GUIDANCE FROM AUSTRALIA FOR FRANCHISORS CONTEMPLATING A DIFFERENT DELIVERY MODEL

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In a landmark decision, the Federal Court of Australia recently dismissed a $650 million claim brought against Mercedes-Benz Australia/Pacific Pty Ltd ("**MBAuP**") by the majority of its Australian dealers. MBAuP issued non-renewal notices ("**NRNs**") to its dealers under their existing dealer agreements and transitioned those who signed new agreements to a fixed-price, direct-to-customer, agency model. Most of its dealers sued, alleging that MBAuP issued the NRNs in bad faith, unfairly pressured them to enter into agency agreements, misappropriated their goodwill and engaged in unconscionable conduct.

The decision in *AHG WA (2015) Pty Ltd v Mercedes-Benz Australia/Pacific Pty Ltd*[1] may have far-reaching implications for franchise systems outside of Australia.[2] This article briefly summarizes the case[3] and considers its potential applicability in Canada.

Background

The dispute involved MBAuP's decision to switch from a traditional dealership model (where dealers purchase and resell inventory to customers at negotiated prices) to an agency model (where MBAuP retains ownership of the inventory, sets fixed prices and dealers become commissioned sales agents). MBAuP viewed the agency model as a solution to emerging marketplace challenges, including new lower-cost entrants and a shift towards online purchasing.

The dealer agreements contained non-renewal provisions permitting MBAuP to end them upon the expiry of their current terms. In December of 2020, MBAuP issued NRNs stipulating that the dealer agreements would end by December 31, 2021. MBAuP then proceeded to offer dealers the new agency agreement and gave them until September 2021 to sign up, failing which MBAuP would cease supplying new vehicles. The agency model was put in place in early 2022.

The Court Rejects the Dealers' Arguments

The dealers sought orders declaring the NRNs and agency agreements void and restoring the original dealer agreements as well as $650 million in damages (arguing that MBAuP appropriated their goodwill by

converting them to sales agents). The primary arguments made by the dealers (and the Court's disposition with respect to each) were as follows:

1. MBAuP violated the duty of good faith under Australia's *Franchising Code of Conduct*[4] (the "***Franchising Code***") and at common law by issuing the NRNs. In this regard, the dealers alleged, among other things, that:

   a. The duty requires parties to cooperate to achieve the objectives of the dealer agreement;
   b. The dealer agreements were "evergreen" in nature and MBAuP could only issue NRNs if dealers failed to meet targets, make improvements as required or otherwise breached the dealer agreement;
   c. MBAuP issued the NRNs for an improper purpose – to continue their existing relationship under the agency model and to appropriate the dealers' goodwill and customer relationships; and
   d. MBAuP issued the NRNs to give effect to its corporate parent's directives to implement the agency model on a global basis.

The Court rejected these arguments, holding that there was no express restraint on the non-renewal power in the dealer agreement (and that dealers were essentially asking the Court to rewrite the agreement). The Court noted that s. 6(6) of the *Franchising Code* provides that the good faith obligation does not prevent a party from acting in its legitimate commercial interests.[5] The purpose of the non-renewal clause was to bring the dealer agreements to an end, and MBAuP's subsequent offering of a different arrangement (the agency model) is not inconsistent with that purpose. The Court also noted that the dealers conflated the accounting concept of goodwill with the legal definition of goodwill, holding that "the continued existence of goodwill depended upon a dealer having the legal right or privilege to conduct the business in substantially the same manner and by substantially the same means that have attracted custom to it".[6] The validly issued NRNs terminated the dealers' right to continue to conduct the business in the same manner and, therefore, any goodwill ceased to exist once the NRNs were issued.[7] Finally, while the transition to an agency model was a global strategy of MBAuP's parent company, the Court found that MBAuP was acting in its own legitimate interests and not simply on the direction of its corporate parent.

2. MBAuP's issuance of the NRNs and pressure to enter into agency agreements amounted to economic duress and bad faith.

The Court disagreed, holding that MBAuP did not exert any illegitimate pressure on dealers to enter into agency agreements. Dealers knew all along that MBAuP had the power to issue NRNs, and the agency agreements were offered after the NRNs had been validly issued. The Court acknowledged that dealers felt pressure to accept agency agreements (which are far less profitable for them), but "such pressure flowed from the circumstances that [the dealers] found themselves in".[8]

3. By issuing the NRNs, imposing agency agreements and failing to compensate dealers for their loss of goodwill, MBAuP's conduct was unconscionable contrary to s. 21 of the *Australian Consumer Law*.

