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Chris Nikou

National Franchising Partner

telephone | +61 3 9640 4354
facsimile | +61 3 9205 2055
email | chris.nikou@middletons.com

Emily Kishida

Editor, Franchising Lawyer

telephone | +61 3 9640 4381
facsimile | +61 3 9205 2055
email | emily.kishida@middletons.com

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Franchisor's right to set-off franchisee's debts tested

The New South Wales Supreme Court case of *JLF Bakeries Pty Ltd (in liquidation) v Baker's Delight Holdings Ltd* dealt with the ability of a defendant franchisor to set-off debts owing by it to the plaintiff franchisee, where the franchisee is under administration.

Background

The franchisee in the case, *JLF Bakeries Pty Ltd (in liquidation)* entered into administration on 25 October 2005. Pursuant to a clause in the franchise agreement between the parties (Franchise Agreement), the franchisor was granted an option to purchase the fixtures, fittings, plant and equipment of the franchisee (Fixtures), in the event the Franchise Agreement between the parties was terminated. The Franchise Agreement further provided that the franchisor could terminate the Franchise Agreement if the franchisee entered into administration.

After receiving notice of the appointment of the administrator, the franchisor terminated the Franchise Agreement (on 27 October 2005) and exercised its option to purchase the franchisee's Fixtures on 3 November 2005. The administrator of the franchisee sued the franchisor for payment for the Fixtures. The franchisor maintained that the purchase price should be set-off against the monies owed to it by the franchisee.

The question explored by the Court was whether the amount owed by the franchisor to the franchisee for purchase of the Fixtures under the option contained in the Franchise Agreement, could be set-off against the amounts owed to the franchisor in respect of an outstanding loan, rent and other expenses under the Franchise Agreement.

Findings

The Court considered both section 553C of the *Corporations Act 2001 (Cth)* and section 86 of the *Bankruptcy Act 1966 (Cth)* which relate to mutual set-off and credit in circumstances of administration and insolvency.

The relevant legislation provides that in situations of mutual debt or dealings between an insolvent company that is being wound up and a person who has a debt or claim against the company, the sum due from the one party is to be set-off against any sum due from the other party provided that at the time of giving or receiving credit to or from the company, the person had no notice of the insolvency.

The Court had to consider when 'credit' was given by the franchisor to the franchisee for the purposes of section 553C of the *Corporations Act 2001 (Cth)*. If 'credit' was given at the time that the franchisor terminated the Franchise Agreement and exercised its option to purchase the franchisee's Fixtures, then the franchisor would have had notice of the franchisee's insolvency, by reason of the appointment of the administrator and could not raise a set-off.

The Court found that 'credit' was given when the option to buy the Fixtures of the franchisee was granted to the franchisor (that is, at the time the parties entered into the Franchise Agreement). At that point in time, a contingent debt (contingent upon termination of the Franchise Agreement) owed by the franchisor to the franchisee arose. Accordingly, the Court held that the franchisor was entitled to set-off against its obligations to pay the purchase price for the debts owed by it in respect of the Fixtures to the franchisee as the obligation arose prior to the franchisee entering into administration.

What this means for franchisors

The following conclusions can be drawn from this case:

- if a franchisee is under administration, the concept of set-off is dealt with by virtue of the *Corporations Act 2001 (Cth)* and the *Bankruptcy Act 1966 (Cth)* (as applicable) rather than the terms of the franchise agreement between the parties;
- an option to purchase property from a franchisee on insolvency/ termination provides a contingent liability for the franchisor at the time of entering into the franchise agreement between the parties (not at the time the option is exercised); and
- if a debt to a franchisee arises after the date of administration, set-off will not be permitted.

Andrew Chambers | Partner
Caroline Carnegie | Lawyer

Franchisors warned to take care when negotiating commercial terms with franchisees

In *Azzi (Franchisee) v Volvo Car Australia Pty Ltd (Franchisor)*, the parties entered into a letter of representation and a formal agreement in relation to a Volvo dealership simultaneously. The issue for the Court was whether the two documents were to be read together or whether the formal agreement overrode the provisions of the letter of representation.

Background

In 1999 the Franchisee and Franchisor engaged in discussions concerning a Volvo dealership. In January 2000, the Franchisee, at the Franchisor's request, redeveloped (at its own cost) the proposed franchise site.

In March 2000, the Franchisee completed and returned to the Franchisor a questionnaire and application for a Volvo dealership, in which the Franchisee stated among their requirements a 10-year minimum term plus an option for 1 further period of 10 years.

The Franchisee commenced trading as a Volvo dealer from 1 July 2000.

Following negotiations and discussions regarding the dealership, Volvo issued a letter to the Franchisee dated 16 August 2000 (Volvo Representation), which was also described in a covering letter as 'our letter of agreement' (Representation Letter).

The Representation Letter, together with a dealer agreement (for an initial term of 1 year) (One-Year Dealer Agreement) was signed by the Franchisee in September that year. The Representation Letter made reference to the initial term and also that the dealership would be renewed for a further period of 5 years at the expiry of the initial term.

The Franchisee and Franchisor relationship subsequently broke down.

In determining the appropriate relief for the parties, the Court was required to determine, among other things, whether the parties intended that the Representation Letter would be legally binding.

