Submission to the Review of Franchising Regulation

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Submitted by

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Since arriving in Australia in 2001 Dr. Spencer has been conducting research into the regulation of the franchise sector, which culminated in the award of a doctorate in law in 2008. Her dissertation included an analysis of the contracts of 19 different franchise systems in Australia and is entitled 'The Regulation of the Franchise Relationship in Australia: A Contractual Analysis'. A copy of this dissertation is available through the Bond University e-publications website.[1] In addition Dr. Spencer has written and delivered numerous articles, conference papers and seminars on the subject of the law and regulation of franchising. Currently, she is a recipient of a grant to investigate and report on the roles of trade associations in regulatory process. She is also at work on a book, *Understanding the Regulation of Franchising*, tentatively scheduled for publication in late 2009. In the course of her research Dr. Spencer has interviewed a range of franchisors and franchisees as well as other professionals involved in the sector in Australia. She has also interviewed leaders of franchise organizations and participants in the sector in several other countries, including the US, the UK, France and Malaysia. Dr. Spencer is a member of the International Society of Franchising.

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[1] See the Bond University e-publications page at http://epublications.bond.edu.au.

Executive Summary

Many of the problems that the regulation of franchising must address are due essentially to opportunism. Franchisor opportunism is characterized first, by market power to a franchisor which is reinforced by information asymmetry, and second, by contractual power to a franchisor which is reinforced by the relational and standard form qualities of the contract. Franchisor opportunism is an inherent risk at all stages of the franchise relationship, and is not contained by franchisees through the contract. On the other hand, franchisee opportunism, such as free-riding and appropriation of intellectual property, is contained by franchisors largely through the contract.

In Australia there is regulation that addresses the issue of franchisor opportunism; however, disclosure, mediation and the few substantive provisions in the Franchising Code of Conduct do not fully achieve the purposes of regulation. Reviews of the regulation of the sector have led to piecemeal approaches to improving regulation, but the result seems to have led less to solutions and rather to more inquiries.

There are many theories on how best to regulate, and, though these theories represent a diversity of perspectives, some convergence in their formulations can be identified. What is most important is proper process that encompasses the full participation of stakeholders in a comprehensive regulatory program. Such a process must address issues of both franchisor and franchisee performance and opportunism at all stages of the franchise relationship in a way that responds to the context of the market and the conditions in the sector. The franchise sector in Australia has matured and conditions in Australian franchise sector call for regulation that responds to the conditions in a mature market. Where, as in the context of franchising in Australia today, self-regulation is ineffective, outside intervention is called for, using strategies and tools tailored the particular issues in the sector. This submission recommends a revision or re-framing of regulatory process, so that it better reflects principles of best practice in regulation.

Unfortunately, even if such a program were undertaken, reframing the regulatory process for the franchising sector will not help to ease the problems for the people who are vulnerable because of the contracts they are in now. That is why this submission also proposes some shorter-term measures for improving the effectiveness of the existing regulatory program through disclosure, mediation and supplementing the current substantive provisions under the Code.

One such measure is the implementation of a statutory duty of good faith, which this submission considers in particular with respect to the issue of nonrenewal (aka passive termination). This is an issue that is important because it exemplifies the vulnerability of franchisees when franchisor opportunism goes unchecked. It is also an issue of particular relevance to the sector in this year, the tenth anniversary of the Franchising Code of Conduct, when many of the first franchises regulated by the Code may be facing the prospect of termination. This submission concludes that a statutory duty of good faith has the potential to provide protection for franchisees against this form of franchisor opportunism. Statutory good faith has been implemented in several US jurisdictions. As a principles-based regulatory tool, it is particularly appropriate to reinforce the trust and cooperation that are implicit to the function of the relational aspect of the franchise contract but that have been heretofore subverted to the standard form.

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1.0 Franchising offers many benefits, however the problems in the sector caused by asymmetries of power and information remain unchecked by current regulatory regime

Franchising is a complex, multi-faceted, versatile and dynamic organizational form. The many benefits of franchising include its ability to facilitate the efficient expansion/adoption of good business practices; to provide a vehicle for investment as well as a vehicle for training of fledgling entrepreneurs; and to promote the growth of small business. Franchising is personal, it's accessible, and at the same time it's larger-than-life. It has all the excitement of the brand, and the sophistication of modern intellectual property.

This submission is offered in support of a healthy franchise sector, and in the hope that this inquiry will help to forge a way forward to that common goal. To this end the submission describes briefly the some of the common problems in the sector, specifically in the franchisor/franchisee relationship. It then explores the nature of and reasons underlying these problems. This discussion is not intended as a criticism of the franchise model, but as a necessary step in finding solutions. The final section of this submission proposes some options.

Franchising is a sector of the economy in which myths and misinformation persist. Though the regulation of franchising has been characterized as 'the world's most comprehensive and protective regulatory regime for franchisees',[2] the Motor Trades Association of Australia has called for 'the strengthening of the Franchising Code of Conduct.'[3] Some journalists have also suggested that the regulation of franchising could be improved.[4]

The principal risk for both parties in the franchise relationship is opportunism. Essentially both sides want to contain opportunism. Franchisee opportunism can take the form of free-riding on the brand or on the efforts of other franchisees and unauthorised use of franchisor intellectual property. Franchisor opportunism takes the form of encroachment;[5] supply requirements;[6] performance requirements;[7] unilateral

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[2] Andrew Terry, *Fending Off Franchise Failure* (2006) Franchising and Own Your Own Business, <http://www.franchise.net.au/articles/00/0C03ED00.asp> at 17 May 2006. Because businesses have the perception that the Code imposes onerous obligations on the franchisor, they may seek structures that do not fall within the Code definition. They may, for example, purport to operate simply as licences, distributorships or managed service agreements.

[3] MTAA Small Business Charter of Fairness, Item 7. For full charter see <http://www.mtaa.com.au/policies/MTAA-Charter.pdf> at 28 November 2006.

[4] '[T]he current federal Government -- or a future one -- needs to ensure that franchisees are given better protection. …[there is] is no excuse for governments not to strive for best practice in franchising. We are a few rungs short of that.' Peter Switzer, 'ACCC to rule on Quizno controversy', *The Australian* (Sydney), 29 August 2006.

[5] *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310.

[6] *Australian Competition and Consumer Commission v Simply No-Knead (Franchising) Pty Ltd* [2000] FCA 1365 (22 September 2000).

variation; and nonrenewal.[8] Franchisees are also vulnerable to the greater power of a franchisor in retail tenancy arrangements,[9] franchisees' ability to communicate effectively among themselves and franchisor insolvency issues.[10]

Typically, a franchisor can control the opportunism of a franchisee through contract, by imposing specific terms and obligations upon a franchisee. A franchisee, however, cannot use the contract in this way because it does not have a role in its drafting and negotiation. Due to the relational nature of the contract combined with its standard form, a franchisee is left with few tools with which to defend itself against the opportunism of a franchisor.[11]

These problems persist because the franchise relationship is by its very nature characterized by asymmetries of power and information, asymmetries that are reflected and reinforced by market and contract. The abuses that can result have been largely unchecked by court interpretation and regulation.

1.1 The market interaction in the franchise relationship involves greater power to franchisor

In the franchise relationship there is a fundamental asymmetry of power in favour of a franchisor. At its essence franchising allows a franchisor to sell rights to its intellectual property while at the same time keeping control over the use of that intellectual property in order to maximize brand value. A franchisor's reasons to franchise are primarily economic. The choice to franchise addresses problems of capital inefficiency and contains transaction and monitoring costs.

Franchisee reasons to franchise are complex, usually less tangible, and arguably less rational. Even where a franchisee's motivations are based on perceptions of economic benefits of franchising, these benefits are in many cases unproven. Despite

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[7] Regulation fails to ensure that the franchisor's system is adequately developed, tested and implemented, while the contract subjects franchisees to stringent performance requirements, often within systems that are not developed and tested.

[8] See Brickley, James A., and Dark, Frederick H., 'The choice of organizational form. The case of franchising' (1987) in Lafontaine, ed., *Franchise Contracting and Organization* (2005) where this issue is outlined as follows: If the manager of a franchised unit has a large proportion of his wealth and income ties to the performance of the unit, his investment portfolio will be relatively undiversified. There is inefficient risk-bearing. Also, bargaining costs between the franchiser and the franchisee increase when there is the potential for post-contractual opportunistic behaviour. … [A]ssume the franchisee pays for the construction of a distinctively designed building… If the franchiser has the ability to withdraw the use of the trademark before the end of the building's useful life or not to renew the contract upon expiration, the franchiser, by demanding higher franchise fees, can appropriate part of the quasi-rent created by the asset.

[9] See Jenny Buchan, *When the Franchisor Fails*, Report prepared for CPA Australia by the University of New South Wales, January 2006.

[10] Buchan observes that, 'The weakness in franchise agreements (contracts) is that they contemplate and provide for the failure of the franchisee but, almost without exception, are silent about the possible failure of the franchisor.' Jenny Buchan, *When the Franchisor Fails*, Report prepared for CPA Australia by the University of New South Wales, January 2006.

[11] For a detailed discussion of the dynamic in the relationship, see Paul Steinberg, *Beguiling Heresy, Regulating the Franchise Relationship* <http://regulating-the-franchise-relationship.com/> at 23 August 2008.

the current disclosure requirements, prospective franchisees often lack information about the sector and about the particular enterprise (for more on the lack of information see ss2.3 & 2.3.1). A franchisee's choice to franchise therefore is necessarily based less on fact than on emotion because accurate, reliable data about the sector and about individual franchise systems is difficult to obtain.

A franchisor owns the brand; for the sake of the brand, a franchisor maintains strict control at all stages of the interaction, 'the essence of franchise duplication [being] ultimately franchisor control over the way in which franchisees run their business.'[12] A franchisor controls the interaction with its franchisees, obtaining professional advice to draft the contract which it presents to a franchisee as a consumer. In addition to the dimensions of a franchisee's role as, variously, investor, employee, and partner, a franchisee's role as consumer involves power imbalance and subjection to control by a franchisor.

A franchisor has the knowledge, selects this business structure to suit its purposes, and markets the structure to prospective franchisees. Because a franchisor's principal objective is to sell franchises; the information provided by franchisors and franchisor associations is biased and, with no registration or monitoring, may be unreliable. Though one might expect the situation to be better for franchisees in a 'sellers' market' where, as in Australia, qualified franchisees are in short supply, the increased intensity of marketing efforts by franchisors may actually exacerbate the problems of obtaining reliable information.

Thus, at the stages of the market interaction and entry into the contract, which set the tone for the continuing relations between the parties, the franchise relationship indicates a strong tendency toward power imbalance in favour of a franchisor. This imbalance is the result of the nature of the franchise form, which is selected, developed and controlled by a franchisor and in which a franchisee, due to the very nature of the arrangement, must follow a franchisor's direction.

The power asymmetry is also the result of the imbalance of information. Prospective franchisees' information comes in large part from the marketing efforts of franchisors and their trade association, the Franchise Council of Australia. Once a franchisee does decide to purchase a franchise, a franchisee must depend on information about the system provided by a franchisor. While a franchisee's own information about its business does grow over time, a franchisor is generally able to access a franchisee's information through arrangement of information systems and reporting requirements, a franchisee is only able to access a franchisor's information as a franchisor permits.

At the level of the market interaction the combination of franchisor control both over the system and over information sets up a high level of risk of franchisor opportunism and high levels of uncertainty for a franchisee.

1.2 The franchise agreement accords greater power to franchisor

The franchise contract reflects and reinforces asymmetries in the franchise relationship. The relational and standard form qualities of the contract, independently

[12] William M. Dixon, 'What is the Content of the Common Law Obligation of Good Faith in Commercial Franchises?' (2005) 33(3) ABLR 207.

and in combination, equate to greater power to a franchisor and greater uncertainty and higher risk for a franchisee. To compound the imbalance the interaction of the two qualities allows a franchisor shift risk to franchisees. Franchisees who characteristically lack experience with this business form may not be aware that this is happening and are not similarly able to manage risk through contract.

1.2.1 The franchise contract as a relational contract

The franchise contract is a relational contract.[13] Relational contracts are defined by features of incompleteness and longevity. Relational contracts must be flexible, sometimes to the point of being vague. There is often a high level of discretion accorded to the parties, and such contracts therefore rely heavily on reciprocity and on trust that develops over time between the contracting parties, 'Both franchisor and franchisee are involved in what is often a long-term relationship where the basis for economic gain will be ongoing harmony and commitment to a common cause.'[14]

Relational contracts can be understood in terms of what they are not. Relational contracts are not discrete contracts; they are 'continuing transactions rather than "one-shot deals".'[15]

- Discrete contracts are impersonal; bring the future into the present; involve bargaining between parties; are instrumentally-oriented; and require mutual consent from both parties. Each contract is an isolated, independent and autonomous act.[16] [A one-off sale of goods is a classic example of a discrete contract]

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[13] Academic literature on the subject is extensive. 'The franchise agreement signed by franchisee and franchisor represents far more than a simple bilateral contract. Implicit (if not explicit) in a franchise is the relational nature of the arrangement.' William M. Dixon, 'What is the Content of the Common Law Obligation of Good Faith in Commercial Franchises?' (2005) 33(3) ABLR 207. Buchan points out that in franchising, 'The relational contract model is arguably the contract model that best explains the legal basis of the franchise relationship…A relational contract attempts to document and provide for a 'continuing process between people whose interests include maintaining business relations' (Williamson, quoted by Seddon and Ellinghaus, p 1124). 'Two firms that are intimately bound up with each other because of the nature of their business will tend to behave in a less strictly contractual way' than they would do if they had a choice of firms to contract with' (Seddon and Ellinghaus p 1126). This is true of franchising where the franchisor and the franchisee are bound together by the franchise. The franchisor must, however, retain flexibility to experiment and develop the business.' Jenny Buchan, *When the Franchisor Fails*, CPA. Relational contract theory was heavily influenced by the work of Ian MacNeil and Stewart Macauley as well as the work of Goetz and Scott. See also Schwartz, Collins, Hviid, and in particular on franchise contracts as relational see Hadfield, Goddard and Terry.

