances discussed above. Franchisors should be wary of their obligations to act in good faith and to reasonably consider the interests of the franchisees.

This article was written by Phil Vickery, Partner, in the Brisbane office.

ARE YOU READY FOR THE EXTENSION OF THE UNFAIR CONTRACT TERMS REGIME TO FRANCHISE AGREEMENTS?

In Brief

Since 2010, the Australian Consumer Law (ACL) and the ASIC Act have prohibited and made void terms in standard form contracts with consumers that were unfair.

From 12 November 2016, the Unfair Contract Terms regime (UCT Regime) will be extended to standard form contracts entered into with "small business".

Despite there already being provisions in place to protect the position of franchisees under the Franchising Code of Conduct, the UCT Regime will apply to franchise agreements where the franchisee is a "small business". In fact, franchising is one of the sectors where the ACCC is presently concentrating its education/compliance efforts – and will no doubt concentrate its enforcement efforts following 12 November 2016.

Franchisors need to ensure that the terms and conditions of their franchise agreements and other related agreements are not at risk of being alleged to be unfair and hence be void and unenforceable.

The Unfair Contract Terms Regime

On 12 November 2015, the Treasury Legislation Amendment *(Small Business and Unfair Terms) Act 2015* was passed and received Royal Assent. This act extended the application of the UCT Regime in the ACL and the ASIC Act to contracts with "small business" (defined below).

Under the ACL, a term of a consumer contract (and shortly, a small business contract) is void if the term is unfair and the contract is a standard form contract.

This article will focus on the impact of the extension to small business and its meaning, rather than on each element required to found an unfair term, but in brief:

- the law presumes that the contract under scrutiny is "standard form". It is up to the party that prepared the contract to prove that it is not "standard form" taking account factors such as:
  - whether the contract was prepared by one party prior to discussions with the other party, and
  - whether there was a real opportunity to negotiate the terms of the contract, particularly the terms being examined, or whether the contract took account of the specific characteristics of the counterparty
- a term is unfair if:
  - it would cause significant imbalance in the parties' rights and obligations arising under the contract, and
  - it is not reasonably necessary in order to protect the legitimate business interests of the party who would be advantaged by the term, and
  - it would cause detriment (whether financial or otherwise) to a party if it were applied or relied upon.
- Further, in considering whether a term is unfair, regard has to be given to the whole contract (i.e. the other rights and obligations under the contract) and the extent to which the relevant term was transparent (including whether it was expressed in plain English and readily available to any party affected by the term).

What is a Small Business Contract and Which Clauses are Subject to the UCT Regime?

The UCT Regime will apply to small business contracts entered into after 12 November 2016, or renewed after that date, or amended after that date (although the regime only applies to the terms amended after that date).

- A small business contract is:
- a contract for the supply of goods and services, or a sale or a grant of an interest in land, and
- at the time the contract is entered into one party to the contract is a business that employs fewer than 20 persons; and either the upfront price payable under the contract:
  - is $300,000 or less, or

    - $1million or less where the duration of the contract is greater than 12 months.

- As per the existing provisions, a term that sets the upfront price payable under the contract cannot (itself) be considered as an unfair term.

Below is further commentary about these terms.

Application of the Unfair Contract Terms Regime to Franchise Agreements

Both during the consultation period with Commonwealth Treasury, as well as the enquiry by the Senate Economics Committee, representatives of the franchising industry and in particular, the Franchise Council of Australia, argued that there should be an exemption from the regime for franchise agreements.

The argument for such an exemption was that the franchise industry was already subject to quite prescriptive regulation, including the Franchising Code of Conduct, which give significant rights to franchisees. In particular, agreements could not be entered into without a franchisee receiving written statements from an independent legal adviser or accountant that the franchisee had been advised about the agreement, provided for cooling off period, required parties to act in good faith and provided mechanisms for dispute resolution.

