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Executive Summary

In Australia a Hotel Management Agreement ("**HMA**") has not been treated as a franchise.

There are strong arguments that a typical HMA is a "franchise agreement" and therefore that Australia's franchise regulatory regime will apply to HMAs.

In that event, there would be material adverse implications for Hotel Operators under HMAs in Australia because they will be franchisors subject to statutory regulation.

As franchisors, Hotel Operators would be subject to a variety of legal obligations to franchisees (Hotel Owners), including an obligation to act in good faith as well as significant pre-contractual and ongoing disclosure obligations.

The Australian franchise regulatory regime also dictates some of the terms that may or may not be included in a franchise agreement, and the rights and obligations of the parties with respect to material commercial terms including capital expenditure, marketing and advertising, HMA transfer, liability, governing law and termination.

Hotel Operators should carefully consider the application of Australia's franchise laws to HMAs, and, if applicable, ensure that the HMA terms and the Operator's conduct comply with Australia's franchise laws.

1. Introduction

In Australia an HMA has not been treated as a franchise but that does not mean that Australia's franchise laws do not apply.

There are strong arguments that the Australian franchise regulatory regime does apply to a typical HMA. In that event, there are potentially material adverse implications for Hotel Operators ("**Operator**") as franchisors.

This paper explores these matters and identifies the key issues which arise in this context.

2. Regulatory Regime

2.1 Franchising Code of Conduct

In Australia, franchising is regulated by the Franchising Code of Conduct ("**Code**"), which is given the force of law under section 51AE of the *Competition and Consumer Act 2010* (Cth) ("**Act**"). Industry codes are regulated by Part IVB of the Act. Section 51AE enables the making of regulations to prescribe an industry code and declare it mandatory. Section 51AD prohibits a corporation, in trade or commerce, from contravening an applicable industry code, including the Code.

The purpose of the Code is to regulate the conduct of franchise participants inter se and to ensure that prospective franchisees are sufficiently informed about a franchise before contracting.

A new version of the Code will soon take effect. An exposure draft was made public in April 2014, with a final version likely to be produced by October or November 2014. Both houses of parliament have recently passed ancillary amendments to the Act to permit the imposition of pecuniary penalties for breaches of the Code and give the Australian Competition and Consumer Commission ("**ACCC**"), which is the primary regulator of the Code, enhanced enforcement powers.

The new Code, which will introduce a statutory duty of good faith and increase disclosure and transparency obligations on franchisors, will apply to franchise agreements entered into or renewed on or after 1 January 2015.

This paper is based on provisions of the April 2014 exposure draft of the new Code. At the time of writing this paper, the final version of the new Code has not yet been released.

2.2 What is a "Franchise Agreement"?

The Code defines a "franchise agreement" as an agreement:

- that takes the form, in whole or part, of a written, oral or implied agreement; and
- in which a person (franchisor) grants to another person (franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and
- under which the operation of the business will be substantially or materially associated with a trade mark, advertising or a commercial symbol owned, used, licensed or specified by the franchisor or an associate of the franchisor; and
- under which, before starting or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount. Examples of an "amount" are provided - such as a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee - and certain exceptions are specified.

Any transfer, renewal or extension of the term or scope of a franchise agreement is also deemed to constitute a franchise agreement.

3. HMA Applicability

3.1 Typical HMA

A typical HMA is a contract between an Operator and Hotel Owner ("**Owner**") for management of the hotel under the Operator's brand, the key features of which are:

- the Operator grants a licence for use of its brand and other intellectual property, such as its operating system ("**IP**"), in relation to the hotel;
- the Owner appoints the Operator to operate and manage the hotel under the brand and operating system, as agent for and on behalf of the Owner;
- the Owner agrees to pay the Operator management fees for its services (typically based on a percentage of hotel revenue and profit); and
- the Owner provides the property and working capital, employs staff, and bears responsibility for all business and financial risk arising out of the conduct of the hotel business, and is entitled to the profit.

3.2 Code

The definition of "franchise agreement" in the Code is broad and has the potential to capture a variety of commercial arrangements, whether or not described as a franchise, including an HMA.

