

THE DISCLOSURE REQUIREMENT IN FRANCHISING

Before a franchisee enters into a franchise agreement, they must be provided with a disclosure document from the franchisor. The purpose of a disclosure document is to supply key information about the nature of the franchise system and to help a franchisee to make an informed business decision about entering into the franchise.

The government has introduced a new *Franchising Code of Conduct* (the Code) which took effect on 1st January 2015.

Franchisors can continue to use disclosure documents in accordance with the old Code up to 31 October 2015, but after this date they must be in accordance with the new Code. There are issues for any company with a financial year that begins on or after 1 January 2015.

Breaches of some disclosure obligations under the new Code carry penalties of up to \$51,000.

Why is a Disclosure Document Required?

Providing a current disclosure document is mandatory under clause 9 of the new Code.

Disclosure documents must be given to potential new franchisees, or existing franchisees renewing, extending or extending the scope of their franchise agreement. Extending the scope could mean the term, territory or any other material provision. If requested, a franchisor must provide an existing franchisee with a current disclosure document within 14 days of a request, but that request can only be made once per year. See below for the exception to this rule.

A franchisor must update their disclosure document annually 4 months after the end of the franchisor's financial year. The exception to this is if:

1. no franchise agreements were entered into in the previous financial year (which includes new franchise grants, renewals, transfers or variations to existing agreements); and
2. in the franchisor's reasonable opinion they will not be entering into any new franchise agreements, renewals, transfers or variations within the next 12 months.

If an existing franchisee requests a current disclosure document, and the franchisor has not undertaken their annual update, then the franchisor then must update their disclosure document and provide it to the franchisee within 2 months of the request.

Disclosure documents for new franchisees must be provided along with a copy of the franchise agreement in the form in which it is to be signed and a copy of the Code.

A new franchisee must be given a disclosure document at least 14 days before they sign a franchise agreement. This gives them time to read the document and obtain legal, accounting and business advice on the terms of the franchise agreement. A franchisee must sign a document saying that they have received independent advice from a lawyer, accountant and business advisor, or that they have decided not to obtain this advice.



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Before a franchisee signs a franchise agreement, they must sign a receipt to say that they have received, read and been given the chance to understand the disclosure document. The franchise agreement can only be signed 14 days after the date on this receipt.

What does a Disclosure Document need to Include?

Whilst the old Code provided two forms of disclosure documents which were dependant on the expected annual turnover of a franchised business, the new Code has a single format disclosure document to be used regardless of turnover.

Some of the information a disclosure document under the new Code must include is:

- A warning statement about the franchisee's 14 day cooling off period.
- Details of the franchisor and the type of business operated under the franchise.
- A summary of the franchisor's last 10 years of business experience.
- Details of any litigation proceedings against the franchisor.
- The details of existing franchisees over the past 3 years with their contact details, including franchisees that have left the system within that time.
- Details of the intellectual property forming part of the agreement.
- Details of the franchise site or territory.
- Details of supply of goods or services.
- Details of marketing or other cooperative funds.
- Details of all the payments required for the franchise.
- The process to be followed at the end of the franchise agreement.
- The franchisor's financial details for the past 2 financial years, including a solvency statement.



The disclosure document must also include a new section under which the franchisor is to give details of whether the franchisee may sell goods or services online. Franchisors also need to disclose if the franchisor or an associate sells online. Franchisors need to include the domain name or URL if goods or services are made available via a third party website. This only seems to apply when a third party website is used by the franchisor or their associate or other franchisees.

A disclosure document must be signed by a director or officer of the franchisor.

See Schedule 1 of the new Code for a full summary of the contents required for a disclosure document. The new Code has streamlined disclosure documents. Many details which the old Code mandated are no longer required to be included in a disclosure document under the new Code. These details pertained to information which was already included in a franchise agreement. This reduces administration for franchisors and encourages franchisees to read their franchise agreements (regardless of this every franchisee should read their franchise agreement in detail).

Information Statement

The new Code includes an Information Statement which must be provided to a prospective franchisee or purchaser of an existing franchised business. This must be provided as early as possible. For the transfer of an existing franchised business this would be at the time the existing franchisee applies for consent. For a new application, the Statement should be given with the information pack. It must be in 11 point font and no longer than 2 pages.