The Court rejected this claim as well, holding that the issuance by MBAuP of the NRNs was a valid exercise of its contractual power. The Court acknowledged that MBAuP presented the agency agreements as standard form contracts on a take it or leave it basis, played hard-ball in its negotiations and did not consider the individual circumstances of each dealer, but held this was a function of the circumstances and risks that the dealers accepted under their dealer agreements.

Key Take-Aways

While not all features of the Franchising Code are part of Canadian franchise law, the content of the duty of good faith is similar in both jurisdictions. The *Mercedes-Benz* decision considered whether the manufacturer's transition from a distribution to an agency model was done fairly under legal principles that, in many ways, mirror those in found in Canada. Accordingly, there is every potential that the decision will find favour in Canadian courts.

Much of the reasoning in *Mercedes-Benz* will only apply if the Canadian agreement in question is for a fixed (but may be auto-renewing) term and contains both termination for cause provisions and a non-renewal right permitting the supplier to end the agreement without cause upon the expiry of its current term. Ideally, the agreement will also contain a symmetrical right permitting the dealer/franchisee to terminate or not renew the agreement without cause on notice (as was the case in *Mercedes-Benz*). If you have an "evergreen" agreement that only permits termination for cause, the analysis in Mercedes-Benz will not provide much assistance.

Assuming your agreement contains the above-noted provisions, there are several key take-aways from the *Mercedes-Benz* decision that may be found to apply here in Canada. Among others:

1. The presence of a non-renewal right in addition to termination for cause rights will be interpreted to mean that the agreement is not intended to be perpetual and may be ended in the manner specified by the non-renewal clause. Arguments by dealers/franchisees that the non-renewal power may only be exercised if they failed to do or achieve something not mentioned in the non-renewal clause are likely to be rejected as an attempt to rewrite the contractual bargain and turn it into one of indefinite duration.
2. The only limitation on a party exercising a non-renewal power, other than the express or implied terms of the contractual provision, is to do so in good faith.
3. A non-renewal clause has two features that distinguish it from other contractual provisions: i) its very purpose is to end the contract; and ii) it can only serve the interests of the party upon whom it is conferred. This informs the content of the duty of good faith in the context of non-renewal provisions,

which must recognize that the nature of the power is to bring the relationship to an end. The duty of good faith in this context requires the party exercising the non-renewal right to do so honestly and for legitimate, non-arbitrary, objectives. In other words, if a party has a legitimate reason to exercise the non-renewal right, and does not mislead the other about its intentions, it will be difficult to find a lack of good faith.

4. A subsidiary is entitled to take the wishes of its parent into account when considering whether to issue a non-renewal. That said, a subsidiary should not be an automaton acting solely on the direction of its corporate parent and without any independent consideration of the matter.
5. Given the nature of a non-renewal clause, a manufacturer will not offend the duty of good faith by taking a "one size fits all" approach and invoking it against all dealers/franchisees as part of a regional strategy. In other words, manufacturers are not required to consider each dealer's individual circumstances when exercising the non-renewal clause in pursuit of some legitimate objective for a particular region.
6. A dealer/franchisee has no goodwill in its business on the valid expiry or termination of the dealer/franchise agreement. Goodwill at law arises from having the right to conduct a business in the same manner and by the same means that attracts custom to the business. This right ceases on termination or expiry of the agreement, and therefore, the dealer/franchisee has no right to any goodwill that may have accrued to the business while it was in operation.
7. To establish economic duress, a plaintiff must show its counterparty applied *illegitimate* pressure that induced it to enter into a contract. Even though a manufacturer/supplier may be contemplating the possibility of a different relationship (agency) when it validly elects not to renew its dealer/franchise contracts, provided that the non-renewal notices were not conditional upon the dealers' refusal to enter into such new relationship and dealers are free to accept or reject that new relationship, duress will be difficult to establish. The fact that dealers/franchisees may be under significant *commercial* pressure to enter agency agreements (which are far less advantageous to them than their prior dealer/franchise agreements) is not enough to satisfy the test.
8. Although *Mercedes-Benz* dealt with statutory unconscionability under the provisions of the *Australian Consumer Law*, the Court's findings that MBAuP did not act unconscionably in issuing the NRNs to pursue a legitimate national strategy in circumstances where dealers/franchisees were not compelled to enter into agency agreements are largely transferrable to Canada. The duty of good faith, much less the doctrine of unconscionability, does not preclude a supplier from acting in its legitimate commercial interests and to prefer its interests over those of its dealers/franchisees.

