	<p>Franchising Council of Australia Legal Symposium</p> <p><i>ACCC report card on franchising issues</i></p> <p>John Martin, Commissioner</p> <p>11 October 2007, Melbourne</p>
---	---

1. INTRODUCTION

The results of the recent Franchising Australia survey (2006) conducted by Griffith University reveal that the growth in the number of franchise systems from 2004 to 2006 experienced a slight downturn.

Industry commentators agree that should at the same time the number of franchisees are overall turnover of the sector has continued to clients be considered a positive sign given the high number of franchise systems per capita in Australia. In fact, some comment¹ that if the growth rate of franchise systems had remained substantially unrestrained and the unemployment continued to be at a low level, the number of failed franchise systems may have increased.

To this point, the level of reported disputes in the franchising sector remains relatively low. Substantial disputes (those referred by franchisors/franchisees to external dispute resolution methods i.e. mediation) were experienced by 35% of participating franchise systems in the past 12 months, but most were with only two franchisees. Both, the survey data and the ACCC database show that mediation is being used extensively as a means of resolving dispute.

In this report card on franchising I will cover:

- an analysis of complaints over the past 12 months
- the three main categories of franchising disputes
- ACCC investigation processes and outcomes
- our continued emphasis on outreach which importantly complements the sector's own education and training programs
- recent developments to make ACCC investigations more transparent particularly matters that have attained a high degree of public exposure; and
- the need for systems to avoid an agreement on précis between franchisor and franchisee and the implications of a NSW Supreme Court decision involving technical breaches of the Code of Conduct

¹ John O'Brian, ACCC Franchising Consultative Panel, 20 April 2006.

2. FRANCHISING COMPLAINTS AND INQUIRIES

In the 12 months to 30 June, the ACCC recorded 855 contacts related to franchising (525 complaints, 330 inquiries). This represents just 1.65% of the total contacts recorded in the national database over that period

The tables below show franchising related contacts and complaints received per month, along with the relevant percentage of total contacts for that month.

Franchising related complaints and inquiries are recorded under a broad range of industry groupings. The categories that have attracted the majority of contacts are: Retail trade (~27%); Rental, Hiring and Real Estate Services (~23%), and Accommodation and Food Services (~8%)

Chart 1: Franchising Contracts

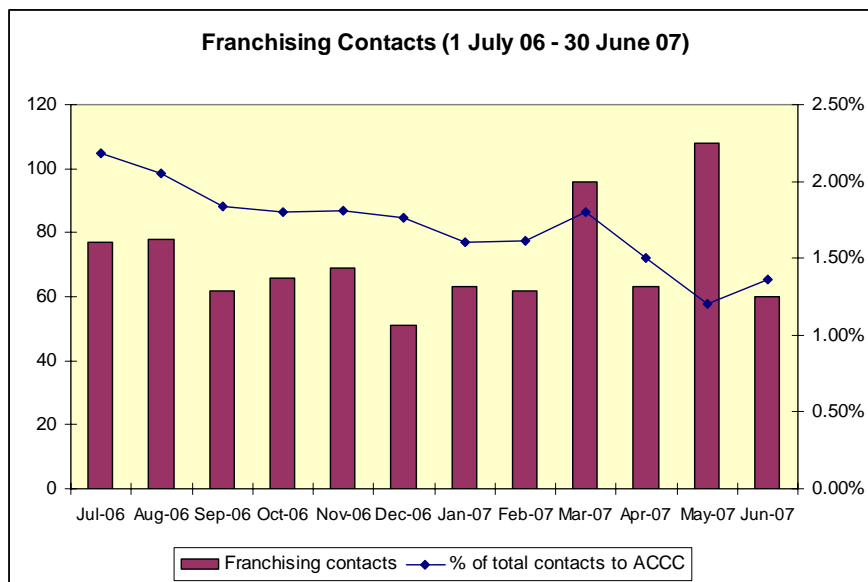
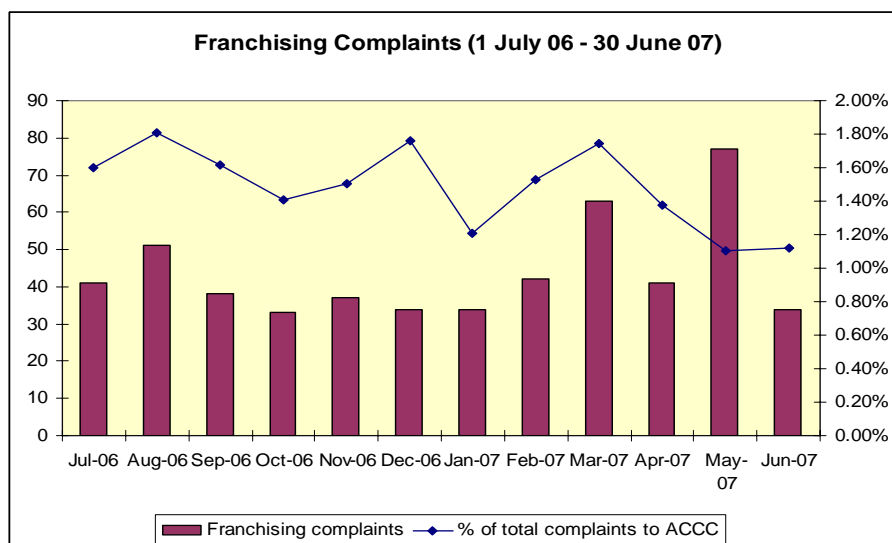
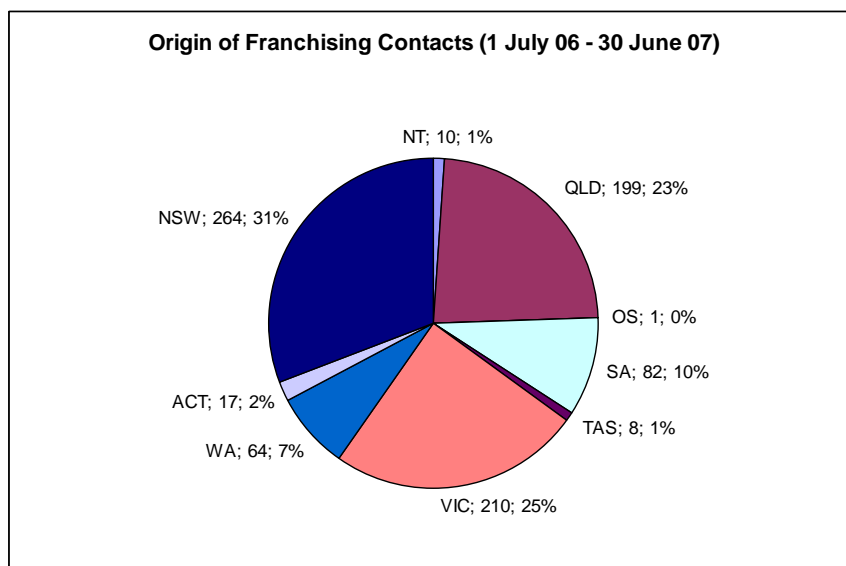


