

SUBMISSION TO THE PRODUCTIVITY COMMISSION

**INQUIRY INTO THE MARKET FOR RETAIL TENANCY LEASES IN
AUSTRALIA**

**DESTRUCTION AND APPROPRIATION OF GOODWILL:
THE PROBLEM OF NON-RENEWAL**

Competitive Foods Australia Limited

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Executive Summary

1. The law in Australia does not provide any or any adequate protection for tenants and franchisees who lose the goodwill they have built up in their businesses when landlords and franchisors fail to renew their leases and franchise agreements upon expiry.
2. Economic literature in the franchise context has long recognised the problem of franchisor opportunism, in which the franchisor exploits its rights of termination and non-renewal to deprive the franchisee of economic benefits which the franchisee has established in relation to the business and business goodwill.
3. Whilst existing Australian tenancy and franchise law responds to the problems associated with wrongful termination, it does not currently respond to the problem of non-renewal, which can be seen as a form of "passive termination" that does not require any default to have been committed.
4. The problem can be illustrated by the "churn" and "appropriation" cases. In these cases the landlord or franchisor derives a financial benefit from their failure to renew the lease or franchise agreement, by taking advantage of the goodwill built up by the former tenant or franchisee without having to pay for it.
5. A change to the law is needed to solve the problem of non-renewal, and bring it into line with the law relating to termination. This should be done by requiring landlords or franchisors to grant a renewal of an existing lease or franchise agreement unless they have a good faith reason for not renewing the agreement. This solution has a precedent in oil industry legislation in Australia, as well as general franchise regulation in a number of states in the United States.
6. A good faith regime in relation to renewal would strike an appropriate balance between the freedom of landlords and franchisors to run their businesses, and the legitimate interests of tenants and franchisees to have their hard-earned goodwill recognised and protected.

Overview of the Problem

7. Building up goodwill is a key part of any strategy for delivering long-term benefits to business owners, particularly retail tenants and franchisees. In this sense it lies at the heart of the entrepreneurial and competitive processes in our economy.
8. Economic incentives for a landlord or franchisor not to renew an existing lease or franchise can include the benefits of "churn", where higher rents or franchise fees to acquire a lease or franchise can be extracted from a new tenant or franchisee because of the goodwill generated at a location by the previous tenant or franchisee. Alternatively, the lessor or franchisor can refuse to renew an existing lease or franchise agreement to set up its own company operations at the site and convert the existing goodwill into a profit stream for itself. In both cases, the landlord or franchisor profits whilst the business owner who built up the goodwill in that business gets nothing.
9. This problem has been extensively canvassed in the economic literature relating to franchises, where it has been labelled 'franchisor opportunism'. This term is equally applicable to both termination and non-renewal of profitable franchisees.¹ Klick, Kobayashi and Ribstein describe the problem thus:

It may be rational for franchisors to exercise their termination rights to expropriate the returns from a franchisee's investment in market discovery and development by terminating contracts in those markets that turn out to be unexpectedly profitable, allowing the franchisor to service the markets itself without having to split

¹ R.D. Blair & F. Lafontaine, *The Economics of Franchising*, Cambridge University Press, New York, 2004, pp. 271-275. See also, for example, P.H. Rubin, 'The Theory of the Firm and the Structure of the Franchise Contract', *Journal of Law and Economics*, (vol. 21, 1978), pp.223-233; J.A. Brickley, F.H. Dark & M.S. Weisback, 'The Economic Effects of Franchise Termination Laws', *Journal of Law and Economics*, (vol. 34, April 2001), pp.101-132.

revenues with a franchisee or to resell the franchise at better terms.²

10. Legislation has been enacted in Australia to address some of the problems associated with termination in the case of both retail tenancies³ and franchise agreements.⁴ The common law also provides remedies in certain cases where there has been a wrongful termination.⁵
11. However, the problem of non-renewal (which Peter George, for example, has described as a form of "passive termination"⁶) is not addressed either by the common law or by any existing legislation – including the Trade Practices Act 1974, the Fair Trading Acts, the Franchising Code of Conduct or the Retail Tenancy legislation. Although the New South Wales Industrial Relations Act 1996 potentially provided an avenue for redress, the application of that legislation may be precluded by recent decisions of the High Court and the New South Wales Court of Appeal.⁷
12. Various solutions to the non-renewal problem have been implemented by legislation in the United States, in the context of franchisees, and in relation to petrol stations. As discussed below, this legislation typically involves the

² J. Klick, B. Kobayashi & L.E. Ribstein, 'The Effect of Contract Regulation: The Case of Franchising', <http://ssrn.com/abstract=951464>, 2006, p.8.

³ See eg. Retail Leases Act 1994 (NSW), parts 5 and 7A.

⁴ Trade Practices (Industry Codes – Franchising) Regulations, 1998, reg. 21-23.

⁵ See eg. Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd (1999) ATPR 41-703; Burger King Corp v Hungry Jack's Pty Ltd [2001] NSWCA 187; Ah Toy Pty Ltd v Thiess Toyota Pty Ltd (1980) 30 ALR 271; Carson Machinery Nominees Pty Ltd v Chamberlain John Deere Pty Ltd (1989) ATPR 40-934.

⁶ George P., 'Terminating a Franchise', *Franchising Alert: Legislative Amendment & Current Issues (Victoria)*, LAAMS, 2001, pp.23.