[14] William M. Dixon, 'What is the Content of the Common Law Obligation of Good Faith in Commercial Franchises?' (2005) 33(3) ABLR 207.

[15] William M. Dixon, 'What is the Content of the Common Law Obligation of Good Faith in Commercial Franchises?' (2005) 33(3) ABLR 207.

[16] Melvin A. Eisenberg, 'Relational Contracts' in Beatson, Jack and Friedmann, Daniel (eds), *Good Faith and Fault in Contract Law*, Oxford (1995), 291. See also Ronaldo P. Macedo, 'Relational Contracts in Brazilian Law', Latin American Studies Association, Guadalajara, Mexico, 1997. Macedo observes that discrete contracts are impersonal - no importance is given to the contracting parties, their belonging to a class, status, group, family or social standing. The predominant idea is that the contract must be kept, based on the "pacta sunt servanda" principle, regardless of the effects it may cause, assumes an essentially selfish, individualist and instrumental conduct by each one of the parties in contractual negotiation. Any premise that the contractual relationship may be predominantly based upon cooperative or solidary behavior is thus excluded. ..Despite the centrality of the idea of meeting

- Relational contracts on the other hand create continuous and long-lasting relationships, 'the terms of exchange are open and substantive clauses are replaced by …clauses to regulate the continuous negotiation process, determined both by promissory relations and non-promissory links … such as status (e.g. weaker party protection), trust and economic dependence.'[17] It is impossible to foresee all the future contingencies and specify all the terms in relational contracts at the time the parties enter the contract. The relational contract therefore 'assumes processual scope... [it] includes terms which establish …processes by which change and adjustment will be specified in the course of contractual performance or fulfillment.' Instead of the one-off, relational contracts 'involve complex relations … in which personal and solidarity, trust, and cooperation relations are determinants.'[18]

In his article, *Franchising, Relational Contracts and the Vibe*,[19] Professor Andrew Terry observes that there has been some reluctance of courts in Australia to embrace the concept of relational contracts, but notes that 'The [New Zealand] High Court's expression in *Dymocks* of the relational nature of franchising is clear and categoric: "The relationship between franchisor and franchisee is not merely a simple bi-lateral contract. It is a relational contract in which a working, on-going relationship is set up for the mutual benefit of both parties. And, from an economic point of view, what is central is the joint maximisation of economic benefits. Both parties are to work in good faith towards that end."'[20]

The importance of the difference between discrete and relational contracts to courts and regulators is that contractual balance can no longer be understood simply in terms of contract formation, but must be understood as it develops over the entire course of the contract relation. 'The very concept of balance… is no longer defined "a priori",

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of minds in classical contractual theory, it acknowledges that non-promissory relations, such as good faith, forbidding of leonine clauses, equity rule, respect to costumes, etc, also interfere in contractual law. However, the classical school of thought refers to them only as subsidiary elements, gapfillers, and still only when the privileged source, i.e., the formally established contract, require them. The development of neoclassical contractual law has mitigated such principles on admitting to a certain degree of indetermination in contracts, widening the hypotheses of contractual changes in the course of performance and protecting the parties' legitimate expectations.

[17] Ronaldo P. Macedo, 'Relational Contracts in Brazilian Law', Latin American Studies Association, Guadalajara, Mexico, 1997, http://bibliotecavirtual.clacso.org.ar/ar/libros/lasa97/portomacedopor.pdf at 26 August 2008.

[18] Ronaldo P. Macedo, 'Relational Contracts in Brazilian Law', Latin American Studies Association, Guadalajara, Mexico, 1997, http://bibliotecavirtual.clacso.org.ar/ar/libros/lasa97/portomacedopor.pdf at 26 August 2008.

[19] Andrew Terry, 'Franchising, Relational Contracts and the Vibe' (2005) 33(4) *Australian Business Law Review* 289.

[20] Dymocks Franchise Systems (NSW)Pty Ltd v Bilgola Enterprises Ltd (1999) 8 TCLR 612, 652. The result in that decision was reversed on a different point in the Privy Council, where it was determined in the Dymock's case that a franchisee's conduct of stating, in a facsimile sent to other franchisees, that it would not participate in franchisor activities was a repudiation of the franchise agreement. See *Dymocks Holdings Pty Ltd v Top Ryde Booksellers Pty Ltd & Ors* [2000] NSWSC 795.

but rather “a posteriori”.’[21] The franchise contract is also standard form, however, and the standard form is focused on contract at formation.

1.2.2 The franchise contract as a standard form contract

Standard form contracts are prevalent across many species of contracting relationships.[22] The standard form ‘is not individually negotiated by the parties but is instead drafted by one party who uses a contract containing the same terms for all transactions of that type. The drafting party may be in the superior bargaining position and may offer the contract on a take-it-or-leave-it basis. … the party in the inferior bargaining position who wishes to contract must adhere to what is demanded by the party in the superior position, there being no room to negotiate.’[23] The franchise contract meets the criteria of the standard form as power asymmetry and lack of negotiation are both inherent in the franchise relationship due to the need for uniformity, the cardinal value in business-format franchising.

Standard form contracts are common because they reduce transaction costs in drafting, negotiation and administration, they offer consistency and anonymity and are credited with ‘democratising the marketplace’.[24] There are disadvantages, however. Because they are not negotiated they can lack the requisite bargained for exchange and may not accurately reflect both parties’ true intentions. Standard form contracts are enforceable, but they are monitored closely and often regulated to control the risks of abuse of power that are a natural part of the form.[25] In its 2008 report, the Productivity Commission found that, ‘Unfair terms appear to be commonplace in standard-form contracts,’[26] noting that, ‘terms of the kind described as unfair… are common in many contracts across many industries in Australia and … their existence is widespread globally where regulatory mechanisms do not discourage this. …In

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[21] Ronaldo P. Macedo, ‘Relational Contracts in Brazilian Law’, Latin American Studies Association, Guadalajara, Mexico, 1997, http://bibliotecavirtual.clacso.org.ar/ar/libros/lasa97/portomacedopor.pdf at 26 August 2008.

[22] In 1971 W. David Slawson estimated that ‘[s]tandard form contracts probably account for more than ninety-nine percent of all the contracts now made.’ W. David Slawson, ‘Standard Form Contracts and Democratic Control of Law Making Power’ (1971) 84 *Harvard Law Review* 529, 529. See also John JA Burke, ‘Reinventing Contract’ (2003) 10(2) *Murdoch University Electronic Journal of Law* [22] <http://www.murdoch.edu.au/elawithissues/v10n2/burke102_text.html> at 14 August 2003.

[23] Peter E. Nygh and Peter Butt (eds), *Butterworth’s Australian Legal Dictionary* (1997). Note that the distinction between standard form and adhesion contracts is not clear; many writers and legal resources use the terms interchangeably. This article will use the term ‘standard form’ because of the negative connotations of the term ‘contract of adhesion’. See Freidrich Kessler, ‘Contracts of Adhesion - Some Thoughts about Freedom of Contract’ (1943) 43 *Columbia Law Review* 629.

[24] John JA Burke, ‘Reinventing Contract’ (2003) 10(2) *Murdoch University Electronic Journal of Law* [22] <http://www.murdoch.edu.au/elawithissues/v10n2/burke102_text.html> at 14 August 2003.

[25] For more on the standard form contract generally see articles by John J.A. Burke and Daniel Barnhizer. For commentary on the franchise contract as a standard form contract see Hadfield, Jordan and Gitterman, Steinberg and Lescatre and Lafontaine.

[26] Productivity Commission Report, The Consumer Policy Framework, http://www.pc.gov.au/__data/assets/pdf_file/0008/79172/consumer2.pdf, 430 at 27 August 2008.

Europe, prior to the introduction of measures against them, market studies revealed the ubiquity of unfair terms in standard-form contracts.'[27]

1.2.3 The franchise contract as a relational as well as a standard form contract

While the standard form carries inherent risks of abuse of power, the risk of such abuse is compounded when the standard form is combined with relational contracts. This is due to synergistic effects of the two contract types as well as to their inconsistencies.

1.2.3.1 Relational and standard form contracts are inconsistent and therefore deprive the contract of its intended meaning

First, the relational aspects upon which the franchisee depends such as trust and cooperation are vitiated by the standard form. While relational contracting stresses 'a community of values and interests and possesses a necessarily moral character, rendering it 'closer to the ideal partnership contract than to the classical sale and purchase contract,'[28] the standard form brings it closer to the latter.

The 'contract as commodity' of the standard form as opposed to 'contract as relationship' of the relational quality of the franchise contract creates conflict where the standard form prevails. The non-drafting party (ie. the franchisee) takes on qualities of consumer of product, rather than an equal party to negotiation of terms.[29] Representation of the franchisee as a consumer (of the franchise product, the intellectual property, the system, the brand) is a critical aspect of establishing fair conditions in the sector. In practice representation of franchisee interests in Australia has largely fallen to the ACCC as regulator on an ad hoc basis, in the absence of any well organised franchisee representative bodies.

1.2.3.2 Standard form and relational contracts synergistically erode bargained-for-exchange

Independently of each other, both the standard form and the relational qualities of the contract erode the element of bargained-for-exchange. The standard form is characterized by an imbalance of power and lack of negotiation of contract; there is no 'promise for a promise'; it thus deprives the parties of complete understanding of contractual terms. The lack of a negotiated process for arriving at agreed terms makes the standard form susceptible to the imposition of onerous terms that a franchisee

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[27] Productivity Commission Report, The Consumer Policy Framework, http://www.pc.gov.au/__data/assets/pdf_file/0008/79172/consumer2.pdf, 424 at 27 August 2008.

[28] Ronaldo P. Macedo, 'Relational Contracts in Brazilian Law', Latin American Studies Association, Guadalajara, Mexico, 1997, http://bibliotecavirtual.clacso.org.ar/ar/libros/lasa97/portomacedopor.pdf at 26 August 2008.

[29] John J.A. Burke, 'Reinventing Contract' (2003) 10(2) *Murdoch University Electronic Journal of Law* [51] <http://www.murdoch.edu.au/elawithissues/v10n2/burke102_text.html> at 14 August 2003; A consumer is defined as 'one that utilizes economic goods' < http://www.m-w.com/dictionary/consumer> at 25 October 2007.

might not fully understand or to which it does not genuinely consent, 'The result is that franchisees are constantly in peril of non-compliance.'[30]

The relational contract is about accommodating uncertainty by building in flexibility, reliance upon trust, and contextual interpretation. Relational contracts further erode the bargained-for-exchange because parties must leave the terms of the contract unspecified to accommodate uncertainty. Where the relational contract is also a standard form contract, where a franchisor drafts the contract but does not negotiate, flexibility is given not reciprocally, but to one party, a franchisor.

The result is that the standard form and relational characteristics of the contract synergistically deprive the franchise contract of the essential element of bargained-for-exchange. The interaction of the two qualities means that a franchisor can take on greater risk and manage risk effectively through drafting and contractual risk-shifting, while a franchisee is not similarly able to manage risk through contract. The franchise contract, as it is both standard form and relational, accords the weight of its flexibility and discretion to a franchisor. A franchisee is faced with the choice to unqualifiedly accept the risk assigned to it by a franchisor's contract or to decline to enter the relationship altogether.

The loss of bargained-for-exchange thus erodes the meaning of the contract for a franchisee and can reduce its commitment to perform. At the same time the loss of bargained-for-exchange leads to increased discretion for franchisor. A franchisor drafts the contract to benefit itself and a franchisee grants discretion for a variety of reasons.[31] This in turn creates higher risk and uncertainty to a franchisee and the potential for inefficient shifting of risk. It also undermines franchisee power, increasing the already marked power imbalance.

1.2.3.3 Standard form and relational contracts result in greater discretion to a franchisor and increased uncertainty and risk to a franchisee

The interaction of the relational and standard form qualities of contract means that a franchisor is able to dictate and strictly control the terms, while a franchisee grants discretion, relying on trust to protect its interests. (see Appendix A)

While standards for the exercise of a franchisor's discretion (for example in franchisor training, support or promotional activities) are rare, franchisee obligations are typically subject to strict standards, schedules, and targets, often to be set and/or changed at the sole discretion of a franchisor. Not all franchisee obligations are strictly specified at the outset, but even the flexible, open-ended requirements of

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[30] California Supreme Court Justice Stanley Mosk in a concurring opinion in *E.S. Bills Inc v Tzucanow* quoted in James V. Jordan and Judith B. Gitterman, 'Franchise Agreements: Contract of Adhesion?'(1996) 16 *Franchise Law Journal* 1, 41.

