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AUSTRALIA'S UPDATED FRANCHISE CODE OF CONDUCT: DOES AN EXPRESS OBLIGATION OF GOOD FAITH BENEFIT THE FRANCHISOR OR FRANCHISEE?

Natalie Sears*

I. INTRODUCTION

AUSTRALIA regulates its franchising operations more heavily than most other countries through the enforcement of its Franchising Code of Conduct (“the Code”).¹ The Code became a mandatory Industry Code under the Competition and Consumer Act 2010.² It aims to inform local franchisees by disclosing details regarding their rights and obligations under a franchise agreement, including disclosure, contractual, and dispute resolution rights.³ The Code is enforced by the Australian Competitor and Consumer Commission and seeks to provide guidance to people interested in entering a franchising relationship.⁴ The most recent revision to the Code occurred in 2010, but since then, the number of business format franchises has grown by over 3,000 units.⁵ Growth within the franchising industry has led to increased unfair trade practices, an issue exacerbated by the imbalance of power inherent in the franchisor/franchisee relationship. Unfair trade practices were a growing concern for the Australian Commonwealth Government while revising the Franchising Code in 2009.⁶ On January 4, 2013, the Australian Government announced another review of the Franchising Code to be con-

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1. See *Trade Practices (Industry Codes—Franchising) Regulations 1998* (Cth) (Austl.), available at <http://www.comlaw.gov.au/Details/F2010C00457/>.
2. *Complying with the Franchising Code of Conduct Franchising*, BUSINESS.GOV.AU, <http://www.business.gov.au/BusinessTopics/Franchising/Buyinganewfranchise/Pages/Complying-with-the-Franchising-Code-of-Conduct.aspx> (last visited Mar. 17, 2014).
3. *Id.*
4. *Id.*
5. LORELLE FRAZER, SCOTT WEAVER & KELLI BODEY, *FRANCHISING AUSTRALIA* 2012 12 (2012) available at <http://www.australianfranchising.com.au/downloads/FranchisingAustraliaSurvey-2012.pdf>.
6. OPPORTUNITY NOT OPPORTUNISM: IMPROVING CONDUCT IN AUSTRALIAN FRANCHISING 2–3(2009) [hereinafter OPPORTUNITY NOT OPPORTUNISM], available at <http://www.innovation.gov.au/SmallBusiness/CodesOfConduct/Documents/GovernmentresponseFranchising.pdf>.

ducted by Mr. Alan Wein. Mr. Wein earned a Law Institute of Victoria (LIV) practicing certificate and is an accredited mediator with the Australian mediation organizations LIV and LEADR, having also gained experience as a mediator in the Office of the Franchising Mediation Adviser (OFMA).⁷ In addition, Mr. Wein was appointed as the inaugural chair of the Victorian government's Small Business Advisory Council in 2000.⁸ The short three-year gap between Code revisions is evidence of the Australian Government's ability and tendency to implement new provisions in the Code more efficiently than other countries, such as the United States.⁹

After Mr. Wein provided his recommendations, the Australian Government announced its response on July 24, 2013 and accepted, in full or in principle, most of his proposals.¹⁰ Among the most anticipated and disputed provisions included the accepted recommendation for an express obligation of good faith.¹¹ The duty of good faith can permeate a franchise agreement in three different ways: "as an express term of the contract, as a term implied in fact on an ad hoc basis to give business efficacy to the contract, or as a term implied in law as a necessary incident of the contract."¹² A default option is that the duty of good faith can be applied to all common law contract principles, regardless of whether such language is present within the franchising agreement.¹³ Prior to the Australian Government's amendment to the Code, a conflict existed in the nation's case law as to whether any of the above options fit within their common law jurisdiction.¹⁴

II. DUTY OF GOOD FAITH

The Australian Government's acceptance of Recommendation 9, an "express obligation to act in good faith," extends to most phases of the franchise relationship, including the negotiation and performance of the parties' agreement, performance of the Code's requirements, and resolution of disputes between the franchisor and franchisee.¹⁵