The *Mercedes-Benz* decision also provides guidance about how manufactures/suppliers can best manage the transition from a dealership/franchise model to one of agency. Manufacturers who are considering moving to an agency-type distribution model should take note of the following lessons:

1. Do not make any representations to dealers/franchisees that their agreements will be extended or that the non-renewal right will not be exercised, or that you will only exercise the non-renewal clause if they fail to do certain things, at the end of the current term. The dealers in *Mercedes-Benz* did not allege that such representations were made, and the outcome of the trial would almost certainly have been different had they done so with convincing supporting evidence.
2. Do not make the issuance of a non-renewal notice conditional upon your dealers/franchisees refusing to enter a different form of agreement. In *Mercedes-Benz*, the NRNs were issued in December 2020 and provided that the agreements would come to an end on December 31, 2021. They contained no conditions regarding the entering into of agency agreements, which were only offered to dealers in mid-2021. You should issue your notices of non-renewal separately from offering the possibility of entering into an agreement that reflects the new distribution model and make it clear that dealers are free to accept or reject that new agreement.
3. You need to have a legitimate commercial interest in sending the non-renewal notices and moving to a different distribution model. The evidence in *Mercedes-Benz* was that the agency model was an appropriate solution to the challenges of a changing marketplace in Australia. It dealt with the competitive threat of disruptors in the market (like Tesla, who sells direct to consumers and other vendors who sell direct online), the problem of intra-brand competition and it provided greater transparency to customers in the form of no-haggle prices. Critical to the Court's dismissal of the breach of good faith, duress and unconscionability claims in *Mercedes-Benz* was its findings that the manufacturer had a legitimate commercial interest in proceeding as it did, and that it had studied its options for dealing with these threats and challenges. Suppliers should accordingly do studies and forecasts to assess the impact on the goals to be achieved by moving to an alternate distribution model.
4. Consult and communicate with your dealers/franchisees about the transition to a different distribution model long before it occurs. MBAuP informed its dealer network that it was considering the agency model in late 2017, that it was assessing the viability of the agency model in early 2018 and then held several subsequent meetings about the subject with its dealers. Such early engagement with dealers may, in the right circumstances, at least encourage them to not actively oppose the change with litigation.
5. When consulting with your dealers/franchisees about your desire to change to a new distribution model, you should avoid: saying you will only implement changes with their consent; exaggerating the justification for doing so; and misrepresenting the likely impacts of the new distribution model on them. The Court in *Mercedes-Benz* noted that "a lack of transparency and spin were the hallmarks of" MBAuP's communications with its dealers regarding the transition to the agency model, but ultimately ruled that none of this impugned its conduct in issuing the NRNs and proposing the agency agreements. The

better position, of course, is not to give the court any basis to suggest you were anything but transparent and honest about the nature and impact of the changes.

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[1] [2023] FCA 1022 ("*Mercedes-Benz*").
[2] Subject to how it is dealt with on appeal to the High Court of Australia. The time for filing an appeal has been extended to January 31, 2024.
[3] The decision is an enormous 3,752 paragraphs and hundreds of pages in length – as such, this article only contains highlights.
[4] Schedule 1 to the *Competition and Consumer (Industry Codes–Franchising) Regulation 2014* (Cth).
[5] While the duty of good faith under Canadian franchise legislation is not identical to that under the *Franchising Code*, it is very similar. Unlike Canadian franchise legislation, for example, the *Franchising Code* expressly provides that the duty applies to the negotiation of proposed agreements and whether the terms of a "new vehicle dealership agreement" are fair and reasonable.
[6] *Mercedes-Benz*, para 2996.
[7] The Court noted that it is settled law that a franchisee will not be compensated for goodwill upon expiry or termination of a franchise agreement. Although the law on this subject is not as well-developed in Canada, our courts are likely to reach the same conclusion. See, for example, *Motor Sales Inc. v Hyundai Auto Canada Inc.*, [1989] MJ No 139 (QB) at para 23, *Azmoon Trading Inc. v Caffe Demetre Franchising Corp.*, 2018 ONSC 2868 at para 24 and *Thompson v Cinnaroll Bakeries Ltd.*, 2002 ABQB 1112 at para 25.
[8] *Mercedes-Benz*, para 3406.

by W. Brad Hanna, Jessie Treagus and Anthony Labib

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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