THE RENEWAL TERM – WHAT TO EXPECT

Franchise renewals, in particular renewing on the "then current franchise agreement," is an area that has sometimes led to disputes between Franchisors and Franchisees, particularly when the then current franchise agreement contains terms different from the original franchise agreement. In the past, as these disputes have tended to settle before court action is taken or matters have progressed to the judgment stage, there has been minimal case law in Australia on this area. Nevertheless, this is an area where we are likely to see more action, as various State and Federal governments' have made comments, recommendations and/or sought to put forward legislative changes that impact this area, and as franchisee class actions become more common.

CURRENT POSITION:

At this stage in Australia law there is no automatic right of renewal, nor any specific legislative requirements on the terms on which a renewal franchise agreement must be granted. Consequently, if a franchise agreement does not provide for a Renewal Term, the Franchisee is taken to know before entering into their franchise agreement that the Franchisee's rights will terminate on the expiry of the Term and the law will generally not interfere with this. It is submitted that this position is based upon the long recognised common law principal of freedom of contract and is in line with the standard American position whose franchising practices Australia has tended to follow.[1] When dealing with franchise relationships, this arguably also respects the considerable resources a Franchisor has generally expended and will continue to expend to establish, develop and manage their intellectual property (which tends to be one of the main assets of a franchise system) and as such, the right to determine how and to what extent they grant others rights to use that intellectual property. If Franchisors lost the right to control their intellectual property and systems, this may result in Franchisors either substantially increasing initial fees and/or eliminating franchising as an expansion option.[2]

Where Australia's Federal government has instead focused is upon increasing the disclosures made to potential, existing and/or renewing Franchisees so that they are in the position to be able to make informed decisions before entering

[1] Given America has a more mature franchising industry and Australia's franchise regulation was initially developed following the American model, it is a good idea to see how they have handled these issues. See for example "Franchise Regulation: The American Experience" Rupert M Barkoff; *Husain v. McDonald's Corporation*, 205 Cal.App.4th 860, 140 Cal. Rptr. 3d 370 (2012); *Prudence Corp. v. Shred-It America, Inc.,* 2010 WL 582597 (9th Cir. 2010); *G.I. McDougal, Inc. v. Mail Boxes Etc., Inc. et al*., Cal. Rptr. 3d, 2012 WL 90083 (CA. App. 2012). This latter case considering situations where the Franchise brand has changed and the initial franchise agreement provides for a brand that no longer exists.

[2] While not dealt with in this Paper, another consideration for this area is whether regulating this area may result in overseas Franchisors being reluctant to enter into the Australian market, especially if Australia moves away from the standard position accepted in most other countries.

into and/or renewing a franchise agreement. [3] In this regard, Disclosure Documents, which must be provided before a franchise agreement (new or renewal) is entered into, must provide detail in respect to:

(a) end of Franchise Term arrangements;
(b) in what circumstances Franchisees may be up for unforeseen capital expenditures;
(c) in what circumstances a Franchisor may unilaterally change the franchise agreement;
(d) contact details of current Franchisees;
(e) details over the last 3 years as to whether a Franchisor has not renewed any franchise agreements, and the contact details of such Franchisees (unless those past Franchisees have authorized the Franchisor not to disclose such details); and
(f) attaching a copy of the franchise agreement in its final form (and as such confirming any Renewal Term provisions). [4]

The above should give Franchisees a better picture of what it can expect and its entitlements at renewals (if any).[5]

On the basis a Franchisee has a Renewal Term, it is essential to then look at the wording and requirements around that Renewal Term. If the renewal requirements set out in any franchise agreement are not met, this may result in a Franchisee loosing the Renewal Term and/or giving the Franchisor more leeway in negotiations when strictly speaking the Franchisee has lost its renewal rights. Depending on the wording describing any renewal that is to be granted, this can impact on what type of franchise agreement a party may be entitled to for their Renewal Term.

"THEN CURRENT FRANCHISE AGREEMENT":

In most franchise agreements the standard wording used when talking about franchise agreement renewals is along the lines that the renewal is to be on the Franchisor's "then current franchise agreement" at the time of renewal. This means that the franchise agreement for any Renewal Term may have different terms than the initial franchise agreement, so long as it is the current standard

3 It should be noted that for any franchise agreements entered into or whose scope was extended from 1 July 2010, under clause 20A of the Competition and Consumer Act (Cth) Franchising Code of Conduct ("the Code"), Franchisors must at least 6 months before the end of any Term give advance written notice to their Franchisee of the Franchisor's decision as to whether or not to renew their franchise agreement. Franchisees with a Term less than 6 months will only require at least 1 month's prior written notice.

