

THEN-CURRENT FRANCHISE AGREEMENT ON ASSIGNMENT

1. Introduction

1.1 On average, franchisees sell their businesses after 7 years of ownership.¹ This means that most franchisees will sell their business and assign their franchise at some point during the term of their franchise agreement.

1.2 Most franchise agreements include provisions which specify how the franchisee may sell its business and assign its franchise to a purchaser. For example, most franchise agreements provide that the franchisee must obtain the franchisor's prior written consent and set out the conditions the franchisee will be required to meet in order to obtain that consent.

1.3 The Franchising Code of Conduct² (**Code**) also includes provisions which govern how a franchisee may sell its business and assign its franchise to a purchaser. These provisions include for example:

- (1) that a franchisor must not unreasonably withhold its consent to the transfer or novation of a franchise; and
- (2) in what circumstances it will be reasonable for a franchisor to withhold its consent, for example, if the proposed transferee has not met the franchisor's selection criteria or the franchisee has breached the franchise agreement and not remedied the breach.

¹ L Frazer, S Weaven and K Bodey *Franchising Australia 2012* p46

² Trade Practices (Industry Codes – Franchising) Regulations 1998

2. Then-current franchise agreement

- 2.1 Many franchise agreements include a detailed list of conditions that the franchisee must meet in order to obtain the franchisor's consent to the sale of its business and assignment of its franchise.
- 2.2 A common condition is that the purchaser must enter into the franchisor's then-current franchise agreement. The purpose of this condition is to ensure that the purchaser will operate under the franchisor's most current franchise agreement, which may be quite different to the selling franchisee's franchise agreement, particularly if it was entered into several years earlier. Often this condition will also state that that then-current franchise agreement may contain different terms and conditions to the franchisee's franchise agreement.

3. What is the “then-current franchise agreement”?

- 3.1 Very few franchise agreements define the “then-current franchise agreement”. Within the franchise sector, it is generally understood to mean the form of franchise agreement that the franchisor is at that time requiring its new franchisees to enter into.
- 3.2 This question has come before the Courts in the following cases:

(1) Masterclass and Bedshed

- (a) In the 2008 WA Supreme Court case of *Masterclass Enterprises Pty Ltd v Bedshed Franchisors (WA) Pty Ltd*³, a franchisee claimed that the franchisor had unreasonably withheld its consent to the sale of its business and assignment of its franchise in breach of the Code and sought an injunction requiring the franchisor to approve the sale and assignment. The franchisor had withheld its consent because the

³ *Masterclass Enterprises Pty Ltd v Bedshed Franchisors (WA) Pty Ltd* [2008] WASC 67

purchaser did not meet the franchisor's selection criteria in that it did not intend to be an owner-operator of the business as was required by the franchisor (that is, it intended to operate the business under management).

- (b) The franchise agreement provided that the franchisor's consent was also conditional upon the purchaser entering into the franchisor's then-current franchise agreement. The franchisor had recently instructed its solicitors to prepare a new template franchise agreement which at that time had been approved by its chief executive officer but not yet entered into by a franchisee.
- (c) The Court agreed that the franchisor's selection criteria were reasonable and that it had not unreasonably withheld its consent to the transfer, and refused to grant the injunction.
- (d) Therefore, the Court was not required to determine whether the purchaser was required to enter into the franchisor's then-current franchise agreement however the following comments were made in obiter, as to what it considered that that was:

*"..in my view a form of agreement which is not the subject of any binding agreement with an existing franchisee but is simply a form of agreement, which at a particular point in time, Bedshed wishes future franchisees to enter into, is not Bedshed's 'then current franchise agreement' within the meaning of cl 12.2 of the franchise agreement. Clause 12.2 contemplates an agreement already in force between Bedshed and a franchisee, not one which is, in truth, simply, at a particular point in time, the form of agreement that Bedshed wishes future franchisees to enter into."*⁴

⁴ Ibid [124]

(e) The Court considered that a then-current franchise agreement cannot be, as it was in this case, a new form of franchise agreement which no franchisee had yet entered into but which the franchisor merely wished future franchisees to enter into. Instead, he considered that it must be the form of franchise agreement that is already be in force between the franchisor and at least one franchisee.