[31] The inherent imbalance of power and lack of negotiation of the standard form generate pressure on a franchisee to grant discretion to a franchisor. In addition, many of the same factors that contribute to a franchisee's disadvantage in negotiating the contract contribute to a franchisee's willingness to take on risk. These factors include inadequate franchisee legal representation, strict franchisor control, and a franchisee's subordination and ensuing lack of confidence.

franchisee are to be performed at a franchisor's discretion.[32] The lack of reciprocity is clear. Contracts in the sample contain few performance standards for a franchisor. Franchisor obligations are typically open-ended, to be performed at a franchisor's discretion.[33]

The franchise contract binds a franchisee over a period of years. A franchisee's extensive obligations are specified in detail and can be strictly enforced. If a franchisee fails to meet them, a franchisor can terminate for breach of contract. A franchisor, on the other hand, is subject to a minimum number of requirements, as a franchisor requires flexibility and discretion in operating the system. As neither a franchisee nor a franchisor can predict future circumstances, a franchisee has to trust its franchisor, and hope that a franchisor will act in a franchisee's best interests. Unfortunately, given the many conflicts of interest in the relationship, this is not always the case.

The loss of bargained-for-exchange that results from its standard form and relational qualities erodes the meaning of the contract for a franchisee and can reduce its commitment to perform, which then increases need for franchisor monitoring and undermines trust. This is true under conditions that are likely to test that commitment.

1.2.3.4 Standard form and relational contracts call for conflicting interpretation by courts and regulators

A focus on formation of the standard form as opposed to a focus on performance of the relational quality of the contract creates a dilemma for regulators. Regulation tends to focus on contract formation with the result that the relational qualities lose meaning. In regulating as well the interaction of the standard form and relational contract characteristics create conflict between an emphasis on formation as opposed to an emphasis on the performance of the contract.

The interaction of the standard form and relational contract creates similar problems for courts in interpretation. Formal interpretation required by the standard form

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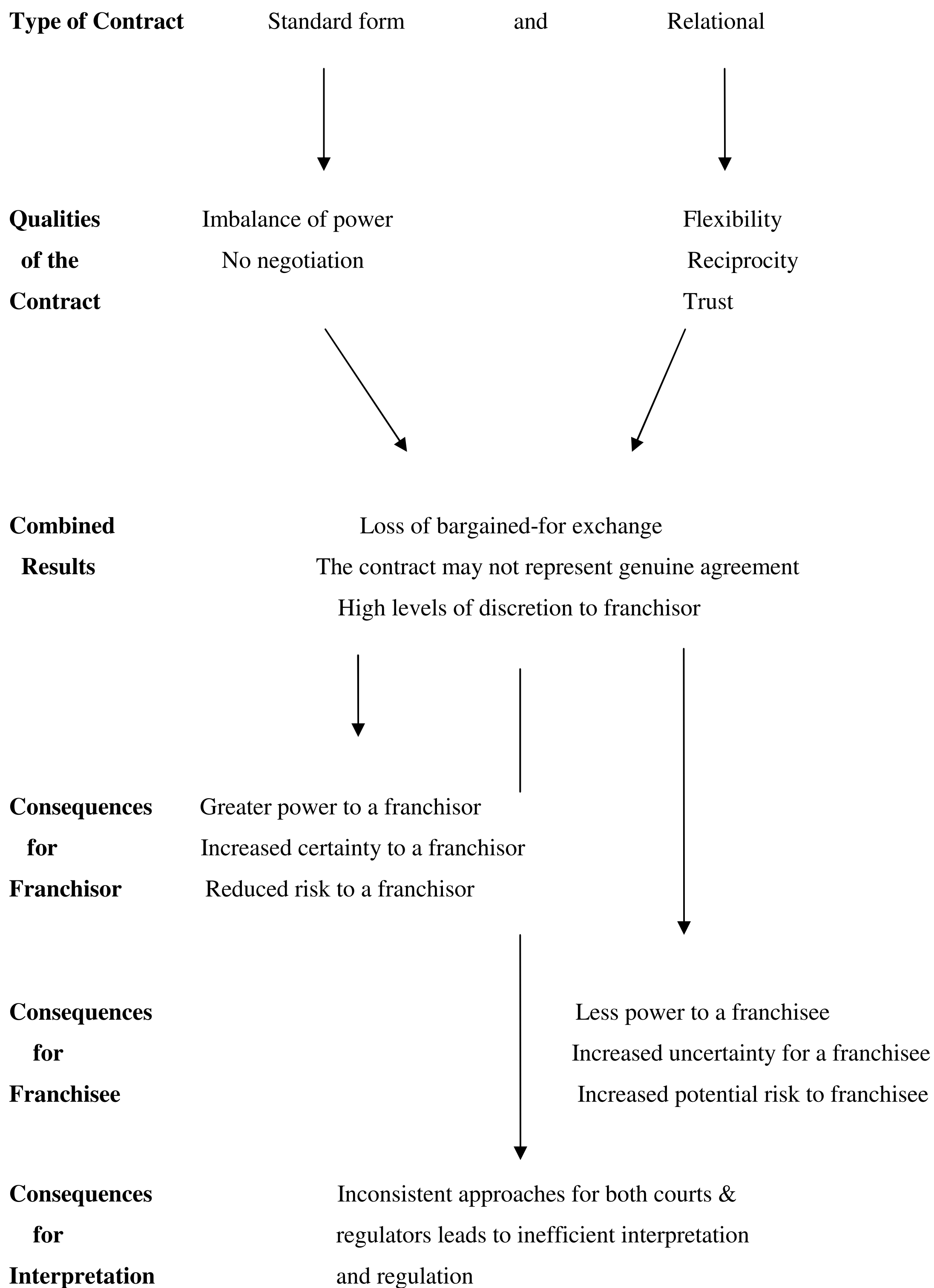
[32] It is not uncommon that franchise contracts impose requirements on a franchisee that fail to clearly specify the nature of the contractual obligation. Minimum performance is one example where the contractual term allows a franchisor to unilaterally impose and vary exact requirements through other schedules and documents such as the operations manual**.** With respect to certainty of contractual obligations, those assumed by a franchisee are often unclear, subject to change by a franchisor through the operations manual, technical and training manuals and other documents, as well as by relying on the collective agreement clause, or on provisions in the contract that accord to a franchisor broad discretion.

[33] Because of the uncertainty in the relationship over time, where they do occur, performance standards are generally not specific, but rather rely on reasonableness standards.. The content analysis of the contracts sampled showed a high frequency of a 'reasonable' standard. Even so, some franchisor legal advisers argue that discretion offers insufficient protection for a franchisor, 'there is general agreement among the courts about one thing—the (implied covenant of good faith) requires that parties to an agreement exercise discretion "reasonably."' In order to avoid even this requirement to act reasonably a franchisor is counselled to, 'go hunting for the "D" word' replacing it with 'the (franchisor's) "right"… Better yet, make clear somewhere in the agreement that whenever the franchisor is reserving a right, it has the uncontrolled or unfettered right…Almost all courts agree that the covenant of good faith and fair dealing does not trump an express right.' See William L. Killion, 'Putting Critical Decision-Making Where It Belongs: Scouring the Franchise Agreement for the "D" Word' (2005) 24 *Franchise Law Journal* 228, 229-230.

conflicts with contextual interpretation appropriate to a relational contract. These different qualities of the contract call for inconsistent approaches to interpretation and enforcement of the contract, and here again, the standard form prevails. Formal rules and express contract terms (a franchisee often does not understand because it did not draft or negotiate) trump contextual interpretation.

This incompatibility of modes of interpretation of standard form and relational contracts both by courts and regulators deprives the contract of the essential element of bargained-for-exchange because it diminishes fundamental precepts of contract law such as consent and intention. The ‘freedom of contract’ that courts go to such lengths to protect is, in this context, largely a myth.

Figure 1.2: The Interaction of the Standard Form and Relational Qualities of Contract



2.0 Identifying the problems in the regulation of franchising

2.1 Principles of good regulatory process

Regulation of the franchise sector in Australia is not optimally effective. Good regulation should be properly conceived in terms of assessment of the current situation, the needs to be addressed and the formulation of goals.[34] To this end it must be based upon accurate information and full stakeholder participation. There are many ways regulation can go wrong – particularly where it is reactive, politically motivated, based on imbalanced information and/or inaccurate information and/or systemically unsound, or where it responds to symptoms without a holistic approach.[35]

Malcolm Sparrow, a leading researcher in theories of regulation and author of *The Regulatory Craft*,[36] has written and lectured extensively on the topic of regulatory process. The key points of the principles of good regulatory process, such as determining the nature and scope of the problem; consideration of cost-benefit; making the regulation clear in terms of policy and compliance; review; and consultation with parties are themes that recur in Sparrow's work, but are reduced to a simple prescription, according to which Sparrow identifies three 'core elements' in reformed regulatory process:

- The first element is a focus on results, which involves rejecting reliance on output measures in favour of 'more meaningful' impact measures.
- The second element is to adopt a problem-solving approach that includes systematic identification of important problems, risk assessment and prioritization.[37] Regulatory craftsmanship requires the use of many different tools, which should be employed to suit the task, not vice versa; '[t]he essence of craftsmanship is having them all, knowing how to use them, and being quite judicious when you will use each one.'[38] Sparrow notes that enforcement should not be overlooked or neglected.
- The third element is to invest in collaborative partnerships to form a shared purpose through collaborative agenda setting. Engagement of multiple parties

[34] See Productivity Commission Report – 6 key principles for developing regulatory reforms draft report p83 (2006 Regulatory Taskforce).

[35] See Julia Black, 'Principles-Based Regulation: Risks, Challenges and Opportunities', http://www.econ.usyd.edu.au/download.php/Julia_Black_PBR_Paper.pdf?id=7431 at 28 August 2008.

[36] Malcolm Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance* (2000).

[37] Also known as "risk-control" or "compliance-management".

[38] Malcolm Sparrow 'Innovating in a Regulatory Environment' (Speech delivered at the National Environmental Innovations Symposium, Kansas City, 6 December 2000) <http://www.epa.gov/innovation/symposium/docs/sparrow.pdf> at 17 September 2007.

> can lead to more effective interventions, and optimal leveraging of scarce public resources.[39]

Sparrow's prescription is supported by the process recommended by Gunningham and Grabosky in *Smart Regulation,*[40] as well as in the 2006 Regulatory Taskforce principles identified as integral to good regulatory process.[41] Despite its simplicity, Sparrow admits that his prescription is not easy.[42] As it usually calls for a change in regulatory style, it has been 'experienced by those who have grappled with it' as different, intellectually demanding, analytically demanding, organizationally awkward and 'unrelentingly difficult'. The substantial challenge for regulatory agencies is 'to construct a framework, so that… innovative methods come forward at the right time, in the right place, for the right job.'[43]

2.2 The purpose of regulation of the franchise sector

The Regulatory Impact Statement for the Franchising Code of Conduct (the Code) lists the 'objectives of government action' as raising standards of conduct in the franchising sector without endangering the vitality and growth of franchising; reducing the cost of resolving disputes in the sector; reducing risk and generating

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[39] Malcolm Sparrow 'PLENARY 4: Effective Regulation' (Paper presented at the John F. Kennedy School of Government, Harvard University at 25th annual conference of the International Organisation of Securities Commissions (IOSCO), Sydney, 14-19 May 2000) <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/plen_4_sparrow.pdf/$file/plen_4_sparrow.pdf> at 14 September 2006.

[40] Gunningham and Grabosky advocate a process of determining objectives, defining the character of the problem, and generating the range of available options to address problems and achieve objectives, and they note that this process raises the need to build in better consultation and participation. See Gunningham et al, *Smart Regulation: Designing Environmental Policy* (1998) 380-387; on the importance of participation see p385.

[41] The Taskforce principles included the following: determine the need/ the case for regulation; the selection of appropriate tools; and effective consultation with regulated parties at the key stages of regulation-making and administration. '…a case for action - should include evaluating and explaining why existing measures are not sufficient to deal with the issue; relevant options need to be assessed Only the option that generates the greatest net benefit should be adopted. Effective guidance should be provided to ensure that the policy intent of the regulation is clear, as well as what is needed to be compliant. Mechanisms such as sunset clauses and periodic reviews need to be built into legislation to ensure that regulation remains relevant and effective over time. …'raising the bar' on the standard of analysis considered acceptable for a regulation impact statement …and, most importantly, making it harder for a regulatory proposal to proceed to a decision … if the government's requirements for good process have not been adequately discharged. To enhance consultation by regulators and their interaction with stakeholders, among other things: standing consultative bodies comprising senior stakeholder representatives should be established or maintained; and each regulator should have a code of conduct, … and report annually against it. Regulated entities should also have timely access to internal and third-party review on the merits of key decisions. Inaugural Public Lecture, Monash Centre for Regulatory Studies, University Law Chambers, Melbourne, 17 May 2006. (The report *Rethinking Regulation* is available at www.regulationtaskforce.gov.au)

[42] <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/plen_4_sparrow.pdf/$file/plen_4_sparrow.pdf 29> at November 2006.

