

Australia's competition authority uncovers unfair contract terms in franchise agreements

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Key Points

- Australia's competition authority, the Australian Competition and Consumer Commission (**ACCC**) released a report in December 2023 showing its findings arising from its audit of franchise agreements and their compliance with Australia's laws against unfair contract terms (**UCT**).
- In short, the ACCC raise **concerns** that "every franchising agreement reviewed contained potentially unfair contract terms". The issues identified related to:
 - unilateral variation clauses;
 - withholding and set-off payment clauses;
 - audit power clauses;
 - restraint of trade clauses; and
 - termination clauses.

Background - Why did the Australian Competition and Consumer Commission audit franchise agreements?

As summarised in our publication, **Australia's new Unfair Contract Terms laws**, from 9 November 2023, businesses, including franchisors, are prohibited from proposing, using and relying on UCTs in their standard form contracts with consumers and small businesses (which may include franchisees). New, substantial penalties apply for having such UCTs. Before 9 November 2023, if a court or tribunal found that a standard form small business or consumer contract contained a term that was unfair, the term would be unenforceable. Since November 2023, new financial penalties apply – and the maximum penalties under the new UCTs law are the greater of:

1. AU\$50 million;
2. three times the value of the "reasonably attributable" benefit obtained from the conduct, if the court can determine this; or
3. if a court cannot determine the benefit, 30% of adjusted turnover during the relevant breach period.

The maximum penalty for an individual is AU\$2.5 million.

This regime applies to:

1. standard form contracts made or renewed on or after 9 November 2023; or
2. a term of a contract that is varied or added on or after 9 November 2023; or
3. where a term of a contract is varied or added on or after 9 November 2023, the changes relevant to deciding whether a contract is a standard form contract apply to the whole contract.

What did the ACCC's review find?

The ACCC's **report** noted that typically franchise relationships involve a power imbalance between franchisors and franchisees – and the relationship can be characterised by significant controls and franchisees having limited bargaining power in negotiating the terms of a franchise agreement. The ACCC noted that there could be legitimate reasons why franchisors may require certain contractual powers however the audit revealed that clauses were broader than what the ACCC considered to be reasonably necessary to protect the franchisor's legitimate business interests.

In particular, the ACCC noted risks associated with five categories of clauses typically in the franchise agreements reviewed (and which are common in many franchise agreements).

1. Unilateral variation clauses - what was the concern?

- The ACCC considered that unilateral variation terms are particularly concerning when:
 - they give the franchisor an unconstrained ability to vary key aspects of the franchise agreement (including the terms under which the franchisee operates), and
 - the franchisee does not receive sufficient prior notice of the change and has no ability to exit the agreement without suffering financial detriment.
- The ACCC identified a range of concerning unilateral variation clauses, including terms that give the franchisor sole or absolute discretion to make changes to the agreement (or related documents) and where the franchisee was only entitled to a very short time period to implement the change.
- These clauses included terms on:
 - the franchisee's key performance indicators.
 - the brand's intellectual property.
 - the layout and fit-out of storefronts.
 - increasing the fees payable to the franchisor.
- In particular, two types of unilateral variation clauses were scrutinised:
 - the unilateral right to vary the franchise's operations manual, and
 - the unilateral right to vary the approved products list and approved suppliers list.
- **Varying the operations manual** - Terms that permit the franchisor to unilaterally vary the operations manual

appeared in 7 of the 10 franchise agreements reviewed by the ACCC - usually at the franchisor's sole discretion. The ACCC stated that there are instances where a franchisor may reasonably require the ability to make changes without seeking the franchisee's consent, for example, to respond to changes in the law. However, they expressed concern that terms which place no constraints or limits on when, how or why the franchisor may unilaterally vary the operations manual are likely to go beyond what is reasonably necessary to protect the franchisor's legitimate interests.