7. *Franchising Code of Conduct*, AUSTRAL. GOV'T DEP'T OF INDUS., <http://www.innovation.gov.au/smallbusiness/codesofconduct/Pages/FranchisingCodeofConduct.aspx> (last visited Mar. 18, 2014); *Alan Wein, LLB*, AUSTRAL. GOV'T DEP'T OF INDUS., <http://www.innovation.gov.au/smallbusiness/codesofconduct/Pages/AlanWeinLLB.aspx> (last visited Mar. 18, 2014).

8. *Id.*

9. Rupert M. Barkoff, *A Look at Franchise Regulation from Ground Level to 30,000 Feet*, 32 *FRANCHISE L.J.* 153, 155 (2013).

10. Press Release, Austl. Gov't, Government to Strengthen \$130 Billion Franchising Sector (July 24, 2013), *available at* <http://www.franchise.org.au/articles/government-to-strengthen-130-billion-franchising-sector.html>.

11. GARY GRAY & BERNIE RIPOLL, *FORWARD LOOKING FRANCHISING REGULATION 4* (2013), *available at* <http://www.innovation.gov.au/smallbusiness/codesofconduct/Documents/GovernmentResponseToFranchisingCodereview.pdf>.

12. Andrew Terry & Cary Di Lernia, *Franchising and the Quest for the Holy Grail: Good Faith or Good Intentions?*, 33 *MELB. U.L. REV.* 542, 546 (2009).

13. *Id.*

14. *Id.* at 546–47.

15. GRAY & RIPOLL, *supra*, note 11 at 13.

Legal scholars and courts have debated whether a duty of good faith should be applied to franchise agreements at all. Some courts believe that an express duty of good faith runs afoul of the economic principle of caveat emptor.¹⁶ Other courts have stated that such a duty would rarely entice franchisors and franchisees to actually comply or cooperate with the standards required of good faith behavior.¹⁷ For example, in *Butt v. McDonald*, Chief Justice Griffith wrote that “a general rule [applies] to every contract that each party agrees, by implication, to do all such things as are necessary on his part to enable the other party to have the benefit of the contract.”¹⁸ The Australian High Court subsequently affirmed this idea in *Secured Income Real Estate (Australia) Ltd v. St Martins Investments Pty Ltd*.¹⁹ Legal scholars in the United States have addressed this issue by critiquing the common assumption that franchisees consider all relevant information before signing franchise agreements.²⁰ Many scholars find that franchisees’ lack of business experience and knowledge hinder their ability to consider relevant information before opening a franchise unit, and are thus more susceptible to franchisor abuse.²¹

The Australian Government previously addressed whether to add an express obligation of good faith, but believed such an obligation should only be included in the Code “as long as the scope of this obligation is well defined.”²² The government stated specific concerns related to enacting a good faith requirement that included potential increases in the risks, costs, and financing of franchising operations.²³ The Government was also concerned that a broad definition of good faith would inhibit franchisors’ or franchisees’ ability to recognize when a breach of that duty occurred.²⁴ It also worried that franchisees would be at a comparative disadvantage because they have less access to legal advice than franchisors. In addition, the Government believed an express obligation of good faith would result in franchisees having to pay increased fees to compensate for franchisors increased risk in the uncertainty of such a provision in the Code.²⁵

Although civil law jurisdictions consistently apply the good faith standard to contract law, which controls franchising agreements, common law jurisdictions such as Australia are not as consistent in applying such a

16. GILES CONSULTING INT’L, DUTY OF GOOD FAITH BACKGROUND BRIEFING PAPER 15 (2012), available at <http://www.innovation.gov.au/smallbusiness/codesofconduct/Documents/Lottery%20Agents%20Association%20of%20Victoria%20Attachment.pdf>.