Chart 2: Franchising Complaints



Over the last financial year the level of contacts remained steady with the exception of a couple of spikes. The rise in March 2007 is largely due to inquiries related to the review of the Code and the expected amendments. The May 2007 spike is largely due to the same issue. Conversely, during May the number of franchising contacts as a percentage of total contacts received by the ACCC was at its lowest point for the financial year.

Chart 3 - State breakdown of contacts



NSW, QLD and VIC account for most franchising contacts. There are no observable special characteristics prevalent in one State but not the others. All States show an even mix of the variety of issues registered in the national database in general.

3. THREE MAIN CATEGORIES OF FRANCHISING DISPUTES

It is the ACCC experience that franchising complaints usually allege problems in at least one of two areas under the *Trade Practices Act 1974* (the Act):

- unconscionable conduct in business transactions (s. 51AC); and
- misleading and deceptive conduct/misrepresentations (ss. 52, 53) or
- disputes around the terms of franchising agreement.

These concerns generally fall into three broad categories:

- scams, frauds or outright exploitation;
- issues arising from structural market pressures; and/or
- poor relationship management

Exploitation and scams

The first type of complaint involves circumstances in which a company or individual appears to be intentionally engaging in misleading or deceptive conduct or is wilfully exploiting its superior bargaining position. Complaints falling within this category include business scams harsh and oppressive behaviour and make income from a strategy of “churning” franchisees. Because of the clear cut compliance factors these activities are usually easy to detect and respond to quickly

Structural pressures

This type of complaint occurs when the provision of goods or services by an otherwise genuine franchising system is not working well with the conditions of supply and demand in the market in which that franchising system is competing.

The various ways in which franchisees can be negatively affected as a result of structural pressures can lead to perceptions that a franchisor has treated its franchisees unfairly and may generate complaints alleging misleading or deceptive conduct and unconscionable conduct.

The issues arising from the difficulties experienced by franchisors as a result of the currently tight labour market also fall within this category. The ACCC has observed that this particular type of problem is now on the increase with a number of middle-tier franchise systems, and even some of the larger ones, experiencing systemic structural issues resulting from the difficulties in finding good franchisees.

Poor relationship management

A type of complaint relative to the issue of structural pressures generally arises as a result of poor communication or consultation between parties to a franchise agreement.

It may occur when one party wishes to change the manner in which either the system or an individual franchise does business. Complaints alleging a lack of consultation often arise in relation to advertising campaigns or changes to product lines offered by a franchise system.

Alternatively, relationship management problems may result from the manner in which one party responds to concerns raised by the other party to a franchise agreement. This may include a reluctance to acknowledge the legitimacy of concerns held by the other party or one party perceiving a complaint to be a personal criticism and responding in kind.

4. ENFORCING THE CODE AND RESOLVING DISPUTES

The overwhelming success of franchising has attracted a number of unscrupulous operators looking to capitalise on the rapid growth in the sector, by deceiving potential small business owners with offers of bogus or unworkable franchising 'opportunities'.

The ACCC enforcement actions have been successful in discouraging these operators and it may be observed that the introduction of the Code and its administration by the ACCC has dissuaded a large number of illegitimate and dubious franchise systems from operating in Australia.

Since the inception of the Code the ACCC has taken 15 successful court cases, 14 involved failure by the franchisor to comply with the disclosure provisions of the Code and misleading potential franchisees into believing they were joining a viable business. Some of these cases also involved franchise systems that wrongly represented themselves as distributorships or licence agreements, to avoid the stringent requirements of the Code. Such conduct is fraudulent in nature and the ACCC considers it unsuitable for a mediated outcome. These matters are prioritised among franchising cases as the ACCC believes that if left unaddressed, this conduct has the potential to undermine the framework of the Code and significantly disrupt the sector.

As a consequence the ACCC has been very active in the franchising sector and has been targeting it as a particular area of concern for its enforcement activities. I must note that franchising scams are not the only area targeted by the ACCC, however the sector's diverse nature and rapid change, and growth in recent years, makes this an area where the ACCC has to constantly reassess its compliance/enforcement mix.

The most challenging complaints to deal with for the ACCC are allegations and disputes resulting from the remaining two categories - *structural* and/or *poor relationship management* issues. These generally manifest as persistent complaints of unconscionable conduct, harassment and coercion and/or misleading and deceptive conduct and present as a complex web of interlinking accusations and claims, requiring time consuming investigations to untangle. However, despite the painstaking analysis these matters rarely uncover breaches of the Code or the Act.

The ACCC approaches such matters by checking whether all mediation has been undertaken by the parties. If formal mediation has already occurred and concerns remain, the ACCC seeks to get a clear picture from both sides through direct communication with franchisees and franchisor. It is the ACCC's experience that it may be ineffective to investigate franchising complaints independently from the franchise system they belong to and therefore, a whole-system approach has been adopted by the ACCC investigation process to ensure that if there are systemic issues, they can be identified and addressed.

