

Legal Update | Franchising

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Is your business arrangement a franchise?

The Federal Court (the Court), in the decision of *ACCC v Kyloe*, has clarified the criteria set out in the Franchising Code of Conduct (the Code), which determines when an agreement is considered to be a 'franchise agreement'. In particular the Court investigated and expanded on an element of the 'franchise agreement' definition and the meaning of 'a system or marketing plan'.

Background

Kyloe was involved in the business of distributing Polar Krush ice-drink machines and the re-sale of various Polar Krush products including cups, straws and frozen drink concentrate – which were branded goods originating from the Northumbrian Ice Cream Company Ltd (NICC).

The ACCC claimed that Kyloe contravened the Code by failing to provide disclosure documents to sub-distributors of Polar Krush products.

Kyloe argued that their business arrangements with sub-distributors did not constitute a franchise agreement, but rather a distribution or dealership agreement, and therefore the Code did not apply.

The Code is a mandatory industry code under the *Trade Practices Act* (TPA), and outlaws certain provisions in franchise agreements and requires other minimum conditions. It requires franchisors to disclose information about themselves and their associates, both before and after the parties agree to their arrangements. A breach of the Code is a breach of the TPA.

'Franchise agreement' is defined by four criteria irrespective of how parties describe their arrangement. If all four criteria are satisfied and no exception to the criteria is present, then the arrangement is considered a franchise agreement and the Code applies.

The four criteria are:

1. an agreement that is written, oral or implied in whole or in part
2. a grant by the franchisor to the franchisee of a right to carry on a business of offering, supplying or distributing goods or services in Australia, under a system or marketing plan substantially determined, controlled or suggested by the franchisor
3. the franchisee's business operation is substantially or materially associated with a trade mark, advertising or commercial symbol that is either owned, used, specified or licensed by the franchisor
4. the franchisee makes particular payments to the franchisor.

Findings

Firstly, Kyloe argued that there was no right granted to carry on a business as they did not attempt to restrict the development of the sub-distribution. This argument was rejected by the Court.

Secondly, Kyloe argued that there was no system or marketing plan in place. The phrase a 'system or marketing plan' is not defined in the Code. Australian Courts have generally looked to American cases for guidance to define a 'system or marketing plan'. Factors that they have considered include centralised bookkeeping, a scheme where an employee could become regional director etc, reservation by the franchisor of the right to approve all promotional material, comprehensive advertising and suggestions in regards to pricing.

The Court found that while Kyloe had entered into an agreement and granted a right to carry on a business, the ACCC failed to establish the presence of a 'system or marketing plan'. The Court found that there was no such system or marketing plan because there was minimal regulation of the sub-distributor by Kyloe, and in particular they did not provide any training or information in relation to sales, advertising, promotion or prices. As a result the Court held that there was no franchise agreement, and therefore, the Code did not apply to this arrangement. Despite a finding that the arrangement between the parties was not a franchise agreement, the decision provides useful discussion regarding the definition of a 'system or marketing plan'.

Factors determining the existence of a 'system or marketing plan'

The Court referred to the following factors as 'helpful indicators' of the presence of a franchise agreement as identified by Bennett J in *Capital Networks Pty Ltd v .au Domain Administration Ltd*:

1. the provision by the franchisor of a detailed compensation and bonus structure for distributors selling its products
2. a centralised bookkeeping and record keeping computer operation provided by the franchisor for distributors
3. a scheme prescribed by the franchisor under which a person could become a distributor, direct distributor, district director, regional director, or zone director
4. the reservation by the alleged franchisor of the right to screen and approve all promotional materials used by distributors
5. a prohibition on re-packaging of products by distributors
6. the provision of assistance by the alleged franchisor to its distributors in conducting 'opportunity meetings'
7. suggestion by the franchisor of the retail prices to be charged for products

8. a comprehensive advertising and promotional program developed by the alleged franchisor.

The Court referred to some further indicators which were considered by the Court of Appeals of Indiana in *Master Abrasives Corporation v Williams*:

1. the division of a state into marketing areas
2. the establishment of sales quotas
3. the franchisor having approval rights of any sales personnel whom the franchisee might seek to employ
4. a mandatory sales training regime
5. the provision of quotation sheets to the franchisee's employees
6. provision by the franchisor of prescribed invoices and other sales forms
7. a requirement that franchisees elicit certain information from their customers and provide that information to the franchisor
8. a restriction on the franchisee selling any of the franchisor's products without first consulting the franchisor.