17. Marilyn Warren, *Good Faith: Where Are We At?*, 34 MELB. U.L. REV. 344, 349–50.

18. *Id.* at 349 n.32 (quoting *Butt v. McDonald*, 7 QLJ 68, 70–71 (1896) (Griffith, CJ)).

19. *Id.* at 349.

20. Robert W. Emerson & Uri Benoliel, *Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws*, 76 ALB. L. REV. 193, 194 (2013).

21. *Id.*

22. OPPORTUNITY NOT OPPORTUNISM, *supra* note 6, at 4.

23. *Id.*

24. *Id.* at 13.

25. *Id.*

concept.²⁶ Despite the Australian Government's decision to decline an earlier implementation of an express duty of good faith, prior case law shows conflicting judicial support of such an implied duty.²⁷ For example, Justice Finkelstein of the Federal Court of Australia wrote that "such a term will ordinarily be implied; not as an ad hoc term . . . but as a legal incident of the relationship."²⁸ In addition, the New South Wales Court of Appeal has opined that the law should always imply a duty of good faith upon parties of contractual relationships.²⁹ But the High Court of Australia has neither addressed the issue of implementing a duty of good faith nor defined the standard, which further complicates the application of the duty of good faith.³⁰ This uncertainty contributes to parties' concerns when resolving disputes because even courts are unsure of exactly what the good faith standard entails.³¹ It will particularly disadvantage franchisees, whom typically have less legal and economic resources at their disposal.³²

Other common law jurisdictions have statutorily provided for a duty of good faith in the franchising context. For example, in the United States, the Uniform Commercial Code § 1-304 provides that "every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."³³ In addition, the Restatement (Second) of Contracts states that the duty of good faith and fair dealing is applied to both parties in every contract.³⁴ In declining to explicitly define the definition of "good faith" within the revised Code, the Australian Government chose to apply case law, impliedly inserting the standard within the contractual relationship context.³⁵ Similarly, the United States' statutes governing this duty also decline to provide a specific definition. The majority view within the United States is to use a standard of honesty and reasonableness when determining whether a breach of the duty of good faith occurred.³⁶

26. Terry & Di Lernia, *supra* note 12, at 543.

27. *Id.* at 547-48.

28. *Id.* at 547 (quoting Garry Rogers Motors (Aust) Pty Ltd v. Subaru (Aust) Pty Ltd [1999] FCA 903 ¶ 34 (Finkelstein, Judge) (internal citations omitted)).

29. Andrew Stewart, *Good Faith: A Necessary Element in Australian Employment Law?*, 32 COMP. LAB. L. & POL'Y J. 521, 541 (2011).

30. Terry & Di Lernia, *supra* note 12, at 548.

31. GILES CONSULTING INT'L, *supra* note 16, at 3.

32. *Id.*

33. U.C.C. § 1-304 (2012).

34. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

35. GRAY & RIPOLL, *supra* note 11, at 13.

36. Auto-Chlor Sys. of Minn. v. JohnsonDiversey, 328 F. Supp. 2d 980, 1006 (D. Minn. 2004).

III. THE DUTY OF GOOD FAITH'S IMPACT ON FRANCHISING RELATIONSHIPS

A. GOOD FAITH REQUIREMENT SEEKS TO REDUCE UNEQUAL BARGAINING POWER INHERENT DURING PRE-CONTRACTUAL RELATIONS

The Australian government's decision to add an express duty of good faith applies to all phases of the franchise relationship, beginning with negotiations between a franchisor and prospective franchisee.³⁷ The unequal bargaining power typically occurring between franchisors and franchisees is of huge concern to the Australian government, so they will apply the duty of good faith to negotiations and dealings before a contract is signed in order to prevent one party from making material misrepresentations or omissions. In the 2013 review of the Code, the Australian government also amended the duty to disclose information imposed upon the franchisor.³⁸ Franchisors must now provide prospective franchisees with a list of risks and other matters they should be aware of before entering a franchising agreement.³⁹

