

## Chapter 6

### The end of a franchise agreement

6.1 A franchise agreement may end in two ways: expiry of the term with non-renewal, or termination before the end of the agreement. In the case of non-renewal, an agreement ends at the conclusion of the period originally agreed, with no new offer being made for a further term. The processes that have to be followed in relation to terminating an agreement before the agreed term ends are covered by clauses 21 to 23 of the Franchising Code of Conduct (the Code).<sup>1</sup> These are discussed at paragraph 6.29.

6.2 The main concerns over end of agreement arrangements raised during this inquiry relate to the following:

- non-renewal of franchise agreements at the expiration of the first term, including whether there should be a right to automatic renewal or whether non-renewal by a franchisor should only be permitted where 'good cause' can be shown;
- the circumstances in which a franchisor should be able to terminate an agreement, including potential abuses of current termination provisions within the Code;
- whether a payment for the franchisee's contributed value to the business should be mandated if the agreement is terminated or not renewed for whatever reason;
- what happens when a franchisor fails;
- property rights; and
- transferability of equity in the value of the business as a going concern.

6.3 End of term arrangements are one of the largest areas of dispute in the franchising sector. The processes for dispute resolution are discussed in Chapter 7.

#### **Non-renewal**

##### *Pre-contract disclosure*

6.4 It has been suggested that concerns about end of term arrangements arise from an initial lack of understanding about the franchise contract and the potential financial implications of fixed term agreements. Professor Lorelle Frazer identified renewal as an area that prospective franchisees are often unclear about:

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1 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, from p. 22

... because people I have spoken to who have gone into franchising do not often realise the implications of the five year term—that they are really renting the business for the five years. At the end of the five years it could all be over. .... Often when they are told that they have a five, plus five, plus five they have the idea that it is a 15-year agreement. Of course, it is saying that it can be renewed after five years and so on. That is an area where prospective franchisees really do not get it. It is not made clear to them.

I gave a seminar to prospective franchisees in a new system once. When I mentioned the issue of renewal, it was clear that it had not crossed their minds at all. They did not realise that the franchise had a possible life of five years. If they are entering thinking it is forever and that perhaps they can sell when they want to, they are going to be very disillusioned, because it is not actually that way.<sup>2</sup>

6.5 The Australian Competition & Consumer Commission (ACCC) submitted that, if a franchise agreement does not contain a statement about the conclusion of an agreement, 'you either have to draw certain implications or it may well be that by omission it becomes misleading or deceptive'. Often the agreement will state what the arrangements will be, although it may be in 'fairly complex legal language, and the problem stems as a consequence of a failure on the part of the franchisee to take appropriate advice prior to entering the agreement'.<sup>3</sup>

6.6 However, Mr Tony Piccolo MP argued that the disclosure of end of term arrangements should be mandatory so that everyone 'knows what the product is that they are buying':

If you go into a business for five or 10 years you know what you are going in for. We would argue that is reasonable. What we are saying, though, is that when you sign a contract for that five, 10 or 20 years you should know what you actually walk out with. You should know that when you sign up, not have to fight it out at the end. That is not provided for at the moment. The parties should adhere to that. We are not saying the code should say what it is. We are saying that when you sign a contract you will discuss these issues and make sure it is catered for in your contract. That should be mandatory, because you try to minimise disputes at the end of a contract, and you know what you walk out with. It would be wrong for us to say, 'Issue this form or that form.' That is inappropriate. But it is appropriate for the code to say, 'Your contract shall address this issue in some way.'<sup>4</sup>

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2 Professor Lorelle Frazer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 10

3 Mr Graeme Samuel, ACCC, *Proof Committee Hansard*, Melbourne, 5 November 2008, pp. 92-93. A discussion of the efficacy of disclosure documents and other pre-contractual issues is at Chapter 4.

4 Mr Tony Piccolo MP, Economic and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 57

6.7 The Franchise Council of Australia (FCA) suggested that franchisees and prospective franchisees may not understand that the end of a franchise term can mean the end of their involvement in the franchise:

We argued before and showed before that the current state of the law is crystal clear, but maybe not everybody understands that at the end of the franchise term if it is over then it is over. ...the industry average franchise agreement term is five years, but franchisees are typically in for seven years. In other words, franchisees in 98 per cent of cases are actually getting that extra term. ... The bottom line is whether there is an endemic industry issue in relation to non-renewal, and we would say, no.<sup>5</sup>

6.8 The FCA also supported disclosing details of end of term arrangements in disclosure documents: 'Put it in capital letters. Make it very clear to anyone who might have gone in with the wrong expectations.'<sup>6</sup>

6.9 The Motor Traders Association of Queensland submitted that it would be desirable if the Code required that arrangements for the renewal of the franchise be defined in the initial agreement, so that both parties are aware of them. Where the agreement was silent on the right to renewal, the renewal would have to be earned through performance. However, where there is a conditional right to renewal, the conditions should be clearly stipulated and agreed between the parties.<sup>7</sup>

6.10 The Small Business Development Corporation of WA also cited the importance of ensuring that prospective franchisees are made aware of their entitlements, if any, at the end of the agreement.<sup>8</sup> The ACCC also submitted that consideration be given to requiring franchisors to 'explicitly advise prospective franchisees about their rights to renew or extend their franchise agreement and about whether any goodwill may accrue to the franchisee upon exiting the system'.<sup>9</sup>

6.11 Some franchise agreements already contain terms relating to end of agreement arrangements. For example, Australia Post indicated that they made clear up front that the term of the agreement is for a specified period and that there will be an exit payment. While noting that none of their agreements had reached the end of their ten year terms, Australia Post franchisees know from the moment they sign up that they are entitled to an exit payment at the expiry of the agreement based on a predetermined formula.<sup>10</sup>

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5 Mr Stephen Giles, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 36

6 Mr Stephen Giles, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 41

7 Motor Traders Association of Queensland, *Submission 36*, pp. 7-8

8 Small Business Development Corporation of WA, *Submission 139*, p. 5

9 ACCC, *Submission 60*, p. 27

10 Mr Paul Ramm, Australia Post, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 100  
Australia Post indicated that they purposefully refer to these payments as 'exit payments' rather than 'goodwill' payments.