While the Court in *Kyloe* stressed that the above list is not intended to be an exhaustive list of relevant considerations it does serve to focus attention on the type of matters which will be used to determine whether the necessary 'system or marketing plan' exists in a particular case.

Implications for Franchisors

Due to the serious consequences for failing to comply with the Code's provisions, understanding when a distribution or licence agreement will be treated as a franchise agreement is crucial. The Court in *Kyloe* stated that if the ACCC's claim that the distribution agreement was in fact a franchise agreement had succeeded then *Kyloe* would have been required to comply with the Code and would have been in breach of the Code.

Distributors or trade mark licensors who do not want agreements with their sub-distributors or licensees to be treated as franchise arrangements and therefore regulated by the Code, must ensure that their arrangements do not satisfy the criteria for a franchise under the Code. The criteria which relates to whether a 'system or marketing plan' exists can be particularly difficult to judge and must be carefully considered.

As compliance with the Code cannot be avoided by referring to a franchise agreement as a distribution or licence agreement, distribution or trade mark licences must be structured appropriately before they are finalised.

Anna Trist | Lawyer

Consent must not be unreasonably withheld to a transfer of a franchise

In May 2008 in the case of *Masterclass Enterprises Pty Ltd v Bedshed Franchisors (WA) Pty Ltd* the Supreme Court of Western Australia (the Court) dealt with the issue of whether a franchisor's consent was unreasonably withheld to a transfer of a franchise.

Background

The franchisor, Bedshed, was engaged in a business with approximately 42 retail stores nationally. In 2003, Masterclass (the franchisee) agreed to purchase the Claremont Bedshed franchised business and entered into a non-exclusive franchise agreement on 12 September 2003 for over 17 years. That franchise agreement said that the business and the premises must at all times be under the direct supervision of the franchisee (or in the case of a corporate franchisee, someone having a substantial interest in the corporate franchisee) and that the franchise cannot be transferred by the franchisee without the written approval of Bedshed, which could not be unreasonably withheld. In effect, the agreement also provided that Bedshed's approval of a transfer was subject to the transferee meeting Bedshed's criteria for the selection of new franchisees

and of the transferee being capable of operating the business as a franchisee.

Masterclass sought to sell Bedshed Claremont to a corporate franchisee, which proposed to have a manager operate the business on a full time basis. Initially the manager had no interest in the corporate franchisee, but was later given a minor interest (of 5%) in the corporate franchisee (and an indemnity in relation to her guarantee and liability as a director). Bedshed refused its consent to the transfer on the basis that it was not satisfied that Bedshed Claremont would be under the direct supervision of a person with a significant stake in the business. Masterclass argued that this was unreasonable and that the clause was an unlawful restraint of trade. Further issues arose as a result of the form of the franchise agreement undergoing changes.

Issues

The case dealt with three issues, namely:

1. Was the consent of Bedshed to the transfer of the franchise unreasonably withheld?
2. Was the requirement that the business be at all times under the direct supervision of the Guarantor (clause 6.2), an unlawful restraint of trade?
3. Was the form of the franchise agreement that Bedshed proposed its 'then current franchise agreement'?

Findings

1. Consent was not unreasonably withheld

The Court held that the franchisor could withhold its consent to the transfer in accordance with the provisions of the Code. Clause 20 of the Code lists circumstances in which a franchisor is entitled to withhold its consent to the transfer of a franchise, however, the Court found this list was not exhaustive. The Court also established that there is an overriding requirement that consent to the transfer of a franchise not be unreasonably withheld.

It was found that the franchise agreement between Bedshed and Masterclass involved a continuing close commercial arrangement over its term. Due to the nature of this franchise agreement, the Court found it was not unreasonable to withhold consent to the transfer on the basis that the business must be supervised by someone with a significant stake in the corporate franchisee.