Having regard to the criteria described in section 3.1, a typical HMA could constitute a "franchise agreement" because each element of the definition is satisfied in that:

- an HMA is an agreement, typically wholly written;
- the substantive effect of the HMA is that the Operator grants the Owner the right to carry on the business of the hotel (through the grant of the licence for use of IP);
- the right to conduct the hotel business is granted under a system substantially determined, controlled or suggested by the Operator;
- the hotel business will be substantially associated with the Operator's IP; and
- the Owner agrees to pay fees, expenses and other charges to the Operator.

The fact that the hotel business is undertaken and managed by the Operator for the Owner does not, in our view, materially alter the position. The business belongs to the Owner and, from a legal perspective, is still conducted by the Owner, as the Operator acts on the Owner's behalf and the Owner is bound by and legally responsible for the Operator's acts and omissions as agent for the Owner.

If an HMA is structured in this way then, under the Code, the HMA will be a franchise agreement and the Operator will be a "franchisor" and the Owner a "franchisee".

4. Operator Implications

If an HMA is a franchise agreement, then there are potentially material adverse implications for Operators in that:

- the Code favours franchisees;
- as franchisor, the Operator must comply with specific obligations in dealing with the Owner; and
- the Code specifies certain terms and conditions of the HMA discussed in sections 4.1 to 4.3.

The consequences of breach of the Code are discussed in section 5.

4.1 Good Faith

Under the Code both franchise parties are subject to an obligation to act in good faith inter se, which cannot be limited or excluded by the HMA. That obligation includes specific requirements for the parties to act honestly and not arbitrarily and to cooperate to achieve the purposes of the HMA. It applies not only to matters arising under the HMA, but also to pre-contractual dealings relating to a proposed HMA.

The Australian government has indicated that good faith, for the purposes of the Code, will have the same meaning as under common law, but that the ACCC will be providing guidance on the subject.

"Good faith" does not have a uniformly agreed definition under Australian common law and the concept has not been considered by the High Court. Decisions of lower courts indicate that good faith can have different meanings depending upon the circumstances in which the obligation arises, and takes its content from the particular contract and context in which it is found.[1]

The formulation frequently cited as a starting point in describing good faith is that of former High Court judge Sir Anthony Mason, who suggested that the concept involves three notions, namely:

- an obligation on the parties to cooperate in achieving the contractual objects (loyalty to the promise itself);
- compliance with honest standards of conduct; and
- compliance with standards of conduct which are reasonable having regard to the interests of the parties.[2]

Authority also indicates that good faith requires a party:

- to have regard to the interests of the other party, but does not require a party to subordinate its own interests;[3]
- not to act arbitrarily, capriciously, unreasonably or recklessly;[4] and
- not to cynically resort to the black letter of the contract or act for an ulterior motive.[5]

The introduction of a statutory obligation of good faith may or may not have significant impact on Operators, depending on whether, under Australian law, an HMA creates a fiduciary relationship between the parties.

The obligations of a fiduciary are much more onerous than an obligation of good faith under the Code. If an Operator under an HMA owes a fiduciary duty to the Owner under Australian law, then the Operator is already subject to a higher standard. In that case, the statutory obligation of good faith will be of little impact.

Conversely, if the Operator is not a fiduciary under Australian law, then the good faith obligation represents a significant new burden. When negotiating an HMA and each time it intends to exercise a right under it, the Operator will need to consider whether any good faith issues arise.

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1 Elisabeth Peden, *Good Faith in the Performance of Contracts*, 159; *Macquarie International Health Clinic Pty Ltd v Sydney South West Area Health Service* [2010] NSWCA 268, [9].
2 Sir Anthony Mason, *Contract, Good Faith and Equitable Standards in Fair Dealing* (2000) 116 The Law Quarterly Review, 66, 69. There has been some criticism of the third principle – for example, see Elisabeth Peden, supra 1, [7.5].
3 Elisabeth Peden, supra 1, [7.2]
4 A Terry and C Di Lernia, *Franchising and the Quest for the Holy Grail: Good faith or good intentions,* [2009] Melbourne University Law Review 542 at [557]-[558].
5 *Overlook v Foxtel* [2002] NSWSC 17 at[66]-[67]; *Mangrove Mountain Quarry Pty Limited v Barlow* (2007) NSWSC 492 at [28]; *J F Keir Pty Ltd v Priority Management Systems Pty Ltd (administrators appointed)* [2007] NSWSC 789 at [27]-[28].

