

**“REVIEW OF FRANCHISING REGULATION NEW ZEALAND”**  
**SUBMISSIONS ON MINISTRY OF ECONOMIC DEVELOPMENT DISCUSSION**  
**DOCUMENT**

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## A. BIOGRAPHY OF SUBMITTERS

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## B. DISCUSSION PAPER Questions 1 to 3

Q1 Are there any particular features about franchise contracts that mean that potential and existing franchisees require further protection?

Q2 Have the problems been defined correctly? Are there other problems?

Q3 What is the magnitude of these problems? Do they apply to the franchising sector as a whole, or are they specific to particular types of franchising or particular industries?

### 1. Introduction.

1.1 According to the Franchise Association of NZ (FANZ), New Zealand apparently has around 409 franchise brands in the market place at this time with approximately 350 of these being considered active. However we believe there are likely many dozens of other business operations and systems that might be captured by the definition of “business format franchising” that the FANZ has no knowledge of, as there is no central register or sector data on franchising other than from willing participants in various surveys carried out from time to time.

1.2 By all accounts, franchising is not only here to stay, but continues to increase in popularity as a method by which average New Zealanders can get their foot in the door in terms of owning their own businesses.

### 2. Problems in Franchising?

2.1 In our experience, with the heightened popularity of franchising as a business model, there has been no shortage of tragic stories where franchisees have suffered loss and their business has failed due to the following broad problems:

- (a) lack of proper due diligence by the franchisee prior to purchase which leads to disclosure and pre-purchase advice issues; and / or
- (b) the one sided nature of franchise contracts, existence of poorly structured or inherently unfair systems and franchisors with a lack of integrity, which are relative when considering issues such as mandatory or minimum substantive franchise agreement content or procedures during or following a franchise term and / or
- (c) franchisors with little or no business experience, financial substance or appropriate skills and commitment to develop and operate a franchise network or fraudulent or unethical franchisors.

2.2 To follow are specific examples of the types of problems suffered by franchisees we have acted for:

*(a) Lack of Disclosure:*

- (i) Being given information that is directly incorrect or false (sometimes deliberately false);
- (ii) Being given information which is partially incorrect in that it does not present the full picture (i.e. a half truth);
- (iii) Believing projections, facts and figures made by franchisor with no evidence or written warranty;
- (iv) Not appreciating the need to seek further and better information from the franchisor;
- (v) A potential franchisee wishing to sign a franchise agreement and commit to initial costs of \$300,000+ to join a well established high profile entertainment retail chain – which very publicly crashed into receivership just a few weeks later. Fortunately for the potential franchisee he did not proceed for personal reasons, but the store was clearly being sold as a last ditch effort to save a failing chain yet still promoted to him as a wonderful opportunity.

*(b) Pre-Purchase Advice*

- (i) Not taking professional legal and accounting advice; or taking it from practitioners with no knowledge of franchise contracts and obligations and financial considerations of the same;
- (ii) Taking advice from professionals recommended by the franchisor and possibly not objective about the offering;
- (iii) Taking good advice from professionals (which may include advice to carry out more investigations, or recommendations that the investment does not seem to stack up), however, not relying on that advice because it comes too late and well after the prospective franchisee is already committed emotionally or even legally to the purchase;
- (iv) Business brokers and real estate agents selling franchises with unrealistic promises and little knowledge of the special ongoing obligations of the purchaser.

*(c) Lack of Franchisor Support or Ability*

In our experience the majority of New Zealand franchisors and franchise advisors follow best practice and are, by and large, of reputable character. But there are definitely less scrupulous, inexperienced or ignorant franchisors and advisors that are involved in the selection, purchase and operation of a franchisee's business. For example, we often see:

- (i) Franchisee given insufficient training and general support by a franchisor prior to and during the franchise term either because it wasn't required under the Agreement, or franchisor failed to provide in breach of an obligation to do so;
- (ii) Franchisee given insufficient assistance when the business is struggling or starts to fail, being left to sink and ending up in an impossible "hole" (This can lead to the practice of "churning" where the franchisor terminates the failing incumbent, and repackages and re-sells the franchise rights to a new franchisee, leaving the original franchisee with nothing and the franchisor gaining a second initial franchise fee for selling the same opportunity);
- (iii) Franchisor is not qualified or equipped to set up and maintain a successful franchised operation, or the product / service has been untested in the market, or the Franchisor does not have the financial means to properly market and support the system.

(d) *The Terms of the Franchise Agreement*

- (i) Franchisors imposing unnecessary controls and restrictions on the operation of the business that disadvantage franchisee and could be non-competitive;
- (ii) Franchisee required to enter into long term, onerous leases with expensive fit out requirements and personal guarantees;
- (iii) Franchisees required to purchase all products and services through franchisor nominated suppliers (often related to the franchisor) and / or to stock a full product range or mix that is overpriced or does not reflect the local market;
- (iv) Franchisor unreasonably withholding consent to matters requiring franchisor consent or approval;
- (v) Franchisor requiring re-branding or premise re-fit during the term at the franchisees cost;
- (vi) Franchisor able to terminate for minor reasons without reasonable notice or opportunity to remedy breach;
- (vii) Franchisee left with expensive plant and equipment after termination of agreement but restrained from using or selling the same;
- (viii) No reasonable term granted or franchisor ability to terminate without cause or on short notice – franchisee needs to be able to recover its investment and earn a decent return on the same.