2. There was no restraint of trade

Although the effect of clause 6.2 of the franchise agreement was to require the franchise business to be supervised at all times under the direct supervision of the guarantor, the Court determined that the franchise agreement did not restrain Masterclass or its directors and shareholders from any other activity. The Court found that there was no basis for concluding that the clause was calculated to have the effect of limiting competition with Bedshed's business, and there was no illegal restraint of trade.

3. 'Then current franchise agreement'

The Court did not accept Masterclass' argument that the requirement that the purchaser sign the new franchise agreement proposed by Bedshed was contrary to the Code, but commented that it was contrary to the existing franchise agreement.

The Court briefly discussed the meaning of the phrase 'then current

franchise agreement'. The franchise agreement between Bedshed and Masterclass required that a purchaser would sign the 'then current franchise agreement'. The Court expressed the view that the new agreement that Bedshed proposed to the purchaser was not the 'then current franchise agreement' (as defined in the existing franchise agreement). Contrary to Bedshed's argument, the Court noted that the phrase 'then current franchise agreement' described an agreement already in force between Bedshed and a franchisee, not one which Bedshed simply proposed to enter into in the future. This was not decided in the case and was merely a comment made by the Court. The Court's comment in relation to this point is contrary to the accepted practice of the franchising industry.

What this means for franchisors

The following conclusions can be drawn from this case:

- The list of circumstances under the Code for which consent may be reasonably withheld is not exhaustive. Depending on the circumstances that arise, such as the close working relationship between the parties and the long term of the agreement, it may be reasonable for the franchisor to withhold consent to the transfer of a franchise.
- Franchisors must consider the implications of the terms 'then current franchise agreement' in franchise agreements.

Recommendations

- Franchisors should review the list of circumstances set out in their franchise agreement where they can withhold consent to a transfer and ensure they are reasonable and only apply that list where it is reasonable to do so.
- Franchisors should discuss with an expert legal advisor the roll out of new franchise agreements to avoid any complications.

Anna Trist | Lawyer

Misleading and deceptive conduct can void franchise agreements

The concept of misleading and deceptive conduct was recently dealt with by the Federal Magistrates' Court (the Court) in the case of *Van Camp v Muffin Break*.

Background

The franchisee in this case, Van Camp, purchased a Muffin Break outlet at the Forest Hill Chase Shopping Centre. It was the first outlet at the particular shopping centre. Van Camp alleged that Muffin Break engaged in misleading and deceptive conduct (contrary to section 52 of the *Trade Practices Act*). Van Camp argued that Muffin Break made a representation that the Forest Hill Chase Shopping Centre site was a suitable site for the establishment of a franchise outlet (which it wasn't) and made further representations regarding the projected sales Van Camp could expect over the initial months of trading (which did not eventuate).

In the franchise documentation executed by Van Camp, there were numerous acknowledgments that the documents were the full embodiment of the agreement and no representations were relied upon.

Findings

The Court found that the nature of the representations, when taken as a whole, were capable of distorting Van Camp's judgment. The representations distracted Van Camp (as they would any reasonable person in the circumstances) from the significance of the acknowledgments which were contained in the franchise agreement he signed. The documents were signed in rushed circumstances and this made them of limited value to the franchisor when using them to rebut their general contention that the representations alleged were never made.

The Court established that Muffin Break, through its employee, Bruschi, engaged in misleading and deceptive conduct when it made representations about the projected sales figures. The Court commented that it was reasonable for a prospective franchisee to rely on a representation of this kind when deciding whether or not to enter an agreement to purchase a franchise. It also considered the fact that there were no reasonable grounds for making the representations, because firstly, Muffin Break denied they were made and secondly the subsequent financial performance of the Forest Hill Chase site suggested the representations were not reasonable. Additionally, it was noted that the site could not be reasonably represented as suitable because there was no proper process where the site was evaluated.

Van Camp was entitled to rescind the franchise agreement and licence agreement (from the time when the agreements were entered into with the respondent). Due to representations made by the franchisor's employee, the franchise agreement and licence agreement were void and the franchisee was entitled to act as if he had never signed them.