To date no Australian court has analysed whether or not an Operator who acts as agent for an Owner under a HMA is a fiduciary. The position remains unclear in Australia. In contrast, the issue has been considered in several high profile cases in the United States. Those decisions suggest that, in that country, the agency of an Operator under an HMA is fiduciary in nature.[6]

Australian law recognises limited classes of relationship as being fiduciary in nature. Recognized fiduciary relationships include those between solicitor and client, employee and employer, director and company, trustee and beneficiary, and partners in a partnership.[7] The franchise relationship is not one of these recognised categories, so franchisors do not ordinarily owe fiduciary duties to franchisees.

However, in the specific context of a franchise agreement constituted by an HMA, it is possible that the Operator may owe fiduciary duties to the Owner, because an HMA creates a special agency relationship between the parties to the HMA. Under an HMA, the Operator conducts management and marketing of the hotel as an agent of the Owner. Agency is one of the relationship categories recognised under Australian law as being fiduciary.[8] Whilst fiduciary duties are a normal incident of typical agency relationships, it does not necessarily follow that every agent is a fiduciary; the existence and scope of fiduciary duties depends upon the particular circumstances of each case and the terms of the relevant contract involved.[9]

There are, in our view, sound arguments to support the view that under Australian law an Operator under an HMA is a fiduciary of the Owner. Although the terms of each HMA need to be considered in each case, it can be strongly argued that many HMAs contain an implied undertaking by the Operator to always act in the interests of the Owner in respect of the management and marketing of the hotel.

We take this view because an HMA involves investment of a high degree of trust and confidence in the Operator, making the Owner extremely vulnerable. By reason of the material risks to which the Owner is exposed, the nature of the Operator's agency and the wide scope of authority vested in the Operator to affect the Owner's legal position, the Operator's role readily lends itself to abuse, unless the Operator is subject to a duty of undivided loyalty to the Owner. We therefore consider it possible that an Australian court would find an Operator to be a fiduciary of the Owner.

If that is the case then the imposition of a duty to act in good faith under the Code imposes a lesser duty than under fiduciary obligations. However, both are a long way off from Operators acting in their own best interests, which is predominantly the case under most HMAs today.

4.2 Disclosure Obligations

Under Australian franchise law an Operator as franchisor must make extensive disclosure to the Owner as franchisee, as a matter of course before contracting into an HMA. The nature and extent of the information to be disclosed goes well beyond that which would ordinarily be provided in pre-contractual due diligence for an HMA.

At least 14 days before entry into the HMA, the Operator must give a disclosure document to the Owner detailing prescribed information, including for example:

- details of relevant litigation involving the Operator, its associates or a director of either, including judgements or proceedings affecting the IP rights for the Operator's system or its ownership, convictions for serious offences or any bankruptcy or insolvency (in some cases for timeframes up to the last 10 years);
- if the Operator is a sub-franchisor, details about the master franchisor and the terms of the master franchise agreement;

6 See, for example, *2660 Woodley Road Joint Venture v ITT Sheraton Corp.* 2002 U.S. Dist. LEXIS 439, 2002-1 Trade Cas. (CCH) ¶ 73,601 (D. Del. Jan. 10, 2002).
7 *Halsbury's Laws of Australia*, Vol. 12, [185-695].
8 Ibid.
9 Ibid, [185-720]; GE Dal Pont, *Law of Agency*, 2nd Ed, [10.17]-[10.18] and [10.22].