Under some circumstances and with support from the ACCC, a number of franchisors have also shown a willingness to refine their business practices

and procedures in ways that lessen the genuine concerns of franchisees. There have been allegations in relation to some matters that a so called “churning” model is being applied in what is otherwise a genuine franchise system. To date ACCC has not found evidence to justify such claims.

ACCC investigation processes and priorities

The ACCC’s role as a national trade practices regulator is not to investigate or take action in every matter which may involve a breach of the fair trading and consumer protection provisions of the TPA. Rather, it takes a risk/cost assessment based approach to selecting matters or industry-wide issues of concern which are appropriate for intervention. In particular, the ACCC focuses on matters of national significance and/or widespread consumer or business detriment.

The ACCC investigates a large number of potential breaches of the Act each year. Most matters are discontinued at the initial investigation stage due to insufficient evidence, no breach, complaint withdrawal or failure by the complainant to respond to the ACCC requests for supporting information. A small number of these initial investigations proceed to the in-depth investigation stage at the end of which, if the evidentiary requirements are satisfied, the ACCC may commence court proceedings. However, the ACCC is not limited to litigation in its choice of effective enforcement actions, it can also rely on the options offered by administrative resolutions and court enforceable undertakings under section 87B.

ACCC investigation categories

The ACCC investigation process can be subdivided into three broad categories through which all matters progress:

- initial assessment;
- initial investigation; and
- in-depth investigation.

This process can be summarised as follows:

Stage 1 - Initial assessment

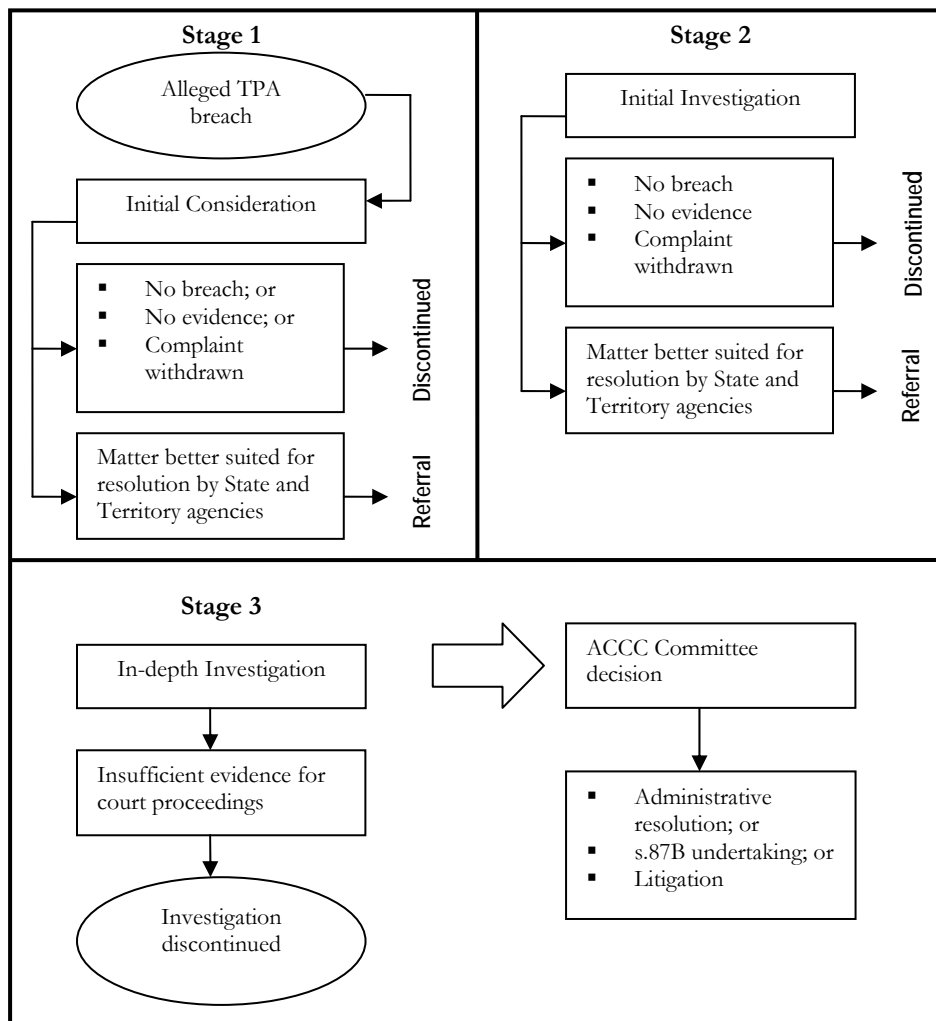
At this stage preliminary assessment of the complaint is made by the ACCC Infocentre staff, ACCC investigators or the ACCC unit specialising in the conduct. The assessment may include the initial interview with the complainant to verify some general data such as, contact details and name of trader; and the initial analysis of the conduct. If the complaint is assessed as valid it is progressed to the next stage.

In some instances the complaint cannot be progressed to investigation due to the reluctance of the complainant to have the matter so escalated, the withdrawal of the complaint or the conclusion reached upon discussions with

the complainant or that the matter is best addressed through dispute resolution. The ACCC recommends mediation as a first step in dealing with most disputes where the ongoing relationship is of value to the parties.

In an effort to streamline this initial assessment process for franchising complaints the ACCC is now trialling a centralised initial assessment system. The system is currently limited to franchising complaints however, if successful, it may be extended to cover other small business issues.

5. THE ACCC INVESTIGATION SYSTEM



Stage 2 – Initial investigation

At this stage the ACCC seeks information from the complainant, and any other relevant persons/traders, to substantiate the claim and establish a precise sequence of events. This may include conducting thorough interviews, obtaining and examining documents pertaining to the alleged conduct and careful application of the law to the known facts.