What this means for franchisors

- Franchisors should not rush potential franchisees into signing documents.
- Staff should be appropriately trained to avoid making representations, or to only make authorised representations.
- Franchisors should not represent a site as suitable if they have not properly evaluated the site.
- Franchisors cannot always rely on the existence of an acknowledgement clause in the franchise agreement, which states that neither party has relied on representations outside the document, to protect themselves from misleading and deceptive representations made.

Recommendations for Franchisors

- Establish a suitable process to induct franchisees into the system which includes reasonable time for the execution of documents.
- Conduct training of existing staff and incorporate into the induction of new staff information about Trade Practices obligations to assist staff to recognise, understand the importance of and to identify issues that arise in relation to representations.
- Keep information which supports any representations made to franchisees and confirm in writing the substance of meetings held with franchisees.
- Include an acknowledgement which is given by the franchisee as part of a separate document, incorporating questions so that franchisees must actively turn their mind to whether representations were made and positively state that they were not.

Anna Trist | Lawyer

Update on Ketchell

Australia's franchising community can breathe a sigh of relief following the much awaited decision by the High Court in Ketchell, which was handed down on 27 August 2008 and has brought a welcome return to stability for the franchising community. This follows a recent franchising case of Hoy Mobile v Allphones where Justice Rares said the NSW Court of Appeal decision in Ketchell was "plainly wrong".

This decision overruled the July 2007 orders of the NSW Court of Appeal which held that a breach of the Code rendered a franchise agreement illegal.

In a unanimous decision, the High Court held that non-compliance with regulation 11(1) of the Code does not result in the automatic illegality and unenforceability of a franchise agreement.

The High Court looked at the following matters to reach its decision:

1. The purpose of the Code and the Trade Practices Act

Both the Code and the Trade Practices Act are intended to regulate the conduct of persons in the franchising industry to "improve business practices, provide protection to franchisees proposing to enter into franchise agreements and to decrease litigation".

The High Court noted that to render void every franchise agreement entered into where a franchisor had not complied strictly with the Code would give the franchisor an opportunity to avoid its obligations and at the same time place the franchisee in breach of its obligations to third parties.

A preferable result is to permit the franchisee to seek relief (as is appropriate in the circumstances of a particular case) as a franchisee may not wish to be relieved of all of its rights and obligations under the franchise agreement.

2. The provision of remedies under the Trade Practices Act

The detailed provisions of the Trade Practices Act dealing with the consequences of non-compliance with an industry code such as the Code, does not support the harsh conclusion of automatic illegality and unenforceability.

The Trade Practices Act sets out a range of remedies that deal with non-compliance with the Code, including injunctions, damages, non-punitive orders and a range of other remedies (such as those varying contracts, obliging compliance with certain contractual terms and refusing to enforce any or all contractual provisions of a franchise agreement).

It is sufficient that a franchisor is aware of the obligations imposed by the Code and that action may be taken by a franchisee under the Trade Practices Act with respect to a breach of the Code.

The High Court's unanimous decision brings certainty to the franchising community, rendering it unlikely that a breach of the Code will lead to franchise agreements being struck down as illegal and unenforceable.

Implications for Franchisors

Franchisors should continue to strictly comply with the Code, as a failure to do so may attract the other remedies available to the ACCC and to franchisees under the Trade Practices Act.

Lisa Ptasznik | Articled Clerk

Please contact us if you missed our recent eAlert on this topic and would like to receive our eAlerts in the future.

Unfair and harsh terms for independent contractors

On 22 August 2008, the Federal Magistrates Court released its judgment in *Keldote Pty Ltd v Riteway Transport*; a case which should be considered by all franchise businesses using independent contractors.

Background

The applicants were 3 drivers contracted to provide linehaul trucking services between Riteway's Melbourne and Sydney depots. In February 2007, Riteway wrote to each of the drivers requiring them to either upgrade their trailer configurations from single trailer units to 'b double' trailers (2 trailers pulled by a single prime mover), or cease providing the service.

The drivers were to be paid increased fees for their services using the new trailers, but the increase was less than the additional costs associated with acquiring and maintaining the new equipment necessary to perform the contract.

Issues

The *Independent Contractors Act 2006 (Cth)* allows the Court to:

- set aside the whole or part of a contract; or
- vary the terms of the contract,

entered into with an independent contractor where the Court is of the opinion that the terms of the contract are 'unfair' or 'harsh'.