[43] See Malcolm Sparrow 'Innovating in a Regulatory Environment' (Speech delivered at the National Environmental Innovations Symposium, Kansas City, 6 December 2000) <http://www.epa.gov/innovation/symposium/docs/sparrow.pdf> at 17 September 2007.

growth in the sector by increasing the level of certainty for all participants; and addressing the imbalance of power between franchisors and franchisees.[44]

To achieve these objectives, the Code relies primarily on three regulatory tools:

- Disclosure; the Code requires extensive information disclosure, particularly at the time of contract formation;[45]
- Mediation; all franchise contracts must contain Code-prescribed provisions that require mediation; and
- Substantive provisions.[46]

It is beyond the scope of this submission to analyse whether these are the appropriate objectives.[47] What is submitted here is that these objectives are not being met as well as they might. The franchise sector, despite this regulation, still reports numerous complaints and reports of abuses. There have been three inquiries into the regulation of the sector in the past two years, with the fourth (the second at the federal level in as many years) currently underway.[48]

2.3 The efficacy of current regulation

This submission summarizes the author's evaluation of the potential for current regulation to be effective. First, according to Sparrow's 'core elements', there is a need for meaningful measurements, the data with which to determine what regulation is required and how best to achieve it. In the franchising sector there is a lack of reliable data about the franchise sector, which compromises any effort to tailoring

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[44] Explanatory Memorandum, Trade Practices (Industry Codes - Franchising) Regulations 1998 (Cth) No. 162 at <http://www.comlaw.gov.au/ComLawithLegislation/LegislativeInstrument1.nsf/framelodgmentattachments/77630AD9222B25BCCA256F73000E7654.> at 24 August 2005.

[45] With disclosure a franchisor must also provide a copy of the Code and a copy of the franchise contract. The disclosure process also requires a prospective franchisee to attest that it has consulted with legal and accounting professionals prior to signing the franchise contract or that it has been advised to but has declined to seek such assistance. In addition to the requirements of Annexure One for disclosure at the time of contract formation, a franchisor must on an ongoing basis also provide financial statements for marketing or other cooperative funds to which franchisees have made financial contributions. The Code is available at <http://www.comlaw.gov.au/ComLawithLegislation/LegislativeInstrumentCompilation1.nsf/0/4FA9F21A9489DC27CA256F71004E4CCB?OpenDocument> at 30 July 2006. Trade Practices (Industry Codes - Franchising) Regulations 1998 (No 162) (Cth), Clause 13, Clause 17.

[46] The Code mandates a seven-day cooling-off period for franchisees. A franchisor must obtain from the prospective franchisee signed statements that a franchisee has been given advice, or has been told to seek advice but has decided not to seek it prior to signing the franchise contract. There can be no general indemnity of franchisor by franchisee. There can be no prohibition on franchisees' freedom to associate with other franchisees. Procedural provisions are required with respect to transfer and termination. See the Trade Practices (Industry Codes - Franchising) Regulations 1998 (No 162) (Cth), Clause 13, Clause 16, Clause 15, Clauses 20-23 and Part 4.

[47] The author does submit, however, that such objectives should be the result of a transparent and participative process.

[48] New Zealand has recently announced its own inquiry <http://www.franchise.co.nz/article/view/683> at 18 August 2008.

regulation to the needs of the sector.[49] The net effect is that it is not always clear how the different interests in the franchising relationship manifest themselves and why; what the risks are for the participants in the sector; and what aspects of problems encountered in the sector could best be addressed through what types of regulatory intervention.

Though some franchisors may feel threatened by greater scrutiny, ultimately, the continued success of the sector depends upon an accurate understanding of this relationship to inform its development, including its regulation. Answers are sorely needed to questions about the problems in franchising and about which problems are most significant to each of the parties at which stages in the relationship. As long as information about the relation is kept private, or is controlled by only one side of the relation, the nature of the dynamic will continue to elude outsiders.

Disclosure as a regulatory tool makes sense, but, in the context of the franchise sector in Australia it is not effective. More importantly, disclosure about particular franchise systems to franchisees as consumers is no substitute for the data that is urgently needed to inform regulatory process.

More meaningful measurements of the performance of the sector and the impact of regulation upon it are critical to any future regulatory initiatives.[50] These can be achieved through better monitoring of existing regulation, including registration of disclosure and also through further research, particularly in economics and law, as well as in the disciplines where it has been concentrated in the past such as marketing and management. The French Franchise Federation, for example, not only encourages independent research, but in fact contributes about 1 million euros annually to fund such research.[51]

2.3.1 The efficacy of disclosure as a tool to achieve the purposes of regulation

Regulatory intervention is often used to address inefficiencies and inequities in market interaction. Reducing the mythology of franchising should help re-balance the power in the relationship and reduce uncertainty for franchisees. The lack of information about franchising makes disclosure seem the perfect solution. Disclosure,

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[49] A similar information problem was identified in the franchise sector in the US over fifteen years ago. In its 1990 report on 'Franchising in the US Economy' the House of Representatives Committee on Small Business noted: 'Despite its growing significance, there is a surprising lack of comprehensive and accurate information concerning all aspects of franchising nationally.' At that time there had been a number of statistical reports. The limitations of such reports, however, were noted by the Educational Foundation of the International Franchising Association (the IFA) in its 1998 'Profile of Franchising': 'For years, those in franchising and those studying it have desired reliable data on the realities of franchising as seen in the business community. Until now, most attempts at such an overview have been based on survey results and, as all researchers know, the return rates on surveys tend to be discouragingly low.... Moreover, some felt that the picture painted by such survey returns was misleadingly positive because those having business difficulties would be less likely to take the time to complete and return surveys.' 'Deacons on franchise legislation', <http://www.franchisebusiness.com.au/articles/> at 14 March 2006.

[50] The Reid Report noted the insufficient date regarding the success of small businesses.

[51] Personal interview with Chantal Zimmer, Director of the French Franchise Federation, Paris, June 2008.

however, cannot be optimally effective because the conditions for effective disclosure are not met. These conditions are first, that reliability, accessibility and useability of the disclosed information must be assured and second, that the recipients of the information must be able to act on that information.[52]

- With respect to the first condition, there are limitations on the efficacy of disclosure with respect to the reliability, accessibility and useability of the disclosed information.
    - o Obtaining and disseminating reliable information can be difficult because Code disclosure is not well-orchestrated with misleading or deceptive conduct provisions of the TPA;[53] and there are deficiencies in monitoring and enforcement.
    - o Accessibility and useability of information are impacted by franchisee inexperience and psychological factors, use of legalese, lack of sufficient expert advice and and inappropriate presentation and timing.
    - o The needed information is not always provided in areas such as
        - How specific contractual terms relate to concrete issues such as those with respect to payments and earnings;
        - What has happened in respect of prior disputes and nature of previous mediations involving other franchisees in the system;
        - How to contact franchisees who are, for one reason or another, no longer with the system; and
        - The advantages and disadvantages of the nature of the franchise business form and the franchisor/franchisee relationship overall.[54]
            - One might say that franchisees agreed to the terms of the contract, which is true, but because it is also relational, a franchisee would have reasonably expected to have a role to play in a relationship of trust, flexibility and reciprocity. What franchisees do not

[52] These conditions, which the author developed from the work of Sunstein and Tietenberg, among others, are outlined in more detail in the author's submission to the South Australia Parliamentary Inquiry. See Cass Sunstein, 'Informational Regulation and Informational Standing: Akins and Beyond' (1999) 147 *University of Pennsylvania Law Review* 613 and Tom Tietenberg, 'Disclosure Strategies for Pollution Control' (1998) 11 *Environmental and Resource Economics* 587.

[53] There is a view that the Code is inconsistent with Sections 52 and 53 of the Trade Practices Act 1974, in that failing to disclose known information in respect of a franchise sale could be regarded as misleading or deceptive behavior, particularly if the information withheld reveals poor historic trading results. Under the Code the franchisor can elect not to disclose such information.

[54] For example, relational contracting means that there are many aspects of the performance of the contract that are left unspecified and therefore cannot be disclosed; it may also detract from the psychological importance of franchisee due diligence. The standard form, relational nature of the contract exacerbates the imbalance of power in the relationship and can lead to the franchisee granting too much discretion to the franchisor and taking on too much risk. Ultimately, the research indicates that the standard form, relational contract may be fundamentally inconsistent with the use of disclosure as the primary regulatory tool.

understand is that, because their contracts are standard form, they've been written out of such participation.

- The Matthews Committee acknowledged the problems of lack of franchisee awareness of the risks involved in franchising. Item 3 recommended a requirement of franchisors to include a Risk Statement with the disclosure document. This was not agreed to by the government. Its statement, 'Decisions relating to the viability and associated risks of any business venture are ultimately the decision of the businesses themselves,' seems to undermine the theoretical basis for the choice of disclosure as a principal tool of regulatory intervention in franchising.[55]

- With respect to the second condition there are essentially two ways a franchisee can act on disclosed information, one is to use the information to negotiate and the second is to use it to inform a decision to accept the terms or to walk away and find a better deal elsewhere.
  - The standard form means that the franchisee has an inability to negotiate, and there are limited alternatives for contract terms amongst different franchise systems in the market.
  - The relational quality of the contract means that the franchisee cannot negotiate in any event to address specific aspects of the performance of the contract, because the working of the contract in practice has been left unspecified and therefore cannot be disclosed. The terms of relational contracts provide for flexibility by providing for discretion to the drafter, which throws the emphasis in the commercial relationship more on trust and so erodes the function of due diligence on the part of the franchisee.
  - Disclosure only works where the party to whom information is disclosed has options. The imbalance of negotiating power between the parties can never be adequately addressed by disclosure in a situation where one party writes the contract and does not allow negotiation of contract terms. Investors and consumers for example can compare what is on offer in the market, and can easily find other options. In the franchising context the time and expense of finding alternatives in the market diminishes effectiveness of disclosure. Also, there is a considerable amount of time and psychic investment in the deal by the time the contract is introduced,[56] and less latitude for substitution of other products in the market.

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[55] See the *Review of the Disclosure Provisions of the Franchising Code of Conduct*, October 2006, <http://www.industry.gov.au/content/itrinternet/cmscontent.cfm?objectID=6B99EC0B-BC2F-F60A-CD6A9D32E1031993> at 14 May 2007 and the Australian Government *Response to the Review of the Disclosure Provisions of the Franchising Code of Conduct*, February 2007, <http://www.industry.gov.au/assets/documents/itrinternet/Response_to_Recommendations_(Final)06Feb0720070206091019.pdf> at14 May 2007.

[56] Accenture presentation – of about 10-11 steps in the recruitment/sales process, contract is introduced in around the third quarter.

- Again, because franchise contracts are both standard form and relational, these options are limited and so the effectiveness of disclosure as a tool to regulate the franchise sector is diminished.

While disclosure is a form of investor protection, and the franchisee does act like an investor, a franchisee's role is in many ways more like that of an employee, consumer of goods and services and business partner. The franchisee needs these types of protection, which may be procedural, such as assistance in the negotiating process, collective negotiation and registration and enforcement of disclosure, but also substantive, such as a requirement of a duty of care on the part of franchisor.

Finally, it is essential to understand that disclosure is limited in its ability to address relationship issues in franchising because it targets only formation of contract, and not performance.[57] The terms of the contract favour the franchisor in the performance of the contract. The contract provides a high level of discretion to franchisor in the performance of the contract. The contract includes heavier obligations on franchisee than on franchisor in the performance of the contract. Contractual obligations on franchisee are often unclear, but all flexibility accrues to franchisor, facilitating franchisor claims of breach throughout the performance of the contract.[58]

To summarize, there are significant problems with disclosure and reliance upon regulation of franchise relationships primarily through disclosure mechanisms. Some specific measures can be taken to improve the function of disclosure as a tool to regulate the franchise sector in Australia:

- Reliability could be improved through registration of disclosure documents, and improved monitoring and enforcement procedures*;*
- Preparation of franchisees to receive information (pre-disclosure education); including education about the differences between franchising and other business forms;
- better coverage in terms of the items that are disclosed;[59]
- timing and presentation; and assistance help with interpretation (at time of disclosure); and
- To address the ability of the recipients to act on the information, measures should be considered to improve franchisees' ability to negotiate, including collective initiatives.

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[57] Most of the findings of the analysis of contract terms in my doctoral research apply mainly to performance obligations. These include issues of encroachment, minimum performance requirements, supply and promotional obligations, agree to agree or 'go along' clauses, leasing and restraint of trade.

[58] 'After 23 years of inadequate FTC enforcement, the major problem facing franchisees today is the post-sale franchise relationship, which comprise 92% of the current franchise complaints before the FTC.' Stanley Turkel, *Fiduciary Duty: Should It Be a Franchisor Obligation?* (2003) Hotel Interactive <http://www.hotelinteractive.com/hi_index.asp?page_id=5000&article_id=1728> quoting Attorney Robert L. Purvin Jr at the Federal Trade Commission.