(2) ACCC v Seal-A-Fridge

(a) By contrast, in the 2010 Federal Court decision of *ACCC v Seal-A-Fridge*⁵, the Court concluded that the franchisor's then current franchise agreement could mean a form of franchise agreement which the franchisor had decided to use but which had not yet been signed by a franchisee.⁶

(b) Consistent with the *Bedshed* case, the ACCC argued that "then-current" could not mean an agreement that no franchisee had ever agreed to and that it must mean an agreement that at least one franchisee had already entered into.⁷ It alleged that the franchisor had engaged in unconscionable conduct by requiring a prospective purchaser to enter into a form of franchise agreement which contained a requirement for increased payments to the franchisor in circumstances where no then current franchise agreement imposed that requirement.

(c) However, the Court rejected this as essentially impractical because it would prevent a franchisor from updating its franchise agreement and

⁵ *Australian Competition and Consumer Commission v Seal-A-Fridge* [2010] FCA 525; *Australian Competition and Consumer Commission v Seal-A-Fridge (No 2)* [2010] FCA 681

⁶ *Ibid* [161]

⁷ *Ibid* [159]

the “discarding of terms that the passage of time, technological change or legislative intervention had rendered arcane or irrelevant”.⁸

4. How different can the then-current franchise agreement be?

4.1 Unconscionable conduct

- (1) In *ACCC v Seal-A-Fridge*, the ACCC argued that the franchisor’s conduct in refusing to grant consent to an assignment unless the purchaser entered into its then-current franchise which included substantially higher fees payable to the franchisor, was unconscionable in breach of the then *Trade Practices Act 1974* (now the *Competition and Consumer Act 2010*).⁹ It alleged that the franchisor was using the assignment opportunity to obtain a better deal for itself and that that constituted unconscionable conduct.
- (2) The Court held that although the franchisor regarded the requirement to execute the then-current franchise agreement as a licence to withhold consent unless the purchaser was prepared to agree to substantially higher fees and that that was not the correct interpretation of the relevant provision of the franchise agreement,¹⁰ the conduct was not unconscionable. The franchisor had no right to refuse to give its consent to the assignment¹¹ however its conduct in withholding that consent involved no moral turpitude and therefore was not unconscionable.¹²
- (3) Unconscionable conduct is difficult to establish and *ACCC v Seal-A-Fridge* confirms that that will be the case on these facts also. In order to succeed in

⁸ Ibid [159]

⁹ Ibid [11]

¹⁰ Ibid [155]

¹¹ Ibid [157] noting that the franchise agreement did not authorise the franchisor to agree to consent only if the transferee agreed to take up some different interest to that possessed and sought to be assigned by the existing franchisee

¹² Ibid [163]

such a case, an element of “bad faith” would be required, for example where a franchisor deliberately requires a prospective purchaser to sign an onerous franchise agreement merely to stop the sale of the business proceeding.

4.2 Breach of the implied duty of good faith

- (1) It is reasonably well-established that there exists an implied duty of good faith in relation to franchise agreements.¹³ This has been construed to mean that parties to franchise agreements must act fairly, reasonably and not capriciously or for some extraneous purpose, however the duty does not operate so as to restrict actions designed to promote the legitimate commercial interests of the party.¹⁴
- (2) Like unconscionable conduct, breaches of the duty of good faith have been difficult to establish¹⁵ and in order to succeed, an element of “bad faith” is required. For example, in *AMC Commercial Cleaning (NSW) Pty Ltd v Coade*¹⁶, the Court held that the franchisor had breached this duty by serving a default notice that was baseless, finding ways to impose financial burdens on the franchisee, failing to supply leads in accordance with the terms of the franchise agreement, failing to render customer invoices within a reasonable time and failure to use reasonable endeavours to collect customer debts.
- (3) Breach of the implied duty of good faith was not claimed in either *ACCC v Seal-A-Fridge* or *Masterclass Enterprises Pty Ltd v Bedshed Franchisors (WA) Pty Ltd*.