(e) *Franchisor Conflict of Interests which impact on the value of the franchisees' businesses or the franchise system.*

- (i) Franchisor purchases a competitor and franchisees in the existing system are strongly encouraged to re-brand at their cost or suffer the loss of marketing and support services of the franchisor to the original system;
- (ii) If the franchisor or their associate is the key or sole supplier their interests may be more focused on achieving maximum product sales to franchisees, rather than the success of the franchised businesses through the right product mix and pricing;
- (iii) Many franchisors seem to be focused on maximizing income from selling franchises rather than focusing on the long term success of each member of the franchise system;
- (iv) Franchisor may advise franchisees on business, legal, financial matters that they should be receiving independent advice on – a problem with immigrant, non-English speaking franchisees selling low skill services;
- (v) A well advised franchisor will more often than not ensure that their intellectual property and franchising / trading entities are independent, and can be structured so that the franchisor entity can quickly be relieved of its rights and value as a franchisor in certain situations. If a franchisee has a valid and successful claim against a franchisor, it is possible that the franchisor entity will have its rights terminated, and be unable to satisfy the claim, and in the meantime the independent associated entity will have the legal right to pick up and carry on where the franchisor left off.

(f) *Territory issues.*

- (i) Franchisor does not act when territory protocols are not followed and franchisees market or solicit work from another franchisee's territory;
- (ii) Franchisor opens multiple franchised or company owned outlets in close proximity which can result in loss of business to existing or original outlets, some of which may not be fully established. (sometimes referred to as 'encroachment')

### 3. **Magnitude of Problems? / General or Sector Specific?**

3.1 The key source of many of the problems comes down to some form of surprise, disappointment or unexpected event or result to the aggrieved party. This is in no way unique to franchising, or even business. But it does seem to be a common theme in our experience with franchise disputes and complaints. In other words lack of knowledge or disclosure or full understanding of commitments and rights prior to entering the contract. If everyone went into a franchise agreement with best knowledge and

comprehension of what they had signed up and committed to, then even if they later realized they had made a mistake, at least it was their mistake based on a fully informed decision. While this may seem an idealist and simple view, it is an area that can be identified, and addressed.

- 3.2 It is of some relevance that the difficulties we have identified above seem to more commonly occur where the initial investment is in the under \$100,000 range and / or with the 'unsophisticated' business person. This may not so much be a reflection of any particular difficulty with franchises in that price range, rather, a reflection of the numbers of franchisees that are available for purchase in that price range, the level of franchisee skill involved being low and.
- 3.3 The Green Acres Master Franchisee Ironing 'scam' was a terrible example of a franchisor – albeit at master franchisee level – selling franchises where there was no work available. We suspect that although this was an extreme case, it is not uncommon and there are matters for concern in the home services sector – e.g. home cleaning, lawns, ironing, house washing, roof cleaning etc. These are at the lower level of investment, there is usually no protected territory and in many cases no client base or client referral.
- 3.4 Of course many home services franchisors excel, and are able to genuinely provide high levels of work and support and act in good faith towards their franchisees, so this is not sector wide.
- 3.5 However it is of note that many of the franchisees in these services are immigrants, most often Asian, with little or no local knowledge and poor English skills.
- 3.6 Asian immigrants sometimes buy a franchise to gain residency or a work permit before they even enter the country. The franchise businesses are sometimes bought by one family member then passed on to someone else. They may borrow money from the franchisor to complete the purchase. The opportunities are advertised in Asian newspapers and websites and sold and re-sold and often fail with the franchisee just disappearing. These problems do not become public because it is a matter of pride within some cultures not to admit failure. The initial investment will have been in the range of \$15,000 to \$25,000 plus vehicle and equipment but we have heard of the businesses being re-sold on websites for a few \$1000s.
- 3.7 It seems to us that people with less money to spend on their franchise are more likely to be less well educated than those who purchase "bigger" franchises and less likely to approach good professionals to seek proper advice at an early enough point in time so that they have not committed either emotionally or legally to a purchase which they can't get out of.
- 3.8 Our experience is people looking to buy 'small' franchises (particularly those under say \$40,000 total investment) will be cost conscious and not keen to incur significant cost on professionals. They may rely on advice or encouragement of the franchisor or think that professionals are not required until settlement or, in particular with Asian

community - that legal or accounting advice is not required at all. If they seek professional advice at the later stage of the decision making process, and the advisor does not make strong or informed recommendations, the purchaser may likely be emotionally “hooked”, generally having formed their own view early on based on franchisor salesperson enthusiasm and perhaps projected figures or other expectations. In this scenario, the impact of the professional advice comes too late.

- 3.9 We do not have a lot of experience with the some of specialized sector franchise systems such as service stations, or vehicle distributorships but we do have anecdotal evidence of leases not being renewed by one oil company when franchise agreements had not expired. The oil company had sold all its company sites to franchisees 5 years earlier, then company policy changed and they decided to take them back as company sites. A group of franchisees had to walk away from their investments and sought initial legal advice from us but were not confident of proceeding against an international oil company.