[59] For example, 7.2 provides that a franchisor is taken to comply with item 7.1 for any information that is confidential if a franchisor gives: (a) a general description of the subject matter; and (b) a summary of conditions for use by a franchisee. With respect to earnings information, the franchisor can simply state that it does not provide such information, leaving one to wonder on what basis the sale of the business is to be made.

These measures may increase effectiveness of disclosure somewhat, and registration of disclosure documents is particularly valuable because of its potential as a source of information about the operation of the sector. While there are many potential benefits to registration, however, a cost-benefit analysis might reveal other alternatives, such as posting the information on the Internet, that are almost equally as effective and may be significantly more efficient.

2.3.2 The efficacy of mediation as a tool to achieve the purposes of regulation

Nor has mediation levelled the playing field in franchising. Its starting point is the condition of imbalance in the relationship and it is often ineffective to alter that condition.

Like disclosure, mediation is essentially self-regulatory in nature; it enlists the participation of the parties in the regulation of their own relationships. Mediation has advantages, for example, it requires little or no government involvement for administration or enforcement. It also has a range of disadvantages. The flexibility of the process makes it easy for franchisors to control, while the confidentiality of the process means franchisors know the outcomes of disputes while individual franchisees suffer the disadvantage that they do not know these outcomes. Perhaps most importantly, the franchise contract as drafted by a franchisor imposes few enforceable obligations on a franchisor, so that a franchisor has little incentive to reach a negotiated settlement. In these ways mediation can actually reinforce the very imbalance of power that creates problems throughout the franchise relationship.[60]

There is a need for an advice and referral process at the preliminary or notice stage; and throughout the process, feedback should be gathered through interviews and surveys, and analyzed to adjust and refine the system. Efforts should also be made to survey franchisors and franchisees that do not use the process.[61] This is a logical part of an expanded role for the Office of the Mediation Adviser (the OMA). According to director David Newton, “our role essentially is to appoint mediators.”[62] A

[60] The author’s research in 2003 indicated that in total OMA had appointed mediators for 308 mediations, roughly 70 per year since its inception in 1998. About 10% of disputes settle after appointment of a mediator but before going to mediation. Just over 62% of mediations conducted resulted in settlement. Newton estimates that few of the disputes that fail to settle through mediation go on to litigation. While over 70% is a healthy rate of settlement, if only 30% of all inquiries (about 124 of 380) go to mediation, then only about 20-25% of all inquiries to OMA achieve resolution through the mediation process. It would be valuable to track the other 75-80%. Of the 400 or so disputes that have been mediated, because mediation is a confidential process, little is known about their outcomes or the level of satisfaction of the parties, especially months or years after the process has been completed. More information about parties’ experiences and satisfaction with the process is crucial to better serve the sector.

[61] Slaiku and Hasson, *Controlling the Costs of Conflict: How to Design a System for Your Organisation* (1998) at 158.

[62] Proceedings of the ACCC Franchising Consultative Panel Meeting, 20 March 2003. As primarily a mediator referral service, with a limited ancillary role to promulgate mediation for small business, the OMA’s narrow scope forfeits a valuable opportunity. As the first port of call for parties with disputes, the OMA’s mandate could be much broader in order to provide the appropriate responses for a wide range of dispute situations. The OMA is uniquely positioned to diagnose, to educate, and to guide parties in achieving the best outcomes in handling disputes.

narrowly circumscribed agenda may have been appropriate in the initial stages of instituting the process, perhaps helping to ensure the OMA's success at the start. Five years on, however, the OMA in a position to build on its success and take on an expanded role in the process.

The burden on the parties in the regulation of this sector in this way must also overcome some significant market inefficiencies with respect to information asymmetry, power imbalance and moral hazard. For franchisees in particular there is a need for more education, training to ensure that franchisees are fairly represented in mediation or any dispute resolution process.

2.3.3 The efficacy of the current substantive measures in the Code as tools to achieve the purposes of regulation

Substantive measures have also proved inadequate to address the purposes of regulating franchising. While the majority of franchisors are fair, there are some franchisors that will, if they can, behave opportunistically despite the protections that each of the following substantive measures seek to provide:

- The Code mandates a seven-day cooling-off period for franchisees,[63] and franchisor must obtain from the prospective franchisee signed statements that a franchisee has been given advice, or has been told to seek advice but has decided not to seek it prior to signing the franchise contract.[64]
    - Because the disclosure regime is inadequate for the reasons set out above, however, a cooling off period does not prevent franchisees from entering contracts, nor does the requirement that a franchisor obtain a signed statement ensure a remedy if it is not complied with.
- There can be no general indemnity of franchisor by franchisee.[65]
    - Franchisees remain vulnerable because franchisors can simply draft specific indemnities.
- There can be no prohibition on franchisees' freedom to associate with other franchisees.[66]
    - Franchisees continue to face claims of defamation and breach of good faith if they risk certain forms of communication with other franchisees.
- Procedural provisions are required with respect to transfer and termination.[67]
    - Nevertheless, franchisees still appear to be vulnerable to franchisor opportunism in both situations.

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[63] Trade Practices (Industry Codes - Franchising) Regulations 1998 (No 162) (Cth), Clause 13.

[64]Ibid, Clause 11(2).

[65] Ibid, Clause 16.

[66] Ibid, Clause 15.

[67] Ibid, Clauses 20-23 and Part 4.

Market forces will not correct the imbalance of power in the relationship. So, while contract formation is a critical stage, performance of the contract, which extends over a period of many years, involves a need for franchisee protection as well. Regulation involves only a handful of substantive requirements with respect to performance. The philosophy behind this is that the state can protect parties in entering contracts, to ensure the agreement they reach is fair, but once they enter the agreement, they must be bound by those terms to which they agree; the courts should not re-write contracts.

Note that this is another aspect where the standard form contract and the relational contract call for different, competing approaches. The regulatory approach to standard form contracts is to enforce but supplement their terms (e.g. requirements to include standard form warranties as in sale of goods legislation). The regulatory approach to relational contracts is more contextual, focusing on duties owed by the parties to the relationship on an on-going basis. The traditional once-and-for-all contractual philosophy has been eroded in other areas of contract law, such as employment law and consumer protection, where good faith duties have been recognised[68] and so it should be in the franchise context for several reasons, including the relational nature of the contract; the employment and consumer-like attributes of the relation; and the weaknesses of disclosure.

The stage of development of the franchise sector is an important factor in informing the design of an appropriate regulatory approach in any given jurisdiction. Franchising presents very different sets of conditions in various countries and markets. A developing sector, for example that of Malaysia, calls for a different approach to regulation than would be required in a developed economy with a mature franchise sector. In Australia the maturity of the sector and economic conditions are such that encouraging growth and the entry of new franchise systems and the training of new franchisees may be of less concern for regulatory intervention, while the challenges of slowing levels of growth and maturing systems makes relationship issues all the more important. One example of this need for a more responsive approach is the current strategic re-orientation currently being undertaken with the leadership of the British Franchise Association in the UK.[69]

2.4 Self-regulation requires full stakeholder representation, while franchise sector regulation marginalizes the franchisee

The trend for many years in regulation has been to rely heavily on sectoral involvement in industry 'self-regulation'. This approach has appealed to regulators in cutting costs and shifting the onus of regulation to the participants. In Australia the regulator has for many years relied on the trade association as a principal participant in regulatory process. This is a phenomenon that has fallen out of favour in other

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[68] See, for example, *Fair Trading (Amendment) Act 2003* (Vic), s32W which provides, 'A term in a consumer contract is to be regarded as unfair if, contrary to the requirements of good faith and in all the circumstances, it causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of the consumer.'

[69] See <http://www.thebfa.org/OneVision.pdf> at 25 August 2008.

jurisdictions.[70] Nevertheless, the Franchising Code of Conduct in Australia retains largely the same form as the original voluntary Code of the mid-1990s.

There were, it should be noted, several items from the former voluntary code that are conspicuously absent from the current Code of Conduct:

- Franchisor will not participate in unconscionable conduct (Item 12.1) and conduct unnecessary and unreasonable in relation to risks to be incurred by one party (Item 12.2(b));
- Provisions for an advisory Council (the FCC) with stakeholder representation (Items 1.2-2.3);
- Registration (with a fee) of compliance, such registration to be made available as a public document (Item 7.3); and
- Council power to remove a registered party for failure to comply (Items 5.1-5.2).[71]

Interestingly, these deleted provisions were some of the most important provisions for the success of self-regulatory measures such as those relied upon in the Code, and their exclusion weakens the efficacy of such measures.[72] Such changes to regulation seem to indicate a lack of appreciation for the ecology of regulation, the interplay of regulatory tools. This is an important disadvantage to the command and control, 'old-style' regulatory process.

The current Code continues to rely heavily on self-regulatory tools such as disclosure and mediation. Because self-regulators can exploit their power to protect their own interests with measures that exclude others from the market and establish anti-competitive conditions, self-regulation risks subverting regulation to certain private interests, 'with self-regulation, regulatory capture is there from the outset'.[73] There is also a failure of separation of powers if self-regulatory functions cover such areas as policy formation, rule-making, rule interpretation, adjudication and enforcement.[74] Self-regulation in the traditional sense may be perceived to offer too much autonomy to the regulated interests, which leads to issues of control, accountability and fairness.[75] There is potential for abuse especially with respect to under-represented interests and the interests of third parties.

Adequate regulation depends on adequate representation of both franchisor and franchisee interests in rule-making fora. The under-representation of franchisee interests is a major problem. As the role of the regulator is changing to that of mediator of the regulatory process, efficient and effective regulation of the franchise industry must comprehend, acknowledge and involve the interests of all stakeholders

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[70] Iain Ramsay, 'Consumer Law, Regulatory Capitalism and the 'New Learning' in Regulation', 28 *Sydney Law Review* 9 (2006).

[71] *Franchising Code of Practice 1995*, Franchising Code Administration Council.

[72] The Gardini Report estimated that approximately 40 to 50 percent of franchisors had not registered under the Code. Robert Gardini, *Review of the Franchising Code of Practice*, Canberra: A.G.P.S., October 1994.

[73] Anthony I. Ogus, *Regulation: Legal Form and Economic Theory* (1994) 107-108.

[74] Ibid, 108.

[75] Robert Baldwin and Martin Cave, *Understanding Regulation: Theory, Strategy and Practice* (1999) 126.

at all stages through different mechanisms. Instead of command-and-control, a participative process offers an alternative to the regulator to the role of imposing rules, allowing it to more fully involve a franchisee and to better assist all stakeholders in the development, enforcement and monitoring of regulation.

In order to minimize opportunistic behaviour, to improve relationships within the sector, and to improve the health of the sector as a whole, franchisors' and franchisee' interests should be aligned as much as possible. [76] The 1997 Reid Report Recommendation 3.1 (para 3.30), noted that '…The code should also provide for adequate representation of franchisees in merchants' associations.' [77] The arrangement of franchise industry groups, however, often fails to reflect alignment of franchisor and franchisee interests.

Franchisee participation in regulatory procedures is negligible because there is virtually no formal franchisee representation to the regulator. In Australia, as in most countries, the only trade association that promotes the sector, lobbies, and educates is dominated by franchisors. Effectively this means that only one half of the sector is represented to the regulator. There are several options to remedy this imbalance; these include;

- greater integration of franchisees into existing trade associations with their well-established channels of communication with the regulator,[78]
- creation of a viable, independent franchisee group,[79] and/or
- other models that may be in place in other jurisdictions, such as a hybrid model where the franchisor association is a primary association that cooperates with a secondary franchisee association under one umbrella organization.

This is a consumer law issue. A consumer is defined as 'one that utilizes economic goods'. [80] A franchisee is a consumer of the franchise product, the intellectual property, the system, the brand. Representation of the franchisee as a consumer is a

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[76] Address to the FCA Plenary Session, October 2006 by Rod Wakefield, CEO of The Coffee Club.

[77] Finding a Balance: Towards Fair Trading in Australia, Report by the House of Representatives Standing Committee on Industry, Science and Technology May 1997, ISBN 0 644 507888 accessed at House of Representatives Standing Committee on Industry, Science and Technology, Parliament of Australia *Finding a Balance: Towards Fair Trading in Australia* (1997), accessed at <http://www.aph.gov.au/house/committee/isr/Fairtrad/report/appends.pdf>.

[78] *The Australian Financial Review* (Australia) June 19, 2006.
Interesting news item: Jun 19, 2006 (The Australian Financial Review - ABIX via COMTEX) -- The Australian Government has signalled *that it would not directly oppose the formation of a representative body for franchisees*. (Italics added) In late June 2006, Australian Small Business Minister, Fran Bailey, stated that collective bargaining can help franchisees reach better deals with big business. However, Bailey refused to comment specifically on franchisee representative associations. Meanwhile, the Australians Competition and Consumer Commission has stated that, while it does not want an "ACTU-style" franchisee body, it would adopt a "pragmatic and informative approach" to franchisee interests if a voluntary association were to be created in Australia.