During pre-contractual negotiations, the duty to disclose will be based on the good faith of both parties. But in reality, the franchisor will be the party disclosing the most pertinent information and therefore also the party most likely to breach the duty of good faith upon failure to disclose.⁴⁰ This scenario has frequently played out in the U.S. court system with the application of the Federal Trade Commission rule requiring disclosure within franchising and business opportunities.⁴¹

B. EFFECTING THE ONGOING FRANCHISE RELATIONSHIP

The express duty of good faith will also have a significant impact on the ongoing relationship between franchisors and franchisees. After signing the franchising agreement, disputes ranging from contract interpretation to required additional capital expenditure issues are likely to arise.

One of the additional recommendations accepted by the Australian government is the requirement for franchisors to give franchisees the basis for additional capital improvements.⁴² One implication of this requirement is that franchisors must now include provisions requiring such improvements within the franchising agreement. If franchisors fail to expressly include this provision within the agreement, they will have to subsequently prove that such capital improvements are not "unreasonable."⁴³ In addition, franchisors will now have to protect them-

37. GRAY & RIPOLL, *supra* note 11, at 13.

38. *Id.* at 8-9.

39. *Id.* at 9.

40. Paul Steinberg & Gerald Lescatre, *Beguiling Heresy: Regulating the Franchise Relationship*, 109 PENN. ST. L. REV. 105, 109 (2004).

41. See 16 CFR § 436.1(d) (2007).

42. GRAY & RIPOLL, *supra* note 11, at 11-12.

43. *Id.* at 12.

selves from claims by franchisees arguing that such improvements breach their contractual duty to act in good faith. This will only complicate interpretation disputes down the road because a franchise agreement alone will provide the court with little guidance as to whether the franchisor's requiring of a franchisee to build a new office space violates the terms of the contract and the duty of good faith.⁴⁴

An additional issue that commonly arises in jurisdictions with an express duty of good faith is whether a franchisor has the ability to waive the duty of good faith within their franchising agreement and whether the express terms of the agreement will supersede the good faith requirement.⁴⁵ This situation commonly occurs when a franchisor attempts to waive the duty of good faith to reduce their liabilities for franchisees' conduct.⁴⁶ The Australian government's decision to use the unwritten law's definition of good faith, rather than to create an express definition within the Code, will only exacerbate this dispute. The practice is also used in the United States, where neither the Uniform Commercial Code nor the Restatement (Second) of Contracts precisely defines good faith. The benchmark used by U.S. courts to determine a breach of good faith is the Restatement's definition of bad faith, which involves "violat[ing] the community standards of decency, fairness or reasonableness."⁴⁷ The Australian courts will continue to apply the unwritten law to define good faith in resolving franchise relationship disputes. But they will have to provide more guidance on what constitutes breach to protect franchisees that have less access to legal services when drafting contracts with franchisors.

A court may also use the duty of good faith to interpret contracts with ambiguous or omitted terms. For example, the court could forbid enforcement of contracts that allow one party (usually the franchisor) to use its inherent discretion to act unreasonably or outside the scope of the contract.⁴⁸ In addition, both the Australian government and United States have stated that the duty of good faith aims to serve exactly those kinds of contracts—where one party has the discretion to determine certain terms of a contract.⁴⁹

Because the Code has not previously required a duty of good faith in Australian franchising agreements, the issue of waivers attempting to exclude the duty of good faith has not been addressed in the Australian court system. In the United States, however, there is still dispute as to whether the covenant of good faith is mandatory and therefore a provi-

44. Carmen D. Caruso, *Franchising's Enlightened Compromise: The Implied Covenant of Good Faith and Fair Dealing*, 26 FRANCHISE L.J. 207, 209 (2007).

45. *Id.* at 211.