¹³ See for example, *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187; *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR; *Far Horizons v McDonalds Australia* (2000) VSC 310; *AMC Commercial Cleaning (NSW) Pty Ltd v Coade* [2010] NSWSC 832

¹⁴ *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR; *Far Horizons v McDonalds Australia* (2000) VSC 310

¹⁵ For example, *Far Horizons v McDonalds Australia* (2000) VSC 310

¹⁶ *AMC Commercial Cleaning (NSW) Pty Ltd v Coade* [2010] NSWSC 832

4.3 Non derogation from grant

- (1) The doctrine of non-derogation from grant has not often been considered in franchising cases in Australian courts¹⁷ however in the case of *JLCS Pty Ltd v Squires Loft City Steakhouse Pty Ltd*¹⁸ the Court acknowledged that it could be applied in the franchising context.¹⁹
- (2) The doctrine originally developed in relation to property leasing cases and its purpose is essentially to protect the spirit of the bargain struck. That is, if a party agrees to confer a benefit on another party, it must not then do anything which substantially deprives that party of the enjoyment of that benefit. If it does so, it is considered to have repudiated the agreement and the other party may accept such repudiation and terminate the agreement.
- (3) The doctrine has not been applied in relation to the requirement that a transferee enter into the franchisor's then-current franchise agreement however it is possible that it could be in circumstances where the then-current franchise agreement constitutes a different interest to that possessed and sought to be assigned by the franchisee, depending upon the wording of the particular franchise agreement.

4.4 2010 Code amendments

- (1) In 2010, clause 20 of the Code was amended to provide that a franchisor must not unreasonably withhold its consent to not only a transfer but also a *novation* (emphasis added).
- (2) A definition of "novation" was also added to clause 3 as follows:

¹⁷ A Terry and C Di Lernia, *Franchising and the Quest for the Holy Grail* Melbourne University Law Review Vol 33 at 552

¹⁸ *JLCS Pty Ltd v Squires Loft City Steakhouse Pty Ltd* (2008) 78 IPR 319

¹⁹ A Terry and C Di Lernia, *Franchising and the Quest for the Holy Grail* Melbourne University Law Review Vol 33 at 552

“novation, in relation to a franchise, means the termination of the franchise and entry into a new franchise with a proposed transferee on the same terms as the terminated franchise”

- (3) This means that in respect of franchises granted on or after 1 July 2010, a franchisor must not unreasonably withhold its consent to the novation of a franchise, that is, the entry into a new franchise with a proposed transferee on the same terms as the terminated franchise. This prohibits a franchisor requiring a transferee to enter into its then-current franchise agreement if the franchisee has requested the franchisor’s consent to a novation in writing and the then-current franchise agreement is not on the same terms as the terminated franchise. Clauses in franchise agreements which require otherwise cannot be enforced.
- (4) The 2010 amendments to the Code also introduced a requirement that a franchisor disclose in its disclosure document whether it will amend or require the amendment of the franchise agreement on or before the transfer or novation of the franchise.
- (5) According to the Expert Panel that instigated the 2010 amendments, the purpose of these amendments was to balance a franchisor’s right to make changes to its agreements for legitimate business reasons (such as changes in the market, regulations or industry standards) and to have incoming signed to its most recent agreements, against the problems this created for franchisees attempting to sell their businesses and which may impact upon their capacity to maximise their return on investment.²⁰ The Panel considered that the amendments would ensure that there is adequate upfront disclosure for prospective franchisees on the process that will apply if a franchisee seeks to

²⁰ B Horrigan, D Lieberman and R Steinwall, *Strengthening statutory unconscionable conduct and the Franchising Code of Conduct* p64

sell the business and which may assist franchisees in undertaking due diligence.²¹

5. Breach of the statutory duty of good faith?

5.1 It is likely that the Code will now be amended to include a statutory obligation of good faith.²²

5.2 If this obligation imposes essentially the same obligations as the implied duty of good faith, it is unlikely to assist claimants in these kinds of cases.

6 Conclusion

6.1 In respect of franchises granted on or after 1 July 2010, a franchisor cannot require a transferee to enter into its then-current franchise agreement if the franchisee has requested the franchisor's consent to a novation in writing and the then-current franchise agreement is not on the same terms as the terminated franchise.

6.2 In all other cases, a franchisor may require a transferee to enter into its then-current franchise agreement if this requirement is:

- (1) clearly disclosed in the franchise agreement and in respect of franchises granted on or after 1 July 2010, also the disclosure document; and
- (2) not applied in a way which will be constitute unconscionable conduct or a breach of the duty of good faith or the doctrine of non-derogation from grant.

²¹ Ibid p61

²² Commonwealth Government response to the Review of the Franchising Code of Conduct *Forward looking franchise regulation* July 2013