ARE YOU READY FOR THE EXTENSION OF THE UNFAIR CONTRACT TERMS REGIME TO FRANCHISE AGREEMENTS?

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IN BRIEF

Since 2010, the Australian Consumer Law (ACL) and the ASIC Act have prohibited and made void terms in standard form contracts with consumers that were unfair.

From 12 November 2016, the Unfair Contract Terms regime (UCT Regime) will be extended to standard form contracts entered into with "small business".

Despite there already being provisions in place to protect the position of franchisees under the Franchising Code of Conduct, the UCT Regime will apply to franchise agreements where the franchisee is a "small business". In fact, franchising is one of the sectors where the ACCC is presently concentrating its education/compliance efforts – and will no doubt concentrate its enforcement efforts following 12 November 2016.

Franchisors need to ensure that the terms and conditions of their franchise agreements and other related agreements are not at risk of being alleged to be unfair and hence be void and unenforceable.

THE UNFAIR CONTRACT TERMS REGIME

On 12 November 2015, the Treasury Legislation Amendment (*Small Business and Unfair Terms) Act 2015* was passed and received Royal Assent. This act extended the application of the UCT Regime in the ACL and the ASIC Act to contracts with "small business" (defined below).

Under the ACL, a term of a consumer contract (and shortly, a small business contract) is void if the term is unfair and the contract is a standard form contract.

This article will focus on the impact of the extension to small business and its meaning, rather than on each element required to found an unfair term, but in brief:

- the law presumes that the contract under scrutiny is "standard form". It is up to the party that prepared the contract to prove that it is not "standard form" taking account factors such as
  - whether the contract was prepared by one party prior to discussions with the other party, and
  - whether there was a real opportunity to negotiate the terms of the contract, particularly the terms being examined, or whether the contract took account of the specific characteristics of the counterparty
- a term is unfair if:

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- it would cause significant imbalance in the parties' rights and obligations arising under the contract, and
- it is not reasonably necessary in order to protect the legitimate business interests of the party who would be advantaged by the term, and
- it would cause detriment (whether financial or otherwise) to a party if it were applied or relied upon.

- Further, in considering whether a term is unfair, regard has to be given to the whole contract (i.e. the other rights and obligations under the contract) and the extent to which the relevant term was transparent (including whether it was expressed in plain English and readily available to any party affected by the term).

WHAT IS A SMALL BUSINESS CONTRACT AND WHICH CLAUSES ARE SUBJECT TO THE UCT REGIME?

The UCT Regime will apply to small business contracts entered into after 12 November 2016, or renewed after that date, or amended after that date (although the regime only applies to the terms amended after that date).

- A small business contract is:
- a contract for the supply of goods and services, or a sale or a grant of an interest in land, and
- at the time the contract is entered into one party to the contract is a business that employs fewer than 20 persons; and either the upfront price payable under the contract:
  - is $300,000 or less, or
  - $1million or less where the duration of the contract is greater than 12 months.
- As per the existing provisions, a term that sets the upfront price payable under the contract cannot (itself) be considered as an unfair term.

Below is further commentary about these terms.

APPLICATION OF THE UNFAIR CONTRACT TERMS REGIME TO FRANCHISE AGREEMENTS

Both during the consultation period with Commonwealth Treasury, as well as the enquiry by the Senate Economics Committee, representatives of the franchising industry and in particular, the Franchise Council of Australia, argued that there should be an exemption from the regime for franchise agreements.

The argument for such an exemption was that the franchise industry was already subject to quite prescriptive regulation, including the Franchising Code of Conduct, which give significant rights to franchisees. In particular, agreements could not be entered into without a franchisee receiving written statements from an independent legal adviser or accountant that the franchisee had been advised about the agreement, provided for cooling off period, required parties to act in good faith and provided mechanisms for dispute resolution.

Notwithstanding these arguments, there is no exemption for franchise agreements. Further, the Australian Competition and Consumer Commission (ACCC), the regulator and primary enforcement agency, has stated that

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"franchising" is one of the key areas where it is presently focusing its education/compliance resources regarding unfair contract terms in the lead-up to 12 November. It will no doubt also be focusing its enforcement resources at the franchising sector after that date, in the event of non-compliance.

In fact, various ACCC publications and speeches relating to the extension of the regime to small business contracts refer explicitly to "franchising" and provide franchising related examples to explain the above terms. The Commonwealth Government has also allocated AUD1.4million to the ACCC to help educate/enforce the new law.

WHAT IS A "SMALL BUSINESS" AND THE "UPFRONT PRICE"?

"a business that employs fewer than 20 persons"

The above phrase raises some uncertainty including what is a "business", whether only "employees" are included or whether contractors/labour hire personnel are included, whether it applies to full time/part time personnel and how the larger business/franchisor will know at the time of entering into the agreement the number of employees of the franchisee?