Notwithstanding these arguments, there is no exemption for franchise agreements. Further, the Australian Competition and Consumer Commission (ACCC), the regulator and primary enforcement agency, has stated that "franchising" is one of the key areas where it is presently focusing its education/compliance resources regarding unfair contract terms in the lead-up to 12 November. It will no doubt also be focusing its enforcement resources at the franchising sector after that date, in the event of non-compliance.

In fact, various ACCC publications and speeches relating to the extension of the regime to small business contracts refer explicitly to "franchising" and provide franchising related examples to explain the above terms. The Commonwealth Government has also allocated AUD1.4million to the ACCC to help educate/enforce the new law.

What is a "Small Business" and the "Upfront Price"?

"a business that employs fewer than 20 persons"

The above phrase raises some uncertainty including what is a "business", whether only "employees" are included or whether contractors/labour hire personnel are included, whether it applies to full time/part time personnel and how the larger business/franchisor will know at the time of entering into the agreement the number of employees of the franchisee?

From a risk management/compliance perspective, and anticipating that for the most part it is likely to be the ACCC rather than counterparties that will be investigating/taking action, our views are as follows:

- Both the legislation as well as the guidance from the ACCC refers explicitly to "employees". Accordingly, the starting position is seeking to ascertain the number of employees.

- The legislation states that both permanent and casual employees are to be included in the headcount, as long as the casual employees are employed on a regular and systematic basis. The legislation is silent on part time employees. The ACCC takes the view that a part time employee is still counted as an employee for the purposes of this definition.

- Accordingly, a franchisor has two options:
  - It could take the more conservative or risk averse approach of assuming that all of its franchisees have less than 20 employees and ensuring that the terms of its franchise agreement are compliant with the unfair contract terms regime. Clearly, this reduces risk and is administratively "easier" for the franchisor, as there is one standard set of terms. However, it may have commercial and legal implications for the franchisor. It may provide rights and benefits to franchisees having more than 20 employees where it would not be in the franchisor's commercial interests to provide such rights to its counterparties. The franchisor will therefore "leave money on the table".
  - It may, as part of entering into the franchise agreement, and each renewal, seek written confirmation that the franchisor has greater than 20 employees – and if it wishes to do so can have a different set of terms depending on the response. While the ACCC states that the response of the smaller party is not determinative if in fact the franchisee had less than 20 staff at the time of entering into the agreement, it will have a significant impact of the ACCC's decision making process about investigation and enforcement (on the basis the franchisor took reasonable steps and acted in good faith).

What is included in the "upfront price"

The ACL defines this term as the consideration that is provided for the supply, sale or grant under the contract which is disclosed at or before the time the contract is entered into, excluding:

- any other consideration that is contingent on the occurrence or non-occurrence of a particular event.

In seeking to give examples as guidance for this calculation process, the ACCC sets out a number of "franchising" examples which we have combined for the purposes of this article as follows:

- A franchisor and a franchisee enter into a five year agreement. Under the agreement, the franchisee agrees to pay an upfront fee of AUD500,000 and a monthly royalty based on 5% of the franchisee's sales. The agreement also provides for a AUD6,000 termination fee.
- The ACCC's view is that in seeking to determine whether the upfront price falls below AUD1million, the AUD500,000 will be included, but not the royalty payments as they are contingent on prospective and unknown levels of sales. The AUD6,000 fee is also not included as that is not referable to the supply or a sale under the agreement.
- Accordingly, if the franchisee had fewer than 20 employees:
  - the agreement is subject to the UCT Regime
  - the fee of AUD500,000 is not to be considered under the UCT Regime, however
  - the royalty and termination payments can be considered under the UCT Regime.

What Types of Terms will be Subject to Most Scrutiny?

The legislation (which provides 14 examples of terms that may be unfair), guidelines by the ACCC, as well as a small number of judgments have provided good guidance as to the types of terms at risk. Many of the examples provide for one party having a right that the other does not have, as opposed to reciprocal right. Some examples that the ACCC has particularly focused on are:

- the right to unilaterally vary the contract, including in particular, to vary the price or the characteristics of the goods or services to be supplied
- early termination fees
- limitation of liability (or no liability clauses)
- automatic rollover clauses
- forfeiture clauses
- termination without cause clauses, and
- broad indemnity clauses.