#### **4. Current Barriers to a Fair Playing Field**

- 4.1 New Zealand has no legal franchise specific requirement for pre-sale disclosure and franchisors (or at least non-members of the FANZ) are not required to issue disclosure documents. Unless the franchisee knows to ask the questions and knows what to make of the answers, they are likely to never find out what they need to know, including the obligations and restraints they are signing up for, full likely costs and fees payable and other facts and figures prior to settlement. This is all the more reason why certain types of franchisees need some form of protection. The present law will not help them on that front if they have not asked, or did not know what to ask.
- 4.2 As to the cost exorbitant nature of any claims, this stands out as a key driver in the need for change. If a franchise bought for under \$100,000 ends in a dispute, it will likely be heard in the District Court. A typical claim in the District Court on say, a misrepresentation claim, will cost anywhere from \$50,000 plus GST and disbursements to \$100,000 plus GST and disbursements. Disbursements will include expert accounting fees. A case in the High Court will cost more. The legal or factual issues in a small franchising dispute could be the same as in a high value case, but the small ones are rarely aired in the current environment.
- 4.3 Our experience is that when franchises fail or have a dispute with the franchisor, franchisees do not have the sort of money to pursue their rights. They have lost their job, their investment, their income and often remain exposed to personal guarantees. They usually have families to feed and other expenses to take care of. Additionally, if the franchise agreement has ended either by termination or failure of the system, franchisees will be faced with the task of seeking fresh employment and they are likely to be under very high stress. We have seen franchisees with good claims simply walk away because they cannot afford to fight through the Courts and because a franchisor has refused to mediate (sometimes where the agreement provided for mediation!).

Often the personal circumstances of these people may not drop to the thresholds of being able to obtain legal aid, meaning they are not “poor enough” to qualify for legal aid. As with all law, it is of no use if it is not accessible. It is critical that any steps taken to regulate the franchising sector are balanced with the provision of accessible, relevant remedies and forums for resolution.

4.4 But it is not just the cost of resolving their dispute through the Courts that puts them off. It is the lengthy delays of the justice system that turns them away. Delays of up to a year and a half are de rigeur for litigation lawyers but are very unpalatable to an ordinary person faced with a franchise or any other type of dispute. Mediation currently provides an excellent option for dispute resolution without that long wait, but sadly, sometimes one or other party will point blank refuse to mediate, as a strategy decision.

## 5. **Issues for Franchisors.**

5.1 It is not only Franchisees that experience problems. Establishing and operating a good franchise system is an incredibly complex business. An ethical franchisor will have the success and well being of any number of independent business owners constantly on its agenda.

5.2 Franchising your business system is not an easy way to make money. We believe this needs to be recognized in any change or initiative because good Franchisors have valid and valuable interests that need to be retained and protected.

5.3 However, it is also not only franchisees that can be unsophisticated and undercapitalized in business. We have seen many instances of a would be franchisor having a ‘great idea’ or a ‘good little business’ and proceeding to ‘franchise’ with no real comprehension of the sophistication, investment and commitment required of a good franchisor.

### 5.4 Balance of Power.

(a) Franchise agreements typically give a franchisor a high level of control over the actions of a franchisee, weighted in favour of the franchisor’s rights, and including numerous obligations on the franchisee. Whilst on the one hand this is “part and parcel” of what franchisees buy into, it can put the parties in a relationship where there is a significant power imbalance.

(b) There is a view that, in and of itself, this power imbalance is unfair, however it needs to be remembered that the control needs to be there because the franchisor has invested huge time and money, and needs to maintain and protect its system and intellectual property and is entitled to a reasonable return on that investment and effort.

(c) As long as there has been good due diligence and disclosure and the franchisee understands what they have committed to, and perform accordingly, many of

the difficulties (within the parties' control) that arise are not due to the actual balance of power in the contract, but are where franchisors seek to abuse that power or act in bad faith. See examples above in paragraph 2.2 (c) – (f). It is the decisions or actions of a franchisor that could work an injustice, rather than the specifics to which parties have contracted.

- (d) We do not think any significant interference in the balance of power in a franchise agreement is necessary.
- (e) However to protect the 'weaker' party - and we believe there is always a weaker party in a well written franchise agreement – we believe it would be worthwhile following Australia's approach with some procedural and fairness minimums to be deemed into all franchise agreements, such as ensuring proper notices and opportunity to remedy are required before termination for non-fundamental breach can be effected, if not moving to a full good faith obligation.
- (f) Having said that, some of the Australian provisions seem to achieve a frustrating result for franchisors in practice, and we would hope that this could be avoided in New Zealand leaving scope for common sense, fairness, reasonableness and good faith principles to be applied, rather than prescription to a high degree.

#### 5.5 Non-Compete and other Restraints

- (a) A significant problem area for franchisors in drafting and enforcement relates to the lack of clarification of what is acceptable or enforceable protection afforded to franchisors under the existing law in regard to restraint of trade clauses.
- (b) Franchisors need, for the overall benefit of their franchise system, to sell a homogenous product. Each franchisee needs to be party to the same form of agreement and the franchisor needs to protect itself and its system by ensuring it retains full control of the intellectual property in the event of a breach by franchisors. It needs to be sure that in the event matters go sour or the agreement comes to an end, the brand is not damaged in any way by subsequent actions of ex-franchisees (such as a breach of a restraint of trade clause).
- (c) This is very important to a franchisor and indeed to the success of the system as a whole. It is standard practice for a Franchise Agreement to include restraints both during the operation of the franchise, and post-termination including non-compete, non-solicitation and non-disclosure or use of information or intellectual property.
- (d) A franchisee gains possession of a large body of information and opportunity that is not available to the general public. Part of the consideration for that disclosure and permitted use is usually a contractual restraint against continued use or disclosure in such a way that would be unfair to the franchisor causing

some loss or confusion. As such, it is therefore also extremely important to the value of the franchise network and for remaining franchisees that restraint of trade provisions exist in franchise agreements and that they are able to be enforced.