4 Under Part 2 of the Code, Franchisors must maintain and provide a Disclosure Document as per the Code. See also in particular clause 20A of the Code and Items 6, 13A, 17A and 17C of the Code's Annexure 1 Disclosure Document. These provisions should be read and full and note that certain of these provisions only apply where a franchise agreement was or is to be entered into after 1 July 2013 and/or has or is to have its scope extended after 1 July 2013.

5 However, to get the benefit of these protections Franchisees need to ensure they have actually reviewed and understood this information (or seek appropriate advice if they do not). Then as appropriate they should ask questions of the Franchisor and/or existing or past franchisees.

franchise agreement being offered to new Franchisees at that time.[6] These changed terms could include, without limitation, different payment terms. The extent that a Franchisee can be required to renew on the Franchisor's current franchise agreement was considered in the NSW Supreme Court in *Civic Video Pty Ltd v Yogies Pty Ltd ("Civic Videos case")*.

Civic Videos Case:

In the *Civic Video case* the Franchisee, Yogies Pty Ltd, entered into a franchise agreement for 5 years with a 5 years option. Upon notification from the Franchisor that the franchise agreement was due for renewal, the Franchisee responded that it wanted to continue on a holding over basis while it attempted to sell the business. This was not agreed to by the Franchisor and the Franchisee consequently confirmed in writing it sought to renew the franchise agreement as per its Renewal Term. This was agreed subject to the Franchisee entered into the Franchisor's then current form of franchise agreement, as was required under the Renewal Term option. This agreement was then sent to the Franchisee with the instructions that following the end of the initial franchise agreement Term, further trading would be under this new Franchise Agreement.
Following a dispute between the parties, the Court confirmed a renewed franchise agreement could be on different terms to the original, but still be a renewal if the original franchise agreement stated the renewal is to be on the then current terms, which was the situation here. Consequently, the Franchisee was bound by the new franchise agreement even though the changes included various fees being changed and/or increased. However, it should be noted that the Court did not:

1. regard the changed standard terms (including the changed payment terms) substantial enough in the circumstances to justify not having the Franchisee bound by such. This implying there could be times when the terms are so substantially changed that they will not be allowed; and
2. go so as far to allow for the increased 10 year Term the Franchisor had sought to impose on the Franchisee, given that the Franchisee only exercised a 5 years option.

In the above case the Franchisee had also claimed the Franchisor acted unconscionably. The Court disagreed with this. The Court found nothing was unconscionable in the way the new Franchise Agreement came to be binding on the Franchisee, since the Franchisee prior to expiry of the original franchise agreement was given the choice and provided with a copy of the proposed new franchise agreement. Additionally, the Court did not find there was anything unconscionable in the new franchise agreement's term's substance and those terms reflected the standard terms offered by the Franchisor at that time to all its'

[6] Additional difficulties may arise where a franchise agreement is updated and the renewing Franchisee is the first to use this new document. This raises the question at what point does an agreement become the current version and what was the status of the document at the time the Franchisee first exercised their option.

Franchisees.[7] Therefore, each case must be taken on a case by case basis to determine how, when and to what extent can changed terms in a Renewal franchise agreement be enforceable.

Initial vs Current Franchise Agreement: when are the changes too substantial?

As indicated by the *Civic Videos case*, when determining whether a Franchisee may have grounds to challenge any of the terms in a renewal franchise agreement that differ from their initial franchise agreement, you need to consider each situation on a case by case basis. Historically, many Franchisors' often attempt to introduce new terms into a franchise agreement on a renewal, these changes ranging from minimal changes to some material changes. Franchise agreements in many instances can last between 5 – 10 years with a further 5 – 10 year option. Consequently, a lot can change within these time periods. Generally, many of the changes made by Franchisors to their standard documents are likely the result of circumstances where the market has changed, new and/or altered laws are now in effect (or about to come into effect), brand changes, and/or there have been developments in technology and/or other areas that need to be reflected in the standard franchise agreement. One example of necessary changes would include the new terms most franchise agreements now need to have so as to deal with the changes in securities laws via the *Personal and Properties Securities Act* (Cth). Additionally, with the internet and social media industries having (and continuing to) rapidly change over the last few years, these areas can have a material impact on franchise operations and/or marketing to an extent that was likely not even dreamed possible just a few years ago, and as such, agreement terms needs to change to reflect the new issues. Therefore, it should not be automatically assumed that any franchise agreement changes will disadvantage a Franchisee and/or are unnecessary.

Nevertheless, given Franchisees have generally paid and invested substantial monies for their initial franchise, and thereafter have likely spent considerable resources on developing their franchise, the Courts, Federal government and various of the State governments have been willing to look into this area. In this regard, in addition to looking towards unconscionable conduct, consideration is increasingly been given towards the existence of and consequent application of good faith to balance what can sometimes be seen as the competing interests of Franchisees and Franchisors.[8]

What impact may Good Faith have?