Findings

The Court found that the parties intended the Representation Letter to be a legally binding agreement as a result of:

- the terms and form of that agreement (although in letter form, the terms were not informal)
- the circumstance that, to the knowledge of both parties, the Franchisee was to incur significant expenditure in redeveloping the franchise site in the belief that it would be granted a dealership in accordance with the Representation Letter

- the fact that the Franchisee commenced to trade as a dealer with only the Representation Letter in place.

In the Court's view, when the Franchisee commenced trading as a Volvo dealer, the parties were in agreement on the terms of the then current version of the Representation Letter including the trading terms and their legal rights and obligations. The Court noted however that at this time, the arrangement between the parties was such that new terms could be introduced from time to time by consent.

The Court did not accept that the agreement for the further term of 5 years as contained in the Representation Letter was superseded by the One-Year Dealer Agreement, or that that One-Year Dealer Agreement was the only legally binding agreement between the parties, given that:

- the final version of the Representation Letter was submitted and executed contemporaneously with the One-Year Dealer Agreement, which is inconsistent with any intention that the latter supersede the former, and indicative that both were seen as necessary components of the relationship
- the Representation Letter deals with matters not covered by the One-Year Dealer Agreement and outside the initial term.

The Court found that to treat the One-Year Dealer Agreement as the exclusive contractual arrangement between the parties would be quite inconsistent with their intent as documented in the Representation Letter. As such the Court concluded that there was a binding contract between the parties encapsulated in the Representation Letter, by which the Franchisor was obliged to grant the Franchisee a dealership for an initial term of 1 year, to be replaced by a further term of 5 years.

This case highlights that franchisors must exercise care when engaging in discussions and negotiations with a franchisee about a franchise, as the courts may construe such discussions and negotiations as constituting a binding legal document.

Quick grabs

Snap shot of some of the election promises for small businesses

Labor

- creating the best educated workforce for the future
- infrastructure, such as high speed broadband
- reducing the regulatory burden on small businesses
- making it easier for small employers to do business with the government.

For more information go to www.alp.org.au/policy

Liberal

- comprehensive plan to help small business operators get the training and skills they need
- assist small business owners and their employees to improve their skills by providing at least 100,000 training vouchers worth up to \$1,500 each.

For more information go to www.liberal.org.au/about/ourpoliciesplans.php

WA franchised businesses up for inquiry

WA Small Business Minister, Margaret Quirk, announced the start of an inquiry into the operation of franchise businesses in Western Australia.

The inquiry's terms of reference are to:

- review the adequacy of existing legislative provisions, both State and Federal
- identify whether emerging trends in the franchising industry disclose patterns of unconscionable conduct that may not be covered under existing laws
- examine whether existing remedies available to franchisees are adequate and, where appropriate, recommend changes
- review existing practice in other jurisdictions, Australia and internationally, on unconscionable conduct and renewal of licences.

The inquiry will be chaired by Chris Bothams, manager of the South East Metro Small Business Centre and will report on 31 March 2008.

Pricing practices boosted

Australia's competition regulator has taken action to boost the level of understanding on pricing practices among franchisors and franchisees. The Australian Competition and Consumer Commission (ACCC) has signalled that it will work closely with the Franchise Council of Australia to educate the franchise industry about pricing practices. This follows the ACCC's discovery that the levels of knowledge and understanding of pricing practices may differ across the franchising sector. The regulator claims it is important for franchisees to remember that price fixing is prohibited under the *Trade Practices Act 1974 (Cth)* (TPA) and that they cannot depend on 'non-complete' clauses in their franchise agreements. One way franchisors can combat this problem is by ensuring their pricing provisions are drafted to provide for maximum recommended retail prices only.

Franchise complaints

The Australian Competition and Consume Commission (ACCC) unveiled a new web page last month to help people understand how it resolved franchising complaints. Chairman Graeme Samuel said the

publication would help dispel the impression that the ACCC silence amounted to a lack of action. The site includes details of previous disputes that have come before the Commission.

Misuse of market power amendments on the horizon

Amendments to the *Trade Practices Legislation Amendment Bill (No. 1) 2007* were passed on 18 September 2007. The Bill amends the *Trade Practices Act 1974 (Cth)* to provide greater protection against misuse of market power and unconscionable conduct.

The Bill amends the misuse of market power provisions in section 46 of the Act to:

- address concerns about establishing when a corporation has a substantial degree of power in a market, which is the threshold requirement for section 46 to apply
- specifically prohibit a corporation from leveraging market power from one market to another
- refer to sustained below-cost pricing conduct as a factor the Court may consider in determining whether a corporation has misused its market power.

The Government's new amendment includes a specific prohibition against a corporation with a substantial share of a market, from engaging in sustained below-cost pricing conduct for the purpose of eliminating or substantially damaging a competitor, preventing the entry of a person into a market, or deterring or preventing a person from engaging in competitive conduct in a market.

The Bill also makes amendments to the unconscionable conduct provisions in section 51AC of the Act to:

- include unilateral variation contract terms as a factor the Court may consider in deciding whether a corporation has engaged in unconscionable conduct
- raise the transaction limit for section 51AC from \$3 million to \$10 million to extend its application to a wider range of transactions.

The Bill will now be returned to the House of Representatives for final consideration. For more information go to www.franbaileymp.com.