6.12 The Cheesecake Shop's agreements were also explicit about end of term arrangements: 'the relationship will end at expiry of the term specified in the contract and ... if termination occurs, goodwill remains with the franchisor'.<sup>11</sup>

6.13 Competitive Foods Australia Ltd (CFAL) contended that the disclosure of end of term arrangements is incidental to the real issue, which is the potential for a franchisor to exploit its contractual rights and obtain a windfall gain at the expense of the franchisee. Franchisors, contrary to industry practice and what has been sold to franchisees as the default position, can opt not to renew agreements to obtain this benefit:

...it is not an answer, as some suggest, people should be more up front in their contracts about what happens at the end of the franchise term.... Franchisors, because they can write the contracts, can write in the most powerful statement, if you like, with no right of renewal, but that does not actually reflect the policy or the practice.... That might be useful to some extent, but it really does not deal with the problem at the end of the day where people enter into this industry believing what is said about it and putting their time, money and effort into it.<sup>12</sup>

6.14 The opportunistic conduct referred to by CFAL is discussed further at paragraph 6.72.

### ***Conditions of non-renewal***

6.15 The committee received considerable evidence on whether agreements should be subject to mandatory automatic renewal at the end of their term, or whether franchisors should be required to show good cause why they have not renewed an agreement.

6.16 CFAL's submission described the potentially serious consequences of non-renewal:

If a franchise agreement is not renewed, the franchisee has no option to take its business elsewhere but must close the business. In addition, there will usually be restraints of trade provisions that prevent a franchisee from starting up any competing business ... unlike retail tenants who can take their business and set up elsewhere when their leases expire.<sup>13</sup>

6.17 The Hon. David Beddall expressed the personal view that 'unless you breach you should virtually have a perpetual franchise'.<sup>14</sup> CFAL indicated that it was not

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11 Mr Warwick Konopacki, The Cheesecake Shop Pty Ltd, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 14

12 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 37

13 CFAL, *Submission 22*, p. 8

14 The Hon. David Beddall, Franchisees Association of Australia, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 33

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arguing in favour of perpetual franchises, but merely that 'the industry practice and the default position should be renewal'.<sup>15</sup> They told the committee:

The franchisee enters into this industry, often many years before, believing that they are doing more than just buying a job. They are putting in the effort. They are putting in the extra dollars of cash flow ... into building up that business because they believe they are building an asset for the future. They do it on an expectation of normal industry practice, which is renewals, and they do so on the basis of trust and relationship...<sup>16</sup>

6.18 Concerns were expressed about any attempt to codify the default practice of renewing agreements by legislating for an automatic right of renewal. The Shopping Centre Council of Australia (SCCA) argued that, while the statistics support the position that franchisees are renewed more often than not, this should not give prospective franchisees the expectation that renewal will be automatic:

...in terms of what actually takes place as opposed to what expectations people are necessarily entitled to expect, what takes place is there is typically renewal...

The expectation is that you then have to renegotiate and enter into a new arrangement if you wish to continue with that arrangement.<sup>17</sup>

6.19 The FCA submitted that the law is clear that, at the end of a franchise agreement, a franchisee has no legal right to an extension and no right to compensation. The FCA cited the High Court decision in *Ranoa Pty Ltd v BP Oil Distribution Ltd*, which stated:

On expiry or termination of the agreement, the franchisee has no right to continue operating the business and no right to share in any goodwill that may have accrued to the system during the franchisee's tenure.<sup>18</sup>

6.20 Mr Piccolo MP also did not support the notion of an automatic right to renewal, stating that this would be a 'fundamental change to the law of contract'.<sup>19</sup>

6.21 McDonald's Australia Ltd conducts a board review at year 17 of its 20-year franchise agreements and, subject to certain criteria being met, would approach the review 'with an open mind' to re-entering another relationship with a franchisee. However, McDonald's expressed concern that any automatic right of renewal would impact on the ability of the franchisor to maintain the integrity of the brand:

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15 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 33

16 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 37

17 Mr Peter Speed, Shopping Centre Council of Australia, *Proof Committee Hansard*, Sydney, 9 October 2008, pp. 42-43

18 FCA, *Supplementary Submission 6*, p. 3, citing (1089) 91 ALR 251 at p. 257

19 Mr Tony Piccolo MP, Economic and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 57

...if there is a specific right of renewal, a positive renewal, or a presumption in favour of somebody to renew an agreement at the end of its term—and in our case, for example, we have a 20-year term—the issue for us is that, part and parcel of our being able to deliver a business system model by which we provide our restaurants around the country, the standards we ask for and expect of our franchisees need to be upheld.<sup>20</sup>

6.22 In the absence of an automatic entitlement to renewal, the committee heard support for the notion that franchisors should be required to show 'good cause' why a franchisee's agreement was not being renewed. For instance, Dr Spencer told the committee that:

Based on our experience in Australia and based on the nature of the relationship as it exists now, I think that a good cause requirement in renewal and in termination is something that ought to be considered.<sup>21</sup>

6.23 CFAL strongly advocated the inclusion of a good cause for non-renewal requirement in the Code. They stated that 'good cause is standard in terms of industry understanding' and considered that it was not a difficult concept but one that 'really reflects either a codification of existing practice, or an indication of what would be desirable practice'.<sup>22</sup> In support of their contention, CFAL submitted an amendment proposal stipulating that 'a franchisor shall not fail or refuse to renew a franchise agreement without good cause'. CFAL's proposed new section of the Code outlines circumstances that constitute good cause for non-renewal, including an intention to use the site for unrelated purposes, dispose of the site, terminate for a breach of the agreement, or purchase the site for market value.<sup>23</sup> This latter issue is discussed later in this chapter at paragraph 6.50 in the context of exit payments.