- **Varying the operations manual - What does the ACCC recommend?**

Specifically, the ACCC recommended that:

1. franchise agreements stipulate that the franchisor must provide reasonable written notice of the change and a reasonable opportunity for the franchisee to comply (noting that what is reasonable will vary depending on the franchise agreement and the type of change); and
2. franchisors should consider whether it is reasonable to require the franchisee to bear the cost of any changes; and
3. where possible the franchise agreement should give the franchisee the "right to negotiate changes" or the time frames by which they must be implemented.

- **Changing approved products lists and approved suppliers lists** - Terms that permit the franchisor to unilaterally vary the approved products list and/or the approved suppliers list appeared in 7 of the 10 franchise agreements reviewed by the ACCC. Terms such as these were noted by the ACCC as motivated by franchisors who aim to promote consistency across different franchise units, health and safety reasons (including traceability of inputs) and ensuring that the products or services provided or used by the franchisees meet certain standards and requirements.

The ACCC's compliance checks identified several clauses within 7 franchise agreements that gave the franchisor a unilateral right to add or remove products and/or suppliers at their sole discretion. However, the ACCC warned that such clauses are more likely to be unfair in the ACCC's view if they:

1. do not limit the circumstances in which the franchisor can make changes to the lists.
2. do not require the franchisor to give prior reasonable notice to franchisees of the change/s.
3. prevent franchisees in all circumstances from selling products already purchased from the earlier approved products/supplier list.

The ACCC expressed particular concern about there being no onus on a franchisor to minimise the financial impact on franchisees when changes are made to the lists.

- **Changing products and suppliers - What does the ACCC recommend?**

The ACCC recommended that clauses in the franchise agreement permitting the franchisor to vary approved products or suppliers:

1. should specify the circumstances in which the franchisor may review or make changes to the lists;
2. require the franchisor to provide the franchisee with reasonable notice of a proposed change to the lists (although the ACCC noted that notice alone may not prevent the term from being unfair);
3. afford the franchisee a reasonable time to comply with changes and, where appropriate, give the franchisee the right to negotiate changes or the timing by when they will take effect; and
4. where appropriate, provide the franchisee with a reasonable opportunity to reduce its losses and sell or use any goods purchased prior to notification of the change.

2. Withholding or setting-off payments - what was the concern?

- Terms that permit franchisors to withhold or set-off payments without giving the franchisee corresponding rights appeared in 7 of the 10 franchise agreements reviewed by the ACCC. The ACCC expressed concern that these types of terms can cause cash flow issues for small businesses.
- The ACCC in particular focussed on one-sided terms that enable the franchisor to withhold payments or set-off amounts in all circumstances may be unfair, especially when the franchisee has no corresponding rights or is explicitly prohibited under the terms of the agreement from reducing payments when the franchisor owes money to the franchisee.

• Withholding or setting-off payments - What does the ACCC recommend?

If a franchise agreement contains clauses permitting the franchisor to withhold payment or set-off, the ACCC recommend that:

1. the franchise agreement includes limitations on rights of set off for the franchisor – such as to require the franchisor to provide the franchisee reasonable notice of its intention to withhold or set-off payments and setting out the circumstances where it would be appropriate for the franchisee to withhold payments or set-off;
2. where possible, the franchise agreement should specify the method by which the franchisee can dispute or seek a review of a decision to withhold payment or set-off.

3. Auditing the franchisee's business - what was the concern?

- The ACCC reviewed the terms that permit the franchisor to audit the franchisee's business appeared in all 10 franchise agreements reviewed by the ACCC – noting that these were often included because of the importance of financial transparency in the franchisor-franchisee relationship.
- The ACCC focussed on clauses which delivered to the franchisor a broad discretion to decide when to audit a franchisee and where reasonable prior notice was not required to be given to the franchisee or those clauses which set out that, if a discrepancy is identified, the franchisee will be required to pay to the franchisor the amount of the underpayment or to reimburse the franchisor for expenses associated with the audit.
- Although the ACCC did not consider that such an approach is inherently unfair they were concerned about clauses which require the franchisee to pay interest on an underpayment at a higher default interest rate than what would apply in the normal course of business or to cover all fees and expenses related to the audit without limitation and where there is no obligation on the franchisor to keep the costs reasonable.