⁷ See paragraphs 44-46 below.

introduction of a "good faith" or "good cause" justification for refusal to renewal at the time of expiry.⁸

13. Good faith requirements are present to a limited extent in existing retail tenancy legislation in Australia.⁹ They were also a central feature of the former Petroleum Retail Marketing Franchise Act 1980 ("PRMFA") and now form part of the Oil Industry Code, which replaced the PRMFA.¹⁰ This legislation was originally introduced to address the specific problem of oil companies taking over successful privately-owned petrol stations and converting them into company owned outlets – a practice that was noted in the Blunt and Swanson Committee reports.¹¹
14. The term "good faith" is increasingly encountered in Australian jurisprudence and in statute law such as s.51AC(3)(k) of the Trade Practices Act 1974. For the purpose of this submission, a useful working definition of "good faith" is provided by Elisabeth Peden who has suggested that "the true meaning of good faith must be a requirement to behave honestly and to have regard to the interests of the other party, without subordinating one's own interests".¹² Alternatively, S. Burton argues that good faith will not exist when one party acted in a way intended to regain the opportunities foregone by them upon entry into the contract.¹³ Other definitions in the context of contractual provisions have referred to where "a party is precluded from cynical resort to the black letter but is not fixed with a duty to subordinate self-interest entirely. The duty is not one to prefer the interests of the other contracting party. Rather it is a duty to recognise and to have due regard to the

⁸ See paragraphs 59-62 below.

⁹ See for example sections 50, 62B, 72B Retail Leases Act 1994 (NSW).

¹⁰ Trade Practices (Industry Codes – Oilcode) Regulations, 2006, reg. 32(6).

¹¹ Trade Practices Act Review Committee, *Report to the Minister for Business and Consumer Affairs*, AGPS, Canberra, 1976, ch. 5 ("Swanson Committee"); Trade Practices Consultative Committee, *Small Business and Trade Practices*, AGPS, Canberra, December 1979, ch.11 ("Blunt Committee").

¹² E. Peden, *Good Faith in Performance of Contracts*, LexisNexis Butterworths, Sydney, Australia, 2003.

¹³ S. Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith', *Harvard Law Review*, (vol. 94, 1980) p. 369.

legitimate interests of both parties in the enjoyment of the fruits of the contract delineated in its terms".¹⁴

15. In a practical sense, good faith would be satisfied where the landlord or franchisor has a legitimate business reason to not renew the agreement, such as a decision to sell or redevelop a building site, or to cease any franchise operations in a particular territory. However, good faith would not be present if the landlord or franchisor was acting for a collateral reason or to achieve a collateral benefit that was not linked to the conduct of the tenant or franchisee in relation to the lease or franchise at the site in question. Thus, for example, in a termination case, the New South Wales Supreme Court held that Burger King was in breach of its good faith obligations to Hungry Jacks by using its contractual powers for the collateral purpose of preventing Hungry Jacks from expanding, so that Burger King could develop its own stores in the Australian market unhindered by its contractual arrangements with Hungry Jacks.¹⁵
16. This submission argues that a legislative "good faith" requirement should be introduced in Australia to address the non-renewal problem. This requirement would fill a gap in the law by striking a fair balance between the interests of landlords and franchisors on the one hand, and that of tenants and franchisees on the other hand, in relation to goodwill on lease or franchise renewal. In particular, landlords and franchisors would have nothing to fear from being required to act in good faith in relation to the renewal of tenancies and franchises.

¹⁴ Commonwealth Bank of Australia v Spira [2002] NSWSC 905; See also J.F. Kein Pty Ltd v Priority Management System Pty Ltd [2007] NSWSC 789 at [24]-[28].

¹⁵ Hungry Jacks Pty Ltd v Burger King Corporation [1999] NSWSC 1029 at [488], [707]–[711] (Rolfe J). This was approved by the Court of Appeal in Burger King Corporation v Hungry Jacks Pty Ltd [2001] NSWCA 187 at [310]. This case, which occupied 67 hearing days and 11 days on Appeal, was decided on the basis of implied contractual terms. However, it should be noted that the implied contractual duty of good faith is a developing area of the law which is attended by controversy and uncertainty: Dixon B., "What is the content of Common Law obligations of good faith in commercial franchises?", *Australian Business Law Review* (vol.33, 2005), pp. 207-223; Peden, *op. cit.*

17. Legislation of this type would not be expected to cause a major disruption to the relations between landlord and tenant or franchisor and franchisee. The evidence collected by Griffith University's 2006 survey of Australian franchising discloses that in 2003-2005 the annual rate of non-renewal was in the order of 1.5-3.7%, and that a further 8-9% of franchises were bought back or acquired by the franchisor.¹⁶ This is consistent with the evidence cited by Blair and Lafontaine, who suggested that 93% of franchises that came up for renewal in the United States in 1986 were renewed. The authors of the Griffith University survey also found that the franchise industry in Australia has "flourished" since the introduction of the Franchising Code of Conduct in 1988.¹⁷ This latter conclusion is not surprising because the Franchising Code of Conduct's termination provisions provide protection to franchisees against opportunistic termination, thus protecting their substantial financial investment and resultant goodwill. The same considerations could be expected to apply if good faith provisions were introduced in relation to non-renewal to supplement the existing provisions dealing with termination.
18. In short, the problem of non-renewal exists for both retail tenants and franchisees. It involves a question of principle that does not depend upon the size of the business or the nature of the industry. The argument advanced in this submission is that once the problem of non-renewal is recognised by the Productivity Commission and the solution of good faith renewal is articulated in its report, a coordinated legislative regime can be implemented to protect retail tenants and franchisees by the Commonwealth and State Governments.

