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Ketchel decision raises alarm bells for franchisers

THE KETCHELL DECISION CREATES POTENTIAL FOR DISGRUNTLED FRANCHISEES TO ATTEMPT TO DODGE THEIR CONTRACTUAL OBLIGATIONS TO FRANCHISORS, WRITES **MALCOLM MCBRATNEY** OF MCCULLOUGH ROBERTSON LAWYERS

The recent unreported decision of the New South Wales Court of Appeal in *Ketchell v Master of Education Services Pty Ltd* [2007] NSWCA 161 (*Ketchell*) has caused significant alarm in the franchising industry and with good reason. In *Ketchell*, the New South Wales Court of Appeal held that a franchise agreement was illegal and unenforceable as a result of a franchisor's non-compliance with clause 11(1) of the *Franchising Code of Conduct* (Code).

The Code is a mandatory industry code prescribed under section 51AE of the *Trade Practices Act* 1974 (Cth) (TPA) and relevantly, section 51AD of the TPA provides that a corporation must not, in trade or commerce, breach a provision of an industry code. Clause 11(1) of the Code requires that a franchisor must not enter into, renew or extend a franchise agreement, or receive a non-refundable payment under a franchise agreement unless the franchisor has received from the prospective franchisee a written statement that the franchisee has received, read and had a reasonable opportunity to understand a disclosure document and the Code.

At first instance, Mr T Hodgson, LCM of the Local Court in Mudgee, found in favour of Master of Education Services Pty Ltd (franchisor), who had lodged a statement of liquidated claim in respect of franchise fees that were unpaid by Ketchell (franchisee). The magistrate acknowledged that the Franchisor had not complied with clause 11(1) of the Code (and this was not in dispute) but held that the contravention did not make the franchise agreement illegal or unenforceable. The franchisor was permitted to recover the payments it sought to recover through the statement of claim (which were acknowledged to be non-refundable payments for the purposes of clause 11(1) of the Code).

Hodgson LCM relied upon the decision in *The Cheesecake Shop v A & A Shah Enterprises* [2004] NSWSC 625 (*Cheesecake Shop*) in coming to this conclusion. In that decision Windeyer J held that section 51AD of the TPA does not make contracts made in contravention of the Code illegal. Rather, section 51AD prevents certain conduct, and Part VI of the TPA provides remedies for breaches of these prohibitions, including the power to declare a contract void. Windeyer J concluded that if a contract was void as illegal, there would be no need for this particular statutory power. On this basis, the magistrate allowed the claim, despite the fact that the franchisor had engaged in prohibited conduct.

On appeal, the original judgment was set aside and the matter was remitted to the Local Court. At the remitted hearing the Local Court found in favour of the Franchisee noting that as clause 11(1) of the Code had not been complied with by the franchisor, the court should not require payment by the franchisee as doing so would result in the franchisor being in further breach of the Code by recovering non-refundable moneys where clause 11(1) of the Code prohibits such conduct.

In a further appeal of the matter in 2006, the Supreme Court held that the magistrate's finding of non-compliance with clause 11(1) of the Code, which effectively meant that a breach of the TPA had occurred, did not render the receipt of non-refundable payments illegal. Again the decision in the Cheesecake Shop case was cited as authority for this position.

However, in July 2007, the Court of Appeal disagreed with the reasoning in *Cheesecake Shop* case in so far as it held that a contract that directly contravenes clause 11(1)(a) and (c) of the Code is not rendered unenforceable and illegal at law. In a decision that will have significant repercussions if upheld, the Court of Appeal found that a contract that directly contravenes clause 11(1)(a) and (c) of the Code is unenforceable and illegal.


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In summary, Mason P, with whom Basten JA and Handley AJA concurred found that:

(a) "the general rule is that if the legislature prohibits the making of a contract then the making of the contract does not give rise to an enforceable right or obligation": *Trade Practices Commission v Milreis Pty Ltd* (1977) 29 FLR 144 at 158 per Brennan J; *SST Consulting Services Pty Ltd v Reison* (2006) 225 CLR 516 at 532, 546;

(b) nothing in the TPA expressly or implicitly negates the application of the above rule or empowers a court to relieve against non-compliance with the directly prohibitory terms of clause 11 of the Code; and

(c) the combined effect of section 51AD of the TPA and clause 11(1) of the Code prohibits the making of a contract in certain circumstances.

Mason P went on to disagree with Windeyer J's reasoning in the *Cheescake Shop* that the remedies available under the TPA for breach of a provision negated the common law principle set out above. Mason P noted that it was reading too much into Part VI of the TPA to view it "as repelling the common law of contractual illegality, even by implication".

Ultimately, the Court of Appeal found that the defence of illegality should have resulted in a rejection of the franchisor's original claim for payment, the basis for this decision being that where a statute prohibits the making of a contract, any contract made in contravention of the statutory prohibition is illegal and unenforceable.

This decision is significant because if upheld, it could be extended to all circumstances of non-compliance with the Code even where such circumstances are procedural, trivial or otherwise innocuous (such as a failure to have a document correctly executed, or a failure to collect a particular pre-contractual document). In fact, in his judgment, Mason P addressed this very issue noting that whether minor, technical or procedural breaches are significant enough to bring down an entire contract is a matter that should be addressed by Parliament rather than the courts. Further, whilst Mason P concentrated his judgment on a direct breach of clause 11(1) of the Code, he did confirm that if the other clauses of the Code contained the necessary prohibitory language, then a breach of those clauses may also result in the relevant franchise agreement being illegal and unenforceable.

While the *Ketchell* case has not increased any compliance requirements for franchisors, it has added significant pressure to the pre-agreement phase. If franchisors do not comply with the Code in all respects this may mean they are unable to enforce their rights under the relevant franchise agreement in the future and may potentially face court action from franchisees or from the Australian Competition and Consumer Commission (ACCC). Of additional concern are the far-reaching ramifications for franchise agreements entered into in the past where a document or statement required by the Code has been overlooked. The potential for disgruntled franchisees to attempt to rely on the *Ketchell* decision as a means of avoiding their contractual obligations is great and the possible consequences of this are disastrous for many franchisors. Whether the consequences will extend to all payments made under an illegal franchise agreement having to be repaid is not something that has yet been considered by the courts, but is an outcome that could possibly destroy the franchise industry.

Importantly, the High Court recently granted special leave to the Franchisor to appeal the *Ketchell* decision, however, before the appeal can proceed the franchisor is required to undertake to pay all of the franchisee's costs of the appeal. The Franchisor has recently been granted an extension of time until early April to provide the relevant undertaking, on the basis that it is seeking an indemnity for the costs from the Franchise Council of Australia whose members have a substantial and vested interest in the outcome of the case. All franchisors and their legal advisers will no doubt be waiting with baited breath for the outcome of the appeal to the High Court, and in the meantime, for the influx of claims based on the current state of play. ■

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