- the number of HMA relationships in which the Operator was involved that ended during the last 3 financial years and contact details of the relevant former Owner;
- details of any agreement significantly affecting the Operator's rights to use the IP;
- the Operator's policy for selection of the territory for the hotel business and whether in the previous 10 years that territory has been subject to a hotel business managed by the Operator (and, if so, the circumstances in which that business ceased to operate);
- detailed information about any marketing or other co-operative fund controlled or administered by or for the Operator to which the Owner may be required to contribute, including how much the Operator is required to contribute, whether other franchisees must contribute at a different rate, and details of the funds' expenses for the prior financial year including a percentage breakdown of the purposes for which the funds were spent;
- circumstances in which the Operator has unilaterally varied an HMA in the last 3 financial years and the circumstances in which it may do so in future in relation to the HMA;
- details of arrangements to apply at the end of the term of the HMA;
- historical earnings data for other hotels in the Operator's system, discussion of differences between such hotels and the Owner's property, and projected earnings for the Owner's business (including detailed disclosure of facts, assumptions and research processes underlying the projections); and
- financial details about the Operator, including a statement as to solvency and copies of financial reports relating to the Operator for each of the last 2 financial years (or, alternatively to the latter, an independent audit report supporting the solvency statement).

The disclosure document must be updated by the Operator on an annual basis, within 4 months of the end of each financial year.

During the term of the HMA, the Operator must also promptly disclose certain materially relevant facts, if not already disclosed in the initial disclosure document. Details such as changes in majority ownership or control of the Operator or certain judgements, proceedings or awards against it, or changes to IP, must be disclosed to the Owner in writing within 14 days.

Record-keeping obligations require the Operator to keep any document which supports a statement or claim made in the disclosure document. The ACCC has audit powers specifically in relation to industry codes. Under Division 5, Part IVB of the Act, it can compel the Operator to produce information or documents which the Operator is required to keep, generate or publish under the Code. This is a random audit power, so there need not be any suspicion of breach before the ACCC can exercise such power. A court can grant an injunction to compel the Operator to comply.

Under section 155 of the Act, the ACCC also has general investigation powers to obtain information, documents or evidence in relation to matters that constitute, or may constitute, a breach of the Act. Refusal or failure to comply with the investigation notice, or knowingly furnishing information or giving evidence that is false or misleading, is an offence punishable by a fine of up to $3,400 or imprisonment for 12 months.

4.3 HMA Terms

The Code specifies certain terms of a franchise agreement and regulates the rights and obligations of the parties in specific material areas.

An HMA would need to contain provisions which materially differ from standard HMA provisions.

The Code potentially affects the following HMA provisions:

(a) **Capital Expenditure**

Under a typical HMA the Operator requires the Owner to fund capital expenditure on the hotel in order to maintain brand standards. If the Owner has a strong negotiating position, it might impose limits on the Operator's rights to exercise this power, but generally the right is broad.

Regardless of the express terms of the HMA, the Code limits the circumstances in which the Operator can (without Owner approval) compel the Owner to undertake significant capital expenditure. The Operator will only be permitted to do so if the expenditure is disclosed in the initial disclosure document or is incurred by all or a majority of the Operator's franchisees or approved by a majority of them. Alternatively, the expenditure must be considered necessary by the Operator as a capital investment, and be justified by a statement including the rationale for making the investment, the amount of capital expenditure required, the anticipated outcomes and benefits and the associated risks.

(b) **Marketing & Advertising Fees**

Under a typical HMA, the Operator provides system-wide services to its portfolio of properties, including group marketing and advertising services. Those services are funded by contributions from the Owners.

The Code imposes requirements with respect to marketing and advertising funds which are intended to increase transparency, including requirements that the Operator must:

- maintain a separate bank account;
- contribute on the same basis as the Owners, if the Operator also conducts a hotel business on its own account (so that Owners do not bear the cost of marketing Operator-owned hotels);
- only use contributions for certain purposes (i.e. to meet expenses disclosed in the disclosure document, which are legitimate marketing or advertising expenses, or which have been agreed to by a majority of franchisees, or to pay the reasonable costs of administering and auditing the fund); and
- prepare and have audited financial statements relating to the fund within 4 months after the end of the financial year, and provide copies of the statements and report to the Owner within 30 days of preparation.