¹⁶ Fraser L., Weaven S. & Wright D., *Franchising Australia 2006*, Service Industry Research Centre, Griffith University, 2006, pp. 62-63.

¹⁷ *Ibid.*, pp, 8-9.

The Goodwill Problem

19. Goodwill is, of course, an intangible asset of a business, and business owners count on their goodwill to attract and retain customers on a daily basis. The financial consequence of non-renewal for the tenant or franchisee is the loss of goodwill in the business which it has established.
20. The law recognises goodwill as a form of property, although the Courts have found goodwill "notoriously difficult to define".¹⁸ In a major review of the law on this topic recently, the High Court accepted that there is a difference between the business, accounting and legal concepts of goodwill.¹⁹ A commonly cited legal definition of goodwill is that it includes "whatever adds value to a business by reason of situation, name and reputation, connection, introduction to old customers, and agreed absence from competition, or any of these things".²⁰ However, from a legal point of view, goodwill is treated as being inseparable from the asset or assets to which it is attached. Thus if the business is terminated or lost, the law regards the property in the goodwill as also being lost, even if, in a business sense, the goodwill continues at the site for the benefit of the new owner.²¹
21. Similar difficulties have also arisen in relation to the accounting treatment of goodwill. At a general level, the International Accounting Board has defined "goodwill" to be "Future economic benefits arising from assets that are not capable of being individually identified and separately recognised". However, the only recognition given by the accounting standards to goodwill occurs at the time of sale

¹⁸ See *Hepples v Federal Commissioner of Taxation* (1992) 173 CLR 492 at 519.

¹⁹ *Federal Commissioner of Taxation v Murry* (1998) 193 CLR 605 at [13] – [23].

²⁰ See *Inland Revenue Commissioners v Muller & Co's Margarine Limited* [1901] AC 217 at 235 cited by Dixon CJ, Williams, Fullagar and Kitto JJ in *Box v Commissioner of Taxation* (1952) 86 CLR 387 at 396-397.

²¹ See generally G. Gathro, 'Goodwill: "Now You See It, Now You Don't"', *Australian Tax Review*, (Vol. 25, 1996), pp. 169-185; A.H. Slater QC, 'The Nature of Goodwill', *Australian Tax Review*, (Vol. 24, 1995), pp. 31-56.

of a business, where goodwill is recognised as the difference between the value of the business as a whole and the value of its assets. Consistently with this approach, any other type of goodwill, which is characterised as "internally generated goodwill", is not recognised in an entity's accounts.²²

22. From a commercial perspective, goodwill arises from a combination of the elements of location, product, people and management. A good product in a poor location, a poor product in a good location, a good product in a good location with poor staffing and so on will all produce sub-optimal outcomes. It may be possible in some cases to separate out different types of goodwill – goodwill in the business, the location or the product.²³ However, from the point of view of the tenant or franchisee, the goodwill with which it is concerned is the value of the business which it has established at a particular location or locations. In the context of opportunistic behaviour by a landlord or franchisor, it is implicit that the tenant or franchisee has contributed extra value by its skill and effort, which is reflected in its goodwill but which also provides the economic incentives for the landlord or franchisor not to renew the lease or franchise agreement.
23. The challenge for the business owner is to use his or her time, money and effort building up the elements which constitute the business.²⁴ A tenant may take a lease in a new shopping centre and, by virtue of its product or marketing efforts, attract customers to that centre. What was once a poor site, becomes a good site which now attracts other tenants. In this way the tenant's goodwill increases further, and the landlord benefits from higher rents paid by other tenants as the perceived value of the centre has improved.

²² See Approved Accounting Standard ASRB 1013; International Financial Reporting Standards 3, para 51, Appendix A.

²³ J. Roberts & M. Druery, *Goodwill: The Nature and Valuation of Goodwill for Stamp Duty Purposes*, New South Wales Office of State Revenue, 1994.

²⁴ Blair & La Fontaine, *op. cit.*, p. 264.

24. Take the case of a fast food franchisee which locates a site and then builds and operates a store in a new location. Whilst the food product may be a recognised brand in the market, the franchisee takes the entirety of the financial risk that it will build up a sufficient customer base at that location to run a profitable operation. On the other hand, the franchisor typically receives a fee on entry into the franchise agreement as well as ongoing royalties based on the franchisee's revenue, irrespective of the return to the franchisee on its investment. Over time, through good management, staffing and marketing, the franchisee can establish goodwill in the restaurant at that site, where none previously existed.
25. However, the tenant can only recoup its goodwill whilst it has a lease at the shopping centre, even though the landlord keeps a permanent benefit because of the other tenants which it has attracted. At the end of the lease, the tenant must leave and either hope that it can take some of its goodwill with it to a new location, or else abandon its goodwill entirely. The only value left to the tenant in such cases is the residual value of its assets, which may amount to a fraction of the going-concern value of the business it previously operated. Thus, the goodwill in the business created by the hard work of the tenant is destroyed as a direct consequence of its lease not being renewed.
26. Likewise, the fast food franchisee can only recoup its goodwill whilst it has a current franchise agreement with the franchisor. When that agreement expires, the franchisor is in a position to exert commercial pressure on the franchisee to give up its restaurant to be run by someone else – including the franchisor itself – so that the franchisee can obtain some value for the goodwill it has established. Otherwise the franchisee may be left with a purpose built restaurant, which has only limited value in terms of other potential uses. If the franchisee yields to the commercial pressure exerted by the franchisor, what would happen in effect is that the franchisor will have appropriated the goodwill in that restaurant for itself or someone of its choosing, at the expense of the original franchisee who built up that goodwill.

