

Franchising Alert

June 2010

This alert contains information on the following topics:

- **Revolutionary changes in Consumer Law now in effect**
- **Termination of franchise - lessons to be learnt from the Blockbuster decision**

Revolutionary changes in Consumer Law now in effect

From 15 April 2010 new laws are in effect which will radically alter the enforcement and application of laws relating to how business relates to consumers.

Key changes

- **National enforcement regime**
The Commonwealth and State and Territory bodies (such as the Fair Trade authorities) will now work co-operatively.
- **Penalties**
Previously, penalties were only criminal penalties. Only the Commonwealth Director of Public Prosecutions could undertake such enforcement and it was rare for a case to be brought by the DPP.
The standard of proof was based on the criminal standard. Now penalties are civil pecuniary penalties and may be enforced by the ACCC and State bodies at the lower standard of proof, thus making the regulators' chances of success much greater. Under the new legislation, the ACCC can seek financial penalties up to \$1.1million for corporations and \$220,000 for individuals. (These penalties do not apply to s52 which prohibits engaging in conduct which is misleading or deceptive).
- **Expansion of penalties**
Civil penalties now apply to breaches of the unconscionability provisions. Previously, there were no pecuniary penalties for breaching those provisions. Penalties range from up to \$1.1million for corporations and up to \$220,000 for individuals.
- **Power to issue substantiation notices**
Such notices will require the recipient to be able to provide information requiring substantiation of their representations. In the past the Commission's information gathering powers were more limited.

- **Power to issue infringement notices**
Rather like a speeding ticket – you may pay up upon receipt of the notice or require the ACCC to take the matter to court.
As with a speeding ticket one suspects that many companies will just pay up rather than take their chances with a legal battle against a well funded regulator. The penalties payable under infringement notices range from \$6,600 for corporations and \$1,320 for individuals.
- **Orders** disqualifying persons from managing corporations.
- **New powers** for the ACCC to conduct random audits of franchise systems.
- **New naming and shaming powers** called Public Warning Notices.

Unfair Contract Terms

In addition and soon to come into effect will be laws about "unfair contract terms". These laws will commence on and from 1 July 2010.

A term will be regarded as "unfair" if it:

- causes a significant imbalance in the parties' rights and obligations under the standard form contract;
- is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the terms; and
- it would cause detriment (financial or otherwise) to a party if it were applied or relied on.

How does this affect you or your franchisees?

Advertising

- If you are involved in advertising, or otherwise make claims about your products, services or systems you must ensure that you can substantiate those



claims made in advertisements. This may require you in some circumstances to have readily available scientific support which you obtain directly or which you require your supplier to provide.

- You may need to independently test supplier claims if you have any reason to doubt the validity of their statements. You will most certainly need such information prior to making any claims so that you are able to promptly respond to requests for substantiation.
- Alternatively you may need to tone down the claim or display prominently any disclaimers. Make sure you are not “trumpeting the benefits and whispering the limitations”.

Franchisor

- The substantiation provisions might apply to you if you are supplying information to your franchisees.
- Could you stand up to a random audit by the ACCC to demonstrate compliance with the code? For example, can you produce all your disclosure document receipts and prove that franchisees were given a proper disclosure document at least 14 days prior to entering into the franchise?

Distributor

- Might you be subject to the Franchising Code? The ACCC is actively looking to find companies who should be complying with the Franchising Code but do not.
- Review your compliance policies and procedures in respect of all areas

relating to consumer protection and to unconscionable conduct (which is not limited to consumers).

- Start reviewing your contracts under the Unfair Contracts terms legislation.

Do you use standard form contracts?

- Check now whether the Unfair Contract terms legislation might apply to your dealings.
- If so, review your terms and conditions now in anticipation of the law coming into effect.

Compliance Programs

- Review your compliance policies and procedures including training to ensure that your organisation has identified risks and remedied those policies and procedures that are defective or out of date.

Termination of franchise - Lessons to be learnt from the Blockbuster decision

In late 2009, the New South Wales Supreme Court handed down a decision in a matter brought by Blockbuster Australia Pty Ltd (Blockbuster) against a franchisee, Karioi Pty Ltd (Karioi).

The judgment contains cautionary lessons for franchisors, particularly in relation to rights accruing when a franchise term is ended, restraints of trade and control of a franchised site.

It is also particularly relevant to established businesses that join a franchise network, as opposed to franchises which are established from green field sites.

Termination vs. Expiration

The central issue in the case was whether the franchise agreement had been terminated or expired. Blockbuster argued that the franchise agreement was terminated and sought to enforce various rights which it said applied on termination but the Court found that the agreement had expired.

The term of the 10 year franchise agreements came to an end in early April 2008. However the parties continued to operate ‘as usual’ until 31 August 2008 whilst negotiations continued about a renewal. Negotiations ultimately broke

down and Blockbuster unsuccessfully argued that the ending of the negotiation period amounted to termination of the franchise agreement.