These obligations (in particular, the financial reporting requirements) are broader and more onerous than those normally found in many HMAs.

(c) **Transfer**

Usually the Owner is prohibited from transferring an HMA without Operator consent (which, under some HMAs, cannot be unreasonably withheld if specified criteria are not met).

The Code enables a person to request the Operator to consent to transfer of the HMA and the Operator must give a written response advising of its decision.

The Operator's consent to transfer cannot be unreasonably withheld. However, the Code specifies certain circumstances in which the withholding of consent is deemed to be reasonable, such as where there is a failure of the proposed transferee to meet financial requirements or the Operator's selection criteria, or if the current Owner owes money or is in breach of the HMA. These circumstances broadly align with HMA practice as circumstances which entitle the Operator to withhold consent.

The most significant difference between the Code requirements and an HMA is that the Operator is deemed to have consented to transfer, if it fails to advise its decision within 42 days.

The new Code introduces a right for a franchisor to "revoke consent" by giving written notice and reasons. However, the Code is silent on how such right would operate in practice (for example, whether it applies to deemed consents, the timeframe in which it can be exercised, and the consequences for the parties, given the former Owner and new transferee may have acted on the assumption of consent). This lack of clarity will give rise to significant uncertainty.

(d) **Liability**

Under the Code, the HMA must not require the Owner to sign a general release of the Operator from liability to the Owner. In contrast, under a typical HMA the Operator disclaims and is released from all liability arising out the HMA, and the Owner indemnifies the Operator (in each case excepting the Operator's wilful misconduct or gross negligence).

(e) **Governing Jurisdiction**

Under the Code, a franchise agreement cannot provide for the jurisdiction for settlement of disputes to be a different State or Territory to that in which the franchised business (hotel) is located (or, if it does, such clause is of no effect).

(f) **Termination**

Under the Code, an Owner is granted a 7 day "cooling off" period following the earlier of entry into the HMA or the making of any payment under it, during which the Owner may terminate without consequence. In that case, the Operator must (subject to some exceptions) repay all amounts to the Owner within 14 days of termination. The Owner would not have such a right in the private context.

5. Consequences of Breach

5.1 Pecuniary Penalties

A civil penalty of up to $51,000 applies to each act or omission constituting a breach of a key provision of the Code. Those key provisions include the obligation to act in good faith and the requirements to provide an initial disclosure document, make ongoing disclosure of materially relevant facts, disclose financial details of marketing or advertising funds and repay amounts if the Owner terminates during the cooling-off period, as discussed in sections 4.1 to 4.3.

The ACCC will also have power to issue an infringement notice for a suspected breach of a civil penalty provision of the Code, in the amount of $8,500 for a body corporate or $1,700 in any other case. Payment of the infringement notice will not constitute an admission of liability, but would exempt the relevant party from having court action taken against it for the alleged contravention.

5.2 Other Remedies

Breach of section 51AD of the Act (which prohibits a corporation, in trade or commerce, from contravening an applicable industry code) also attracts a range of other remedies, including:

(a) **Injunction**

The court has broad power under section 80 of the Act to grant an injunction, in such terms as it determines to be appropriate, against a person who has engaged, or proposes to engage, in conduct which would constitute a contravention or an attempted contravention of section 51AD. The power extends to persons who are involved in such conduct (by aiding, abetting, counselling or procuring, or being directly or indirectly knowingly concerned in or party to, a contravention, or conspiring with others to contravene section 51AD).

(b) **Enforceable Undertaking**

Section 87B confers upon the ACCC the ability to accept formal administrative undertakings, by way of a binding agreement under which the parties agree to certain actions, for example stopping the offending conduct or setting up or reviewing a compliance program. The court may make enforcement and compensation orders if the undertaking is breached.

(c) **Compensation**

If the Operator's breach of the Code causes loss or damage to an Owner, the Operator may be liable to compensatory damages. Under section 82, a person who suffers loss or damage by the conduct of another person that was done in breach of Part IVB of the Act (which regulates industry codes) may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention in the extended sense of "involved" referred to above in section 5.2(a).