27. With the vast expansion of retail tenancies and franchises within the Australian economy in recent years, it is no longer sufficient to say that this problem should be addressed by the parties making appropriate provision in their contracts for renewal options. In most cases, prospective tenants and franchisees alike are offered their initial contracts on a 'take it or leave it' basis. These contracts can often contain standard form conditions that apply nationally or internationally. There is no effective opportunity for negotiation at the outset, and as the next section demonstrates, no legal protection is available to a tenant or franchisee at the time of expiry of the agreements in relation to non-renewal.
28. A related problem recognised in the franchising literature is that franchise contracts can be described as relational contracts, which are 'incomplete'. That is, franchise contracts are necessarily flexible and depend upon good faith obligations because the franchisee makes a significant up-front investment of time and resources when it is unclear how the relationship will develop, having regard to the franchisee's need to maintain standards of quality control over its franchise system.²⁵ However, for the reasons also set out below, the common law does not extend good faith obligations to impose a duty on a party to enter into a contract (that is, in the present case, to renew the contract on expiry).

Law's Failure to Protect Goodwill on Non-Renewal

29. The failure of the law to protect goodwill on expiry of leases and franchise agreements dates back to the hey-day of unregulated, laissez faire capitalism of late 19th century England.

²⁵ Terry A., 'Franchising, relational contracts and the vibe', *Australian Business Law Review*, (vol. 33, 2005), pp. 289-300; Hadfield G.K., 'Problematic Relations: Franchising and the Law of Incomplete Contracts', *Harvard Law Review*, (vol. 42, April 1990), pp. 927-992.

30. *Llewellyn v Rutherford*²⁶ was an 1875 English decision which laid down the principle that a tenant had no general law right to any compensation for goodwill on expiry of the term of the lease. The nub of that decision was encapsulated in the words of the Chief Justice, Lord Coleridge, who stated:

Here is a public house in which a thriving business has been carried on, having attached to it that which has been variously described as goodwill, a thing which has an appreciable value and is every day bought and sold. That goodwill the tenant is about to forgo. In the absence of a stipulation to the contrary, it would be an increased value of the premises, which on the tenant's going away would enure to the benefit of the landlord: he might let them for an increased rent or he might obtain a premium. In the absence of a stipulation, the tenant could derive no advantage from such increased value. The end of the term having arrived, all he could take away would be the stock-in-trade and the tenant's fixtures. The goodwill is lost to him.

31. Lying behind the *Llewellyn* principle are two fundamental ideas which create the potential for injustice to tenants and franchisees in relation to the goodwill built up during the course of their tenancy or the operation of their franchise:
- (a) Freedom of a contract – ie. once a contract expires a party such as a landlord or franchisor cannot be compelled to enter into a new contract.²⁷
 - (b) Contractual certainty – ie. parties are bound by the terms of the contract as framed, in the circumstance that existed at the time that the contract was entered, subject to any variations that were subsequently agreed by both

²⁶ *Llewellyn v Rutherford* (1875) LR 10 CP 456.

²⁷ S.A. Smith, *Contract Theory*, Oxford University Press, Oxford, 2004, p. 59.

parties.²⁸ This principle assumes that contracts are complete in terms of addressing all possible future contingencies and specifying the performance required of the parties in each situation.²⁹

32. The Llewellyn principle has been applied as recently as 1989 in Australia in a case involving BP and a petrol station at Engadine (Ranoa Pty Ltd v BP Oil Distribution Ltd³⁰). Nine years after granting a licence to the service station operator, BP terminated the licence and took over the site. The Federal Court decided that the PRMFA did not apply to the case, because the statutory protection under the PRMFA was limited to the first nine year period. After referring to the Llewellyn principle, the Court held:

Where a franchisor elects to grant a new lease the franchisee has the benefit of continued exploitation of the goodwill of the site; perhaps for another nine years. But where a franchisor elects not to grant a new lease, the franchisee is turned from the site without compensation for any goodwill which it may have developed during its period of occupancy. A franchisee, such as the appellant, may regard this result as harsh, the harshness being exacerbated if it should be the case – we do not know whether it is so – that franchisors are more likely to decide themselves to operate sites to which substantial goodwill attaches. But if this result is harsh, it is a product of the circumstance that the Act does not require the franchisor who elects not to renew to pay any compensation to the franchisee.

²⁸ J.W.Carter & D.J.Harland, *Contract Law in Australia*, (2 ed.) Butterworths, Sydney, 1991, pp.259; P.D. Finn 'Essays on Contracts', Law Book Co, Sydney, 1987, p. 30. There are some limited exceptions that have been recognised in contract law to deal with changed circumstances, such as the doctrine of frustration; Smith, *op. cit.*, pp. 305; G.H.Treitel, *The Law of Contract*, (11 ed.), Thomson, London, 2003, pp. 901 – 905; *Chitty on Contracts* (29 ed.), Sweet & Maxwell, London, vol 1, 2004, at para 23-56.

²⁹ G.K. Hadfield, *op. cit.*, p.927.

³⁰ Ranoa Pty Ltd v BP Oil Distribution Ltd (1989) 91 ALR 251.