7 This case also provides an interesting insight into situations where a Franchisee does not return its renewal franchise documents and the renewal documents are on different terms to the original franchise agreement. Here the Franchisee was regarded as having accepted the new agreement's standard terms to the extent they were consistent with the option it had intended to exercise. This was based on the documents having been provided prior to the expiry of the initial franchise agreement's Term, the Franchisor made it clear that after the expiry of the initial Term these new agreement's terms would be effective and the Franchisee paid its new fees and continued operating the business after the expiry of the initial Term.

8 Given unconscionable conduct and good faith are both areas each deserving of their own papers and the size constraints of this paper, we will only briefly touch upon unconscionability and good faith in this paper.

Good faith is a growing concept increasingly relevant to franchising, particularly franchise renewal situations.[9] In 2010 the Code was amended to specifically provide that "nothing in this code limits any obligation imposed by the common law, applicable in a State or Territory, on the parties to a franchise agreement to act in good faith."[10] As a result of this and the growing case law on good faith, it is submitted that most lawyers would now accept that good faith exists and it applies to franchise agreements.[11] The growing importance of good faith is arguably further displayed via the numerous recommendations and proposed legislative changes that various government inquiries have supported in recent years.

Currently, to determine what is good faith and/or when it applies requires consideration of how the courts have ruled on this area. There is currently no statutory definition of good faith or legislative guidance how, when or even if it applies in franchise situations. Therefore, following on from how the courts have tended to deal with this area in the past, when considering whether a party has acted in good faith tends to look at each matter on a case by case basis and consider whether the relevant party exercising its power did such for the purpose the power was intended, and not for an improper purpose.[12]

Additional guidance on good faith and its application to franchising may soon come depending on if and how certain of the 2013 Federal review of the Code's recommendations are legislated. One of the review's recommendations put forward was that the Code confirm that Good Faith (as defined by the common law as oppose to a statutory definition) applies at all stages of a franchise relationship (prior, during an after) and that it cannot be limited or excluded by contract, including the franchise agreement. At the same time it would also be confirmed that good faith is not intended to prevent a party from acting in its legitimate commercial interests and a Franchisor will not be automatically regarded as acting not in good faith just because there is no term in a franchise agreement specifying a right of renewal.

The direction taken by the Federal government seems in line with America's position where "in every contract there is an implied covenant of good faith and fair dealing. This implied covenant cannot be used to override the express terms of contract. However under the implied covenant principle when a party as been granted discretion in making or implementing various decisions, it must act reasonably in so doing absent an express provision to the contrary."[13] In America

[9] Mathews Report in 2006; South Australia and Western Australia franchising inquiries in 2007 & 2008; Federal inquiry in 2008 & 2013.

10 Clause 23A of the Code.

[11] See cases *Coal Cliff Collieries v Sijehama Pty Ltd* (1991) 24 NSWLR1; *United Group Rail Services Limited v Rail Corporation* [2009] NSWSCA 177; *Macquarie International Health Clinics Pty Ltd v Sydney South West Area Health Service* [2010] NSWCA 268.

[12] See above.

13 "Franchise Regulation: The American Experience" Rupert M Barkoff, page 1 16.

one example of how this was used in a franchising situation was in *Re Vylene*.[14] In that case good faith was successfully used by the Franchisee "where the Franchisor, who had just broken off a sexual affair with the franchisee," entered "into negotiations to grant a new franchise for a particular area before expiration of the current Term."[15] This action was contrary to the fact "the contract required the Franchisor to negotiate with the Franchisee about renewal possibilities before it could negotiate with a third party."[16]

CONCLUSION

Franchise Renewals is an area that is likely to continue be debated especially as Australia continues to grow as a franchising nation. Currently, the standard starting point is that you must look to the wording used in the franchise agreement and if allowed under that agreement the initial and renewal franchise agreements may differ. How far they can differ currently requires parties to look at each case on a case by case basis, but depending on how the 2013 Code Review recommendations progress may determine whether we will have more guidance to the questions "how much is too much".

In the interim, when looking at renewal issues parties should consider:

1. carefully reviewing how franchise renewal clauses have been drafted;
2. reviewing whether Disclosure Documents are sufficiently detailed to provide full and clear disclosure to existing and/or potential franchisees;
3. whether effective systems are in place to ensure that the required renewal notifications are made;
4. carefully considering how, when and what changes are made to the standard franchise agreements. In particular, for Franchisors they should consider how they educate parties on these changes, especially when they could be regarded as "substantial" changes;
5. whether a party has acted within their legitimate commercial interests, exercised their powers is in line with the proper purpose for the relevant powers and that Franchisor decisions are reasonably consistent among Franchisees in substantially the same circumstances; and
6. Keeping up to date on how the law progresses in this area.

14 In Re Vylene 105 BR 42 (Bankr CD Calm 1989).
15 "Franchise Regulation: The American Experience" Rupert M Barkoff, page 1 16.
16 See above.