- (e) Hand in hand with the restraint provisions, there is usually a requirement that the franchisee hand back the operation of the business, or assets of the franchise, including customer lists, occupation of premises and copies of intellectual property.
- (f) We have seen many cases where these contractual requirements have been enforced against a franchisee, however we have also seen the opposite whereby a defaulting or non-renewing franchisee does not have the contractual requirements enforced, resulting in the ex-franchisee simply changing name of the business and carrying on without the franchisor.
- (g) Restraint of trade is obviously a big area for debate with all sorts of policy and economic considerations, but given the uniqueness of franchising as a commercial, ongoing relationship we believe that a declaration or guideline about post termination restrictions in franchising could be useful, especially when it is not an area that is often addressed above the District Court level, meaning there are few guidelines about what is acceptable. Under existing law, it can be all too easy for franchisees to avoid the imposition of a restraint of trade clause which can have huge economic impact on a franchisor.

## C. Discussion Paper: Questions 4 - 10: Options, Benefits, Costs

Q4 Which of the options outlined do you favour? Why?

Q5 Have all of the options (and sub-options) been identified? Are there other options (and/or sub-options) that should be considered?

Q6 If information disclosure is to be introduced, which classes of information should be required to be disclosed?

Q7 What are the benefits of each of the options (including any further options)?

Q8 What are the costs and risks of each of the options?

Q9 Can you give any estimates of the compliance costs associated with the options?

Q10 With any of the regulatory options discussed are there potential conflicts with any existing law, such as securities law or company law?

### 1. **Option 1: Preserve the Status Quo?**

1.1 Resistance in New Zealand to the introduction of franchising legislation has traditionally been strong amongst the franchisor community. It is our perception that that resistance appears to have been based on the following concerns.

- (a) A perception that compliance costs for franchisors will be exorbitant; and
- (b) that current legislation, eg the Fair Trading Act, already provides sufficient remedies for franchisees.

We do not believe these concerns justify preserving the current situation for the following reasons.

#### 1.2 Compliance costs prohibitive?

- (a) The relevance of this objection obviously depends on what the minimum, mandatory costs will be. If change imports the requirement for more sophisticated disclosure and documentation from franchisors, then as well as costs for franchisors, it will have a reflected increase in cost for potential franchisees who have to understand and take advice at a higher level.
- (b) There is no empirical evidence that compliance costs will drive franchisors out of business. We think that any compliance cost will largely be a “one off” and that it is an area where assistance could be offered through an industry or government body – for example the disclosure document being in a downloadable standard form, and perhaps a standard franchise agreement format or minimum clauses could be provided, along the lines of the ADLS forms. These should be optional, but could include minimum or mandatory requirements. Another alternative could be a similar service to the Employment Agreement builder available to employers on the Department of Labour website:

<http://www.ers.dol.govt.nz/relationships/builder/>

- (c) We think that compliance costs will be regulated by competition in the franchise services market in that consultants, solicitors, accountants and other service providers will compete to provide competitive fees to ensure compliance is handled economically and effectively.
- (d) For the many reputable franchisors who view suggested changes as a positive for franchising, compliance costs will be rationalised as good for business because the changes will provide an overall boost to the public's perception of franchising as a great business model and therefore something to get into and embrace, not something to be suspicious of.
- (e) Anecdotal evidence of the Australian experience is that similar resistance to change was raised in that jurisdiction also but that, once introduced, apart from an initial fall off in the numbers of franchises coming on to the market (perhaps more reflective of delayed entry to market due to the need to complete compliance), franchising has continued to flourish in that jurisdiction

### 1.3 Current legislation already provides a remedy?

- (a) As identified in paragraph 4 above, the authors strongly believe that current legislation either does not provide a sufficient remedy or that, where it does, the costs and complexities of obtaining that remedy, and the delays and uncertainty involved create a situation where seeking that remedy is of little practical use.
- (b) For example, if a franchisee makes a decision to buy a franchise without having full information about the franchise (ie, not conducting adequate due diligence due) unless it can be shown that there is a representation by silence or misleading and deceptive conduct flowing from a failure to disclose the full picture, there is no remedy.
- (c) Because of the one sided nature of the franchise agreement, the current situation is simply not fair to many franchisees. Ignorance and naivety is not provided for.
- (d) To take another example, a franchisee may have a very good case against a franchisor who has given inaccurate projection figures or a professional who has given bad advice about the franchise. Or, the franchisor may be in clear breach of its obligations during the Term, or have terminated the agreement improperly. However, in our current experience, at least in Auckland, it may take some two years before the case comes to trial. In the meantime it could be discovered that the professional has no insurance and the franchisor may go out of business or assign all its value to an associated entity. If the franchisee gets judgment, there may be no money there to pay the claim. In this scenario, there is a "remedy", but bothering to seek it is just impractical.

## 2. **Option 2: Education**

- 2.1 Education is of course important. It is helpful for people who want to learn about franchising and who understand and can process what they have learned. Unfortunately, it is not a panacea for those people who get caught up with the hype and promotion of a system and do not really want to be told what might be wrong with the opportunity. Education is very important to back up or support regulation but the cost of reaching and ensuring effective education for those that most need it would be enormous, and there are plenty of situations in business, and society in general where the best efforts at educating and informing have not prevented the problems – e.g. unregulated investments; internet and pyramid scheme scams; the dangers and consequences of smoking, drink driving, drugs etc. Education is only good for people who want it.
- 2.2 Franchise Education in the future should also target franchisors or potential franchisors, with consideration needed as to whether some certification or qualification standards are necessary (or at least strongly promoted as being desirable) before a franchisor can become a member of the Association, and / or launch a new franchise system and / or sell franchises.