46. *Id.*

47. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

48. Frank J. Cavico, *The Covenant of Good Faith and Fair Dealing in the Franchise Business Relationship*, 6 BARRY L. REV. 61, 78–79 (2006).

49. *Id.* at 79.

sion parties cannot contract around.⁵⁰ For this reason, many franchising agreements written in the United States include provisions attempting to revoke the duty to act in good faith, "except as may be provided by statute or regulation," knowing that the duty of good faith is an implied covenant, rather than statutory principle.⁵¹ It is likely Australian courts will uphold the principle that the good faith requirement is binding because unlike in the United States, the Australian Code expressly provides for an obligation to act in good faith, rather than simply implying a covenant to do so.

C. DUTY OF GOOD FAITH IS LIKELY TO RESULT IN INCREASED LITIGATION BETWEEN A FRANCHISOR AND FRANCHISEE

The most likely repercussion of incorporating a duty of good faith into franchising agreements will be a significant increase in litigation between franchisors and franchisees claiming a breach of this duty. Franchisees will likely supplement their lawsuits against franchisors with this claim and franchisors will follow suit. As a result, the issue of whether express terms of a franchising agreement, where applicable, will supersede the duty of good faith and control the outcomes of such lawsuits will arise.⁵² The Australian government's amendment to the Code will make the duty of good faith binding upon every franchise agreement entered into. But the issue may still arise as to whether contractual provisions in conflict with the duty of good faith will prevail or be held unenforceable against the franchisee.

The Government's decision to include an express duty of good faith in the Code reflects their longstanding aim to improve franchise relationships and neutralize the unequal bargaining positions of both parties.⁵³ But the Australian government's decision to apply unwritten law relating to good faith to franchising agreements will likely cause confusion among franchisors, franchisees, and even the courts.⁵⁴ In accepting the duty of good faith recommendation, the Australian government also stated concerns that "merely referring to the unwritten law will make it difficult for parties without legal representation to appreciate what may be required of them."⁵⁵ This obstacle will prove especially burdensome to franchisees, which ordinarily have fewer resources and access to legal representation than their franchisor counterparts.

Franchisees, franchisors, and courts looking for guidance in determining what actions constitute a breach of the duty of good faith can look to

50. Kathryn Lea Harman, *The Good Faith Gamble in Franchise Agreements: Does Your Implied Covenant Trump My Express Term?*, 28 CUMB. L. REV. 473, 478 (1997).

51. Caruso, *supra* note 44, at 207.

52. *Id.*

53. See GRAY & RIPOLL, *supra* note 11; OPPORTUNITY NOT OPPORTUNISM, *supra* note 6.

54. GRAY & RIPOLL, *supra* note 11, at 13.

55. *Id.*

case law that used the business unconscionability provision in 51AC of the Trade Practices Act of 1974.⁵⁶ That section of the Trade Practices Act allows courts to determine if a party has acted unconscionably by factoring in whether their actions were made in good faith.⁵⁷ But the new amendment creating an express duty of good faith should aid courts, which have previously been in conflict over whether such a duty is present in the franchising sector.⁵⁸ The courts were primarily in dispute as to whether an implied term of good faith is applicable in a commercial contract, especially because such a term conflicts with common law principles of caveat emptor.⁵⁹ But, because the obligation of good faith will now be statutorily required, the courts will have no other option but to impose such obligation upon both parties to a franchise agreement.