What is the Purpose of a Disclosure Document?

Disclosure documents will provide a potential franchisee with information to help them decide on whether or not to enter a franchise. Franchisees may be able to judge whether the franchisor has a satisfactory level of knowledge and experience in the franchised business, or whether the financial figures make the franchise a viable business option for that particular franchisee.

Potential franchisees should make contact with current and ex-franchisees. This allows them to assess franchisee satisfaction with the franchisor's training, support and systems, and the reasons why any

franchisees have left the franchise system.

Continuing Disclosure

During the term of a franchise agreement, a franchisor must notify its franchisees within 14 days of any materially relevant facts, including:

- Franchisees instituting proceedings against the franchisor.
- Investigations or judgments against the franchisor.
- Change of ownership or control of the franchisor or its intellectual property.
- The franchisor becoming externally administered.

The Views of the Courts

In the 2014 appeal decision of *SPAR Licensing Pty Ltd v MIS QLD Pty Ltd*, the franchisee for a grocery franchise signed a franchise agreement 6 months after receiving a disclosure document. In that 6 month period, the franchisor's financial reports became outdated because their financial position deteriorated significantly. The Court found that because the disclosure document and solvency statement was no longer current when the franchise agreement was signed, the franchisor deprived the franchisee of the ability to make an informed business decision. The franchise agreement was set aside.



The 2013 case of *Dorrian v Rushlyn Pty Ltd* focused on a disclosure document which did not disclose that up to 15 regional master franchisees had ceased to operate within the past 3 years, as well as the franchisor providing inadequate training to a franchisee. The Court found that these details should have been disclosed to the franchisee by the James' Home Services franchisor, and that the requisite training was not provided. The franchisee was awarded \$658,993.40 in compensation. If the new Code had applied to this case then the franchisor may have faced penalties of up to \$51,000.

The franchisor in the 2008 case of *Master Education Services Pty Ltd v Ketchell* did not receive a statement that the franchisee had read the disclosure document prior to signing the franchise agreement. The High Court held that the franchise agreement was still valid. The non-compliance with this requirement alone was not enough to hold a franchise agreement as void and unenforceable. This decision does not mean that a franchisor should ignore this requirement under the Code. Again, if the new Code had applied then the franchisor may have faced penalties of up to \$51,000.

Franchisors have been found to contravene the Code by failing to supply franchisees with a disclosure document in cases which focus on misleading and deceptive conduct.

In the 2012 case of *Rafferty v Madgwicks*, the parties entered into a manufacturing business venture which eventually broke down. Amongst the questions of misleading and deceptive conduct, the Court was asked to decide whether the venture constituted a franchise agreement. The Court held that the arrangement was in fact a franchise agreement and awarded damages because the old Code was breached through the failure to provide a disclosure document. Again, if the new Code had applied then the franchisor may have faced penalties of up to \$51,000.

Lessons for Franchisors and Franchisees

It is vital for franchisors to maintain an up to date disclosure document by making amendments at the appropriate time of every financial year, and when there is a material change in the franchisor's circumstances. Providing out of date information could be construed as misleading a franchisee and breaching the Code. The new Code has introduced an obligation to act in good faith, therefore in some situations non-compliance with disclosure obligations may be seen as acting in bad faith and leave a franchisor open to penalties.

Franchisors need to be mindful of the changes and penalties brought by the new Code and ensure that their disclosure documents are updated by 31 October 2015, or the date directed by their legal advisor for franchisors not operating on a standard Australian financial year.

Bear in mind, giving out an old disclosure document and a new Code will be very confusing to a franchisee. We recommend updating as soon as possible, regardless of the timing in the Code.

In order to fully understand a disclosure document, franchisees and franchisors should always obtain the advice of a lawyer.

At Bywaters Timms we can provide franchisees with detailed advice on their disclosure documents and franchise agreements, and assess whether the information disclosed is up to date.

We can assist franchisors in fulfilling all of their disclosure obligations and meeting the time restraints under the Code by assisting with their annual updates. We can also assist a franchisor set up a franchise system by preparing their disclosure document, franchise agreement and other related documents.