## 3. **Option 3: Franchise Specific Regulation**

This is our preferred option for the future of franchising in New Zealand.

### 3.1 Definition of Franchising

- (a) One preliminary area that is considered important by us is an effective definition of “Franchising” along with sensible exemptions to certain scenarios from full or partial compliance with any regulation.
- (b) The definition of what is covered by regulation needs to be broad enough to cover sales of businesses with continuing obligations or purchasing requirements yet sophisticated enough to leave certain intellectual property and distribution agreements, and high level commercial negotiations and transactions to be agreed and entered into under normal commercial laws where franchising regulation would have little benefit to either party.
- (c) We suggest this because MacDonald Pilcher have recently been involved in negotiations with parties in regulated jurisdictions in three separate occasions where the original structure of a deal has had to be re-formulated specifically to get around franchise regulation which if applicable would have added no value, and incurred great cost and delay to both sides.
- (d) If the definition is too ‘catch all’ – which in our opinion the Australian and American and other jurisdictions are – then we risk pulling in traditional manufacturing licences, distribution agreements, authorized representatives of a

brand, technology licences and so on which are quite a different concept, but can share many of the same features as “franchising”.

### 3.2 Mandatory information Disclosure?

- (a) Bearing in mind the problems we have described of franchisees either not knowing what information to ask for, not understanding the information they do receive, or not getting relevant information until well after they are already emotionally or legally committed to a purchase, we believe that some form of purchaser protection is appropriate, and endorse the mandatory disclosure requirements promulgated in the relevant Australian legislation. We also note and support the Australian provision for mandatory disclosure to be reduced for smaller franchises.
- (b) A primary reason that is put forward by detractors of introducing mandatory disclosure of information is compliance cost. Whilst we have sympathy in this regard for franchisors and in particular franchisors of smaller systems, we do not agree the cost of compliance should be a reason in and of itself to reject mandatory information disclosure as a means of addressing the problems which have been identified in the discussion paper, as discussed in detail in paragraph C 1.2 above. We believe that given the imbalance within the franchise agreement, the benefit of disclosure outweighs the negative.
- (c) As to the type of information which is provided we agree with the range of information which is required to be supplied under the Australian legislation which is similar to that under the current voluntary Code. The purpose of the disclosure document should not only be to alert the franchisee to the obligations, payments and restrictions they are committing to under the written agreement, but to give useful information about the people / entity they are about to enter into a long term business relationship with.
- (d) Disclosure documents and other preliminary materials often have a sales and promotion pitch to them, detailing the success of the system, the high demand for products and services and often optimistic projected figures, with no information at all being given about such less rosy topics as the history of failed sites and disputes with franchisees. In fact some current members of the FANZ do not disclose all information required by that Association, preferring to leave it out if not specifically requested.
- (e) Rather than use the standard form Australian disclosure document as a starting point (we believe that document to be cumbersome and to require some disclosures which are not of great relevance), we believe as a starting point the disclosure document presently required by the New Zealand Franchise Association should be considered along with more detail on the following areas:

- (i) details of any superior licensor of the franchisor entity and the circumstances in which the franchisor could lose its franchising rights;
  - (ii) details of all associated or related entities or involvement of the directors, key management or controlling owners, in other ventures – especially if the franchisor entity is a shell company, with no trading history or assets;
  - (iii) full business and personal history (including past business ventures and whether they have ever been bankrupted, convicted of any crime or judgments have been entered against them);
  - (iv) whether any complaint has been made or proceeding filed against the franchisor, or an officer personally in anyway relevant to the franchise system;
  - (v) full contact details of all past and current franchisees and full details given of all non-renewals, terminations and transfers of franchises;
  - (vi) a summary of the various rights, payments, obligations of franchisee under the Franchise Agreement in plain English – too many disclosure documents just cut and copy in pages from the Agreement;
  - (vii) details of any rebates, incentives or other benefits that might be received by the franchisor or any officer or associate thereof based on products and services (including landlord incentives) purchased by franchisee, especially if purchasing is a controlled/restricted area.
- (f) To put it simply, a potential franchisee should have the right to know if these people have the substance and commitment they require to want to invest their money with, and commit to a long term undertaking alongside. While a potential franchisee may not be able to assess this, their advisors should have their eyes open and ask the difficult questions that may need to be asked.
- (g) Many disclosure documents we see under the FANZ Code meet the requirements of the Code, but manage to leave a lot of information out that could be relevant to a franchisee's decision. For example, people often have managed to escape prosecution or conviction, yet are not good people to give your money to, or to deal with. If all occurrences of disputes or complaints had to be disclosed they can at least be explained or discussed and assessed.
- (h) Another key issue we believe needs to be covered is disclosure of actual historical figures of other franchisees or comparable company owned units. We think projected figures are a distraction and less relevant than information about how actual franchisees are already doing. We think it is important to give

disclosure of the bad with the good (not averages or ranges), and franchisees and their accountants need figures to work with during due diligence.

- (i) It is, in our experience, common for franchisors to give no financial performance information to potential franchisees leaving them to proceed based on assumptions that no-one will confirm or deny.
- (j) We believe that disclosure documents should be capable of being written by a franchisor, with some accounting input. (See above suggestions for standard forms and minimum requirements paragraph 15a (ii))
- (k) Currently in New Zealand when a franchisor retains a lawyer or specialist franchise consultant to write or advise on preparation of a disclosure document we estimate the professional fees range anywhere from \$1000 - \$10,000.00. Much of the cost will be related to financial information if it is provided. However to engage these professionals is the choice of the franchisor. They can elect whether to write the document or engage an outsider to do so. They can decide what level of advice to seek and whether or not they are happy paying the fees.