33. This passage highlights the importance of a legislative solution to the non-renewal problem. The existence of the PRMFA protection for non-renewal must have been sufficiently strong that BP waited until the day the nine year restriction lapsed before it terminated Ramoa's rights, and took over the Engadine outlet presumably knowing that it could do so without the franchisee having protection or right to compensation under the common law.

Inadequacy of Existing Australian Law

34. This section addresses the inadequacy of existing Australian legislation to deal with the non-renewal problem, and explains why further legislation is required.

Retail Tenancy Legislation

35. Retail tenancy legislation in all states except Queensland stipulates a minimum 5 year term for a retail lease.³¹ The intention behind these provisions is to provide some certainty in relation to the tenant's business planning, for example in relation to the recovery of start-up and fit-out costs.³² Otherwise there is no provision to deal with the renewal of expiring leases.
36. Although W.D. Duncan argues that the minimum 5 year term also protects a tenant's goodwill,³³ this protection is of limited value. The Ranoa case mentioned above is a neat illustration of the problems with fixed minimum terms – once the nine year term under the PRMFA expired, BP gave notice that it was terminating the licence and resumed the site without paying compensation to the existing business proprietor. Any legislation that imposes minimum terms does not resolve

³¹ Retail Leases Act (NSW), s.16(1); Retail Leases Act 2003 (Vic), s.21(1); Retail and Commercial Leases Act 1995 (SA), s.20B; Commercial Tenancy (Retail Shops) Agreements Act 1985 (WA), s.13(1); Business Tenancies (Fair Dealings) Act 2003 (NT), s.26.

³² W.D. Duncan, *Commercial Leases in Australia* (4 ed.), Law Book Company, Sydney, 2005, para 12.270.

³³ *Loc. cit.*

the problem of the loss of goodwill for non-renewal of a tenancy (or franchise), it merely defers the problem.

Trade Practices Act 1974

37. The Trade Practices Act ("TPA") and the cognate provisions in the state Fair Trading Acts and Retail Tenancy legislation represent, amongst other things, a modification of the strict contractual principles, such as those previously discussed. This is recognised, for example, in the powers granted to the Courts in s.87 of the TPA to vary the terms of a contract where a breach of the TPA is established. The Courts also have power to award damages (s.82) and injunctions (s.80).
38. A common use of the TPA concerns claims of misleading and deceptive conduct in breach of s.52. In a contractual setting, such as leases and franchise agreements, the TPA enables the Court to vary the terms of a contract or award damages if a person enters into a contract based upon a misrepresentation or other pre-contractual conduct. However, this approach is backward-looking in the sense that the right to renewal arises because of some past conduct of the landlord or franchisor on which the tenant or landlord relied, rather than the circumstances that exist at the time of expiry.³⁴
39. Secondly, the TPA attempts to regulate business dealings by means of the unconscionability provisions in ss.51AA-51AC. Although there is an extensive debate in the jurisprudence about the meaning of the term "unconscionability", the High Court held in *ACCC v Berbatis* that there was no unconscionability involved in a landlord taking advantage of its bargaining position where the tenant did not have a right to renewal of its lease. In that case, Chief Justice Gleeson observed:

³⁴ See for example *Tone'n'Tan Pty Ltd v Bailey & Ors* [2007] WADC 97; *Far Horizons Pty Ltd v McDonalds Australia* [2000] VSC 310.

Unconscientious exploitation of another's inability, or diminished ability, to conserve his or her own interests is not to be confused with taking advantage of a superior bargaining position....

In the present case, there was neither a special disadvantage on the part of the lessees, nor unconscientious conduct on the part of the lessors. All people involved were business people, concerned to advance or protect their own financial interests. **The critical disadvantage from which the lessees suffered was that they had no legal entitlement to a renewal or extension of their lease; and they depended upon the lessors' willingness to grant such an extension or renewal for their capacity to sell the goodwill of the business for a substantial price.** They were thus compelled to approach the lessors, seeking their agreement to such an extension or renewal, against a background of current claims and litigation in which they were involved. They were at a disadvantage, but there was nothing "special" about it.³⁵ (emphasis added).

40. In view of the High Court's approach in the *Berbatis* case it must be doubtful whether the unconscionability provisions could ever be used to address a failure by a landlord or a franchisor to renew a lease or franchise agreement. Although s.51AC of the TPA may provide additional assistance to small businesses (where the transactions involve less than \$10 million), relief under that provision is still dependent upon proving that the conduct was "unconscionable" – and this was the very matter addressed in the *Berbatis* judgments.³⁶

³⁵ ACCC v C.G. *Berbatis Holdings Pty Ltd* (2003) 214 CLR 51, at [14] – [15].

