

Submission to the Review of Franchising Regulation

SHOULD FRANCHISES BE PERPETUALLY RENEWABLE

1. The British Franchise Association defines a franchise as:

"a contractual licence granted by one person (franchisor) to another (the franchisee) which:

- (a) permits or requires the franchisee to carry on during the period of the franchise a particular business under or using a specified name belonging to or associated with the franchisor;
- (b) entitles the franchisor to exercise continuing control during the period of the franchise over the manner in which the franchisee carries on the business which is the subject of the franchise;
- (c) obliges the franchisor to provide the franchisee with assistance in carrying on the business which is the subject of the franchise (in relation to the organisation of the franchisee's business, training of staff, merchandising, management or otherwise);
- (d) requires the franchisee periodically during the period of the franchise to pay to the franchisor sums of money in consideration for the franchise or for goods or services provided by the franchisor to the franchisee; and
- (e) is not a transaction between a holding company and its subsidiary or between subsidiaries of the same holding company or between an individual and a company controlled by him".

2. The "business" referred to in 1. above usually includes confidential information/know-how of the franchisor in relation to the business including trade marks and/or patents.

3. Recent case law, particularly the Dymocks case, appears to acknowledge a developing view that a business format franchise involves an element of joint venture between the franchisor and each of its franchisees working for their mutual benefit so as to improve and enhance the franchise system.

4. The thrust of this argument is that whilst at least initially the franchisor may be the owner/contributor of the material ingredients of the franchise, the franchisor provides these elements "in good faith" to each of the franchisees and to them "as a whole" in consideration of the franchisee's agreement in good faith to use the system and its ingredients together with the endeavour and hard work of the franchisee to build the system.

5. Traditionally, at the end of the term or the last renewal (if the initial term was subject to rights of renewal) the franchisee has no rights in connection with the system all of which revert to the franchisor and, unless there is specific provision for some financial compensation to be given to the franchisee on expiry, the franchisee has no legal right to any payment in respect of goodwill or the benefit that it has created for the system by its endeavours during the term of the Agreement. The franchisee would, of course, be entitled to its fixtures, fittings and items that it has purchased (i.e. such as fit out) unless the franchise agreement gives the franchisor the right to buy it at an agreed price or at a price to be determined in accordance with agreed principles. As most franchise agreements contain "restraint of trade" clauses preventing the franchisee after termination from carrying on a similar business at or within a specific radius from the premises and the

leasing arrangements (in the lease and or franchise agreement) usually give the franchisor the right to takeover the premises on termination for any reason of the franchise agreement, the

franchisee is in a position of not being able to sell the business as a going concern and that the "fit-out" has to be sold on a "break up" value basis and is worth next to nothing.

6. The traditional situation is that the franchisee comes in with nothing, makes an income and/or exits during the course of the franchise for whatever the franchise may sell for on the open market but the franchisee is always in danger of the decreasing unexpired residue of the term being a disincentive to purchasers and a downward pressure on the achievable price. Ultimately with a short unexpired term the franchise may become effectively unsaleable and on actual expiry the franchisee may be left with nothing.

7. If a franchise is a relationship of "good faith" between two or more persons for ultimate benefit of the system, the question is whether each of the parties who contribute to the venture should reap the benefit on a long term basis?

8. Is it correct that the franchisor should have sole discretion to decide if the franchisee can have a renewal if not included in the agreement or if the last right of renewal has been exercised and is on the point of expiring notwithstanding that the franchisee's efforts in popularising the "brand" ?

9. Should the franchisee not be entitled to "security of tenure" on a perpetual basis (subject to exceptions) and subject to the franchisor being entitled to receive its just rewards on a renewal?

10. My opinion is that if the franchisee has complied substantially with its obligations under the Franchise Agreement during the term, it should have the right to renew "as of right" and subject to payment of a renewal fee to the franchisor at the "market rate" for the time being.

11. Notwithstanding an automatic right of renewal for the franchisee, the franchisor should have the right to refuse renewal in certain circumstances such as:

(i) if there are circumstances requiring a material modification of the system or re-branding of the system such that it is appropriate effectively to cease the old system;

(ii) if the nature of the franchise is such that a very short initial term was anticipated with low capital costs so that it was anticipated that franchisees would enter and leave the system after very short intervals and that renewals were not anticipated;

(iii) if the franchisee specifically and with legal advice agrees to dispense with the automatic right of renewal.

12. Automatic renewal would not seem to materially prejudice the franchisor as renewals would be granted subject to payment of renewal fees equivalent to (or a proportion of) the then current initial franchise fee, to the franchisee having complied with its obligations under the Franchise Agreement, to payment of royalties and other payments at the rate applicable to new agreements and to the franchisee signing the franchisor's then current form of franchise agreement at the renewal date.

13. A franchisee would feel secure in its business knowing that it can obtain a renewal subject to compliance with its obligations.

14. A franchisee would have less concern about contributing to marketing of the system as it is in its long term interest. The franchisees' efforts are thus acknowledged in regard to the building of the brand and having a stake in the future of the enterprise by being entitled to renewals and not being at risk of being ejected purely by reason of expiry of the Franchise Agreement.

15. In order to fall within the exceptions entitling the franchisor not to renew, the franchisor would need to provide evidence of a "settled intention" to implement the "ground" entitling the

exemption. If a franchisor otherwise than in good faith seeks to rely on the exemption, a Court should be able to "test" the position and, if not satisfied, then have the power to grant a renewal.

16. How could a Court grant a renewal ?

(a) By enforcing legislation which introduces a right of renewal in a franchise agreement; and/or

(b) By enforcing franchise agreements of FANZ members where such agreements have been entered into after amendment of the FANZ Rules/Code of Practice to the effect that the members agree to their franchise agreements being read and construed as incorporating a right of renewal in a form set out in the Rules.

17. This hypothesis may also have a "silver lining" for franchisors who may be able to justify higher initial fees and renewal fees due to the better prospects of the franchisee and their ability to give more enduring security over the business to bankers.

18 This article is an hypothesis and is the author's opinion only. It is not to be taken as the view of or supported by Stewart Germann Law Office (SGL). If in principle it is seen worthy of progress, legislation and/or amendments to the FANZ Rules/Code of Practice would need to be considered to implement the practicalities.

Clive Neifeld
Auckland

18 August 2008