### 3.3 Mandatory Professional Advice?

- (a) We also agree with the introduction of compulsory requirements for franchisors to ensure their franchisees obtain legal and accounting advice and that the lawyer and accountant certify that the effects and implication of any agreement have been explained to the franchisee.
- (b) We note that in many cases this is being done already and it is one more step in ensuring the franchisee goes into what might be an onerous arrangement with their eyes open.
- (c) We think the suggestion of just requiring a franchisor to advise franchisees to get independent advice will not go far enough. We think that a franchise agreement should be conditional on this advice and certification of the same, (unless the parties are sophisticated business people / experienced in franchising in which case some exemption could perhaps be provided).
- (d) There has been some mention of the professional advisors being required to be registered or certified in some way. We do not agree that this should be a compulsory requirement. However it could be of value for advisors to have the option of being registered as an affiliate or advisor member of the official franchise body (if one is constituted pursuant to regulation) as is the case with the current FANZ. It would then be a matter of promotion and awareness and market forces.

- (e) We comment that lawyers have traditionally been discouraged or even prohibited from promoting themselves as specialists in any field. Any requirement for 'certified' or specialist franchise advisors would need to be consistent with the relevant professional rules of conduct, and not infringe competition laws by shutting out professionals who choose not to become part of that franchise advisory certification or qualification process.

#### 3.4 Summary of Advantages of Pre-Contractual Disclosure and Advice

- (a) Franchisees given, and required to take, every opportunity to making a better and informed decision about whether they should buy a franchise;
- (b) Franchisees are less likely to be aggrieved at a franchisor if things go wrong, because they have been given and understand the full picture at the outset.
- (c) The impact of (a) and (b) should = less disputes.
- (d) We suggest that if a potential franchisor is not willing to disclose anything that might be material to a franchisee, or does not think a franchisee should get proper advice, or is not capable of writing a disclosure document, or is trying to cut costs and cannot fund the proper development of their franchise system, **then perhaps they are not the right people to be franchisors.**

#### 3.5 Consequences of Non-Compliance

- (a) We acknowledge that where a statute provides that there is a compulsory supply of information and a compulsory certification, the lack of these matters being attended to could raise some uncertainty over the validity and enforceability of the franchise agreement. This issue has recently been considered in the Australian Courts where the disclosure procedure is mandatory.

An excellent summary of the latest cases can be found at:

[http://www.apf.gov.au/Library/pubs/BN/2008-09/Franchising.htm#\\_Toc214254817](http://www.apf.gov.au/Library/pubs/BN/2008-09/Franchising.htm#_Toc214254817)

- (b) The High Court decision in Master Education Services Pty Limited v Ketchell [2008] HCA 38 (27 August 2008) it was said "it would be an unusual result if every franchise agreement was struck down in every case" and "...when a statute contains a prohibition on entry into a particular agreement [as clause 11 of the Code does], a contravention of the prohibition does not necessarily mean that the agreement is void – that will depend on *'the mischief which the statute is designed to protect ... and the consequences for the innocent party.'*
- (c) We suggest that New Zealand Courts would likely follow any precedent set in Australia on similar matters, however because we are encouraging people not to take their claims to court by introducing compulsory mediation, it would be desirable to make it clear in the words of regulation that a technical non-compliance would only result remedies or provisions dealing with the actual consequences for the innocent party be incorporated. (Obviously if the

seriousness of the consequence to the innocent party could still lead to an agreement being avoided, but it would not be the only remedy).

### 3.6 Cooling Off Period?

- (a) We agree that this is in theory a safeguard for those who may be given to changing their mind after signing an agreement. We note that in a number of franchises, seven day cooling off periods is already being observed.
- (b) Having said that, none of the authors personally knows of any franchise where a franchisee pulled out during the seven day cooling off period. Our experience is that franchisees rarely pull out during this honeymoon phase, where they have not yet often even commenced operation of their franchise. And if mandatory disclosure and advice is incorporated the franchise should already be fully informed in a rational manner where signing under pressure is not likely to be a problem.
- (c) Prescribing a compulsory cooling off period is probably not necessary, and in fact can hold up matters, unless it remains possible for people to sign franchise agreements without reasonable time to review the documents and take advice.
- (d) If a compulsory cooling off period is introduced then we suggest that there is some guideline or standards included as to the costs the franchisor can claim from the canceling franchisee prior to refunding their payments. We have seen franchise agreements where the deduction is more of a penalty than cover of franchisor costs, which could act as a dis-incentive for people to exercise the cooling off "option".