If at this stage the investigators fail to uncover sufficient corroborating evidence to support the claims, the investigation is discontinued for lack of evidence. In some instances, the facts brought to light by the vigorous process of investigation establish a clear lack of trade practices breach and the matter is discontinued. The complainants are then either referred to a more appropriate agency or advised to seek private resolution.

All complainants are advised that if any new corroborating evidence becomes available it can be provided to the ACCC for review. If new evidence is received the investigation is re-commenced. If the initial investigation process is successful at collecting supporting information and the complainant has not withdrawn the allegation the matter is progressed to the next investigation stage.

Stage 3 – In-depth investigation

At this stage additional evidence is collected and all the existing information is reviewed and analysed by the ACCC senior enforcement staff. If it is agreed that the allegation/s is substantiated and reliable evidence exists to support that allegation, the matter will generally be referred to an internal Committee for consideration. The Committee will then decide how the matter should be most appropriately pursued, having regard to the impact that the action may have on the ongoing business relationship and the national market. The Committee may elect to pursue the matter through litigation, resolve it by administrative resolution or by means of an enforceable undertaking.

In deciding how a matter may be most appropriately pursued, the ACCC considers inter alia the relief available to the complainant and any other persons affected by the conduct. This may necessitate a more efficient and timely resolution than litigation. Furthermore, the ACCC also considers the deterrent effect and precedent value of litigation against other alternatives.

Investigation outcomes

The following table provides a breakdown of the final outcomes for the 106 franchising complaints (only s. 51AD) that have progressed through the ACCC investigation system 2006/2007.

Breakdown of the ACCC franchising complaints outcomes

Resolution	Number
No breach	11
Insufficient evidence	12
Referred to other agency	2
Guidance / Information provided	24
Administrative resolution	1
No action	3
Active investigations	53
Total	106

No breach

Upon more detailed investigation it was determined that the conduct outlined in 11 franchising complaints received by the ACCC did not constitute a breach of the Code. The majority of issues related to contractual disputes between the franchisor and franchisee. In many cases complainants alleged misuse of marketing funds, unfair termination or failure to provide correct disclosure however, more detailed assessment of the issues revealed that the conduct described did not amount to a breach of the Code despite the allegations. For example, in one case the complainant alleged failure by the franchisor to provide him with a disclosure document. When the ACCC investigated the matter it turned out that the disclosure document was in fact received by the franchisee however, the franchisee or his business advisor failed to read it.

Insufficient evidence - A further 12 matters did not progress past initial investigation as there was insufficient evidence to support the allegation/s. While the alleged conduct may have constituted a breach of the Code, the evidence provided was insufficient to establish a contravention. In some of these matters the complainants failed to respond to repeated ACCC requests for further information or withdrew their complaints due to mediation or private action. The consideration of these complaints by the ACCC was discontinued due to lack of evidence corroborating the allegations.

Referred to another agency - Two franchising complaints were referred to mediation following discussions with the complainants. It was agreed that the matter was more suitable for mediation due to the need for ongoing business relationship between the franchisor and franchisee.

Guidance / Information provided - On some occasions the initial complaint is the result of a misunderstanding about the rights and obligations under the Code. Once those are resolved and where appropriate, the necessary clarification is provided, the complaint is also withdrawn.

Twenty four out of 106 section 51AD complaints investigated by the ACCC in the last financial year were resolved by providing complainants with advice or information to enable them to address their issue independently.

Administrative resolution

One matter was finalised through an administrative resolution. In one case the franchisor (a very small business) was genuinely unaware of the application of the law to his business.

No action

Three complaints that may have represented breaches of the Code were not pursued because the complainant were already taking private legal action in relation to the matter, or were taking similar legal action to which this matter could be linked.

Active Investigations

At the time this report card was prepared there were 53 active investigations involving franchising issues.

As you can see from the number of franchising complaints being considered by the ACCC, the majority of investigations are in relation to alleged breaches of the Code however, we also investigate allegations of misleading and deceptive conduct, exclusive dealing, retail price maintenance, price fixing and unconscionable conduct.

Investigation of unconscionable conduct in franchising allegations

Sixty eight franchising complaints received by the ACCC last financial year involved allegations of unconscionable conduct. These allegations generally present as a complex web of interlinking accusations and claims (i.e. misleading and deceptive conduct, harassment and coercion, misrepresentations) and personal grievances, and require intensive, time consuming investigations to untangle the legally relevant facts. As discussed earlier, when investigated by the ACCC, most of these allegations could not be substantiated by sufficient evidence necessary to establish a breach in court proceedings and therefore, had to be discontinued.

However, the majority of unconscionable conduct allegations received were discontinued because the facts did not indicate that the conduct was unconscionable within the meaning of the Act.

While the ACCC considers that these matters are sometimes due to a misunderstanding among small business complainants of the concept of unconscionability under the TPA, it is nonetheless determined to pursue such matters as enable it to clarify the law and thereby firm up a better definition of what constitutes unconscionable conduct

5. FRANCHISING – OUTREACH EDUCATIONAL INITIATIVES

Since the introduction of the Code the ACCC has employed a comprehensive strategy for delivering compliance and awareness messages across Australia and has rolled out a variety of outreach initiatives aimed at reaching all franchisees, franchisors and those considering entering the industry. The ACCC has also published several publications that explain and clarify the rights and obligations afforded by the Act to the franchising sector. When developing these materials and initiatives, emphasis is placed on providing simple, concise materials in a range of mediums, including hard copy booklet and pamphlets, face to face presentations, video/DVD and internet based information.