6.24 CFAL's proposal further outlines the procedures that must be followed in relation to renewal and non-renewal, including a requirement to provide notice of an intention not to renew or to renew with varied terms and conditions.<sup>24</sup>

6.25 These proposed 'good cause' amendments were opposed by the SCCA, who argued that renewal except for good cause was based on the false premise of an initial expectation of renewal:

I do not quite understand why there is that expectation. The term of the franchise ... is for a period of five years or whatever is stated. If the parties were negotiating for a longer term or they had that expectation, then you would anticipate that the longer term would be included into the

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20 Mr Philip Maloney, McDonald's Australia Ltd, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 39

21 Dr Elizabeth Spencer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 43

22 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 34

23 CFAL, *Submission 22*, Attachment 1

24 CFAL, *Submission 22*, Attachment 1.

arrangement or there would be some option or other term that would allow there to be a rollover. Therefore, the premise that there is an expectation that there will be renewal is not necessarily well founded and it is not well founded from the franchisor's point of view. If you are talking about the franchisee, they may in their own mind have that expectation, but that is not necessarily something that has been agreed by the other party.<sup>25</sup>

6.26 The Cheesecake Shop concurred with this view, warning of the possible implications for the sector:

Why is franchising different from any contract for service? If you start to say you cannot not renew other than for a good reason you will always have an argument as to whether or not it is a good reason, so to avoid the argument you pay some money. I think you will find if you do that franchising will cease to be used in those circumstances where there may be an obligation to renew because it is just too risky.<sup>26</sup>

6.27 Yum! Restaurants Australia (YRA) expressed concern about the uncertainty that such amendments might create, emphasising the importance of parties to a contract being able to rely on the agreed length of its term:

If it was made clear by the committee in its recommendations that whatever happens the parties have the right ultimately to rely upon the length of contract, if there was some notice period before that and some discussion, we would not have a problem. But the proposition is more than that.<sup>27</sup>

## Termination

6.28 The Code specifies three ways in which a franchise agreement may be terminated. These are described below.

### *Termination – breach by franchisees*

6.29 Section 21 of the Code stipulates the process for terminating an agreement for a breach of its terms by a franchisee.<sup>28</sup> Before a franchisor can terminate an agreement in accordance with this section of the Code, the franchisee must be given notice of an intention to terminate and afforded a reasonable opportunity to remedy the breach.

6.30 Concerns have been expressed that the Code provides insufficient protection for arbitrary or unreasonable termination for breaches. This refers to instances where

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25 Mr Peter Speed, Shopping Centre Council of Australia, *Proof Committee Hansard*, Sydney, 9 October 2008, pp. 41-42

26 Mr David Meagher, The Cheesecake Shop Pty Ltd, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 20

27 Mr Nick Bryden, YRA, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 89

28 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 22

franchisees have their agreement terminated for inconsequential, trivial or otherwise minor breaches of the agreement; an excuse for terminating rather than a reasonable and legitimate justification. One option to protect franchisees from this conduct is by introducing a good faith requirement into the Code. This proposal is examined in Chapter 8.

6.31 Another possibility raised with the committee would be to disallow termination where franchisees had exercised 'due diligence' in attempting to remedy breaches, or where the breach is not a 'fundamental breach'. Peregrine submitted that:

Franchisees need confidence that their franchise agreement will not be unreasonably terminated or that they won't be "held to ransom" or "threatened" with unnecessary demands of the franchisor.<sup>29</sup>

6.32 Peregrine proposed three alternative approaches to dealing with arbitrary termination

- Defence of due diligence
  - Whereby a franchisor cannot terminate for a breach where the franchisee has displayed all due diligence in remedying the breach
- Good faith obligation
  - Introduce an obligation to act in good faith
  - Specify acts which are 'prima facie' not good faith
  - Specify that terminating a franchisee who has displayed all due diligence to remedy a breach is not acting in good faith
- Fundamental breach only
  - Only allow termination for a fundamental breach
  - Describe in the Code what a 'fundamental breach' is.<sup>30</sup>

6.33 In contrast, 7-Eleven argued that the Code should be amended to allow franchisors to terminate an agreement without complying with section 21 where a franchisee 'breaches the franchise agreement, otherwise than by conduct set out in subclauses 23(a) to (f), at least three times'.<sup>31</sup> This is the 'three-strikes-and-you're-out' approach, regardless of any subsequent remedy of the breach to avoid termination in accordance with section 21.

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29 Peregrine Group of Companies, *Submission 116*, p. 4

30 Peregrine Group of Companies, *Submission 116*, p. 4. See SA Parliamentary Economic and Finance Committee, *Franchises*, May 2008, p. 70 (SA Report), which also considered that a statutory duty of good faith would operate to discourage arbitrary termination. The need for a statutory duty of good faith is discussed in Chapter 8.

31 7-Eleven, *Submission 105*, p. 2



### *Termination – special circumstances*

6.34 Section 23 of the Code provides that a franchisor is not required to comply with sections 21 or 22 and may terminate a franchisee under specified circumstances, including where the franchisee: no longer holds a licence required to carry on the business; voluntarily abandons the business; is convicted of a serious offence; or agrees to the termination of the agreement.<sup>32</sup>

6.35 Concern was expressed that, though section 23 of the Code gives the franchisor the right to terminate a franchisee if they become bankrupt or insolvent, there is no right for a franchisee to exit the contract in the event of franchisor failure.<sup>33</sup> Mr Howard Bellin highlighted the examples of Quiznos and Kleins, where franchisees received little or no compensation following the failure of these franchisors.<sup>34</sup>

6.36 It was also noted that, though section 18(2)(g) of the Code requires the franchisor to give written notice to a franchisee or prospective franchisee when the franchisor becomes an externally administered body corporate, the appointment of an administrator for a franchise system does not of itself terminate or constitute repudiation of the agreement. When companies fail, secured creditors are given priority over remaining assets, followed by unsecured creditors, shareholders and then other parties. When a franchisor fails, a franchisee may be terminated with little prospect of compensation or ability to continue trading, yet may still be required to pay franchise fees, including royalty payments, to the liquidator until the franchisor is wound up—despite no longer receiving support or services from the franchisor.<sup>35</sup>

6.37 In response, the ACCC recommended that consideration be given to providing some form of protection to franchisees in the event of franchisor failure, such as granting the franchisee the right to exit the franchise agreement.<sup>36</sup>

### *Committee view*

6.38 The committee shares the concerns raised regarding the plight of franchisees when franchisors fail. The committee's earlier recommendation that disclosure documentation include an explicit statement of the consequences of franchisor failure (see Recommendation 1 at paragraph 4.80) is a step towards improving this situation.