### 3.7 Enhanced Dispute Resolution?

- (a) We are not alone in our belief that litigation is not the way of the future when it comes to resolving disputes. This is particularly so in franchising where franchisees can sometimes be persons of not great sophistication, yet who have invested relatively large sums of money, against the security of their homes. But whether the client is in this category is such an individual or is a commercially sophisticated entity, when a dispute arises, all clients by and large want a resolution of their dispute within a short time frame and they want it done cheaply.
- (b) Increasingly we see Franchise Agreements written in New Zealand as having an alternative dispute resolution clause, and we have experienced clients preferring mediation as a means of dispute resolution for the reasons that:
  - (i) A mediation can be organised quickly;
  - (ii) Compared with litigation or arbitration it is vastly cheaper (a fraction of the cost); and

- (iii) The parties have the opportunity to negotiate an outcome, something denied to them in a Court or arbitration setting.
- (iv) Parties tend not to be interested in mediation generally only where they feel their case is so strong that mediation would be pointless because they are not prepared to make any concession. Often, our suspicion has been that where this stance is taken, it is taken on the advice of a barrister or solicitor advising that party.
- (v) Optional or voluntary mediation can be a problem where a party takes a strategy decision to refuse to attend mediation. We have seen cases where a party with a meritorious case has sought mediation but been turned down (even in breach of an ADR provision in the franchise agreement). Sadly, the party seeking mediation has then not been in a position to take the matter any further, generally because money is running out for them and they simply cannot afford to go to Court. In these types of cases, which are not that uncommon, an injustice arises and people usually end up feeling unhappy with the justice system.
- (vi) Our experience is that where mediation is being insisted upon by a party to a contract, that tends to be because that party feels they have a genuine dispute. (It is rare that mediation is sought by a party simply wanting to waste time). In this instance, even where the other party is equally defiant about their position, and even where mediation is held but does not result in a settlement, mediation can still be useful as a forum to discuss and bring focus to the real issues in contention. If the matter then needs to go to Court, the nub of the issues at contest is well identified and this will save cost and reduce “litigation drift”, a condition where the issues in cases do not get properly defined at the outset and/ or the issues keep changing because there is just no focus.
- (vii) The authors have collectively been involved in many mediations and have rarely experienced a franchise mediation which has not resulted in a settlement or, at the very least, in both parties making offers, notwithstanding settlement has not been achieved as a result of those offers. A good mediator (of which there are a number at work in Auckland and other parts of NZ) will work hard to ensure that the parties actively engage at mediation and that a settlement is achieved.
- (viii) In many cases, especially in multi party franchising disputes (where one or more franchisees raise a joint dispute with their franchisor), being able to resolve the matter through mediation has avoided a full scale costly battle where no one but the lawyers would have been the winners. The well publicised *Dymocks* case, where costs issues were subsequently the subject of a second round of fighting, was an important case in the

development of the law relating to good faith in franchising but it came at a huge cost to the unsuccessful party who was required to pay in the order of \$1,000,000 in costs!

- (ix) The costs savings with mediations are indisputable. A franchise mediator in Auckland currently charges around \$3,000.00 to \$4000.00 plus GST a day. Whilst lawyers do not need to be present at mediations, many parties in dispute will involve lawyers, but the cost of a lawyer is merely the cost of the time spent at the mediation and any preparation (perhaps say a day). All up, a mediation can be conducted at under \$10,000. The option of not involving a lawyer is attractive for some parties. Recently one of the authors was involved acting for a party in a franchising dispute where the lawyers were only consulted at the point once agreement had been reached in mediation so the lawyers role was limited to drafting the final agreement. No one was any less happy with the outcome of the mediation because their lawyer had not been present for the entire time.
- (x) Having made the foregoing points, we believe it is important that where injunctive relief is sought, an applicant should always be able to go straight to court. Mediation would not be an appropriate dispute resolution for dealing with an injunction issue.

### 3.8 Recommendations Regarding Mediation

- (a) We believe that compulsory mediation prior to issue of any proceedings (except for injunctive relief) is the way of the future in dealing with franchising disputes. It is cheaper, quicker to organize and is generally welcomed by parties in a dispute.
- (b) We believe that clause 9 of the FANZ Code of Practice sets out a workable mediation clause. There needs to be a clear exception however where injunctive relief is required.
- (c) We favour shortening the period of time referred to in clause 9(ii) and 9(iii) of the FANZ code to say 10 and 5 days respectively. We think the current time frames are too long.
- (d) We do not think there is any need to state where the mediation has to take place as normally this is not an issue and can frequently be something the mediator takes control of.
- (e) We do not think there needs to be any provision for where the costs should lie as normally costs are split 50/50. However, it may be appropriate that some form of fund is established to assist franchisees (or franchisors) with costs in certain situations to ensure cost is not an issue or barrier to mediation as it can be with court proceedings. \$10,000 or even \$1000 is still a lot of money to a

party that has none and it is feasible that many low value yet important disputes might never reach mediation due to cost barriers.

- (f) We think it is sensible that a formula be specified as to who is to be the mediator where the parties cannot agree. We believe that if in doubt the mediator should be one selected by the President of the Auckland District Law Society, LEADR or a similar ADR body.

### 3.9 Mandatory Good Faith Clauses?

- (a) It has been said of bad faith that it is hard to define but that “you know it when you see it”.
- (b) We have seen many examples of good franchisors in New Zealand actively observing good faith and basic concepts of fairness, notwithstanding their contract does not provide for that. Having said that we have seen cases where lack of good faith has been displayed by an unscrupulous or ignorant franchisor and, in this scenario, the express obligation of good faith would be a good safety blanket for franchisees. However we think that any such obligation should be reciprocal on franchisees.
- (c) Objection to acting good faith being an implied or necessary term in an agreement may be seen as wishing to reserve the right to act in bad faith.
- (d) We disagree that a compulsory obligation of good faith creates confusion and uncertainty. Indeed, we have observed that a number of franchise agreements already provide for good faith. In those contracts where we have seen an express obligation of good faith we do not believe the inclusion of that provision has created an uncertainty at all.
- (e) Franchise agreements have sometimes been described as relational contracts and, in that regard, they share a commonality of character with an employment contract. In both types of contract, the parties observe the terms of the contract whilst continuing to work together. As with employment contracts, there can also be a power imbalance in the relationship. In employment law, the law protects an employee from an abuse of that power by the express requirement of an employer to act in good faith.
- (f) We are not suggesting a wholesale importation of employment law concepts and principles into franchise law and in fact suggest this is strongly resisted, but we make the point to highlight some common threads that underpin franchising and employment.
- (g) Good franchisors will be more than happy to welcome the obligation as they are already observing good faith anyway to their franchisees.