D. DOES THE DUTY OF GOOD FAITH BENEFIT THE FRANCHISEE, AS INTENDED BY THE AUSTRALIAN GOVERNMENT, OR THE FRANCHISOR?

The Australian government declared that the express duty of good faith now applies to every franchising agreement with the hope that it will benefit their growing franchise industry.⁶⁰ A duty of good faith, on its face, appears to benefit franchisees, typically small business owners who are outdone in size and power by large franchisors looking to form agreements most favorable to their concerns. But the Australian government declined to provide a formal explicit definition within the Code and instead decided to use the current case law on the implied duty of good faith as a guide for franchisors and franchisees.⁶¹ The Australian government pointed out that because of this decision, parties without legal representation would find it difficult to ascertain the true meaning of the duty of good faith.⁶² Further complicating the effort to define an obligation of good faith is the fact that many requirements in the Code already go beyond what traditional notions of good faith require. Examples of this dilemma include the requirement for franchisors to disclose information that may have been withheld for their own economic advantage and to give notices of intended conduct. For this reason, some scholars have suggested that it may have been better to prohibit intentional conduct that is intended to injure the other party within their franchise relationship.⁶³

Adding to the ambiguity of this new amendment, previous case law has conflicted on the extent of the duty of good faith's application.⁶⁴ For example, one court found that McDonald's action in denying a current fran-

56. Terry & Di Lernia, *supra* note 12, at 545.

57. *Id.*

58. *Id.* at 546-47.

59. *Id.* at 549.

60. See GRAY & RIPOLL, *supra* note 11.

61. *Id.* at 13.

62. *Id.*

63. Steinberg & Lescatre, *supra* note 40, at 198.

64. Terry & Di Lernia, *supra* note 12, at 561.

chisee the ability to open a new store was not made in bad faith, but rather an action taken in accord with its own legitimate business interests.⁶⁵ Some courts, in deciding the standard for finding a breach of good faith, have evaluated the intent of the franchisor's actions in making decisions, while other courts have used a standard of requiring franchisees to avoid conduct that would damage or destroy a franchisee's business.⁶⁶ The ambiguities present in both the updated Code and case law will be a great concern to franchisees bringing suit against their franchisors.

IV. CONCLUSION

The duty of good faith is one of the most widely disputed, and accepted, notions of contract law around the world. Australia's recent amendment providing for an explicit obligation of good faith in the franchising sector further increases regulations in an already highly regulated franchising industry. This amendment is important because it will affect the way foreign and domestic franchisors conduct business in Australia with their local franchisees. Although such a duty would seek to equalize power among parties throughout all phases of the franchise relationship, U.S. case law covering similar ideals proves otherwise.

In order for Australia to continue growing their franchise industry, there must be a more clearly defined duty of good faith. The Australian government accepted Mr. Wein's recommendation for an express obligation of good faith, but declined to provide a specific definition within the Code. As it stands, Australian case law addresses only the implied common law obligation of good faith, and court decisions vary widely regarding the duty's application and measure of breach. When the obligation of good faith becomes codified, Australian courts will likely see an increase in litigation surrounding disputes among parties in a franchise relationship. The majority of suits will probably be brought by franchisees, who may use this duty to supplement other claims against their franchisor counterparts. In addition, there will be more riding on these case decisions, as the new Code will provide for civil pecuniary penalties for violating the obligation of good faith.⁶⁷ The only guidance franchisors and franchisees have in acting in accordance with the duty of good faith will have to come out of court decisions. The average franchisor will have more legal resources at their disposal to resolve these disputes and ensure compliance during the ongoing franchise relationship. Most franchisees, however, are local Australian citizens who don't have access to such resources. Therefore, it appears that the inequality in bargaining power sought to be decreased through an express obligation of good faith will actually remain until the obligation of good faith is more clearly defined through case law. Moving forward, it is wise for franchisees to define the controlling obligation of good faith and the subsequent duties upon both

65. *Id.*

66. *Id.* at 562.

67. OPPORTUNITY NOT OPPORTUNISM, *supra*, note 6, at 7.

parties in a franchise agreement. This specificity can only help franchisees narrow their opportunity for error during the ongoing relationship and assist courts in resolving disputes between the parties. Overall, it appears that the obligation of good faith will prove beneficial to the franchisor relationship, but will require considerable common law development with regards to its scope and application. Let the litigation begin.

Updates