6.39 In light of recent failures of this type in the Australian sector, the committee further recommends that the government explore avenues to better balance the rights and liabilities of involved parties in the event of franchisor failure.<sup>37</sup>

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32 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, p. 23

33 Section 23(b); See for example, Ms Heather Shearer, *Submission 79*, p. 3; ACCC, *Submission 60*, p. 27

34 Mr Howard Bellin, *Proof Committee Hansard*, Melbourne, 5 November 2008, pp.72-73

35 ACCC, *Submission 60*, p. 28

36 ACCC, *Submission 60*, p. 28

## Recommendation 4

**6.40 The committee recommends that the government explore avenues to better balance the rights and liabilities of franchisees and franchisors in the event of franchisor failure.**

### *Termination – no breach by franchisee*

6.41 Section 22 of the Code provides for termination where there has been no breach by a franchisee. Before franchisors are permitted to terminate the agreement in these circumstances, it must 'give reasonable written notice of the proposed termination, and reasons for it, to the franchisee'.<sup>38</sup>

6.42 For a franchisee to have their agreement unilaterally terminated would generally represent a significant financial upheaval, necessitating a fair period of time for them to organise their affairs before the agreement ended. But mandating a uniform minimum period was considered potentially difficult to apply, given the variable terms of franchise agreements.<sup>39</sup>

6.43 Concerns about franchisors exploiting the termination provisions to 'churn' franchisees were raised in a number of submissions.<sup>40</sup> This refers to the practice in which a franchisor sells and re-sells a unit franchise, making a profit each time the business changes hands regardless of the profitability of the unit franchise. The termination provisions in the Code, particularly section 22, potentially enable this to occur. They also give franchisors the opportunity to capitalise on successful franchise units once the hard work has been done to establish their continuing profitability. These practices may be described broadly as opportunistic termination—that is, franchisors using the powers contained in the Code to obtain a 'windfall gain' at the expense of franchisees.

6.44 While it has been argued that it is not in the franchisor's interest to capriciously fail to renew or terminate an agreement that has been operating successfully, the economic temptation for doing so has also been highlighted. According to CFAL, the benefits from this conduct can be obtained in three ways:

- buying a franchise back at less than market value and then selling it on for its full value to another franchisee;
- once the viability of an individual franchise unit has been established, taking it over to run as a company store to be able to recoup 100 per cent of the profits rather than a percentage through royalties;

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37 Notably Kleins and Quiznos

38 *Trade Practices (Industry Codes – Franchising) Regulations 1998*, Section 22(3), p. 23

39 See for example, YRA, *Submission 118*, p. 14

40 See for example Ms Sam Gow, *Submission 61*; Ms Sue Brown, *Submission 84*; Ms Dianne Grey, *Submission 96*; and Ms Cheryl Borradale, *Submission 125*

- churning successive franchisees who pay up-front franchising fees and royalties which may be higher because the store is an established going-concern rather than a start-up site.<sup>41</sup>

6.45 However, the costs associated with training a new franchisee and other associated costs are a sound economic reason to retain successful franchisees. Accordingly, the extent to which churning is a significant problem in franchising has been questioned, despite the concerns raised by many contributors to the inquiry. The Franchising Australia 2008 Survey found that approximately nine per cent of franchise units experienced a change in ownership in the 2007 financial year, consistent with the 2006 survey results. Professor Frazer stated that, were the practice of churning of units to be widespread, she would have expected this figure to be higher:

I am not saying that I have evidence on churning or not. I am just saying that I would have expected it to be higher. I know that there are allegations about churning. The ACCC has even said that churning exists. So I am sure it does in some cases. But, that would be a rogue operator. It does not make business sense to churn. It would be much easier to keep a good franchisee in the system. Normal practice would be to do that. There would be instances of it, but it would not be good practice to do it, nor would it make sense.<sup>42</sup>

6.46 Furthermore, Mr Conaghan of DLA Phillips Fox argued that since the introduction of the Code the incidence of churning has been significantly lessened because of the disclosure requirements:

In the early 1990s before the code and disclosure obligations came in, churning was perceived as a problem in the industry. In our experience, since the disclosure obligations have come in, and even more so since the 1 March changes came in, in our experience there was a significant lessening of the churning element because of the disclosure aspects and particularly because of the contacts of former franchisees.<sup>43</sup>

6.47 Professor Lorelle Frazer described the contrast between opportunistic 'churning' and the difficulties associated with non-renewal:

I would see churning as when you put a franchisee into a store that you know will fail—it is in a bad location or whatever—and it does fail and then you are move them out and get another person in. You keep doing that because you are obtaining the initial fee. It is a different matter if the franchisee has come to the end of the agreement and they knew they had that agreement. It may not be fair, but I think legally that is the situation. If the franchisor takes over that unit, probably because it has been a good

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41 CFAL, *Submission 22*, p. 8

42 Professor Lorelle Frazer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 11

43 Mr Anthony Conaghan, DLA Phillips Fox, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 51

operation, then you need to look at whether that is fair and whether anything can be done to stop it happening.<sup>44</sup>

6.48 Other submissions took the view that enforced equitable financial settlements could address abuse of the termination provisions of the Code. For instance, Spier Consulting argued that a franchisor's right to unilaterally terminate an agreement should be modified or removed, but, if retained, compensation or a guaranteed buy-back should be provided for and included in the disclosure document.<sup>45</sup>

6.49 The equitable financial treatment of franchisees who have had their agreements terminated, or not renewed, is discussed in the following section, starting at paragraph 6.52.