### 3.10 Institutional Options

- (a) We favour having a franchise association, incorporated society or industry body.
- (i) This would have an educational, advisory and registry function. (See 4.1 below on registration).
  - (ii) We would recommend compulsory membership of every system that is defined as a franchise. Similar to the Motor Vehicle Sales Act 2003 where every vehicle trader or consultant must be registered, or cannot sell or deal in cars. If a franchisor was not a member of the association or had been banned it could not market franchises for sale or enter into new franchise contract and any resulting contract would not be able to be enforced.
  - (iii) There would be a cost of membership contributing towards funding the services. This is a cost of quality assurance, and as mentioned above, if franchisors are trying to cut costs, they might be in the wrong business.
  - (iv) We note the existing FANZ is well established and has systems and networks in place and should be well placed to take these functions and role to the next level.
  - (v) The members of the current voluntary Association comprise service providers and franchisors holding considerable knowledge and experience in franchising.
  - (vi) However it is currently possibly a narrow representation of franchising in New Zealand with the absence of many larger established and international systems. For example MacDonalds, Muffin Break, Oil Companies, Vehicle Dealers are not members.
  - (vii) Compulsory 'membership' should take care of this fairly quickly and ensure a well rounded input of skills and experience from across all sizes of franchise systems and sectors in all sectors.
- (b) We also favour a separate independent body being set up to monitor and have the authority to investigate and act in a tangible way on any complaints or minor disputes.
- (i) This would run alongside the mediation requirement.
  - (ii) It could perhaps include power of suspension of the right to sell franchises during an investigation.
  - (iii) A good model for this could be the banking and insurance ombudsmen. We note that both those systems are voluntary for participants in their respective industry. So it would need to be decided if franchisors could opt out as participants in a franchise ombudsman scheme.

- (c) While we recommend that mediation should become a compulsory path for franchise disputes that might otherwise go straight to court, minor disputes or complaints could be a cost effective alternative to mediation and allow people who are not in a contractual relationship with franchisors or franchisees to make complaints.

#### 4. **Other Matters for Consideration**

##### 4.1 Registration System?

- (a) We suggest registration could be of benefit. All franchise systems could be centrally registered, preferably on a public web based register. The desirability of registration of franchisors and / or franchise systems is a topic of great debate.
- (b) It does not currently exist in Australia, but does exist in the USA. The existence of a registration system in the USA seems anecdotally to have become a cumbersome and costly exercise with long delays for approval of documents which require annual updates.
- (c) We suggest a much simpler system where the fact of being a “franchise” and the act of joining the industry association as discussed above in 3.10(a) could cover the registration function, with franchisor members being required to file their disclosure documents and franchise agreements with the Association to ensure they meet minimum regulatory requirements. We note that the infrastructure is already there for a screening process for all applicants to the current FANZ and this is contracted out to an independent scrutineer.
- (d) The controversial question will be whether the substance of the system and franchisor need to be examined or whether minimum requirements should be met or passed so that only ‘qualified’ persons or systems can be franchisors / franchise systems. For example:
  - (i) minimum business experience,
  - (ii) pilot outlet having been operated,
  - (iii) sufficient franchisor capital backing being in place.

In our opinion substantive regulation or qualification of franchisors or franchise systems is a step too far and the type of ‘regulation’ that people are wary of. It presents barriers for entry and it would be very difficult and costly to specify the qualifications and experience across such a broad range of businesses and industries and to monitor and keep up with applications and renewals. We believe the focus should remain on disclosure and some minimum contractual fairness requirements, leaving franchisees to make their own decisions about what is important when choosing a franchise system.

#### 4.2 Failure to Meet Standards.

- (a) Any law would need to provide meaningful consequences and penalties for people holding out as franchisors or selling franchises which meet the definition of 'franchising', but they have failed to comply with the minimum regulatory requirements or to become members / register as a franchisor. (Similar to the Motor Vehicle Sales system).

#### 4.3 Overseas Systems in New Zealand.

- (a) Finally there needs to be recognition of the status of overseas systems whereby a locally based franchisee is contracting directly with an overseas franchisor to operate a unit in New Zealand.
- (b) In Australia the Code of Conduct purports to apply to overseas systems entering the country, but we are not sure how this works where the franchise agreement is stated to be under the laws and subject to the jurisdiction of the courts of the franchisor's own country.
- (c) Perhaps if the overseas franchisor is required to take the step of registering in New Zealand it would monitor direct entry. The excessive requirements of the USA should be avoided, it should be more of a formality that gives the international (and local!) franchisor confidence to invest in their franchise system, and enter into a well run, commercially focused, quality assured franchise market.

### **D. CONCLUSION**

We believe franchising provides a robust and positive contribution to the New Zealand economy. It is well established and expanding steadily providing good income opportunities for many New Zealanders and migrants. Carefully crafted legislation could greatly assist eliminating the actions of unethical or inefficient franchisors that can ruin franchisee's lives and lead to financial failure. Legislation that does not unfairly fetter well run systems will contribute to the overall growth of franchising. It will assist our country's economy and the income and wealth creation of many New Zealanders.