The ACCC regularly revises its strategy to ensure guidance materials are topical, timely, simple, relevant and accessible. In recent times, the ACCC has undertaken the following educational initiatives which have primarily

targeted prospective franchisees who may not have a strong (or any) awareness of the Code. The importance of exercising due diligence ahead of entering a franchising arrangement has been another focus of the ACCC's materials:

- published and launched *Being Smart about your Retail Lease* – checklist before signing a lease agreement which aims to assist prospective franchisees in making an informed decision before they sign a franchise and related lease agreement.
- presented at Franchise Council of Australia *Franchising 101* Seminars targeted at prospective franchisees.
- launched the new *Franchisee Manual*. This publication was launched in August 2007 and will assist both prospective and existing franchisees in understanding their rights and obligations under the Code.
- implemented the Franchise Opportunity Advertisement Monitoring Project, where advertisements that may potentially be of concern under the Code or the Act are recorded and correspondence and educational publications are sent to the franchisor to assist them in understanding their obligations. The project has already assisted in securing the commitment of a number of major franchising networks in distributing the ACCC educational materials to their potential and existing franchisees. A number of franchisors have also invited the ACCC to present at their annual franchisee conventions.
- coordinated the work of the external law firm selected for redeveloping the *Franchising Code of Conduct Compliance Manual (Franchisor Manual)* which will assist prospective and existing franchisors in understanding and complying with the regulations. The *Manual* is planned for release in September 2007.
- developed an online *Franchisee Start-up Checklist* for prospective franchisees, to assist them in exercising due diligence and providing electronic tools to allow them to do this.
- attended Franchising and Business Opportunity expos in Adelaide, Melbourne, Sydney, Brisbane and Darwin to talk directly with prospective and existing franchisees and franchisors and provide them with information on the Code and the ACCC more generally.
- developed a strategy for reaching prospective franchisees who are of Culturally and Linguistically Diverse (CALD) backgrounds
- organised seminars for prospective franchisees in Brisbane to explain their rights and obligations under the Code, as well as to highlight the importance of 'due diligence' ahead of purchasing any new business

- worked to ensure that the issues of franchising and unconscionable conduct were addressed where appropriate when educating small businesses about the Act.

The ACCC also draws upon feedback from its Franchising Consultative Panel (20 April 2007) and Small Business Advisory Group in respect of existing and emerging issues affecting the sector. The issues discussed at recent meetings have included:

- due diligence by franchisees and franchisors
- the need to match educational materials with potential franchisees to ensure they are aware of regulations and exercise due diligence
- review of the Franchising Code of Conduct (presented by the Office of Small Business, DITR)
- franchising issues and ACCC litigation matters
- ACCC information and outreach activities in the industry sector

The representatives observed that franchisee selection in the environment of very low unemployment was the most challenging issue facing the sector at the present time.

6. OTHER ISSUES

Amendments to the Franchising Code of Conduct

As you will be aware, in July 2006 the Minister for Small Business announced a Review of the *Part 2 – Disclosure* provisions of the Franchising Code of Conduct. The ACCC made a submission to this Review, and was involved in providing commentary on the recommendations (specifically, their enforceability from a regulatory perspective) outlined in the Final Report by the Review Committee, contributing to the Government response.

The *Trade Practices (Industry Codes – Franchising) Amendment Regulations 2007* was tabled at the Federal Executive Council Operations (Exco) on 13 August and were confirmed on 14 August. The new provisions will come into effect on 1 March 2008.

Overview of Amendments

The main changes to the Code, which may affect the ACCC's enforcement activities include the following:

- the definition of a 'serious offence' incorporates an 'offence' as defined under the Corporations Act 2001;

- the exception for application of the Code to franchisors based overseas with only one master franchise in Australia is omitted;
- a disclosure document must conform to Annexure 1 if at any time during the franchise agreement it has an expected annual turnover of \$50,000 or more;
- a franchisee who has received a disclosure document in the form of Annexure 2 and requests additional information in Annexure 1 must be provided with this. The exception of reasonable circumstances is omitted;
- a copy of the franchise agreement in the form it is to be executed is to be provided to prospective franchisees in addition to a copy of the Code and disclosure document, at least 14 days prior to signing an agreement or making a non-refundable payment;
- a franchisor must not induce a prospective franchisee not to form an association;
- franchisors cannot waive any verbal representations within contractual agreements;
- the financial statement for marketing or cooperative funds must be prepared within 4 months of the end of the financial year, additional requirements apply to the exception to waive this where 75% of franchisees agree;
- materially relevant facts must be disclosed within 14 days, not 60, of the franchisor becoming aware of them; and
- undertakings or orders under s87B are listed as a materially relevant fact.

Please note that the above list is not exhaustive. These amendments are reflected in both Annexure 1 and Annexure 2 of the Code.

Proposed ACCC compliance strategy

The ACCC is currently developing both internal and external compliance strategies to educate ACCC staff and the franchising sector about the changes to the Code.

Whilst the strategies are in development, it is anticipated that they will involve the following:

Internally

- distribution of information materials including fact sheets and a comprehensive summary of the Amendments, noting the implication that this may have for investigation and enforcement activities, to all staff, which will be available on the intranet;

- specific training on the Amendments to Infocentre staff; and
- presentation of a training seminar via VCU for all staff outlining the amendments to the Code and allowing for questions.

Externally

- distribution of educational materials including fact sheets that will be featured prominently on the franchising section of the ACCC website and distributed to the sector with the Assistance of the ACCC's Franchising Consultative Panel (FCP) members, notably the Franchise Council of Australia (FCA);
- making the publications available via the www.business.gov.au website;
- liaising with FCP members as to the development of further educational initiatives;
- amending all franchising publications, however, prior to this, alerting the audience to the amendments within existing publications both electronically and in hardcopy noting that some of the information may be out of date and inaccurate;
- focusing on the Amendments within external presentations to the Small Business and Franchising Audience; and
- discussing the Amendments within external training seminars that include, for example, the regular Franchising 101 Seminars that are held by the FCA at which the ACCC presents.

Franchising complaints and inquiries section of the ACCC website

The newly developed franchising information space on the ACCC website (at www.accc.gov.au/franchisinginvestigations) focuses on three main areas:

- the ACCC's processes for investigating alleged breaches of the Franchising Code of Conduct (the Code)
- a summary of the conduct and outcomes of those investigations that have resulted in a court or administrative based outcome, and
- topical concerns and issues.