The fact that the ACCC is focusing on the types of clauses above does not necessarily mean that they are unfair. It will always depend on the particular circumstances of each case.

However, as regulators are more likely to intervene when they consider a term is likely to cause a detriment to a material number of counterparties to the larger party, it will be important to ensure that you consider carefully whether you have a legitimate business interest in including such a term in your contracts –and having evidence in place to support the claim of a legitimate business interest.

It is also important to take care about the claims/representations you make, for example in Disclosure Documents and other supporting materials provided to franchisees/prospective franchisees about their rights. While such documents are not subject to the UCT Regime (unless incorporated into the contract) if you misrepresent the rights and obligations under the contract, the ACCC will, in addition to taking enforcement action on the basis of unfair terms, can also allege that you are making misleading or deceptive representations. Breaches of these provisions can lead to very significant penalties.

What To Do/Practical Risk Management Tips

Clearly, franchisors must review their franchise agreements to ensure that they are compliant with the UCT Regime and where there are such terms, consider the rationale for the terms and whether the terms are necessary to protect the legitimate interests of the franchisors – and evidence the necessity for these terms.

However, in addition to these agreements there will be a multiplicity of other agreements which are very relevant to your businesses such as confidentiality agreements, procurement agreements, supply agreements, various services agreements and the like.

While all agreements may ultimately need to be considered from the perspective of unfair terms if your franchisees are small businesses, in terms of prioritising your review, focus on:

- the agreements are core to the operation of your franchise system
- the agreements and the terms most likely to be alleged to be unfair
- the need for each of these terms, and the importance of these terms to your business system:

- consider the extent to which you have had to rely on the term
- consider the implications for you if the terms is not included in the agreement
- consider any "push-back" and complaints from franchisees about the term and the manner in which you have resolved such complaints,

and having regard to the above, come to a view as to whether the term requires amendment or deletion. If the term is in your view necessary to protect your interests, proactively evidence, for your internal purposes, the nature of the interests necessary to be protected.

In addition, again prioritising your core/more important agreements, as part of the same process, consider how transparent/plain English are the terms and conditions of your agreements and whether you need to take any steps to make more transparent or highlight the terms that may be alleged to be unfair but which you consider are necessary to protect your legitimate interests. The more transparent/highlighted the better placed you will be in any negotiations with the ACCC in the future.

As stated above, in addition to considering your agreements, consider the statements made in supporting or related documents that are provided to franchisees/prospective franchisees to ensure that they are not likely to be alleged to mislead them as to their rights and obligations.

Finally, implement processes into your organisations such that future agreements or amendments to agreements, where the counterparties are likely to be small business, are considered from the perspective of unfair contract terms and at the time of inclusion of terms that may be alleged to be unfair, provide for/evidence the rationale for such terms.

This article was written by Ayman Guirguis, Partner, in the Sydney office.

FALSE TESTIMONIALS AND REVIEWS – LEARNING FROM ONE FRANCHISORS MISTAKE

A Whistle & Co (1979) Pty Ltd, is a franchisor of an Electrodry Carpet Cleaning business with over 100 franchisees throughout Australia (except in Sydney). Between February 2012 and June 2012 the franchisor was involved in publishing fake testimonials on the internet. The involvement took the form of posting and requesting that franchisees post false testimonials and reviews about Electrodry on popular product review websites, including Google, True Local and Yelp. Testimonials and reviews were posted from non-existent customers and from people that had not received Electrodry services.

For this conduct, the franchisor was ordered by the Federal Court to pay penalties of AUD215,000. The Court expressly noted that but for the franchisor's cooperation a much larger penalty would have been imposed. Other orders, including injunctions, corrective advertising and the payment of costs were also made.

The ACCC commented on the use of testimonials as a "useful and genuine marketing tool" but stressed the importance that businesses understand "making or inducing false or misleading representations about testimonials breaches the Australia Consumer Law."