5.3 Contractual Implications

Contravention of the Code by an Operator will not automatically result in the relevant HMA being deemed void or unenforceable, though that is one of several potential consequences. Under section 87, a court may make a variety of remedial orders to compensate for loss or damage suffered as a result of a contravention of section 51AD of the Act, or to prevent or reduce the loss or damage suffered or likely to be suffered. Such orders may be made against the person who contravened section 51AD, or any person involved in the contravention in the extended sense of "involved" referred to above in section 5.2(a). With respect to an HMA and the Operator, such remedies would include an order:

- declaring the whole or a part of the HMA void;
- varying the HMA;
- refusing to enforce any or all of the provisions of the HMA;
- directing a person who engaged in the contravening conduct (i.e. the Operator) or who was involved in the contravention to refund money or return property;
- for payment of compensation to a person suffering loss or damage; or
- directing the supply of specified services by a person who engaged in the contravening conduct (i.e. the Operator) or who was involved in the contravention.

6. Existing Contracts

The new Code will apply to franchise agreements entered into or renewed on or after 1 January 2015. The existing Code applies to franchise agreements entered into on or after 1 October 1998 (with certain successive amendments to the existing Code applying, respectively, to franchise agreements entered into on or after 1 March 2008 and 1 July 2010).

As currently drafted, the regulations prescribing the new Code do not repeal or limit the operation of the existing Code. Therefore, once the new Code takes effect, it will operate concurrently with the existing Code (which will continue to apply in accordance with its terms).

The definition of "franchise agreement" in each version of the Code is nearly identical. An HMA would constitute a franchise agreement under either version.

The result of the concurrent operation of the Codes therefore means that:

- existing HMAs (entered into on or after 1 October 1998) will continue to be regulated by the existing Code; and

- new HMAs (entered into on or after 1 January 2015) will be subject to regulation under both the new Code and the existing Code.

Commentators have raised concerns with the latter outcome.[10] Franchisors and franchise agreements subject to dual regulation will be the subject of confusion and uncertainty. Hopefully, the existing Code will be amended to provide that it does not apply to franchise agreements entered into on or after 1 January 2015.

The definition of franchise agreement also includes a franchise agreement which is transferred, renewed or has its term or scope "extended". This means that the renewal, transfer or extension of an existing franchise agreement, on or after 1 January 2015, will result in the franchise agreement being subject to the new Code.

A potential complication for existing franchise agreements in this respect is the broad definition of "extend" proposed in the new Code. That term is defined, in relation to extension of the scope of a franchise agreement, to mean a material change to the:

- terms and conditions of the agreement;
- circumstances that effect the agreement; or
- rights of, or liabilities that would be imposed on, a person under or in relation to the agreement.

In particular, the second limb of the definition is concerning because it captures events unrelated to any agreement between the parties, for example a change in supplier of goods for the purposes of the franchise.[11]

Further uncertainty arises because the existing Code has a sunset date of 1 April 2019. The existing Code will cease to have effect on the sunset date and franchise agreements formerly covered only by the existing Code will not be subject to any code at all, unless the issue is subsequently addressed (for example by introducing amending legislation to extend the sunset date, or amending the new Code to regulate franchise agreements entered into prior to 1 January 2015).[12]

7. Conclusion

In Australia an HMA may constitute a franchise agreement under the Code. Operators should therefore carefully consider their contracts and whether the Code applies. If so, Operators must ensure that their HMAs conform with the Code and that the Operator complies with its obligations under the Code. Failure to do so will have serious implications.

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Aequus Counsel Pty Ltd is a legal and corporate adviser based in Sydney Australia with significant expertise and experience in cross border transactions in the hospitality industry.

[10] See, for example, the submission by the Competition and Consumer Committee of the Business Law Section of the Law Council of Australia, *Review of the Franchising Code of Conduct,* 5 May 2014, 25-26.
[11] Ibid, 26-27.
[12] Ibid 26.

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