

Good faith will create uncertainty, not solve problems.

The recent report by the Federal Parliamentary Joint Committee on Corporations and Financial Services entitled “*opportunity not opportunism: improving conduct in Australian franchising*” (“the Franchising Report”) asserted that there was evidence of opportunistic conduct in the franchising sector, and the best deterrent was “to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith”.¹

At first reading the recommendation appears innocuous enough. “Good faith” seems like a concept that fair minded people could readily accept, and the assertion that it is “widely accepted” as an implied duty invites the conclusion that the legislative intervention will cause minimal disruption. But is that true? The Franchise Council of Australia, the Shopping Centre Council and the Australian Competition and Consumer Commission all counselled against the inclusion of an explicit good faith obligation into the Trade Practices Act, so it will be interesting to see how the Government reacts to the Franchising Report, particularly as in December 2008 the Senate Standing Committee on Economics delivered its report on the need, scope and content of a definition of unconscionable conduct for the purposes of Part IVA of the Trade Practices Act 1974 (“the Unconscionable Conduct Report”). In that report the committee declined to recommend the insertion of a definition of good faith into the Act, commenting that the introduction of a definition of good faith “would only add uncertainty.”²

Given the Unconscionable Conduct Report, and the similar outcomes when this issue has been considered in the past, it would be surprising if the Government acted to introduce a specific good faith obligation into either the Franchising Code of Conduct or the Trade Practices Act. The Matthews Report of October 2006 noted that “recognition in the code of a concept of good faith and fair dealing would provide positive reinforcement to the development of improved relationships and dealings between franchisors, franchisees and prospective franchisees. The report recommended that “A statement obligating franchisors and prospective franchisees to act towards each other fairly and in good faith be developed for inclusion in the code.”³ However the government’s response to the report agreed with the

¹ Recommendation 8.

² Paragraph 5.43

³ Recommendation 25

“intention” that franchise participants act towards each other fairly and in good faith, but felt that this was adequately addressed in s51AC of the Trade Practices Act 1974 (Cth), which lists includes “good faith” as a factor that can be taken into account when determining unconscionability. The Unconscionable Conduct Report appears to clearly support the clarification of existing law in relation to unconscionable conduct as the preferred method of addressing any concerns.⁴

The “evidence” that is used in the Franchising Report to justify the introduction of the prohibition is for the most part untested assertion. The report acknowledges the structural integrity of the current regulatory regime, but expresses concern because of the “continuing absence of an explicit overarching standard of conduct for parties entering a franchise agreement”.⁵ The Report asserts that:

[T]he interdependent nature of the franchise relationship leaves the parties to the agreement vulnerable to opportunistic conduct by either franchisors or franchisees. Franchisee opportunism may take the form of free riding, unauthorised use of franchisors’ intellectual property rights, under-performance, or failure to accurately disclose income. However, the franchisor’s control over the provisions in the contract enables franchisors to address opportunistic behaviour of this kind by enforcing the terms of the franchise agreements.

Franchisor opportunism has been described as ‘predatory conduct and strong arm tactics by franchisors’ involving the exploitation of a pre-existing power relationship between the franchising parties, which makes the franchisee ‘vulnerable or economically captive to the demands of the franchisor’. There is an inherent and necessary imbalance of power in franchise agreements in favour of the franchisor, but abuse of this power can lead to opportunistic practices including encroachment, kickbacks, churning, non-renewal, transfer, termination at will, and unreasonable unilateral variations to the agreement.⁶

The Franchise Council of Australia and others took issue with the apparent lack of evidence to justify the assertions of opportunism, with the evidence and veracity of many of those submitting to the inquiry had previously been questioned.⁷ However the Committee

⁴ See for example paragraphs 5.41 – 5.43

⁵ Para 8.1

⁶ Para 8.2, 8.3

⁷ The FCA noted that many of the allegations of illegal franchisor behaviour are either old, and relate to concerns already remedied by most recent Code changes that took effect March 1, 2008, or had already been examined by the ACCC and others and found not to justify action. The FCA also observed that recent SA & WA franchising inquiries arose not because of a groundswell created by endemic franchising problems, but

remained concerned at the risk of what it termed opportunistic conduct. The Committee's conclusion was that the optimal way to provide a deterrent against opportunistic conduct in the franchising sector was "to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith".⁸ The committee recommended that the following new clause be inserted into the Franchising Code of Conduct:

Standard of Conduct

Franchisors, franchisees and prospective franchisees shall act in good faith in relation to all aspects of a franchise agreement.