It is intended that the topical concerns and issues section will address different matters relating to the franchising sector as they arise. At present, it discusses two franchise systems that were the subject of ACCC investigation for alleged breaches of the Code but which were not, for a number of reasons, the subject of litigation by the ACCC. The discussion includes detail of the

allegations made, the ACCC's action in response to those allegations and the conclusions reached as a result of that action.

It should be noted that it is not usually the ACCC's practice to make public comment about investigations that are not formally concluded, whether by section 87B undertaking or litigation. However, the ACCC considers that the two investigations noted on the site have been the subject of:

- considerable public comment (appearing in at least two separate media outlets), and
- of a lengthy (at least six month) investigation by the ACCC and that as such it is in the public interest for the ACCC to comment upon their outcomes.

Similar criteria (relating to public comment and consideration by the ACCC) would be applied to any other investigations information about which the ACCC is considering listing on this area of the website. This area of the site does not constitute a public record or register and as such, the information will be removed after a set period (three months).

Price Fixing

One of the issues that came up this year is the application of section 45 of the Act in franchising. Recently the ACCC investigated a small franchise operating a mobile business. The franchisor established the system seven years ago and continued running it with the same people that were on board when it started. The franchisees had their own vans and conducted their business in exclusive territories set out in the franchise agreement. The franchisor had its own territory and operated a corporate business as well as running the franchise.

The prices these operators were charging remained unchanged since 2005 until last year, when the franchisees, using the opportunity offered by the Annual Franchisee Conference, expressed their concerns over the issue.

As it turned out, the franchisor shared their concern and accepted that the prices needed to be brought up to market levels. Unfortunately, the franchisor then proceeded to discuss the precise figure with his franchisee. The final price was the result of an agreement between the franchisor and the franchisees.

The franchisor and franchisees operated within their exclusive territories, however, but for the agreement to not seek business in another franchisee's territory they would have been competitors. On this basis, the ACCC concluded that the price agreement between the franchisor and franchisees was illegal.

As you are aware, the ACCC is committed to ensuring that all market participants understand their rights and obligations under the Act and strongly believes that prevention is better than cure. Therefore, I suggest that

franchisors and legal advisors in the audience need to be reminded of the application of section 45 of the Act and especially the application of section 45A(8) that states that 'the price fixing prohibition applies not only to the parties in competition with each other but also the parties that, but for a provision of any contract, arrangement or agreement, would be, or likely to be, in competition with each other'. [Emphasis added]

The ACCC understands that granting of exclusive territories is common practice within franchise systems and is often integral to the successful and viable operation of the franchise. The ACCC also understands that the pricing policies of goods and/or services offered by a franchise system are usually determined by franchisors. And, if the franchisor owns any corporate franchise outlets, the franchisor will also adhere to the established pricing system.

These are some of the reasons why the ACCC suggests that you review your pricing practices to ensure they are in full compliance with the law. To assist the franchisors in doing so the ACCC will be running an educational initiative on pricing practices and the Act. If you require any information on the initiative please contact the ACCC staff in the FCA exhibition area or call the ACCC Infocentre.

The NSW Supreme Court decision on a technical breach of the Code *Ketchell v Master of Education Services Pty Ltd* [2007] NSWCA 161

The facts

The New South Wales Court of Appeal handed down its decision in *Ketchell v Master of Education Services Pty Ltd* on 19 July 2007.

The case concerned a claim made by a franchisor, Master of Education Services Pty Ltd, against a franchisee, Ketchell, for unpaid monthly franchise fees. The claim was brought by the franchisor under a franchise agreement executed by it and the franchisee on 11 February 2000.

When entering into the Agreement, the franchisor did not comply with Clause 11(1) of the Trade Practices (Industry Codes Franchising) Regulations 1998 (Cth) (the Code). The franchisee relied upon this non compliance in defence to the franchisor's claim.

The case has a long history. On 8 December 2004 Local Court Magistrate Hodgson found in favour of the franchisor. He held that while the franchisor had failed to comply with clause 11 of the Code, this did not make the contract illegal, citing *The Cheesecake Shop v A & A Shah Enterprises* [2004] NSWSC 625 in support of this finding.

On 29 April 2005, Master Malpass of the Supreme Court of NSW remitted the matter back to the Local Court on the basis that the Local Court had failed to address real issue tendered in defence by the franchisee regarding the franchisor's non compliance with clause 11 of the Code.

At the remitted hearing, the Local Court Magistrate found for the franchisee. He held that:

- (a) a copy of the disclosure document was not provided to the franchisee;
- (b) there was an onus on the franchisor to comply with the mandatory requirement contained in clause 11 before entering into the franchise agreement;
- (c) the Court should not require payment by the franchisee of the monies claimed because to do so would result in the franchisor being in further breach of the Code by recovering non refundable monies where clause 11(1) prohibits that conduct.

The franchisor then appealed that decision of the Local Court to the Supreme Court of NSW.

On 10 February 2006, Master Malpass of the Supreme Court of NSW upheld the franchisor's appeal, and entered judgment for the franchisor. He held that the Local Court Magistrate's finding of non-compliance with clause 11(1) of the Code, though tantamount to a finding of contravention of the TPA in light of section 51 AD, did not render the receipt of the non-refundable payments illegal. He held that the matter was covered by the decision in *The Cheesecake Shop Case*. The franchisee then appealed that decision to the New South Wales Court of Appeal. It is that decision which is discussed in this casenote.

Decision

The Court of Appeal unanimously upheld the franchisee's appeal, with Basten JA and Handley AJA agreeing with the judgment of Mason P.

The issues for decision, as stated by the Court of Appeal, was whether the non compliance by a franchisor with clause 11(1)(a) and (c) of the Code (that is, the franchisor entering into the franchise agreement without the franchisor having received from the franchisee a written statement that the franchisee had received, read and had a reasonable opportunity to understand the disclosure document and the Code) sterilised the contractual claim made by the franchisor for unpaid monthly franchise fees under the franchise agreement on the basis of statutory illegality.