[79] There have been at various stages of the recent past two franchisee organizations in Australia, but neither conducted a formal interface with the ACCC and neither has been recognized by the FCA. It appears that every franchisee organization that has been attempted in Australia is now defunct.

[80] <http://www.m-w.com/dictionary/consumer> at 25 October 2007.

critical aspect of establishing fair conditions in the sector.[81] There are significant aspects of the roles of franchisees as consumers of the franchise product, yet franchisees are not collectively represented.[82]

The under-representation of franchisee interests in the process of regulation is a major problem, but the various attempts that have been made to organize franchisees have met with little success. The responsibility falls to the government to drive the needed change, to ensure a program of efficient and effective regulation that comprehends, acknowledges and involves the interests of all stakeholders at all stages. Instead of command-and-control, a participative process offers an alternative to the regulator to the role of imposing rules, allowing it to more fully involve a franchisee and to better assist all stakeholders in the development, enforcement and monitoring of regulation.

2.5 Directions for reform of franchise sector regulation

Current regulation of the franchise sector is not well-tailored to its purposes. It has been observed that the procedures used to select the current regulatory measures were inconsistent with best practice.[83] To the extent that there has been discernable regulatory process, it has often lacked full participation and transparency.

There are also problems with implementation:

- resources allocated to enforcement are limited;[84]
- there are only ad hoc procedures for monitoring, review and evaluation (partly due to lack of funding for these functions which could have come from registration fees); and
- there is little education or assistance for prospective franchisees, or for operating franchisees who encounter problems.

Disclosure is targeted to protect investors while a franchisee plays many roles other than that of an investor, e.g. consumer, also agent, employee, joint venturer, mortgagee, etc. Mediation is a dispute resolution mechanism that offers advantages and disadvantages, but it is not a regulatory tool to redress imbalance of power. Because they are self-regulatory and procedural in nature, mediation and disclosure, the principal tools used in the regulation of the franchise sector do little to address the stated goals of the Code of Conduct. In fact, rather than redressing imbalance of power in the relationship or increasing certainty for franchisees, these procedures can exacerbate these problems. Further, there is no evidence that they raise standards of conduct in the franchising sector or that they reduce risk. The handful of substantive regulations are procedural and do not address many of the most important concerns.

[81] This aspect of the relationship was recognized by the Swanson Committee and reiterated at Section 1.29 of the Reid Report.

[82] As previously noted, franchisees also play roles analogous to those of investors and employees.

[83] Characterized at various points by executive fiat, low levels of consultation, and limited evaluation of alternative methods, for example through cost-benefit analysis. See Fred Anderson et al, 'Regulatory Improvement Legislation: Risk Assessment, Cost-Benefit Analysis, and Judicial Review' (2000) 11 *Duke Environmental Law and Policy Forum* 89.

[84] Trust is more important when enforcement budget is low. See Coulson, *Trust and Contracts: Relationships in Local Government, Health and Public Services* (1998).

Franchisors retain high levels of discretion that they justify by their need to exercise control of the brand.

The question then is how to achieve regulation that works. There is a diversity of approaches and theories about best practice in regulation that can be brought to bear, for example, to require registration and better monitoring for disclosure; a convening clause for mediation and particular changes for substantive provisions.

2.5.1 Three options for reform

There are fundamentally three options for reform of franchise regulation. The first is to revise the process; the second is to retain the existing regulatory regime and to fine-tune its deficiencies; and the third combines the first two, undertaking to address the most pressing problems in existing regulation as an interim measure while revision of the process is underway.

Because the procedures used to select the current regulatory measures were inconsistent with best practice, the first and most effective option for reform of the regulation of the franchise sector should involve a revision of regulatory process.[85] Regulation of franchising should be reoriented toward collaborative approaches involving both franchisee and franchisor representation to develop meaningful measurements, identification of problems and selection of tools. This is the avenue to regulation that is most likely to redress imbalance of power and uncertainty for a franchisee because it addresses these problems structurally at every layer of regulation. Reframing regulatory process is a long term project, however, and it won't help the people currently in franchise arrangements, who are vulnerable because of the nature of the contracts they're in now.

The second option involves measures to revise the components of regulation to improve their efficacy, to fine-tune disclosure and mediation as outlined above in Sections 2.3.1 and 2.3.2, and to add some more substantive provisions, e.g. unfair terms provisions. Education is an important part of the answer, but it is not a remedy that can be applied after the parties have established their terms and course of dealing. Education needs to be instituted more for future generations, as there are many respects in which it can be effective as a prophylactic measure. Education is, however, less effective as a remedial measure.[86] What is required is a combination of solutions to address the diversity of problems and contexts in which problems arise in franchising both now and into the future.

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[85] From the wide range of options available to it in formulating rules and strategies, Australian franchise regulation has relied upon a relatively narrow range of options, namely some constraints on formation of contract, extensive disclosure and mandatory mediation. These may be the most appropriate methods, but the procedures used to select them were not ideal (exec fiat, low consultation, low evaluation of alternative methods); currently there are only limited procedures for evaluation and review; command and control invites 'creative compliance'.

[86] 2006 Taskforce Report, 'Reducing the regulatory burden: the way forward' Gary Banks Chairman, Regulation Taskforce and Productivity Commission, http://www.pc.gov.au/speeches/cs20060517 at 26 August 2008.

A third option combines the elements of both of the first options. It calls for commitment to a revision of regulatory process over the long term. In the short term some further substantive measures can be employed judiciously to ensure that the discretion enjoyed by franchisors is not used to unfairly disadvantage franchisees, who are, like consumers or employees, critical to the economic success of this model, but who enjoy little protection as consumers or employees,. Under such a program immediate action can be taken to address the short-term inefficiencies of regulation, as well as a longer-term objective of instituting reflexive and responsive regulatory process.[87]

3.0 Nonrenewal and the question of a statutory duty of good faith

Among the many tools available to address the immediate issues facing the franchising sector is an obligation of good faith. It is a tool that provides a low-intervention, principles-based constraint to franchisor opportunism, one that is perfectly calibrated to the relational nature of the contract. There are many reasons why good faith may be an appropriate measure in addressing various forms of franchisor opportunism that can arise over the course of the relationship. One area in particular where a duty of good faith should be considered is the issue of nonrenewal.

Nonrenewal, also called passive termination, involves a franchisor's failure to renew at the end of the term. It is a significant example of the way in which the power and information advantage enjoyed by franchisors can create unanticipated hardship for franchisees.[88]. The publicity surrounding the nonrenewal of franchises in WA has brought this problem into sharper focus. It is a problem that needs to be addressed for its own sake as well as for the insight it provides for other issues in the relationship.

A franchisee enters the contract believing that the contract will be renewed; it is estimated that 90% of franchises are renewed in Australia.[89] Occasionally, however, a franchisee's reasonable expectation of renewal is not met; the resulting loss for a franchisee in this position can include remaining lease obligations, fitout and refurbishment costs, costs to train staff and the loss of goodwill.[90] Currently, a

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[87] Christine Parker, 'The Pluralization of Regulation' (2008) 9(2) *Theoretical Inquiries in Law* <http://www.bepress.com/til/default/vol9/iss2/art2> at 25 August 2008.

[88] Power imbalance at termination is discussed in the South Australian Parliamentary Inquiry into Franchises, 65-69.

[89] According to Schaeffer, 'The vast majority of franchise systems, 94% offer renewal terms to their franchisees, except in the lodging industry where only 40 percent of the brands include renewal options.' IFA Educational Foundation - FRANdata research report #5, December, 2006., Australian data from the *Franchising Australia 2004 Survey*, Griffith University and the Franchising Council of Australia Ltd. (2004) indicates that 91% of franchisors offer a renewal term of less than 5 to 10 years.

[90] W. M. Dixon, 'What is the Content of the Common Law Obligation of Good Faith in Commercial Franchises?' (2005) 33(3) ABLR 207. Dixon states, 'a franchisee will incur considerable costs in setting up the franchise by a potential requirement to pay a considerable franchise fee, specialised equipment and inventory acquisition and other set-up costs. These costs of the franchisee are frequently described as "sunk costs", as they may not ultimately be recoverable if the franchisee goes out of business, for any reason. Sunk costs may be threatened by a franchisor's opportunistic exercise of a broad contractual discretion. The mutuality of the franchise relationship is evidenced by franchisors risking the value of their reputation capital "in exchange for shifting sunk investments to franchisees".'

franchisee has no recourse in such a situation, because on expiry of the contract a franchisee has no enforceable right.

Franchising is often compared to a marriage. An official of the Franchise Council of Australia once made this comparison concluding, 'When it's over, it's over.' This may be true, but the state will not permit one party to a marriage to walk away with everything that the other has contributed over the years of the relationship. Similarly, a franchisor should not be permitted to walk away with everything that a franchisee contributes over the course of the franchise relationship. Since most franchises are renewed, those franchisors that fail to renew are actually free-riding on the reputation of others. Such free-riding creates market inefficiency, and appropriate methods to correct it should be considered by legislators.

3.1 The use of a statutory duty of good faith as a form of principles-based regulation

Nonrenewal is an issue that raises the possibility of the option of a statutory requirement of good faith. A statutory requirement of good faith for termination and nonrenewal has been enacted in approximately half of the US states that have relationship laws for the franchise sector. The reason for this is that the adoption of good faith as a regulatory option in such a situation affords some significant advantages.

One advantage of good faith is that it is a principles-based rather than a rules-based regulatory strategy. It has therefore an aspirational quality that rules cannot offer, and is potentially more conductive to relationships of trust rather than suspicion. 'If we trust someone simply because legal sanctions apply for breaking rules, we do not, in fact, trust them at all.'[91] Also, principles rather than rules allow regulation to respond effectively to evolving conditions without the need for frequent amendment to rules, amendment that can undermine the effectiveness of such rules.[92]

3.2 The importance of good faith in the relational context

Good faith is particularly appropriate, even essential, to effective relational contracting because it accommodates the incompleteness of contracts and the limits in the forecasting capacity. With respect to franchising, Gillian Hadfield asserts that good faith is necessary to bring 'the resolution of franchise disputes in line with realities of the franchise relationship.'[93] Andrew Terry quotes Thomas J. in *Bobux*, 'Good faith is required to ensure that the requisite communication, co-operation and predictable performance occurs for the advantage of both parties. In short, the obligation seeks to hold the parties to the promise implicit in a continuing, relational commercial transaction.'[94] Good faith accomplishes these ends by emphasising the participatory nature of contracts, and by encompassing social rules and practices, as well as non-promissory elements. Good faith stresses the moral element of contract

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[91] Stavros B. Thomadakis, 'What Makes Good Regulation?' IFAC Council Seminar (2007), http://www.ipiob.org/downloads/speeches/What_Makes_Good_Regulation.pdf at 1 September 2008.

[92] Ibid.

[93] Ibid.

[94] Thomas J in *Bobux Marketing Ltd v Raynor Marketing Ltd* [2002] 1 NZLR 506.

relations, counteracts threats to solidarity and helps to overcome barriers for communication. Overall, good faith highlights values and legally protects the trust element, without which no contract is effective.[95]

Indeed, it has been argued that good faith is essential to give the intended effect to relational contracts,

> 'The concept of good faith gains an importance which was nonexistent before. … [G]ood faith has been gaining increasing importance in contemporary contract doctrine and practice, largely constituting the main link among the principles of cooperation, trust and solidarity in modern contract law. From a relational perspective, good faith may be seen as the primary source of contractual responsibility. …obligations arise because society imposes them and not only because an individual promise has stipulated them. Other society objectives and values, such as the idea of distributive justice or individuals' well-being also have to be balanced against the private interests in the contract. Such balance is achieved through the concept of good faith. For relational theory, good faith plays the relevant role of encouraging the continuity of contract relations ...Good faith enables one to think of suitable contract agent behavior in different contexts, according to the outlines and meanings of each concrete existing contract relationship. It works as a true "calibration norm"of relational contract theory .' [96]

Similarly, in his analysis of good faith in commercial contracts, William Dixon argues that the relational norms of honesty, trust and flexibility offer the definition required in the application of good faith in commercial contexts, 'I have suggested elsewhere that an obligation of good faith, in contractual performance and enforcement, should be implied, as a matter of law, in commercial contracts that are relational in nature, rather than commercial contracts per se.'[97] He concludes, 'In short, the express recognition of good faith as a relational concept offers a structured path forward for common law claims arising from commercial contracts.'[98]

3.3 A duty of good faith helps to address many of the issues that are caused by the interaction of the standard form and relational qualities of the contract

Good faith addresses the dangers that arise due to the power imbalance, the discretion to a franchisor and the shifting of risk to a franchisee. A franchisor will not relinquish this power and indeed, power in itself is not a bad thing. The problem arises when power is abused; and a good faith requirement can deter abuse.

Good faith is also appropriate to meet the conditions created by the commodification of contract (namely the application of traditional contractual doctrine to standard form

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[95] Based on the work of R. Macedo, 'Relational Contracts in Brazilian Law', Latin American Studies Association, Guadalajara, Mexico, 1997.