Leaving aside the evidential issues, a few observations can be made which call into question the appropriateness of the recommendation:-

- There are no examples given of conduct that the Report considers to be in bad faith, only general assertions about what might constitute conduct that could be "opportunistic";
- The report implies that conduct that is "opportunistic" should not be permitted, nor should "predatory conduct" nor "strong arm tactics" by franchisors. "Vulnerable and economically captive franchisees" merit protection. Yet there is no effort made to link between these words to "good faith". Indeed it would seem on the proposed definition there is no link. Rather, the link is with the already existing prohibition on unconscionable conduct. (This conclusion is of course consistent with the previous conclusion of the Government when they considered the recommendation of the Mathews Committee on this issue, and with the conclusions of the Unconscionable Conduct Report);
- The use of the term "opportunistic" is new, and ill-considered. As a matter of law there is no definition of, or prohibition on, opportunistic conduct in any law. Indeed it is currently accepted that conduct that is "opportunistic", as that word would be

rather as a result of a commercially motivated lobbying campaign managed by a single company and supported by a small group of disaffected former franchisees.

⁸ Para 8.56

understood in general speech, is lawful. “Opportunistic” conduct, or by definition conduct that takes advantage of an opportunity even where the advantage to one party is more than might have been originally expected, is specifically sanctioned. The fundamental principle of “buyer beware” is built upon the assumption that if the buyer does not beware, the seller could engage in opportunistic conduct. And in defining the limits of terms such as unconscionable conduct the courts have clearly stated that hard bargaining and tough action to enforce contractual rights are lawful.

- The report suggests “abuse of power” needs to be addressed, yet the material expansion of the existing prohibition on abuse of market power contained in s46 of the Trade Practices Act has been explicitly rejected in the past. Encroachment, kickbacks, churning, non-renewal, transfer, termination at will and unreasonable unilateral variations to the franchise agreement are all listed as “opportunistic” practices that can occur due to an abuse of power. However the report fails to provide any examples where abuse of power has occurred, nor articulate how the statements are relevant to good faith. Further, the report fails to admit that many of these issues are already explicitly addressed in the Franchising Code of Conduct, including in the Code changes that only took effect in March 2008.

On close analysis it would appear that the proposition justifying the enactment of legislation is difficult to support. In short, it is not legally possible “to explicitly incorporate, in its simplest form, the existing and widely accepted implied duty of parties to a franchise agreement to act in good faith”. Such a duty does not exist in any simple form or indeed at all, and it is not widely accepted.

The upshot is that the inquiry does not make a compelling case for the need for change. Nonetheless the question remains - should good faith be embraced as a concept? In a paper to be presented to the International Society of Franchising in February 2009 Professor Andrew Terry discusses the concept of good faith generally, noting as follows:-

Outside legislative direction, an obligation of good faith can arise in the franchise agreement in three ways – as an express term of the contract,⁹ as a term implied in fact on an *ad hoc* basis to give business efficacy to the contract,¹⁰ or as a term implied in law as a necessary incident of the contract. A fourth possibility is that the obligation of good faith is a principle of construction which is “inherent in all common law contract principles”¹¹.

However Professor Terry notes that this fourth option is only a “possibility”, and although suggested by some academics and judges at lower levels of the courts it is a possibility strongly contested by other academics and by judges at higher levels of the court system. By way of example he notes the comments of Bergin J in *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710 that it is “erroneous to suggest that the modern approach to the construction of contracts, whether one refers to it as commercial construction or otherwise, is driven by a concern to ensure good faith”.¹²

It would seem that the courts are developing their own ways to address this issue, and legal intervention will be unhelpful. In the context of franchising the courts have already held there to be an implied duty of good faith in the Federal Court case of *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* and in the Court of Appeal in *Burger King Corporation v Hungry Jack's Pty Limited*. However in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NC* [2005] VSCA 228 the Victorian Court of Appeal expressed reluctance, or in the words of Dodds-Streeeton J in a later case,¹³ “evinced a reserved approach”, to endorsing the implication of a term of good faith as a legal incident of commercial contracts expressing a preference for “ad hoc implication meeting the tests laid down in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* [1977] HCA 477 rather than implication as a matter of law creating a legal incident of contracts of a certain type”.