6.50 As with non-renewal, there was some discussion about the possibility of franchisors being required to show 'good cause' before terminating an agreement. There was little disagreement that a franchisor should retain the right to terminate in the interests of the integrity of the franchise system, but it was argued that termination in the absence of a breach should only take place where there is good cause to do so. For instance, the MTAA stated that, while franchisors should retain the right to terminate an agreement for a clear and material breach by the franchisee, they should not be able to terminate without due cause.<sup>46</sup>

6.51 However, the FCA argued that the Code has detailed processes such that 'you cannot terminate a franchise agreement for an improper purpose' and in any case such behaviour would eventually have market repercussions:

... let us say the franchisor does get up on a bad hair day and does something that is inappropriate but perhaps not outside the law. Eventually enough franchisees will get jacked off with the system that they will sell out of the system. You will find it difficult to attract good-quality franchisees because when they do their due diligence in ringing up those past franchisees they will not necessarily be talking well about the system. Over time you will get fewer franchisees applying, you will get fewer conversions, poorer quality franchisees and eventually you will kill your own system.<sup>47</sup>

## Exit arrangements

6.52 The committee received extensive submissions and evidence addressing the question of whether franchisees whose agreements were not renewed should receive

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44 Professor Lorelle Frazer, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 12

45 Spier Consulting, *Submission 151*, p.3

46 MTAA, *Submission 90*, p. 13. See also Mr Andrew Robinson, Motor Traders Association of New South Wales, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 94; Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008.

47 Mr John O'Brien, FCA, *Proof Committee Hansard*, Melbourne, 5 November 2008, pp 32-33

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an exit entitlement in return for their contribution to the business. This was a particularly complex and contentious aspect of the committee's inquiry.

### ***Goodwill***

6.53 There are three recognised types of goodwill: product/brand goodwill; site goodwill; and operator/personal goodwill.<sup>48</sup> Being able to differentiate between the relative values of each at the end of an agreement is a vexed question. In particular, what degree of goodwill could or should be attributed to the franchisee?

6.54 DLA Phillips Fox contended:

When a franchisee sells the franchise business, inevitably in the business purchase contract will be a description of goodwill. It has a particular meaning for revenue and tax consequences in that business purchase agreement. In relation to a franchisor and the goodwill that it has, that term goodwill is used in a different context. There is a lot of confusion about goodwill and what it means in a particular circumstance.<sup>49</sup>

6.55 Ms Deanne de Leeuw argued that goodwill should be attributable to the input of franchisees:

When a franchisee is terminated or their franchise agreement is not renewed, the franchisor takes ownership of the goodwill generated by the franchisee through their investment and hard work. If they can sell that franchise on, the profit generated from the sale remains the property of the franchisor. It should not be legal for a franchisor to take over a franchise without fairly compensating the franchisee.<sup>50</sup>

6.56 However, the Franchise Alliance queried whether a franchisee has created any goodwill whilst in the system, or whether the business goodwill is all associated with the brand; the system of business; the ongoing support, training and strategising of the franchisor; group marketing; and local area marketing devised by the franchisor. As such, it would belong to a franchise group and not a sole trader. The Franchise Alliance cautioned that any change to the law in Australia relating to goodwill would have far-reaching consequences for franchising, including that it would be likely to change the design and structure of franchise systems and make them more akin to partnerships.<sup>51</sup>

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48 Ms Jenny Buchan, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 84

49 Mr Anthony Conaghan, DLA Phillips Fox, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 55. NB refers to SCCA's submission, clause 7.2.

50 Ms Deanne de Leeuw, *Submission 114*, p. 30

51 Franchise Alliance, *Submission 48*, p. 3

6.57 The SCCA considered that 'personal goodwill' lies with the individual and cannot be traded. Therefore, 'at termination that "personal goodwill" remains with the individual and he or she should not be entitled to any compensation in relation to it'.<sup>52</sup>

6.58 The Cheesecake Shop highlighted an additional complication of whether goodwill should be payable to a master franchisee:

Throughout the term of the master franchise agreement, the master franchisee receives a substantial amount of money for each franchisee that joined the system. Asking for a goodwill payment at the end of the term when the master franchisee has already received a lump sum for every franchisee that joined and an ongoing royalty for providing ongoing support would, put simply, be double dipping. The master franchisee should not be paid twice for the same thing.<sup>53</sup>

6.59 CFAL argued that the issue of goodwill would not arise if franchisors continued to renew agreements, as this would enable the franchisee to sell the business and recoup their goodwill:

Goodwill only becomes an issue if the franchisor wants to step across the line and, if you like, corporatise, privatise, remove inefficiencies, or whatever term is used, and cease being the franchisor of that business.

....

If it wants to change that relationship and wants to, in effect, take the business off the franchisee, why should it not pay the fair value for that business like anybody else in the market?<sup>54</sup>

6.60 CFAL further submitted that the goodwill in a franchise is held jointly by the franchisor and the franchisee, but the franchisee's financial interest in the joint goodwill was subject to the franchisor's decision to renew:

It is a goodwill because the franchisor has provided the systems, recipes, trademarks and advertising, but it is also your goodwill because you have put in the time and effort, you built the store, you hired the staff, you organised the supply chain, your people manage the store and you look after your people well so that you have good motivated employees. It is a jointly owned goodwill, but it is a goodwill that the franchisor can destroy at the stroke of a pen, and that is the real issue.<sup>55</sup>

6.61 Eagle Boys Dial-A-Pizza also acknowledged the joint nature of the goodwill in a franchise:

We have many franchisees that sell their business after a number of years for well in excess of what they paid to get into it because they built up what