• Auditing the franchisee's business - What does the ACCC recommend?

If a franchise agreement contains clauses permitting the franchisor to audit the franchisee's business, the ACCC recommend that If the franchise agreement requires the franchisee to pay for the costs of the audit, those costs are proportionate and reasonable.

4. Restraints of trade - what was the concern?

- Terms that seek to limit when and/or where one party can supply goods or services for a period of time once the franchise agreement ends, appeared in all 10 franchise agreements reviewed by the ACCC.

- The ACCC noted that restraint of trade clauses are not inherently unfair, but that they are often framed in ways (whether preventing franchisees from trading in a certain area for a certain time or doing business with current or former customers of the franchise or soliciting employees of the franchise to leave the brand) which were not clear or transparent as the drafting methods can increase uncertainty about the extent to which franchisees are restrained.

- **Restraints of trade - What does the ACCC recommend?**

The ACCC noted that restraints which go beyond what is reasonably necessary to protect the franchisor's legitimate interests are likely to be unfair and:

1. franchisors should consider how to define the restricted conduct, restraint period and/or restraint area to only capture what is reasonably necessary to protect the franchisor's interests; and
2. ensure clauses are consistent with the franchise law and are clear and transparently drafted.

5. Termination clauses - what was the concern?

- The ACCC identified that most franchise agreements enabled the franchisor to terminate for breach of any term of the agreement (irrespective of whether the breach was material or minor) and few granted franchisees corresponding rights to terminate if the franchisor is in breach of the agreement and fails to remedy the breach.
- The ACCC in particular commented on the right of the franchisor to terminate the franchise agreement for convenience (that is, without cause where the franchisee had not breached the agreement).
- The ACCC noted termination clauses can be reasonably necessary to protect franchisors and their franchisee networks from harm caused by significant misconduct by a franchisee and can assist parties to the agreement to reduce their losses in the event a franchise unit is performing poorly.
- In the ACCC's view, clauses that permit the franchisor to terminate where the franchisee has failed to remedy a material breach of the agreement are unlikely to raise UCT concerns, provided the franchisee is afforded a reasonable opportunity to remedy the breach. The ACCC considers termination clauses to be more likely to raise UCT concerns where the franchisor is allowed to terminate the contract in a significantly wider range of circumstances compared to the franchisee. Although not common amongst the agreements reviewed, they were particularly concerned to find one contract which granted the franchisor the power to terminate a franchise agreement before it expired and without the consent of the franchisee, even if the franchisee had not breached the agreement. In the ACCC's view, such a clause is likely to be unfair because it goes beyond what is reasonably necessary to protect the franchisor's legitimate interests and will cause significant detriment to the franchisee if relied on. The ACCC noted that an obligation on the franchisor to provide the franchisee with reasonable written notice of the proposed termination and the reasons for it would not of itself prevent the clause from being unfair.

- **Termination clauses - What does the ACCC recommend?**

The ACCC stated that if a franchise agreement contains termination clauses, they recommend that:

1. the franchisor should consider whether termination is an appropriate remedy for particular breaches of the agreement;
2. ensure clauses are written in plain language, presented clearly and not hidden in the contract;
3. the franchise agreement has appropriate counter-balancing terms (i.e. the balance of termination rights between the franchisor and franchisee); and
4. franchisees are provided a reasonable opportunity to remedy any potential breaches that may give cause for termination under the agreement.

What should franchisors do in response to the ACCC's report?

Given the ACCC's report in the strongest indication of the enforcement focus of Australia's competition law regulator, franchisors should audit their franchise agreements and make any amendments necessary to address the ACCC's concerns about UCTs being in them. Franchisors should ensure that their contract terms do not go further than reasonably necessary to protect their legitimate interests and, in addition to complying with the Australian UCTs and franchising laws, franchise agreements should employ clear and transparent language to minimise risk of non-compliance.

Dentons can assist franchise parties to audit their franchise agreements for compliance with UCTs and franchise laws.

Please contact **Robyn Chatwood** or your usual Dentons franchise expert if you need assistance or advice on these matters.

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