³⁶ By contrast, unconscionability may be available in wrongful termination cases. See, for example *Automasters Australia Pty Ltd v Bruness Pty Ltd & Anor* [2002] WASC 286 (where the plaintiff

41. It must therefore be highly unlikely that the unconscionability provisions could be used to attack the decision of a landlord or a franchisor to enter into an agreement that has no provision for compensation for goodwill at the expiry of the agreement, and no mechanism for good faith renewals upon expiry. As previously mentioned, landlords and franchisors generally have standard form agreements that they propose to prospective tenants and franchisees on a "take it or leave it" basis. However, in view of the *Berbatis* decision, it is unlikely that the lack of bargaining power on the part of the prospective tenant or franchisee at the time of entry into such an agreement would enable them to claim that a refusal to amend their standard form agreement would be "unconscionable".
42. Thirdly, the Franchising Code of Conduct³⁷ which is enforceable under s.51AD of the TPA, is of no assistance in relation to the question of renewal. Although regulations 21-23 of the Code impose restrictions on the power of termination of a franchise agreement, there is nothing in the Code that deals with franchise renewals, even though the economic literature treats termination and non-renewal as being related means by which franchisor opportunism can be effected.³⁸
43. Fourthly, it is unlikely that any of the provisions relating to anti-competitive conduct under Part IV of the TPA will apply to a single instance of non-renewal. Most of these provisions (eg. s.45, 46 and 47) depend to some extent on proving the existence of a market, market power in that market or a lessening of competition in that market. It is unlikely that a market will be defined by reference to the sale of a single product (in the case of franchises) or the conduct of a business at a single location (in the case of leases), with the consequence that the other elements of

terminated the defendant's auto repair franchise without complying with the Franchising Code of Conduct in circumstances found to be capricious and unreasonable).

³⁷ Trade Practices (Industry Codes-Franchising) Regulations 1998.

³⁸ Note however that the Franchising Code of Conduct does require disclosure of renewal conditions to the extent that such conditions are contained in the franchise agreement – cl.17, Annexure 1, Trade Practices Industry Codes – Franchising) Regulations 1998.

market power and lessening of competition will not be established. The costs of running a Part IV case, which typically involve extensive expert economic evidence, would usually be a formidable barrier that would prevent most tenants and franchisees from pursuing such a claim in any event.

Industrial Relations Act 1996 (NSW)

44. S.106 of the IR Act was one potential source of relief for franchisees in New South Wales in relation to the protection of goodwill. That provision applies to contracts which relate to "work in any industry", and permits the Industrial Court to vary any contract which is "unfair, harsh or unconscionable" or contrary to public interest. The use of the additional words "unfair" and "harsh" may have a wider scope for intervention than was given by the High Court in *Berbatis* to the term "unconscionable". The other significant point about s.106 is that subs.106(2) permits the Court to consider the question of unfairness at the time of the hearing and not merely at the time the contract was entered.
45. In the past, the IR Court has frequently intervened to vary and amend the terms of franchise and similar agreements.³⁹ For example, in *Stowar v Myer Stores Ltd*⁴⁰ it protected goodwill built up by lorry owner drivers whose contracts with Grace Bros were terminated when it sold its delivery contract to Linfox. The Court held that Grace Bros' reliance on its strict legal rights to terminate those contracts was in breach of a predecessor to s.106, in circumstances where the drivers were led to believe that their contracts had a value that could be realised on sale or retirement.
46. However, the potential application of s.106 to franchises may be precluded as a consequence of a recent decision of the New South Wales Court of Appeal in

³⁹ See for example *Caltex Oil (Aust) Pty Ltd v Feenan* [1981] 1 NSWLR 169; *A&M Thompson Pty Ltd v Total Australia Ltd* [1980] 2 NSWLR 1.

⁴⁰ *Stowar v Myer Stores Ltd* (1993) 50 IR 9.

McDonald's Australia v Industrial Relations Commission⁴¹ in which the Court held that s.106 did not apply to certain contractual disputes arising under a franchise agreement, because those issues did not relate to "work in an industry". This approach is consistent with a more limited approach to s.106 taken by the High Court in 2006 in its decision in Fish v Solution 6 Holdings.⁴²

General Law Relief

47. There are numerous doctrines at common law and in equity that can apply to modify the strict operation of contract law. These include principles of misrepresentation, undue influence, unconscionability and the like. However, like s.52 of the TPA these are all backward-looking and require the tenant or franchisee to bring legal proceedings to establish and vindicate their rights. However, two of these principles are worth particular mention.
48. First, the doctrine of estoppel may be available to supplement the terms of the contract in appropriate cases. In Bond Brewing v Reffell Party Ice⁴³ the New South Wales Supreme Court found evidence of an invariable practice by a landlord to acknowledge and pay out the goodwill of a tenant on expiry of a brewery lease. The evidence in that case showed that the tenant had entered into the particular lease on the assumption that this practice would be continued, and the court held that the landlord was obliged to honour that assumption.
49. Secondly, the courts have also recognised that contractual powers must be exercised reasonably, in good faith and for a proper purpose. This was one of the key features of the Burger King and Hungry Jacks litigation referred to earlier. Although this and similar cases illustrate that courts can enforce appropriate

⁴¹ McDonalds Australia Holdings Ltd & Anor v Industrial Relations Commission of NSW & 2 Ors [2005] NSWCA 286.

⁴² Fish v Solution 6 Holdings Ltd (2006) 225 CLR 180.

⁴³ Bond Brewing v Reffell Party Ice Suppliers (unreported, Waddell CJ in Eq, 17 August 1987).

commercial behaviour, these principles are limited to the exercise of powers under existing contracts, such as the power to terminate a contract for default. These principles would not apply, under the current law, to a decision by a lessor or franchisor not to grant a new contract upon expiry of the old contract.

50. In summary, the existing Australian law essentially provides no relief or assistance to tenants or franchisees to protect their goodwill by providing a right of renewal upon expiry of their agreements. Even where some remedy may exist, based for example on a pre-contractual representation, the tenant or franchisee is still placed in the disadvantageous position of having to bring costly and time-consuming court proceedings to protect its interest.⁴⁴ These disadvantages provide a formidable practical barrier to tenants and franchisees seeking relief. For most tenants and franchisees, there would be little point in spending eighteen months or more locked in a battle to obtain a renewal of their agreement or compensation for their loss of goodwill, because either their business will have been lost or their goodwill will have dissipated in the meantime.