Each contract between Riteway and the drivers contained a clause which required the drivers to replace their vehicles every 5 years (unless otherwise approved by Riteway) and allowed Riteway to approve the type and classification of vehicles being used for the service, subject to the requirements of Riteway "from time to time". The drivers claimed (among other things) that this contractual ability to require them to replace their vehicles without a commensurate compensation for the additional expense was unfair.

Findings

The judgment elicits the factors that the Court will consider when making any future decisions under the Independent Contractors Act. These include the following points.

- The 'unfairness' or 'harshness' of the contract is to be determined at the time when the parties originally entered into it.
- Whether or not a contract is unfair or harsh is a matter to be decided upon examination of the facts of each particular case.

- Unfairness or harshness may arise either from the terms of the contract itself or from the surrounding circumstances.
- The test involves a common sense approach to balancing the respective advantage and disadvantage between the parties.
- Where a contract is found to be unfair or harsh, the Court has a discretion as to whether the contract should be avoided or varied.
- Whilst the discretion allowed to the Court is extensive, it should not interfere with a bargain freely made by a person who:
 - is not being exploited; or
 - was not in a situation of disadvantage, that is, the parties had relatively equal bargaining strength and there was no undue influence, pressure or unfair tactics used during negotiations.

Whilst the drivers challenged a number of aspects of their contracts with Riteway, many of these arguments related to factors occurring after the time that the contracts were entered into and therefore could not be considered by the Court. However, the drivers were successful in establishing that the provisions requiring them to replace their vehicles at Riteway's direction were unfair.

The Court ruled that Riteway's requirements "from time to time" could be manipulated so as to disadvantage the drivers, unless the drivers had the ability to protect themselves from the potential financial burden of acquiring more expensive equipment.

Accordingly, the Court exercised its discretion to vary the terms of the contract so that any replacement vehicle had to have "specifications reasonably equivalent to the vehicle to be replaced".

Recommendations

Franchisors should consider whether the *Independent Contractors Act* applies to their franchise systems. If it does, clauses in the franchise agreement which may be considered 'unfair' or 'harsh' such as clauses requiring replacement of a vehicle "from time to time" should be revisited in light of this case.

Michael Jeffery | Lawyer

Quick Grabs

Mandatory update to disclosure document due to be made by 31 October 2008

Franchisors should keep in mind that they are required to update their disclosure documents by 31 October 2008. The updated document must comply with the amendments made to the Code on 1 March 2008 and must contain information for the financial year ending 30 June 2008. Please contact Middletons if you require assistance to update your disclosure document.

Preparation of annual financial statement for marketing fund to be completed by 31 October 2008

The amendments to the Code introduced a requirement that franchisors prepare an annual financial statement detailing the receipts and expenses of any marketing or other cooperative fund by 31 October each year. This statement must be given to franchisees (regardless of whether they ask for it) within 30 days of it being prepared.

If your franchise system is required to have its financial statement audited, then a copy of the auditors report, which must be prepared by 31 October each year, must be given to franchisees (regardless of whether they ask for it) within 30 days of it being prepared.

If you require more information in relation to your obligations or rights under the Code with respect to the management and reporting for marketing or other cooperative fund, please contact Middletons.

Parliamentary Committee Inquiry

In June 2008 the Parliamentary Joint Committee on Corporations and Financial Services announced that it too would conduct an inquiry to identify improvements to the Code with particular reference to:

- the nature of the franchising industry and the rights of franchisors and franchisees
- whether an obligation for franchisors, franchisees and prospective franchisees to act in good faith should be explicitly incorporated into the Code
- the interaction between the Code and particular parts of the *Trade Practices Act*
- the operation of the dispute resolution provisions under the Code
- related matters.

The Committee is due to release its report in December 2008.

Changes to the Code

Most franchisors are aware of the impact of the changes to the Code, which came into effect on 1 March 2008. The ACCC has provided further guidance in relation to the disclosure process, and in particular what kinds of changes can be made to the franchise agreement without the need for disclosure to be repeated. Middletons provides comprehensive advice to franchisors in relation to the impact of the Code changes. Please contact us for further information.