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52 SCCA, *Submission 115*, p. 18

53 The Cheesecake Shop, *Submission 136*, pp 2-3

54 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, pp 29-30

55 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 29

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the previous speaker spoke about as the personal good will component. Obviously we are retaining the good will component associated with the brand and what they have helped us build. What they have built their business into over that period of time helps us as well, so there is shared good will there.<sup>56</sup>

6.62 A factor that was considered to contribute to the extent to which goodwill could be attributed to the franchisee was the nature of the franchise system:

It depends on what you are talking about really. Looking at franchise relations, say, you are talking about a McDonald's store. In terms of McDonald's, if you walk into one store as compared with another store, it makes no difference what the franchisee particularly is doing. The branding is such and the regulation is so strict that essentially you get the same product at any store. The goodwill of that store is referable entirely to the franchisor from that perspective. If you are looking at other arrangements where you might have, say, a pool store, a franchisee may have a much greater role in terms of the product that is being offered and the service that is being provided. In that circumstance you can actually see that the franchisee has made a contribution, you might say, to the franchisor's business or reputation. In that instance the question becomes not who made the contribution but who in fact owns that goodwill. If you have an employment arrangement and someone develops a product, then invariably, if that was part of the employment contract, it belongs to the employer even though the employee was largely responsible. In a context of this nature, if the contract was drafted on the basis that the franchisor was the party to get the goodwill, that is the arrangement that pervaded the contract and the franchisor should be the party that has the goodwill.<sup>57</sup>

6.63 DLA Phillips Fox dismissed the contention that a justification for a goodwill payment at the end of an agreement is the 'franchisee having enlarged the franchisor's goodwill or, more precisely, the value of the franchisor's intellectual property':

Whilst it cannot be denied that the franchisee needs to apply a certain level of business acumen and skill, it does not have an obligation...to develop the market using its own initiative, systems or marketing plan. Accordingly it is difficult to appreciate on what basis, if any, a franchisee has contributed to or added to the franchisor's customer base...Clearly this would be the only basis on which a franchisee may arguably be entitled to some goodwill compensation because for the balance the franchisee relies upon and uses the franchisor's intellectual property. By operating a franchise under an agreement...cannot entitle a franchisee to a proprietary interest in franchisor intellectual property convertible to a dollar value.<sup>58</sup>

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56 Mr Murray Stewart, Eagle Boys Dial-A-Pizza, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 69

57 Mr Peter Speed, SCCA, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 44

58 DLA Phillips Fox, *Submission 81*, p. 9

6.64 The ability of a franchisee to sell their business before the expiry of their term did not, in Professor Andrew Terry's view, necessarily entitle them to a goodwill payment:

The fact that a franchisee has a right to sell a franchise acknowledges, in itself, that they can benefit from the sale of the business as well as from their trading.

...If you are putting the question directly 'should franchisees have any right to goodwill on termination of that agreement or expiry of that agreement? I would not be putting that case.'<sup>59</sup>

6.65 The reverse implication of the argument for an entitlement to goodwill was also highlighted:

...if franchisees have a right to claim payment for good will in defined circumstances, it follows that an underperforming franchise may be deemed to have undermined the franchise brand and negatively impacted the performance of other franchisees, thus rendering the failed franchisee liable to pay compensation arising from the negative good will generated.<sup>60</sup>

6.66 A number of submissions argued that the introduction of a form of goodwill payment at the end of an agreement would invite dispute and increase franchising costs and, in addition, may adversely impact on the feasibility of franchising as a business model.<sup>61</sup> The National Retail Association (NRA) expressed concern that:

Any change to the law dealing with the concept of good will may inevitably result in increased costs for both franchisors and franchisees. That is, if franchisees have a right to claim goodwill upon the termination of the franchise agreement, then the anticipated cost of these claims will be factored into franchise negotiations and inevitably lead to higher costs of entry and/or operation for franchisees.<sup>62</sup>

6.67 Mr Meagher of The Cheesecake Shop indicated that, if they were expected to make a goodwill payment at the expiry of the franchise agreement, it would affect the way they draft their contracts.<sup>63</sup>

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59 Professor Andrew Terry, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 71

60 National Retail Association, *Submission 109*, p. 6. See also McDonald's, *Submission 142*, p. 6

61 See for example FCA, *Submission 103*, pp 11-12 and Supplementary Submission 2; Mr Andrew Foote, *Submission 106*, p. 10, The Cheesecake Shop, *Submission 136*, p. 2, YRA, *Submission 118*, p. 2. For retrospectivity and implications beyond the franchising sector, see for example, FCA, *Supplementary Submission No 2*, p. 5; Mr Nick Bryden, YRA, *Proof Committee Hansard*, Canberra, 17 October 2008, p. 89; Mr Milton Cockburn, SCCA, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 47; Small Business Development Corporation of WA, *Submission 139* p. 6

62 NRA, *Submission 109*, p. 5. See also McDonald's, *Submission 142*, p. 6

63 Mr David Meagher, The Cheesecake Shop, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 17



6.68 While the contribution of the franchisee to the goodwill of the business is recognised in some agreements, devising a fair method of calculating exit or goodwill payments could present difficulties if sought to be applied universally.<sup>64</sup> The Australian Retailers Association (ARA) agreed that there should be some recognition of the franchisee's contribution to the goodwill of a particular location, but the percentage would need to be negotiated and agreed at the start of the agreement.<sup>65</sup>

6.69 The Franchisees Association of Australia Inc (FAA) suggested that there could be a formula in the Code 'based on the amount of capital invested at the start to ensure that you return that capital over a period and there is such an opportunity'. However the FAA acknowledged that it would be difficult to include such a measure in the Code.<sup>66</sup>

6.70 The NRA noted the complexity of assigning goodwill in a franchise context but concurred with the view that the issue should be dealt with up front in the franchise agreement:

As we generally understand it, that is the way it should be happening now. This issue should be dealt with and both parties should be aware of their rights or obligations when they entering into the agreement. The proposition that we are most keen to articulate is that the concept of goodwill is not as easily translated as we generally understand it to be in the franchise sector. The franchise sector survives on what I regard as very high and stringent forms of replication.... These are operations that survive on their replication, their sameness. It is not easy, if you want to make a judgement about goodwill, to determine what goodwill is attributable to the contribution of the franchisor, the system or the brand and what portion is attributable to the franchisee.... It is a very complicated subject. Our view is that if it is to be dealt with at all in terms of the code, it should be dealt with only to the extent of saying that it is something that ought to be specifically provided for in the agreement up front.<sup>67</sup>

6.71 Mr Piccolo MP proposed that a formula for an exit payment could be negotiated:

When you exit, for example, the parties might say, 'We will agree up front that the formula will be that when we cease as an exit payment you will get 10 per cent of six months returns' or whatever formula they agree to. That is still theirs. That is up to the parties to freely contract to, but it has to be

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64 See for example, Mr Gary Black, NRA, *Proof Committee Hansard*, Brisbane, 10 October 2008, pp 17-18

65 Mr Richard Evans, ARA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 18

66 The Hon. David Beddall, FAA, *Proof Committee Hansard*, Brisbane, 10 October 2008, p. 33.

67 Mr Gary Black, NRA, *Proof Committee Hansard*, Brisbane, 10 October 2008, pp. 16-17.

addressed. Most of the ones which go bad do not address that. That is why you spend a lot of time in courts in disputes, et cetera, because it is silent.<sup>68</sup>

### ***Market value***

6.72 As a proposal to ensure fair financial outcomes for both parties at the end of an agreement, the suggestion was put forward to provide restitution to franchisees on the basis of what they would have received for the business had they sold it to another franchisee prior to the agreement ending.

6.73 CFAL acknowledged that the debate over quantifying the division of goodwill between franchisors and franchisees had generated confusion:

I talked about the goodwill being jointly owned. I think there was a bit too much focus on the word ‘ownership’. The goodwill is jointly created by the franchisor and franchisee. In a sense, nobody owns it. It is jointly created, but nobody owns it, although in practice what happens is that when you sell the business the franchisee is able to recoup the benefit of that goodwill.<sup>69</sup>

6.74 To resolve the complexities around seeking to quantify who has contributed what to the business, CFAL argued that a franchisor should be required to pay market value for a franchise they decide not to renew:

All that is sought is some protection from the ability of a franchisor to appropriate the value that a franchisee has created in the business based on existing market practice.<sup>70</sup>

It goes to the nub of our arguments about renewal provisions and good cause. What should really happen in this industry is that industry practice should be enforced in the code, and that way you solve the problems. The problems arise when franchisors do not want to be franchisors any longer and actually want to run the business as well. If they do that, they should pay for the business as if they were any other person coming to acquire the franchise business on the market.<sup>71</sup>

6.75 The Australian Retailers Association (ARA) considered the position of a franchisee in the event of non-renewal:

Should they [franchisors] have the power to reduce the value to zero? If the outlet or the franchise is saleable on the market, the answer is, no. The franchisee should in fact share some of that sale cost. I am not sure as to the percentage.<sup>72</sup>

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68 Mr Tony Piccolo MP, Economics and Finance Committee, Parliament of South Australia, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 58.

69 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 36

70 CFAL, *Supplementary Submission 6*, p. 36

71 Mr Tim Castle, CFAL, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 30

72 Mr Richard Evans, ARA, *Proof Committee Hansard*, Melbourne, 5 November 2008, p. 20

6.76 Ms Deanne de Leeuw also highlighted the inequitable financial position a franchisee finds themselves in should the franchisor choose not to renew:

The franchisor will not pay for the franchisees goodwill either; the franchisee will only be offered the 'market value' for their equipment, as determined by the franchisor. One day a franchisee could 'own' a franchise valued at a million dollars, the next day all they have is a cheque 'buying' their equipment at a greatly depreciated value; with no legal recourse.<sup>73</sup>

6.77 CFAL argued that, while some had contended that an explicit duty to act in good faith would assist in addressing end of agreement concerns, this would not prevent opportunistic conduct where a franchisor is able to make a 'windfall gain' at the expense of the franchisee.<sup>74</sup> They submitted that '[m]ore specific provisions in the Code dealing with renewal of franchise agreements are necessary in order to recognise the contribution of franchisees'.<sup>75</sup>

### State inquiries

6.78 Both the Western Australian (WA) and South Australian (SA) inquiries made recommendations in relation to renewal and termination.

6.79 In its Final Report on Franchises, the SA Economics and Finance Committee concluded that making 'renewal an assumption in the franchise contract would constitute an undue interference in the specifics of a business relationship and compromise the ability of a franchisor to protect the value and reputation of their brand'. But a statutory duty of good faith would 'provide improved certainty to both parties as to their rights and obligations upon entering into renewal negotiations'.<sup>76</sup>

6.80 The SA Committee recommended that:

- the Code be amended to insert a provision imposing a duty to conduct renewal negotiations in accordance with good faith and fair dealing by each party (rec 7.2.14);
- the Code be amended to include a provision mandating that franchise agreements must include the basis on which termination payments or goodwill or other such exit payments will be paid at the end of the agreement. (rec 7.2.15); and
- the exclusion or inadequate determination of goodwill or other such exit payments by a franchisor during negotiations with a franchisee regarding

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73 Ms Deanne de Leeuw, *Submission 114*, p. 29

74 See for example Mr Robert Gardini, *Proof Committee Hansard*, Sydney, 9 October 2008, p. 3; MTAA *Submission 90*, p. 6. But see McDonald's Australia Limited, *Submission 142*, p. 6 for concern about good faith applying to renewal negotiations.