It is fair to say that the franchise agreement in the Blockbuster case was not clear about all of the rights which accrued to the franchisor at termination, as opposed to expiration. This point may seem trivial but the law of contract recognises the difference between expiration and termination of an agreement.

Importantly, as was the case in this decision, many franchise agreements provide a franchisor with differing rights depending on whether a franchise agreement is terminated or expires. Unfortunately, some franchise agreements intermingle concepts of termination and expiration or are imprecise about rights which may accrue when expiration occurs, as opposed to termination.

For example, in the Blockbuster case the franchisor had an option to purchase all the franchisee’s assets (including goodwill) if the agreement expired. The Court rightly held this was a significant benefit to a franchisee.

There however was no option or obligation to purchase all assets (including goodwill) if a termination occurred. In fact, on

termination Blockbuster had a separate right to selectively choose various fittings and equipment, rather than a right to purchase all assets (including goodwill).

Blockbuster tried to enforce its right to selectively choose assets it wanted from the franchisee on the basis the agreement was terminated. The Court denied this relief on the basis that the agreement expired and the right to selectively choose assets only applied if the agreement was terminated.

Blockbuster also sought relief to have the franchisee assign to it the lease of the franchised premises. This relief was based on an express clause in the franchise agreement which on its face required the franchisee to assign or transfer the lease if required by Blockbuster.

Again this is a common term seen in many franchise agreements. The problem for Blockbuster was that the clause was found in section 18 of the agreement which was headed “Action upon Termination”.

Interestingly, under the heading to clause 18 it had a preamble to the following subsections which said “Upon this Agreement being terminated or expiring for whatever reasons”. Despite this wording, the clause in question made no mention of whether it applied on termination, expiration or both.



The Court ‘read down’ the clause against Blockbuster and held that the right to require an assignment of the lease only arose on a termination. This meant the franchisee was able to remain running the store as a video outlet under a different trading name. The court said that it would ‘defy business commonsense’ if Blockbuster was able to force an assignment of the lease from the franchisee in circumstances where the franchise agreement had expired and Blockbuster did not elect to purchase the assets and goodwill of the franchisee.

Restraint of Trade

Blockbuster also sought to enforce a restraint of trade clause to prevent the former franchisee running a competing video outlet and using confidential information. Blockbuster said that its legitimate rights to be protected were the customer database, the store location and industrial property/confidential information about operating systems, marketing strategies and pricing structures.

In coming to its decision, the Court emphasised that to determine whether a restraint provision is enforceable involves two distinct findings. Firstly, what is the legitimate interest to be protected by the restraint clause and secondly, is the restraint reasonable in that it should provide “no more than adequate protection to the party in whose favour it is imposed”. This distinction is commonly overlooked when restraint clauses are drafted or disputed.

In positive news for franchisors, the Court accepted that Blockbuster had a legitimate

interest in protecting the customer database and its confidential information. It also accepted that director restraints were separate and distinct, and independently enforceable provided they were reasonable.

The Court however declined to accept that Blockbuster’s legitimate interest extended to the store location in circumstances where the store was an existing video outlet, prior to it coming under the Blockbuster banner. This is an important issue for some franchise systems who commonly take over established businesses.

Ultimately based on the facts of this case, the Court held that the restraint clause was unreasonable. It declined to enforce the restraint clause in Blockbuster’s favour so as to prevent the franchisee from continuing to trade as a video outlet. This was largely because the franchisee had operated the video outlet for many years prior to becoming a Blockbuster franchisee and had built up substantial goodwill of its own.

The Court also held that Blockbuster could have protected itself by exercising its option to purchase the franchisee’s assets (including the goodwill) but declined to do so.

Confidential Information

In terms of confidential information, the Court held that this was protected by various clauses in the franchise agreement which were independent of the termination clauses and restraint clauses. The Court held that the franchisee had breached the franchise agreement by using the confidential information and damages were

payable. In addition, the franchisee was required to give to the franchisor copies of the customer database which had been created and developed during the period of the 10 year franchise.

Key Considerations from the Blockbuster Case

1. Careful consideration needs to be given whether a franchise agreement has expired or has been terminated.
2. Where a site is valuable and needs to remain part of the franchise system, rather than relying on contractual rights to take assignment of the lease at the end of the franchise, franchisors should consider whether they should hold the head lease. If this carries too much of a risk for a franchisor they need to ensure that the franchise agreement and lease have appropriately worded clauses that allow the franchisor to compel an assignment or transfer if the franchise agreement ends.
3. Franchisors need to consider what rights they want to accrue depending on whether the franchise agreement expires or is terminated. The rights must clearly state whether they apply on termination, expiration or both.
4. Franchisors need to consider what ‘interests’ need protecting and what is reasonable to protect those interests. Generalised restraint clauses can be very difficult to enforce, especially if the incoming franchisee has an existing business with an established location and existing goodwill.

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