[96] Ronaldo P. Macedo, 'Relational Contracts in Brazilian Law', Latin American Studies Association, Guadalajara, Mexico, 1997. See also Stewart Macaulay on contract relations among businesses in the state of Wisconsin, 'Non-contractual Relations in Business: A Preliminary Study'.

[97] W. M. Dixon, 'What is the Content of the Common Law Obligation of Good Faith in Commercial Franchises?' (2005) 33(3) ABLR 207.

[98] W. M. Dixon, 'Common Law Obligations of Good Faith in Australian Commercial Contracts – a Relational Recipe' (2005) 33 ABLR 87, 98.

contracts as discussed above) and the role of a franchisee as a consumer. Good faith is widely used in consumer protection, for example in the Uniform Commercial Code (UCC), where, 'Good faith is specifically mentioned in fifty different UCC provisions.'[99]

A statutory duty of good faith may be appropriate for broader application in franchise regulation, for example in some of the other instances where franchisor opportunism is an issue. As a starting point, however, it could be particularly useful with respect to non-renewal. Non-renewal is different from all other situations in which franchisor opportunism may arise, because there is no contractual or regulatory protection available to franchisees facing nonrenewal. Nor can good faith be implied after the term of the contract has expired. It is therefore the primary example of a situation where franchisor opportunism requires protection in the form of a statutory duty of good faith.

3.4 A trend toward increased reliance on good faith in Australia

The implied obligation of good faith has been accepted in NSW courts[100], particularly in connection with the exercise of contractual rights, and the doctrine has been recognised also in Victoria.[101] Finkelstein J in *Pacific Brands* expressed the view "that the duty of good faith is an incident (not an ad hoc implied term) of every commercial contract unless [it] is either excluded expressly or by necessary implication"[102]

While closely related doctrines have formed part of English and Australian law for well over 100 years,[103] there has been no express adoption of good faith by the High

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[99] Paul J. Powers, 'Defining the Undefinable: Good Faith and the United Nations Convention on Contracts for the International Sale of Goods', 18 *Journal of Law and Commerce* (1999) 333-353, <http://www.cisg.law.pace.edu/cisg/biblio/powers.html> at 25 August 2008.

[100] See *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234; *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187. See also McDougall who states, 'Certainly, since the decision in *Burger King v Hungry Jack's Pty Ltd* [2001] NSWCA 187, it has been clear – at least in New South Wales – that a duty of good faith in the performance of obligations, and the exercise of rights, may be imposed *by implication* on the parties to a contract.'

[101] McDougall cites *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum N L* [2005] VSCA 228. 'In that case Buchanan JA, who gave the leading judgment, appeared to accept that an obligation of good faith could be implied into some contracts. However, his Honour at para [25] expressed reluctance "to conclude that commercial contracts are a class of contracts carrying an implied term of good faith as a legal incident…., so that an obligation of good faith applies indiscriminately to all the rights and power [sic] conferred by a commercial contract". His Honour did recognise, in the same paragraph, that it might "be appropriate in a particular case to import such an obligation to protect a vulnerable party from exploitive [sic] conduct which subverts the original purpose for which the contract was made." …The existence and scope of an implied obligation of good faith is not yet settled in Australian common law. The judgment in *Esso* indicates that it may become more difficult, at least in Victoria, for parties to be able to successfully argue for the implication of an obligation to act in good faith.'

[102] *Pacific Brands Pty Ltd v Underworks Pty Ltd [2005] FCA 288* at para [64].

[103] Justice Robert McDougall, 'The Implied Duty of Good Faith in Australian Contract Law' (New South Wales Supreme Court Speech, 21 February 2006) <http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/pages/SCO_mcdougall210206> at 26 October 2006.

Court.[104] The reluctance of the courts to act on their own volition may be seen, for example, in Justice Kirby's concern that the idea of an implied term of good faith and fair dealing ' appears to conflict with fundamental notions of *caveat emptor.'* Other reasons that may be advanced by the courts for rejecting an implied obligation include the interests of commercial certainty, and because the parties already have recourse to other settled rules, including estoppel and unconscionability…. Further, good faith is unlikely to be implied in the face of contrary contractual intention (either express or derived by necessary implication from the contract as a whole considered against its factual matrix).

Where it has been recognised by the Courts, the content of the duty has been evolving. In one of the early cases in this area, *Renard,* Priestley JA equated the concept of good faith to that of reasonableness (26 NSWLR at 258), although later decisions of the NSW Court of Appeal in *Alcatel*, *Burger King* and *Vodafone*[105] have all recognised that the duty of good faith is distinct from traditional duties of cooperation and reasonableness, although there is clearly some overlap between them. In other jurisdictions, Buchanan JA in the Victorian Court of Appeal in *Esso* referred to Priestley JA's equation in *Renard* (26 NSWLR) at 263 of good faith with reasonableness; and to the view of Finkelstein J in *Garry Rogers Motors Aust Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703, where his Honour said at 43,014 that the obligation of good faith required a party not to act capriciously.[106] Buchanan JA referred further to conduct seeking to prevent the performance of the contract or withholding its benefits, or seeking to further an ulterior or extraneous purpose, as indicating breach of the obligation (and, thereby, indicating further content of the obligation); he drew these examples from the decisions of Byrne J in *Far Horizons v McDonalds Aust* [2000] VSC 310 at para [120] and Sheller JA in *Alcatel* (44 NSWLR) at 368.'[107]

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[104] In *Esso Australia Resources v Southern Pacific Petroleum (Esso Australia Resources Pty Ltd (ACN 091 829 819) v Southern Pacific Petroleum NL (receivers and managers appointed) (administrators appointed) (ACN 008 460 366) & Ors* (Unreported, Supreme Court of Victoria Court of Appeal, Warren CJ, Buchanan JA and Osborn AJA, 15 September 2005), their Honours appear to be heralding certain limitations on the implication of an obligation of good faith where 'commercial leviathans are contractually engaged'. …Two judges of the High Court made similarly cautious comments in *Royal Botanic Gardens and Domain Trust v South Sydney Council* [2002] HCA 5; (2002) 186 ALR 289.

[105] *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349*; Burger King v Hungry Jack's Pty Ltd* [2001] NSWCA 187*; Vodafone Pacific Limited v Mobile Innovations Limited* [2004] NSWCA 15.

[106] *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum N L* [2005] VSCA 228 at para [28].

[107] Justice Robert McDougall, 'The Implied Duty of Good Faith in Australian Contract Law' (New South Wales Supreme Court Speech, 21 February 2006), 'Thus, I do not think that it is fruitful to enquire, in some a priori way, as to the content of the concept of "good faith" in a contractual context. It is necessary to look at the particular contract, to see what might be comprehended as a particular expression of the general concept of good faith, and then to enquire whether that particular term, or a term having that particular content, should be implied, or whether is excluded by express terms or necessary implication from them. But it would not follow that, because one particular element of good faith is excluded thereby, or others are likewise excluded. For example, Dr Peden suggests (op. cit. [7.2]) that one incident of the contractual duty of good faith is "to have regard to the interests of the other party, without subordinating one's own interests". The suggested obligation to do that may be denied by an express term (properly construed), or by necessary implication from all the terms (properly construed), of the contract; but it would not follow that there is no duty of good faith whatsoever. Rather, in those circumstances, there may be a duty of good faith, the content of which is limited, or diminished, by reason of the terms of the contract properly construed.'

The Matthews Committee[108] noted that,

> 'In the Australian jurisdictions that have accepted the existence of the concept of good faith in contract law, there does not appear to be a clear consensus regarding:
>
> (a) whether good faith obligations are to be imposed on franchise agreements:
>
> > (i) because good faith obligations are to be found in all commercial contracts, and franchise agreements are a species of commercial contracts;
> >
> > (ii) because franchise agreements are a category of contracts in which good faith obligations are to be imposed; or
> >
> > (iii) on a case by case basis, depending on the particular circumstances in which the franchise agreement was formed;
>
> (b) what the precise content of good faith or fair dealing obligations might be in franchise agreements, and what might constitute a breach of such obligations; and
>
> (c) what the consequences of a breach of good faith or fair dealing obligations are.'

Implied good faith has not yet been wholly embraced by Australian courts, for a variety of reasons. The problem with with the adoption of good faith by courts in Australia is an issue of 'policy rather than practicality or theory:… to what extent should the courts interfere in the bargains of parties, by imposing terms that the courts think necessary?'[109] Justice McDougall notes that '…the interests of certainty in contractual activity should be interfered with only when the relationship between the parties is unbalanced and one party is at a substantial disadvantage, or is particularly vulnerable in the prevailing context."[110]

The nature of the relationship and of the agreement between franchisor and franchisee is the type of relationship Justice McDougall describes. Imbalance and its ensuing disadvantage for franchisees is the prevailing context in franchising, but the application of good faith by the courts cannot be assured. This unpredictability, rather than militating against the adoption of express good faith, is in fact why it is needed. Uncertainties attending the implication or construction of good faith in contracts can be avoided through express and /or statutory good faith. Express contractual obligations of good faith are fundamentally impracticable in the franchise context, however, because of the lack of negotiating power of a franchisee.[111]

As long as courts are unwilling to imply or construe a duty of good faith, it is up to legislators to provide for it, to fill the gap and to supply some certainty. Without

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[108] Matthews Committee Report (Oct 2006) Appendix F.

[109] Justice Robert McDougall, 'The Implied Duty of Good Faith in Australian Contract Law' (New South Wales Supreme Court Speech, 21 February 2006) <http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/pages/SCO_mcdougall210206> at 26 October 2006.

[110] Justice Robert McDougall, 'The Implied Duty of Good Faith in Australian Contract Law' (New South Wales Supreme Court Speech, 21 February 2006) <http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/pages/SCO_mcdougall210206> at 26 October 2006.

[111] Express term of good faith rarely appears in contracts sampled.

statutory guidance, the courts may be ill-equipped to develop the appropriate duty of good faith that can respond to the challenges identified in this paper posed by both the relational and standard form nature of franchising contracts. There are numerous precedents for imposing or recognising obligations of good faith in statutory contexts in Australia – these include the Oil Code Regulations of 2006 (Clause 32(6)-(9)), the unconscionability provisions of the Trade Practices Act (eg. s.51AC), the Victorian Fair Trading Act (s.32W), and Native Title legislation. A statutory duty of good faith also reflects a trend toward increased reliance on good faith in other countries.

3.5 Adoption of good faith in Australia would be consistent with a trend toward reliance on statutory good faith in other jurisdictions

Civil law states take an expansive approach to the duty of good faith, applying it to both to contract formation and performance,[112] while common law jurisdictions typically impose a narrower duty applicable only to contract performance.[113] Though in the UK lawyers rely on the common law to find the duty, in the US a duty of good faith is implied in every contract governed by the Uniform Commercial Code (UCC).[114] The *Restatement (Second) of Contracts* also imposes a duty of good faith in the performance and enforcement of contracts. In Canada as well studies have concluded that there is a need for a good faith standard for performance in contracts of sale, recommending the adoption of a good faith doctrine very similar to that set forth in the *Restatement (Second) of Contracts*.

Good faith is also imposed under international conventions. In the first ten years of the CISG, courts have recognized a good faith obligation in contract performance as a requirement for contracting parties. The UNIDROIT Principles of International Commercial Contracts [the "UNIDROIT Principles"] impose a greater duty of good faith on contracting parties than the CISG does. An obligation of good faith is also imposed by other international agreements. For example, the Principles of European

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[112] In France a pre-contractual duty of good faith is based in tort and on contract after contract formation. In Belgium the civil code requires all contracts to be executed in good faith and contractual interpretations are informed by custom and usage. German legislation requires contracting parties to observe good faith not only in contract negotiation, but also in contract performance. Good faith incorporates the customs practiced by the contracting parties as well as a general requirement to act reasonably. The German duty of good faith goes beyond a requirement to act reasonably; it requires a relationship of trust based on the commercial dealing of the parties in a particular transaction. See Paul J. Powers, 'Defining the Undefinable: Good Faith and the United Nations Convention on Contracts for the International Sale of Goods', 18 *Journal of Law and Commerce* (1999) 333-353, http://www.cisg.law.pace.edu/cisg/biblio/powers.html 25 August 2008.

[113] In the European civil law jurisdictions, the German, French, Dutch and Italian, for example, good faith is emphasised as a paramount and statutory duty in contractual reciprocity. Within English law, and maybe to a lesser extent Scottish law, the concept of good faith is left more to "find its own way" within judicial deliberation. It is not expressly insisted upon as a condition of a legal contract; it is "naturally presumed" rather than formally enshrined. Paul J. Powers, 'Defining the Undefinable: Good Faith and the United Nations Convention on Contracts for the International Sale of Goods', 18 *Journal of Law and Commerce* (1999) 333-353, http://www.cisg.law.pace.edu/cisg/biblio/powers.html 25 August 2008.

[114] Section 1-203 of the UCC.