Legislative Solutions

51. Three main legislative remedies have been used to respond to aspects of the goodwill problem in Australia, the United States and in England. For the purpose of this submission, a copy of the relevant provision of the PRMFA, s.17, is attached as Appendix 1, and a schedule of relevant US state legislation provisions dealing with non-renewal in franchise agreements is attached as Appendix 2.

Express Compensation for Loss of Goodwill

52. The English Landlord and Tenant Act 1927 (now repealed) made express provision requiring a landlord, in certain circumstances, to compensate a tenant who could

⁴⁴ See for example footnote 14 above.

establish that he or she had built up goodwill in the premises. Goodwill in this sense was recognised to be the increase in the rental value of the premises on expiry of the lease that resulted from the business carried on by the departing tenant. This compensation was payable not for what the tenant had lost, but what the landlord had gained, which may be different amounts. Significantly, the landlord could avoid a claim for compensation by offering a renewal of the lease for a further period of up to 14 years.⁴⁵

53. A further problem with the English legislation was the need to apportion any increase in the value of future rental payments between the outgoing tenant and other factors. Thus in deciding cases under the Act, the English Courts had to divide customers between those who were personal to the outgoing tenant, those who were attached to the location and those customers who had no attachment to either.⁴⁶ Similar problems in formally valuing goodwill have been identified in the Australian High Court in other contexts.⁴⁷
54. Like many other issues where formal valuations are required, this type of approach has its limitations. Valuers acting rationally can differ in their opinions, depending upon their instructions and the factors that they might take into account.
55. A better course would be to allow market forces to determine the appropriate value to be paid for goodwill, by encouraging direct negotiations between the landlord or franchisor with the tenant or franchisee. This is most likely to occur if the tenant or franchisee has some rights to ongoing tenure that the landlord or franchisor must "buy out" if it wishes to bring the agreement to an end. In these circumstances, the landlord or franchisor is likely to pay a value which truly reflects the economic

⁴⁵ *Halsbury's Laws of England*, Second Ed., vol.20, pp. 294-297.

⁴⁶ *Whiteman Smith Motor Co Ltd v Chaplin* [1934] 2 KB 35; *Clarridge & Co Ltd v Simpson* [1935] AC 325.

⁴⁷ See *FCT v Williamson* 1943 67 CLR 561 at 563-564.

return to it of the goodwill, rather than a figure determined as part of a formal valuation process by a valuer or a Court.

Petroleum Retail Marketing Franchise Act 1980 (Cth)

56. This Act (the PRMFA) contained a partial mechanism relating to non-renewal of franchise agreements in relation to petrol stations, subject to the nine-year time limitation previously mentioned. Section 17 of the PRMFA (Appendix 1) was a response to evidence found by the Swanson and Blunt committees of oil companies taking over petrol stations as company owned stores without providing any compensation to the previous owners for any goodwill built up by them.⁴⁸
57. Section 17 of the PRMFA contained a scheme which related to renewals as follows:
- (a) The franchisor was required to renew the franchise agreement unless:
 - (i) The franchisee was in default of certain key terms of the franchise agreement (as stated in s.16 of the PRMFA);
 - (ii) The franchisor proposed "in good faith and in the normal course of business" to vary a term of the franchise agreement (other than a payment term), and the franchisee did not agree; and/or
 - (iii) The franchisor proposed "in good faith and in the ordinary course of business" to sell the premises to an unrelated third party or to lease them to an unrelated third party for a use other than for the sale of petrol.
 - (b) Where the franchisor proposed to sell the premises to a third party, the franchisee was given a first right of refusal to acquire the premises;

⁴⁸ See paragraph 13 above.

- (c) The franchisor was permitted to increase the amount payable under a renewed franchise agreement, provided that the amount of the increase was "reasonable" having regard to market conditions;
 - (d) If a franchisor decided not to renew the franchise, it was required to serve a written notice upon the franchisee within 30 days stating the reasons for its decision, and it bore the onus of establishing those grounds if the matter was challenged by the franchisee in Court;
 - (e) The franchisee could apply to the court for an order that the franchise agreement be renewed, although the court retained a discretion not to renew the franchise agreement if it was "just and equitable, having regard to all the circumstances" that the agreement not be renewed.
58. Although the PRMFA was repealed in 2006 as part of a package of reforms covering the oil industry, the substance of these provisions has been continued in reg. 32(6) of the Oilcode, which is enforceable under the Trade Practices Act. However it is argued that the detailed provisions contained in s.17 of the PRMFA provide a very good model for any future reform in Australia to address the non-renewal problem identified in this paper.

United States Legislation

59. The problem of non-renewal of franchise agreements has been the subject of a range of legislative responses in the United States, as set out in Appendix 2. Of the 19 state and territory legislative schemes, some dating back to the early 1970s, there is a consistent theme which runs through that legislation that emphasises the need for good faith or good cause in relation to non-renewal.
60. To take one example, the Connecticut statute provides in s.42-133f(a) that:

"No franchisee shall... fail to renew a franchise, except for good cause which shall include but not be limited to the franchisee's refusal or failure to comply substantially with any material or reasonable obligation of the

franchise agreement or for the reasons stated in subsection (e) of this section."