In *The Cheesecake Shop Case*, Windeyer J held that:

“[Section 51AD](#) does not make contracts made in contravention of the Code illegal. The section, like [s51AC](#), is addressed to conduct. The matter is really determined by a consideration of Pt IV of [the Act](#). [Section 52](#) prohibits certain conduct; [s51AD](#) prohibits certain conduct; [s51AC](#) prohibits certain conduct; [s51AA](#) prohibits certain conduct. For all breaches Part VI remedies are available, including a power to declare a contract void. If it is void as illegal, there is no need for this. The argument must fail.”

Mason P disagreed with “so much of the reasoning in *The Cheesecake Shop Case* as holds that a contract that directly contravenes clause 11(1)(a) and (c) of the Code is not rendered unenforceable by the common law”.

The general common law rule is that if the legislature prohibits the making of a contract, the making of the contract does not give rise to an enforceable right or obligation.” (*Trade Practices Commission v Milreis Pty Ltd* (1977) 29 FLR 144 at 158 per Brennan J, citing *Chai Sau Yin v Liew Kwee Sam* [1962] AC 304 at 311

In *SST Consulting Pty Ltd v Rieson* (2006) 225 CLR 516 at 532 the High Court referred to “...the ordinary rule that a contract whose making is illegal will not be enforced.

Mason P considered that:

- (a) Section 51AD read with clause 11 directly prohibits the contract in question, and the recovery of monies claimed;
- (b) Clause 11 provided that given the non-receipt of a written statement in accordance with the sub-clause, the franchisor “*must not*” enter into the franchise agreement; and that it “*must not*” receive non-refundable payments under a franchise agreement;
- (c) There is no need to seek guidance from implications in the legislative framework;
- (d) Clause 11 of the Code prohibits not just conduct, but the contract itself and the recovery of money under it.
- (e) The TPA contains no provision empowering a court to relieve against non-compliance with the directly prohibitory terms of clause 11;
- (f) Nothing in the TPA expressly or implicitly negates the application of the “general rule” referred to in *Milreis* or the “ordinary rule” referred to in the joint judgment in *SST Consulting Services*.
- (g) The combined effect of section 51AD and clause 11 is relevantly on all fours with section 45(2) in that section 45(2) prohibits the making of a contract in certain circumstances

In summary, *Ketchell* is authority for the proposition that a franchisor will not be able to enforce a contractual claim against a franchisor, if the franchisor failed to comply with the mandatory requirements set out in clause 11 of the Code.

In *Ketchell*, the franchisor argued that such a finding brings down contracts for breach of the Code irrespective of whether the breach is substantial or merely minor, technical or procedural. However, Mason P stated that this was an argument that needed to be taken up with the Parliament. It should be noted that not all instances of a franchisor’s failure to comply with a provision of the Code will result in a finding that a franchise agreement is void for illegality.

Mason P reached his conclusion because the express provisions of clause 11 directly prohibit a franchisor from entering into a franchise agreement and receiving non refundable payments unless it receives the required written statement from the franchisee.

What does this case mean for future franchise agreements where cl 11 has not been satisfied and the franchisee wants to enforce its rights?

Ketchell dealt with an application brought by the franchisor seeking to recover money. It is possible that the case will be sought to be relied upon by a franchisor seeking to defend contractual claims brought by a franchisee. Mason P did not seek to make any qualification in his judgment regarding whether the franchise agreement, which was entered into in circumstances where the franchisor did not comply with clause 11, might still be enforceable by a franchisee.

As a matter of statutory construction, it is arguable clause 51AD and clause 11 should be interpreted in a way which allows a franchise to enforce a franchise agreement which was entered into in circumstances where the franchisor did not comply with clause 11 of the Code.

In *Yango v Pastoral Company Pty Ltd v First Chicago Australia Ltd* [1978] HCA 42, a High Court case frequently referred to by Courts considering statutory illegality, Mason J said:

“The principle that a contract the making of which is expressly or impliedly prohibited by statute is illegal and void is one of long standing but it has always been recognized that the principle is necessarily subject to any contrary intention manifested by the statute. It is perhaps more accurate to say that the question whether a contract prohibited by statute is void is, like the associated question whether the statute prohibits the contract, a question of statutory construction and that the principle to which I have referred does no more than enunciate the ordinary rule which will be applied when the statute itself is silent upon the question. Primarily, then, it is a matter of construing the statute and in construing the statute the court will have regard not only to its language, which may or may not touch upon the question, but also to the scope and purpose of the statute from which inferences may be drawn as to the legislative intention regarding the extent and the effect of the prohibition which the statute contains”.

Referring to the above quote, Gleeson CJ, Gummow, Hayne, Heydon and Crennan JJ in their joint judgment in *Australian Competition and Consumer Commission v Baxter Healthcare Pty Limited* [2007] HCA 38 said:

“That passage was cited by Kerr LJ in Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd, where his Lordship said that when a statute contains a unilateral prohibition on entry into a contract, it does not follow that the contract is void. Whether or not the statute has this effect depends upon the mischief which the statute is designed to prevent, its language, scope and purpose, the consequences for the

innocent party, and any other relevant considerations. Ultimately, the question is one of statutory construction. As was pointed out in SST Consulting Services Pty Ltd v Rieson, the Act is far from being silent upon the question of the consequences of illegality, but, rather, contains elaborate provisions. That is not to say that the express provisions of the Act answer all questions that may arise, but they answer many of them, and set the context in which others are to be resolved.”

In *Yango*, Jacobs J said:

“It is often said that a contract expressly or impliedly prohibited by statute is void and unenforceable. That statement is true as a general rule, but for complete accuracy it needs qualification, because it is possible for a statute in terms to prohibit a contract and yet to provide, expressly or impliedly, that the contract will be valid and enforceable. However, cases are likely to be rare in which a statute prohibits a contract but nevertheless reveals an intention that it shall be valid and enforceable, and in most cases it is sufficient to say, as has been said in many cases of authority, that the test is whether the contract is prohibited by the statute”.