Contract Law include provisions requiring good faith generally and in negotiating a contract.[115]

Adoption of good faith in Australia therefore would be consistent with a trend toward increased reliance on good faith in other countries. In Australia it has been recognized that, '…No individual or commercial entity can foresee all circumstances. The purpose of good faith is to act as a "leveller" which brings events into line, which were either subjectively or objectively agreed upon in the contract. The sheer volume of cases where courts are asked to rule on good faith indicates that contractual parties have embraced the concept of good faith and the "leap of faith" as discussed by Gummow J is long overdue.'[116]

3.6 Statutory good faith in the US and Canada

Only a few US states have passed franchise statutes of *general application* that expressly require the parties to deal in good faith.[117] In Canada Section 7 of the Alberta Act provides, 'Every franchise agreement imposes on each party a duty of fair dealing in its performance and enforcement.' [118] Ontario has a similar provision.[119] Under the Civil Code of Quebec contracts must not only be carried out in good faith, they must also be negotiated in good faith. [27]

Approximately 20 US states and territories have 'relationship statutes' that govern various aspects of the franchise relationship.[120] Such relationship statutes generally provide protections against wrongful termination.[121] Most such statutes with were enacted in response to perceived unequal bargaining power and the use of "adhesion

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[115] See Paul J. Powers, 'Defining the Undefinable: Good Faith and the United Nations Convention on Contracts for the International Sale of Goods', 18 *Journal of Law and Commerce* (1999) 333-353, http://www.cisg.law.pace.edu/cisg/biblio/powers.html 25 August 2008.

[116] Bruno Zeller , 'Good Faith - Is it a Contractual Obligation?', 13 *Bond Law Review* 214, 239.

[117] Jane Cohen and Larry Weinberg, Good Faith and Fair Dealing: A Primer on the Differences between the United States and Canada. …In 1987 the National Conference of Commissioners on Uniform State Laws adopted the Uniform Franchise and Business Opportunities Act (UFBOA). …The UFBOA expressly imposed a duty of good faith. … however, no state has adopted the UFBOA.

[118]Franchises Act, S.A. 1995, (Alberta Act), s. 7.

[119] Arthur Wishart Act (Franchise Disclosure), 2000 (the Ontario Act) ss. 3 (1).

[120] The states with relationship laws are: Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Washington and Wisconsin. The District of Columbia, Puerto Rico and the Virgin Islands also have statutes that govern the termination of franchises. South Dakota and Virginia's statutes do not directly address termination but they arguably restrict a franchisor's discretion in refusing to renew a franchise. The remaining states do not have franchise relationship statutes, but may have industry-specific (i.e., petroleum or auto dealer) statutes. See http://law.richmond.edu/jolt/v6i1/lockerby.txt See also From http://www.franchise-law-firm.com/franchise_sales_reference/state_relationship_laws.htm.

[121] Such protections override the terms of the franchise or distributorship agreement. Also note the distinction between rights to renew (and good cause for failure to renew) under the agreement and a straight expiration of the contract where there is no renewal right provided for, at least in those states that distinguish between the two. See *Wright-Moore Corp. v. Ricoh Corp.*, 980 F.2d 432 (7th Cir. 1992)(Indiana).

contracts" … and were designed to protect licensees against indiscriminate termination."[122]

The content of a duty of good faith is an important consideration, but not a simple one. The essence of the obligation is shared throughout world, but there are particular aspects of the doctrine that vary among legal traditions and jurisdictions.[123] Despite extensive case law Germany has not established a definition but does require a contracting party, before and after a contract is formed, to respect the relationship of trust between the parties and to act reasonably in not breaching that relationship. Italy has a pre-contract duty of good faith in negotiating as well as a contract performance duty; good faith becomes an ethical obligation which is an integral part of public policy. [124] In common law jurisdictions good faith requires parties to perform their obligations under the contract fairly, honestly, and in a manner acceptable in their trade or business. *Black's Law Dictionary* defines good faith as "an intangible and abstract quality with no technical meaning or statutory definition, and it encompasses, among other things, an honest belief, the absence of malice and the absence of design to defraud or to seek an unconscionable advantage. . . ." The UCC defines good faith as "honesty in fact in the conduct or transaction concerned." Good faith is defined in the *Restatement* as a "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party."

The problems that may arise due to this lack of a unified and precise definition of good faith can be circumvented largely by inclusion in the statute of what meaning is intended. Most relationship statutes in th US provide that franchisors may not terminate franchisees without good cause, good cause and notice, just cause, good faith, good faith with good cause, or due cause.[125]

Though it has been observed that , "Good cause" differs substantially from "good faith,"[126] but the two concepts do overlap where in some instances good faith informs the meaning good cause. Under most statutes "good cause" is determined solely by

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[122] Similarly, the Petroleum Marketing Practices Act was enacted because Congress was concerned that threats of arbitrary termination or non-renewal were being used against franchisees to exact unfair concessions. For a summary of provisions of the various relationship statutes in the US see Appendix C in Barkoff and Selden, *Fundamentals of Franchising, 2d Ed.* (2004), 325.

[123] Paul J. Powers, 'Defining the Undefinable: Good Faith and the United Nations Convention on Contracts for the International Sale of Goods', 18 *Journal of Law and Commerce* (1999) 333-353, http://www.cisg.law.pace.edu/cisg/biblio/powers.html 25 August 2008.

[124] Ibid.

[125] Delaware and Indiana each forbid a franchisor from refusing to renew *without good cause or in bad faith,* using the disjunctive to emphasize that the franchisor's motives for nonrenewal are distinct from, and equally important as, having *good cause.* Even in states which do not have relationship statutes, all reasons for termination should be carefully documented. The common law in Pennsylvania, for example, requires that, ". . .in the absence of a provision in a franchise agreement authorising termination or non-renewal without cause, a franchisor must act in good faith and in accord with the franchisee's commercially reasonable expectations in terminating a franchise relationship." FRANCHISE TRANSFER, SUCCESSION AND RENEWAL ISSUES, Robert Calihan, Steven Emmons, Rochelle B. Spandorf, Craig Tractenberg; INTERNATIONAL FRANCHISE ASSOCIATION 4th annual legal symposium (2001).

[126] Byron Fox and Bruce Schaeffer**,** *Franchise Regulation and Damages*, §17.01 Wrongful Termination.

whether or not the franchisee violated the terms of the franchise. In general, the determination as to whether or not there is "good cause" ignores the business interests of the licensor, especially if the licensed services or products continue to be offered in the territory of the terminated licensee. Termination of a franchise requires prior written notice identifying the "good cause" for termination by setting forth the reasons in advance. The applicable statute often spells out certain acts, omissions, or circumstances that constitute good cause. Most states with relationship laws find good cause to exit, based upon a franchisee's (1) failure to pay monies owed to the franchisor;(2) failure of a franchisee to obtain prior consent to an assignment of its franchised business in violation of the franchise agreement;(3) failure to meet contractual sales quotas;(4) the sale of competing goods;(5) failure to adhere to the quality standards of the franchise system;(6) failure to comply with the required hours of operation;(7) misuse of trademarks; and(8) the abandonment of the franchised business. Arkansas and California define *good cause* by a non-exhaustive list of examples. A number of other states take a similar approach by listing permissible reasons for non-renewal.[127]

If the statutory "shopping list" is not applicable to a particular situation, the following commonly constitute good cause:

- Failure to meet performance criteria. To constitute good cause, the performance criteria must be reasonable, essential, and applied in a non-discriminatory way.
- System-wide changes. A non-discriminatory, reasonable change in all of a manufacturer's dealerships may constitute good cause under certain circumstances.
- Violations of contract or law.
- Market withdrawal. There are conflicting decisions as to whether a manufacturer's withdrawal from a market constitutes good cause. However, a change in distribution allegedly required by economic necessity is not good cause for termination of existing dealers absent withdrawal from the market.[128]

[127] These include events such as failure to act in good faith and in a commercially reasonably manner; a franchisee's voluntary abandonment of the franchise business; a franchisee's conviction of certain crimes; a franchisee's conduct that substantially impairs the franchisors' trademarks; a franchisee's insolvency or bankruptcy; loss of the right to occupy the franchised premises; monetary or reporting defaults; and repeated breaches of contract within a short time frame.

[128] http://www.weblocator.com/attorney/ca/law/b26.html#cab261200 at6 September 2008.

Summary of Recommendations

1. Address the need for better quality, unbiased data about the sector

1.1. Encourage research, not just in the disciplines where it has been concentrated in the past such as marketing and management, but also in law and economics where research has been lacking.

1.2. Require registration of documents to provide a rich source of relatively accurate data.

2. Address the inadequacies of the three principal tools currently used in regulating the sector

2.1. Disclosure

2.1.1. Improve the reliability and accessibility of information

2.1.1.1. There is little benefit and some potential harm in expanding disclosure requirements, as a large amount of information already required, but fine-tuning of disclosure can ensure that information is best targeted to a franchisee's due diligence and is presented in a timely and accessible way.

2.1.2. Ensure useability of the information by recipients

2.1.2.1. Encourage franchisee participation in collective understanding and structuring of franchise agreements.

2.1.2.2. Improve franchisee ability to understand and participate by implementing a comprehensive education program, perhaps including a franchisee certification requirement.

2.2. Mediation

2.2.1. Expand the role of the OMA to

2.2.1.1. Ensure options for dispute resolution are available where mediation is not the method best suited to the interests of both parties;

2.2.1.2. Assist parties to understand and select from among these options and to access the proper tools to prepare for the selected procedure; and

2.2.1.3. Gather more thorough information about the progress and outcomes of conflict in the sector.

2.3. Substantive measures, such as encroachment, use of funds for promotions, supply requirements, transfer and termination

2.3.1. A broad range of prescriptive, procedural, and performance-oriented tools must be considered to most effectively achieve the specific aims of regulatory intervention.

2.3.1.1. Because the current measures are aimed essentially at ensuring procedural standards are met, there may be a need for a further

requirement of substantive fairness in the exercise of franchisor discretion in these stages of the relationship such as a statutory duty of good faith and good cause for failure to renew.

3. Reframe regulation as a democratic, participative, collaborative process consistent with the 'new learning' about regulation.

3.1. This requires a reframing of the roles not only of a franchisee, but also of franchisors and of the regulator.

3.2. Reframing franchisees' roles

3.2.1. Regulators have viewed franchising as a business-to-business transaction, and have not regarded franchisees as needing consumer-like regulatory protection. This evaluation of the power in the relationship is inaccurate; in fact the imbalance of power in every aspect of the franchising relationship, including the regulatory process itself, contributes significantly to the ineffectiveness of current regulation.

3.3. Reframing franchisors' roles

3.3.1. Franchisors control information about the sector generally and dominate discourse within and about regulation of the sector.

3.3.2. Franchisors provide the disclosed information as they see fit, without the benefit of monitoring.

3.3.3. Franchisors draft 'industry standard' contract terms that they are unwilling to negotiate, thus depriving franchisees of their ability to act on disclosed information.

3.3.4. Franchisor trade associations are the only organizations 'educating' franchisees to equip them to use the information.

3.4. Reframing the regulator's role

3.4.1. The regulator facilitates this arrangement; there is no reason to expect franchisors to try to change it.

3.4.2. Recognition by the regulator and representation to the regulator of franchisees as consumers is a critical aspect of establishing fair conditions in the sector.

3.4.3. The role of the regulator should extend to facilitating the education and collective activity of franchisees in order to better represent and protect their own interests.

3.4.4. Where franchisees are unable to protect their own interests due to inherent power imbalance, then targeted regulatory intervention should be supplied.

APPENDIX A – Contract terms granting discretion to a franchisor

The following two excerpts from Australian franchise contracts provide for franchisor discretion with respect to general conditions and terms and changes thereto (italics added):

- 'Franchisee further acknowledges and agrees that (franchisor)shall have sole control and discretion over the development of the System and the designation of the Products and services to be offered in the Store, and that Franchisee will comply with franchisor's requirements in that regard.'[129]

- 'Standard franchise agreement means the standard terms and conditions pertaining to the grant of a franchise by us as amended by us from time to time in our *absolute discretion*.'[130]

Another contract ensures franchisor discretion to exercise control in various aspects of performance (italics added):

- 'The Franchisee must not sell the Products from a removable site or vehicle, whether within or outside the Territory, without the express prior written consent of the Franchisor. The consent of the Franchisor may be granted or withheld at the Franchisor's *absolute discretion* and on such conditions as the Franchisor shall determine.'

- 'The Franchisee may not establish or operate another business similar to the Business, whether inside or outside the Territory, without the prior written consent of the Franchisor. The consent of the Franchisor may be granted or withheld at the Franchisor's *absolute discretion and on such conditions as the Franchisor shall determine*.' [131]

Most franchise contracts contain fewer obligations for a franchisor than for a franchisee. A franchisor's contractual obligation usually involves some commitment to maintain and promote the brand and to provide training, but these obligations are almost always to be carried out at a franchisor's discretion. A contract arranged with an 'Our Obligations' section for a franchisor and a 'Your Obligations' section for a franchisee provides a neatly packaged example of disparity between franchisor and franchisee obligations. The franchisor's 'Our Obligations' section is two pages in length and consists of 14 items, many of which can be performed according to franchisor discretion, while the franchisee's 'Your Obligations' section covers four pages and consists of 58 items, many of which are highly specific and/or are also subject to franchisor discretion.

[129] System F1.

[130] System F5.

[131] System F2.