61. The purpose of the provision was explained by a Connecticut appellate court in *Hartford Electricity Supply Company v Allen-Bradley Company Inc*⁴⁹ as being designed to "try to equalise the distribution of power between franchisees and franchisors" by preventing a franchisor from "unfairly exerting economic leverage over a franchisee". In order to achieve this objective, the franchisor bears the onus of proving that it acted with "good cause", and the court must be satisfied objectively that such "good cause" existed.⁵⁰
62. The close parallels between the approach of the US state legislation, such as the Connecticut statute, which applies across a wide range of industries, and the PRMFA, suggests that a good faith legislative based on the PRMFA model would provide a legislative solution to address the non-renewal issue in relation to both retail tenancies and franchises generally. It should also be noted that specific federal legislation exists in the US in relation to petroleum marketing, which also imposes a good cause regime in relation to the renewal of gas (petrol) station franchises.⁵¹

Recommendations for Legislative Reform: The Way Forward

63. Having regard to the deeply entrenched principles of freedom of contract and contractual certainty, landlords and franchisors have an unfair advantage in relation to the renewal of leases and franchise agreements. This power, which Chief Justice Gleeson referred to as their "superior bargaining position", includes the power to

⁴⁹ *Hartford Electricity Supply Company v Allen-Bradley Company Inc* 250 Conn 334, 736 A.2d 824, (1999).

⁵⁰ A survey of the fact situations in which the "good cause" provision have been applied by the US courts are set out in the *CCH Business Franchise Guide* (US), 'Relationship and Termination', para 825.

⁵¹ Petroleum Marketing Practices Act, 15 USC 2801-2806.

destroy or appropriate goodwill built up by a tenant or a franchisee in the conduct of a business at a particular site over many years.

64. Whilst the evidence, at least in relation to franchising, would suggest that there is an overwhelming renewal of franchise agreements, there is evidence over a long period that franchisors can and do take advantage of their legal power not to renew. Both the Blunt and the Swanson Committees, for example, recommended that legislation be introduced to deal with the problem of termination and non-renewal. Whilst legislation and the common law now respond to problems associated with termination, the non-renewal problem remains. As recently as 2006, the Matthews Committee indicated that it had received a number of submissions from franchisees and ex-franchisees who "expressed concern about the consequences to them on termination, expiry or non-renewal of the franchise agreement".⁵²
65. Legislation is the only way that a level playing field will be established to ensure that landlords and franchisors will act in good faith at the time of expiry of the existing lease or franchise agreements. This requirement to act in good faith will protect both the legitimate commercial interests of landlords and franchisors, whilst also protecting the goodwill built up by the tenants and franchisees.
66. By imposing a requirement that the landlord or franchisor grant a renewal unless they have a good faith reason not to renew, the tenant or franchisee will obtain some security in relation to the goodwill they establish. If circumstances change, particularly in relation to long-term contracts, landlords and franchisors will be protected by their ability to act in good faith to respond accordingly. However, if the landlord or franchisor wants to act opportunistically, to take advantage of the goodwill built up by the tenant or franchisee, they must pay for it – in the first instance by negotiating a market price.

⁵² *Review of the Disclosure Provisions of the Franchising Code of Conduct*, Office of Small Business, Canberra, 2006, item 20.

67. These conclusions point strongly to the adoption of a regime which imposes a good faith requirement on the landlord or franchisor, with other protective mechanisms such as those built into the PRMFA or US legislation referred to in Appendix 2. That is the landlord or franchisor must give a notice of its reasons for refusing to renew, and if challenged bears the onus of establishing those grounds in Court on an objective basis.
68. There is no particular difficulty in establishing whether or not a party has acted in "good faith". The Courts are well accustomed to dealing with such issues on the facts of the individual cases, as the decision in the Hungry Jacks' litigation demonstrates.
69. There may be some role for the Court to intervene in cases where the landlord or franchisor does want to take back the premises, or take-over the franchise operation, and offers to pay a "good faith" price for goodwill, which the tenant or franchisee does not accept. In these circumstances alone, there may be a role for the Court to enter into questions of valuation of goodwill. That is, the offer to pay a fair value for the tenant's or franchisee's goodwill may be a factor which the Court can take into account in deciding whether or not the landlord or franchisor has acted in "good faith" in refusing to renew the lease or franchise.
70. The only circumstance in which legislation would be unnecessary is if all landlords and franchisors adopted the approach apparently taken by McDonald's in the United States in 1975, when the first group of its franchise agreements expired. This was described by Professor Andrew Terry and Dr P.D. Guigni as follows:

Those operators who were not to be renewed were given three years' notice and McDonald's either arranged for approved buyers for that operation or offered to purchase the business itself at market value and

then offer it for sale to a new franchisee. The company did not permit itself to take over a non-renewed business for the purpose of managing it as a company-owned outlet.⁵³

71. Regrettably, this form of behaviour is voluntary and is contrary to the economic incentives which exist in the absence of legislation requiring good faith renewals of leases and franchise agreements. Because the problem of goodwill and the risks associated with non-renewal are matters of major significance to both tenants and franchisees, it is recommended that a legislative response to the problem of opportunism be implemented to maintain appropriate rewards and incentives for this important class of economic activity.

Dated: 16 August 2007

⁵³ A. Terry & P.D. Giugni, 'Freedom of Contract, Business Format Franchising and the Problem of Goodwill', *Australian Business Law Review*, (Vol.23, August 1995), pp.241-258.

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