75 CFAL, *Supplementary Submission 6*, p. 44

76 SA Report, p.69

a franchise agreement should constitute 'unconscionable conduct' and should be included in any discussions regarding an amendment to section 51AC of the Trade Practices Act. (rec 7.2.16)

6.81 In relation to goodwill, the SA Committee concluded:

...inherent in recognising that the success of a franchise depends on both parties is the need to recognise and, where necessary, quantify the value of franchisee efforts over the term of a contract. While an individual franchise may not succeed without the brand power and resources provided by the overarching system, the efforts of the franchisee operating that outlet at that location need to be acknowledged when the relationship reaches critical points such as renewal or expiration.<sup>77</sup>

6.82 The Inquiry into the Operation of Franchise Businesses in Western Australia recognised the gap in protection for franchisees at the expiry of an agreement. This 'gap' exists because:

- Pursuant to contract law, when the term of an agreement expires, there is no obligation to renew. While theoretically it is possible for the common law and equity to intervene, this rarely occurs.
- There is no legislation specifically addressing renewal issues at a Commonwealth, state or territory level.
- The Code addresses termination but not renewal of franchise agreements.
- The restrained interpretation of the unfair business conduct provisions of the TPA, particularly s51AC, makes it unlikely that a franchisor's refusal to renew a franchise would contravene the legislation.<sup>78</sup>

6.83 The WA Report found, in contrast to the later SA inquiry, that the use of a 'good faith', unconscionability or similar standard to regulate franchise renewal was 'unlikely to be effective where the franchisor's conduct simply involves the exercise of a legal right'. Instead, the WA Report considered there was merit in further examination of the right to compensation upon renewal.<sup>79</sup>

6.84 The WA Report recommended the Code be amended to require franchisors to:

- explicitly specify, in the disclosure document, what end of agreement arrangements are in place under the franchise agreement (rec 3.1)

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77 SA Report, p. 75

78 WA Small Business and Development Corporation, *Inquiry into the Operation of Franchise Businesses in Western Australia*, April 2008, pp 21-22 (WA Report)

79 WA Report, p. 24

- explicitly specify, in the disclosure document, what the position is in relation to the franchisee's entitlement or lack of entitlement to goodwill or other compensation if the agreement is not renewed. (rec 3.2)
- conduct a pre-expiry review with the franchisee at least one year prior to the expiry of the franchise agreement. The purpose of the review is to inform the franchisee of any variations between the existing and new agreement and any conditions that need to be met in order for agreement renewal. (rec 3.3)
- specify, in the disclosure document, a reasonable period of notification in which to inform the franchisee of their intention not to renew the agreement. (rec 3.4)<sup>80</sup>

### **Committee view**

6.85 The committee is of the view that franchisors should be entitled to decline to renew franchise agreements on expiration if that is their choice. The committee therefore does not support an automatic right to renewal or the requirement for good cause to be shown for not renewing a franchise agreement. It is not the role of the law to force unwilling parties to enter into any commercial arrangement, including new franchise agreements. However, the committee notes that a franchisee should receive reasonable notice from a franchisor of any decision not to renew. Furthermore, a decision by a franchisor not to renew should not be designed to extract extra payments from a franchisee, nor to generate a windfall gain for the franchisor.

6.86 The committee considers that franchisee expectations about renewal need to be better managed, and the financial implications of non-renewal better understood, before fixed term franchise agreements are initially signed. Franchise agreements should clearly stipulate what the end of term arrangements and processes are, and these arrangements should be fully and transparently disclosed to prospective franchisees. In particular, the committee is of the view that pre-agreement disclosure documentation should explicitly discuss the transfer process that will apply to equity in the value of the business as a going concern at the time the agreement ends.

6.87 The present situation where a franchisee's contribution to their business has a market value prior to the end of the agreement which can be arbitrarily reduced to an amount determined by the franchisor afterwards is inequitable. At the end of an agreement, a franchisee has already committed considerably to the franchise system, financially and through their hard work, and is financially tied to the business. Franchisees stand to lose the prospect of returns on their capital investment, which in many cases is substantial.

6.88 The committee contends that a starting point for making an exit arrangement could be the market value of the business as a going concern.

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80 WA Report p. iv. See also ARA, *Submission 135*, pp. 15-16

6.89 The committee puts forward the following scenario as an example of an appropriate arrangement. If at the end of the term of a franchise agreement the franchisor exercises their right not to renew, they should give reasonable notice of this decision to the franchisee. The franchisee should then be given the right to sell the business at market value. First right of refusal could be held by the franchisor. Such an arrangement would take place in the context of both parties acting in good faith (as further discussed in Chapter 8).

6.90 The committee believes that franchisors who, as a matter of general practice, choose to end agreements with their franchisees at the end of the term should make clear at the disclosure stage not only their intention to do so but also the exit process that will apply.

### **Recommendation 5**

**6.91 The committee recommends that the Franchising Code of Conduct be amended to require franchisors to disclose to franchisees, before a franchising agreement is entered into, what process will apply in determining end of term arrangements. That process should give due regard to the potential transferability of equity in the value of the business as a going concern.**

6.92 Concerns raised during the inquiry about opportunistic termination and 'churning' of franchisees by exploiting the termination provisions of the Code are legitimate. Although most franchisors succeed on the basis of mutually beneficial relationships with their franchisees, evidence from the inquiry suggests a small element of franchisors seek financial gain through opportunistic termination. However, the committee does not propose to address this problem directly by recommending changes to the circumstances in which franchisors are presently able to terminate agreements under the Code. Franchisors need to retain the ability to protect the value of their brand across the network by being able to terminate agreements that are not deriving benefit for the network. Furthermore, the committee is of the opinion that it would be sensible to allow recent changes to the disclosure provisions of the Code, which enable prospective franchisees to access information about the history of the franchise site (including contact details of former franchisees) and were designed to help alert franchisees to the possibility that churning is taking place, to have an effect before recommending any further changes designed specifically to address this problem. Instead, the committee seeks to reduce opportunistic behaviour through the introduction of broad good faith requirements, as discussed in Chapter 8.