In *Tonkin v Cooma-Monaro Shire Council* [2006] NSWCA 50, the New South Wales Court of Appeal considered whether:

- (a) the Council could recover the costs associated with removing noxious weeds from a landowner’s property in circumstances where the Council had not issued tenders for the weed removal works undertaken by a contractor;
- (b) the contractor had a contractual claim against the Council;
- (c) such a contract was void for illegality.

Section 55(1)(a) of the *Local Government Act* provides that a Council must invite tenders before entering into a contract to carry out work that by or under any Act is directed or authorised to be carried out by the council.

Ipp JA, with whom Handley and Tobias JJA agreed, in the context of the contractual claim by the contractor against the Council, stated that:

“There is no universal rule that can be applied to the construction of statutes in order to determine whether the effect of a failure to comply with a provision of a particular statute is to render a category of contracts (or an individual contract) to which that provision applied invalid or unenforceable. Each statute has to be considered as a whole and as a separate entity.”

Ipp JA stated that:

“In my opinion, it is unlikely that the legislature would have intended that an innocent party, who contracts in good faith with a Council that is in breach of s 55(1), is to be left with an unenforceable contract. Parliament

*has provided a remedy (s 435) that operates in respect of non-compliance with s 55(1). To paraphrase Mason J in **Yango** (at 429), it is not for the Court to hold that further consequences should flow with resultant loss to innocent contractors.”*

He referred to *Fuji Finance Inc v Aetna Life Insurance Company Ltd* (1994) 4 All ER 1025. That case concerned [s 16\(1\)](#) of the *Insurance Companies Act* (UK) which prohibited insurance companies from carrying on activities other than in connection with their insurance business. A life insurance company issued a policy of general insurance in contravention of [s 16\(1\)](#). Nicholls V-C held that, although [s 16\(1\)](#) prohibited the insurance company from issuing the policy, Parliament was not to be taken to have intended to render the policy unlawful and unenforceable at the instance of the insured. His Lordship, amongst other things, was persuaded to this view by reason of there being alternative remedies in the legislation, the existence of problems with persons who would be “left high and dry without adequate recourse” against companies which entered into contracts contravening [s 16\(1\)](#), and the fact that default under [s 16\(1\)](#) was not a criminal offence.

He also referred to *Deutsche Rückversicherung AG v Walbrook Insurance Company Ltd* (1996) 1 All ER 791 in which the English Court of Appeal adopted a similar approach. That case concerned a Belgian reinsurance company which entered into reinsurance contracts in the United Kingdom without statutory authority to carry on insurance business there. In doing so it contravened s 2 of the *Insurance Companies Act 1982* (UK) which provided, relevantly, that no person might carry on any insurance business in the United Kingdom unless authorised to do so. The Court of Appeal held that the effect of the prohibition was to make such a contract unenforceable only on the part of the reinsurer. The contract was held to be enforceable on the part of the insured.

Interestingly, no reference was made to *Tonkin* By Mason P in *Ketchell*.

In *Australian Broadcasting Corporation v Redmore Pty Ltd* (1989) 166 CLR 454 it was found that a contravening contract was not illegal and void. In that matter the relevant provision in the *Australian Broadcasting Act 1983* (Cth) provided that the Corporation “shall not, without the approval of the Minister, ...enter into a contact under which the Corporation is to pay or receive an amount exceeding \$500,000”. The majority justices construed the prohibition as ‘directory’, with the direction being addressed to the ABC and not to an innocent outsider. The judges considered this was a case in which the particular legislation was found to preclude common law illegality stemming from breach of the statutory prohibition.

However, in *Ketchell*, Mason P considered that section 51AD and clause 11 were distinguishable from the statutory provisions considered in *Redmore*, although he did not provide any significant details as to why the provisions were distinguishable.

In summary:

- (a) *Ketchell* concerned an application by a franchisor seeking to enforce a franchise agreement in circumstances where the *franchisor* had not complied with clause 11 of the Code;
- (b) *Ketchell* is authority for the proposition that clause 11 directly prohibits a franchisor from entering into a franchise agreement in circumstances where it has not complied with clause 11 of the Code;
- (c) Mason P considers that the terms of section 51AD and clause 11 are express, and that it is not necessary to seek guidance from implication in the legislative framework;
- (d) Judicial analysis contained in caselaw does support an argument that section 51AD and clause 11 should be interpreted in such a way as to allow a franchisee to enforce a franchise agreement where the franchisor has not complied with clause 11 of the Code, but the comments of Mason P in *Ketchell* do not provide any assistance in support of such an argument. The strongest reason why such an argument should be accepted is that it could not have been Parliament's intention, and it would be absurd, if a franchisee was deprived of any contractual rights because a franchisor failed to comply with its obligations (inserted into the Code for the purposes of protecting the franchisee) under clause 11 of the Code;
- (e) Even if a franchisee, or a franchisor, does not have contractual rights under a franchise agreement held to be void for illegality, it may still have other rights in equity, for instance.

Finally, the comments made by Kirby J in *Colin John Fitzgerald v F J Leonhardt Pty Ltd* [1997] HCA 17 are worth noting:

"Illegality, and the associated problems of statutory construction and public policy, have been described as a "shadowy" and "notoriously difficult" area of the law where there are "many pitfalls". Many of the authorities on the point are difficult to reconcile. Commentators claim that some of them are marked by "obscurities, supposed distinctions and questionable techniques of decision". They suggest that this is an area of the law which is "intensely controversial and confused". The House of Lords has recently proposed that it is ripe for thorough re-examination by the Law Commission so that it may be subjected to legislative reform. Special concern has been expressed about the danger that illegality, in some way connected with a contract, will (unless tightly controlled) let loose the "unruly horse" of public policy to a "blind gallop through the doctrinal forests of [the law]". Various other equine metaphors are invoked to express the suggested dangers of uncertainty and the potentially harsh and unjust outcomes that would follow enlargement of court discretions to decline relief on the ground that a contract is somehow touched by illegality".