From a risk management/compliance perspective, and anticipating that for the most part it is likely to be the ACCC rather than counterparties that will be investigating/taking action, our views are as follows:

- Both the legislation as well as the guidance from the ACCC refers explicitly to "employees". Accordingly, the starting position is seeking to ascertain the number of employees.
- The legislation states that both permanent and casual employees are to be included in the headcount, as long as the casual employees are employed on a regular and systematic basis. The legislation is silent on part time employees. The ACCC takes the view that a part time employee is still counted as an employee for the purposes of this definition.
- Accordingly, a franchisor has two options:
    - It could take the more conservative or risk averse approach of assuming that all of its franchisees have less than 20 employees and ensuring that the terms of its franchise agreement are compliant with the unfair contract terms regime. Clearly, this reduces risk and is administratively "easier" for the franchisor, as there is one standard set of terms. However, it may have commercial and legal implications for the franchisor. It may provide rights and benefits to franchisees having more than 20 employees where it would not be in the franchisor's commercial interests to provide such rights to its counterparties. The franchisor will therefore "leave money on the table".
    - It may, as part of entering into the franchise agreement, and each renewal, seek written confirmation that the franchisor has greater than 20 employees – and if it wishes to do so can have a different set of terms depending on the response. While the ACCC states that the response of the smaller party is not determinative if in fact the franchisee had less than 20 staff at the time of entering into the agreement, it will have a significant impact of the ACCC's decision making process about investigation and enforcement (on the basis the franchisor took reasonable steps and acted in good faith).

What is included in the "upfront price"

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The ACL defines this term as the consideration that is provided for the supply, sale or grant under the contract which is disclosed at or before the time the contract is entered into, excluding:

- any other consideration that is contingent on the occurrence or non-occurrence of a particular event.

In seeking to give examples as guidance for this calculation process, the ACCC sets out a number of "franchising" examples which we have combined for the purposes of this article as follows:

- A franchisor and a franchisee enter into a five year agreement. Under the agreement, the franchisee agrees to pay an upfront fee of AUD500,000 and a monthly royalty based on 5% of the franchisee's sales. The agreement also provides for a AUD6,000 termination fee.
- The ACCC's view is that in seeking to determine whether the upfront price falls below AUD1million, the AUD500,000 will be included, but not the royalty payments as they are contingent on prospective and unknown levels of sales. The AUD6,000 fee is also not included as that is not referable to the supply or a sale under the agreement.
- Accordingly, if the franchisee had fewer than 20 employees:
  - the agreement is subject to the UCT Regime
  - the fee of AUD500,000 is not to be considered under the UCT Regime, however
  - the royalty and termination payments can be considered under the UCT Regime.

WHAT TYPES OF TERMS WILL BE SUBJECT TO MOST SCRUTINY?

The legislation (which provides 14 examples of terms that may be unfair), guidelines by the ACCC, as well as a small number of judgments have provided good guidance as to the types of terms at risk. Many of the examples provide for one party having a right that the other does not have, as opposed to reciprocal right. Some examples that the ACCC has particularly focused on are:

- the right to unilaterally vary the contract, including in particular, to vary the price or the characteristics of the goods or services to be supplied
- early termination fees
- limitation of liability (or no liability clauses)
- automatic rollover clauses
- forfeiture clauses
- termination without cause clauses, and
- broad indemnity clauses.

The fact that the ACCC is focusing on the types of clauses above does not necessarily mean that they are unfair. It will always depend on the particular circumstances of each case.

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However, as regulators are more likely to intervene when they consider a term is likely to cause a detriment to a material number of counterparties to the larger party, it will be important to ensure that you consider carefully whether you have a legitimate business interest in including such a term in your contracts –and having evidence in place to support the claim of a legitimate business interest.

It is also important to take care about the claims/representations you make, for example in Disclosure Documents and other supporting materials provided to franchisees/prospective franchisees about their rights. While such documents are not subject to the UCT Regime (unless incorporated into the contract) if you misrepresent the rights and obligations under the contract, the ACCC will, in addition to taking enforcement action on the basis of unfair terms, can also allege that you are making misleading or deceptive representations. Breaches of these provisions can lead to very significant penalties.

WHAT TO DO/PRACTICAL RISK MANAGEMENT TIPS

Clearly, franchisors must review their franchise agreements to ensure that they are compliant with the UCT Regime and where there are such terms, consider the rationale for the terms and whether the terms are necessary to protect the legitimate interests of the franchisors – and evidence the necessity for these terms.

However, in addition to these agreements there will be a multiplicity of other agreements which are very relevant to your businesses such as confidentiality agreements, procurement agreements, supply agreements, various services agreements and the like.

While all agreements may ultimately need to be considered from the perspective of unfair terms if your franchisees are small businesses, in terms of prioritising your review, focus on:

- the agreements are core to the operation of your franchise system
- the agreements and the terms most likely to be alleged to be unfair
- the need for each of these terms, and the importance of these terms to your business system:
    - consider the extent to which you have had to rely on the term
    - consider the implications for you if the terms is not included in the agreement
    - consider any "push-back" and complaints from franchisees about the term and the manner in which you have resolved such complaints,

and having regard to the above, come to a view as to whether the term requires amendment or deletion. If the term is in your view necessary to protect your interests, proactively evidence, for your internal purposes, the nature of the interests necessary to be protected.

In addition, again prioritising your core/more important agreements, as part of the same process, consider how transparent/plain English are the terms and conditions of your agreements and whether you need to take any steps to make more transparent or highlight the terms that may be alleged to be unfair but which you consider are necessary to protect your legitimate interests. The more transparent/highlighted the better placed you will be in any negotiations with the ACCC in the future.

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As stated above, in addition to considering your agreements, consider the statements made in supporting or related documents that are provided to franchisees/prospective franchisees to ensure that they are not likely to be alleged to mislead them as to their rights and obligations.

Finally, implement processes into your organisations such that future agreements or amendments to agreements, where the counterparties are likely to be small business, are considered from the perspective of unfair contract terms and at the time of inclusion of terms that may be alleged to be unfair, provide for/evidence the rationale for such terms.

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