I am reluctant 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

⁹ See for example *Automasters Australia Pty Ltd v Bruness Pty Ltd & Anor* [2002] WASC 286 at 351, *Bamco Villa Pty Ltd v Montedeen Pty Ltd* [2001] VSC 192

¹⁰ See for example, *Re Kellcove Pty Ltd v A* [1990] FCA 220, *Laurelmount Pty Ltd v Stockdale & Leggo (Queensland) Pty Ltd & Anor* [2001] QCA 212

¹¹ Chapter 2 “Good Faith”, *Contract Law in Australia*, 5th Ed, Lexis Nexis, Butterworths, Australia (2007), JW Carter, Elisabeth Peden and GJ Tolhurst, [2-01]

¹² *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710 at 174

¹³ *Meridian Retail Pty Ltd v Australian Unity Retail Network Pty Ltd* [2006] USC 223.

of *good faith* applies indiscriminately to all the rights and powers conferred by a commercial contract. It may, however, be appropriate in a particular case to import such an obligation to protect a vulnerable party from exploitative conduct which subverts the original purpose for which the contract was made...

Franchising is of course an example of a commercial contract in which a vulnerable party may be susceptible to exploitative conduct. Warren CJ in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NC* [2005] VSCA 228 at para 4 noted that even if a term of good faith *could* arise as legal incident of a commercial contract it would not arise in every case:

Ultimately, 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. Where commercial leviathans are contractually engaged, it is difficult to see that a duty of good faith will arise, leaving aside duties that might arise in a fiduciary relationship. If one party to a contract is shrewder, more cunning and out-manoeuvres the other contracting party who did not suffer a disadvantage and who was not vulnerable, it is difficult to see why the latter should have greater protection than that provided by the law of contract.

Although these issues have not yet been explicitly addressed by the High Court of Australia, the comments of Kirby J in *Royal Botanic Gardens and Domain Trust v South Sydney City Council* [2002] HCA 5 do not provide great comfort to those who argue that an obligation to act in good faith should be implied into every commercial contract. He notes, when considering whether there exists an implied term of good faith in every commercial contract:

... in Australia, such an implied term appears to conflict with fundamental notions of caveat emptor (ie: buyer beware) that are inherent (statute and equitable intervention apart) in common law conceptions of economic freedom. It also appears to be inconsistent with the law as it has developed in this country in respect of the introduction of implied terms into written contracts which the parties have omitted to include.

The proponents of good faith fail to address the development of the law in relation to the explicit prohibition on unconscionable conduct in business transactions, and do not explain the distinction between unconscionable conduct and good faith. In its submission to the Franchising Report the Franchise Council of Australia argues that unconscionable conduct should cover the field and obviate the need for any additional conceptually similar concept. The FCA's suggestion has logical and practical appeal. It avoids confusion as to what statute

or concept applies, and it helps avoid possible conflict between interpretations of behaviour determined against a good faith test and an unconscionable conduct test. It is difficult to resist the conclusion that good faith has surfaced as the flavour of the month because proponents of reform have failed to convince Government that there needs to be an extension of the current interpretation of unconscionable conduct.

Perhaps the most persuasive argument against the enhancement of the good faith concept is a practical one. As an implied duty it is logically subject to express provision to the contrary. As a matter of law the duty to act in good faith cannot impose obligations inconsistent with other terms of the contract, and it may even be possible to exclude or limit its application by express agreement between the parties. Good faith cannot be an independent source of obligations but rather relate to a violation in bad faith of an express term of the agreement. So with time and carefully crafted new franchise agreements it is likely to be rendered largely ineffectual. Of course in the meantime, imposed on existing contracts negotiated (dare I say) in good faith, the concept is likely to create great uncertainty, increase disputation and probably increase the expectations gap between parties to a contractual relationship.

The conclusion reached by Professor Terry in his detailed article on the topic is compelling, if not almost self-evident. He notes:-

The concept of “good faith” has gained traction as the solution to all real and imagined ills within the franchising sector. For those agitating for reform it has assumed symbolic significance and if introduced would be argued to accommodate circumstances beyond any appropriate sphere of influence. The perception that “good faith” is the universal solvent is both misleading and dangerous but is given life by the equating of good faith with good ethics. A principle of good faith must presumably accord with ethical standards and community values, but this is not, and should not be, a concept the content of which is defined by them. While an understanding of good faith as requiring “a fair go” would be enthusiastically perceived as a panacea for both the real and imagined ills of the sector, the reality of good faith as a legal concept is quite different. If franchisor opportunism is a problem warranting legislative intervention this should be by carefully crafted legislative responses rather than by defaulting to an undefined and overreaching standard of indeterminate scope and application.

I expect the Government will reach the same conclusion.