The line drawn between acceptable conduct and misleading and deceptive conduct is not always so clearly discernible or observed in practice. Given the lure of the anonymity inherent in the internet and the perceived difficultly of verifying information like testimonials and reviews, many were surprised that the ACCC invested resources to investigate the franchisor's conduct. This case shows that the ACCC does not shy away from taking action, even in circumstances where that action may be difficult to prove. Franchisors, particularly when they are starting out, may be tempted to solicit favourable publicity to increase their online profiles. Franchisors using or allowing the use of testimonials and reviews that are not genuine risk substantial fines and significant risk to the reputation of the franchise system. K&L Gates can assist if you are unsure whether conduct is likely to be assessed as being misleading and deceptive.

This article was written by Anna Trist, Special Counsel, in the Melbourne office.

YEARLY DISCLOSURE DOCUMENT UPDATE TIME

Franchisors with more than one franchisee, must update their disclosure document between 1 July and 31 October each year.

Assuming that the franchise system and franchise agreement itself have not changed, the update is generally limited to the following sections:

- Dates:
  - preparation date (item 1.1(d))
  - number of years operating in Australia (item 2.4)
  - details of changes in franchise ownership in the last financial year (item 6.4)
  - marketing fund expenses from the last financial year (item 15.1(g))
  - date of solvency statement (item 21.1)
- Confirmation that the existing content has not changed over the previous year:
  - company/associates details and experience (items 1.1(b), 2 and 3)
  - whether any litigation or insolvency proceedings have occurred in the last year or with respect to any new directors (item 4)
  - whether the use (or lack of us) of agents has changed (item 5)
  - whether intellectual property has been added or dropped from the portfolio (item 8.1)
  - whether there are any additional suppliers that provide a financial benefit or rebate (item 10.1(j))
  - whether the payments franchisees should expect to make need to be updated (item 14)
  - whether any unilateral changes have been made (item 17)
  - whether capital expenditure has been taken into account in the last year (item 18.2)

    - whether any earnings information provided has changed (item 20)
- Updated franchisee information:
    - numbers of and details of existing franchisees (item 6)
- Updated financial information:
    - financial reports and/or statements/certificates (depending on the option used by the franchisor) (item 21)
    - payments generally (item 14)
    - marketing fund expenses from the last financial year (item 15.1(g)).

In 2016 it is particularly important that franchisors pay attention to ensure that the disclosure document accurately and transparently discloses arrangements which apply at the end of term, renewal and unilateral changes. The particular importance with respect to these issues arises from the application of the unfair terms legislation from 16 November 2016.

Franchisors should also turn their mind to the preparation and (if required) audit of financial reports of any cooperative or marketing funds in accordance with the Code. Financial reports need to be prepared and (if required) audited within four months after the end of the last financial year (usually 31 October). Financial reports must be provided to franchisees within 30 days of preparation and audit reports (where prepared) provided within 30 days of preparation.

There are significant penalties for non-compliance with the Code.

K&L Gates can assist with yearly updates. If you have any queries regarding the completion and use of the disclosure document, marketing/cooperative fund audits or obligations under the Code generally, please feel free to contact us to discuss these in further detail.

This article was written by Anna Trist, Special Counsel, in the Melbourne office.

NOTES:

[1] [2016] FCA 43.

KEY CONTACTS

CHRIS NIKOU
PARTNER

MELBOURNE
+61.3.9640.4354
CHRIS.NIKOU@KLGATES.COM

ANNA TRIST
SPECIAL COUNSEL

MELBOURNE
+61.3.9640.4381
ANNA.TRIST@KLGATES.COM

AYMAN GUIRGUIS
PARTNER

SYDNEY
+61.2.9513.2308
AYMAN.GUIRGUIS@KLGATES.COM

PHILIP VICKERY
PARTNER

BRISBANE
+61.7.3233.1209
PHIL.VICKERY@KLGATES.COM