

Submission

By



to the

Ministry of Economic Development

on

**Review of Franchising Regulation in New
Zealand**

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**REVIEW OF FRANCHISING REGULATION IN NEW ZEALAND DISCUSSION
DOCUMENT
SUBMISSION BY BUSINESS NEW ZEALAND¹
21 NOVEMBER 2008**

1. INTRODUCTION

1.1 Business New Zealand welcomes the opportunity to comment on the *Review of Franchising Regulation in New Zealand* discussion document (referred to as 'the document'). While we generally support reviews of existing regulation to ensure it meets current objectives, in this instance Business New Zealand believes that at present there appears to be no clear and present problem with current franchise regulation law of a general nature. Therefore, the status quo approach should be viewed as the most favourable option going forward regarding franchising law in New Zealand.

2. SUMMARY OF RECOMMENDATIONS

2.1 Business New Zealand makes the following **recommendations** with regard to the document, namely that:

- (a) If there is to be a regulatory outcome in regard to franchising in New Zealand, that a proper definition of franchising is worked on and discussed with affected groups (p.5);
- (b) The status quo approach continues to be viewed as the most favourable option going forward regarding franchising law in New Zealand (p.6);
- (c) Notwithstanding the recommendation above, education initiatives are viewed as the next best step in terms of providing useful material to both franchisees and franchisors (p.6);
- (d) At this point in time, any steps directly leading to mandatory information disclosure does not proceed (p.7);
- (e) Until such time there is widespread evidence of professional advice not being undertaken across most franchise sectors, any steps towards mandatory professional advice is not required (p.7);
- (f) Until such time as potential unintended consequences are fully examined, moves towards mandatory cooling off periods does not proceed (p.8);
- (g) After sufficient consultation, any moves towards mandatory mediation process is introduced in association with the Franchise Association of New Zealand (FANZ), and is given an appropriate period in which to succeed before any follow-up options are considered (p.9);
- (h) Given the current lack of evidence regarding contractual power imbalances with franchise agreements in general, no widespread statutory minimum requirements are introduced. Also, any specific sector issues

¹ Background information on Business New Zealand is attached in the appendix.

should involve further discussions between the Government and industry representatives (p.10); and

- (i) Alternative options are fully explored before any moves towards mandatory requirement for contracts between franchisors and franchisees to include 'good faith' provisions are considered (p.10).

2.2 The document asks a series of questions relating to franchise regulation in New Zealand for submitters to comment on. However, Business New Zealand wishes to discuss some key aspects that need to be considered when examining whether further regulation is required for New Zealand's franchise industry.

3. BROAD ECONOMIC ISSUES TO CONSIDER

3.1 Business New Zealand is pleased to see that the document sets out to ask a fundamental question that should be required of any investigation into possible changes to regulatory practices, namely "*is there a problem?*". In fact, we would go further with this line of questioning, as it is crucial that policymakers take a step back and ask a series of fundamental questions. These include – but are not limited to:

- Is there a problem *in New Zealand* with current franchise systems (i.e. are there significant issues of "market failure" which need to be addressed)?
- If there is a problem, is the problem significant?
- What are the costs and benefits (including unintended costs) of any proposed changes outlined in the document?
- What are the potential options for improving outcomes which don't impose significant costs (e.g. by improving education to market participants)?

3.2 We are pleased to see that in general, the document covers these questions at various levels. How the questions are answered will provide the core reasoning behind future actions undertaken.

3.3 In addition, there are three broad issues to be answered, namely market failure, evidence of a sufficient problem, and the correct path of change (if any) to take.

Market Failure – a possible case for government intervention?

3.4 Before determining whether increased franchise regulation and other interventions are justified as part of sound policy, it is first necessary to determine on what grounds government might decide to intervene.

3.5 On page 8 of the document, it states that "*at the end of 2007 and the beginning of 2008 there were high profile cases of franchise deals going wrong and a number of people being left without the business they thought they had purchased....these events raised questions about whether*

franchisees are sufficiently protected by our current laws and structures. This is why we are carrying out this review". However, on the same page it is also stated that *"This review should not be viewed as a response to the alleged scams involving franchise"*. Business New Zealand believes that these two statements are contradictory and a case of 'splitting hairs'. If these high profiled cases had never been publicly discussed, then the associated document would almost certainly never have been published.

- 3.6 Generally markets work best when left undisturbed by government interventions (e.g. regulation/taxes/expenditures). However, in certain circumstances markets do not perform their functions efficiently and government intervention may be justified. Therefore, the next issue needs to be raised, namely does the evidence show there to be a significant problem?

Does the evidence show a significant problem?

- 3.7 We note the document comments on more than one occasion that any moves towards regulatory outcomes are hard to justify. For instance, paragraph 34 states that *"..these reports in themselves are not evidence of a widespread problem in New Zealand's franchising sector"*, while paragraph 36 states that *"officials are not aware of any systemic problems within the franchising sector"*. Lastly, paragraph 50 states that *"with a few exceptions, the status quo appears to be working well and there is no evidence of widespread problems with the current framework"*. It is clear from the Government's own words; there is little justification for any regulatory outcomes.

- 3.8 Even if there are grounds for some changes to be made to franchise regulation in New Zealand, such changes need to be approached in a systematic way. Namely, any moves towards widespread Government-led regulatory measures must start from the position of minimising distortion and unintended consequences when intervention is made.

The Correct Path of Action to Take

- 3.9 Instead of viewing Government-led regulation as the first and only solution, in Business New Zealand's 'Regulation Perspectives'², we stipulate nine actions that the Government could adopt to improve the quality of regulation in New Zealand. Of these, the following six actions clearly relate to the discussion document on franchise regulation:
- a) *Define the Problem*: Require all proposals for regulation to include clear analysis of the problem to be addressed.
 - b) *Do a Cost Benefit Analysis*: Require all proposals for regulations to include a cost-benefit analysis by an independent agency with a service similar to that provided by the Australian Productivity Commission.
 - c) *Travel up the Pyramid*: Consider non-regulatory options first, moving 'up the pyramid' to generic light-handed options, then more stringent options only if clearly warranted.
 - d) *Keep it Generic, Light-Handed*: Give preference to light-handed generic regulation.

² <http://www.businessnz.org.nz/file/1053/Regulation%20Perspectives.pdf>

- e) *Regulate only when Required*: Introduce new regulations only when justified by clear cases of significant – not minor – market failure.
- f) *Self-Regulation as a Goal, not a Pathway*: Self-regulation should not be introduced as a precursor to future government-imposed regulation; instead it should be allowed to stand on its merits.

3.10 Of the six actions listed in 3.9 above, action (c) is a key step when regulatory decisions are made. Business New Zealand would strongly oppose any moves by the Government that automatically led outcomes to the ‘tip’ of the regulatory pyramid. Instead, if action is needed, proper approaches should be taken from the base up.

Positives with Franchising

3.11 All business models have their advantages and disadvantages, and franchising is no exception. However, the document does not take the opportunity to outline the advantages of franchising as a business model. Instead, it tends to focus on the disadvantages of its current regulatory settings. We would like to point out that there are other significant advantages with franchising compared with other business models, including buying into an established brand, accounting and budgeting systems, volume purchasing power, collective advertising and often outside help running the business.

3.12 Overall, Business New Zealand believes in the need for significant caution so that any proposed changes do not let the pendulum swing too far in favour of the franchisee, which could jeopardise further franchise operations in New Zealand. While some changes may be warranted, they need to come from a clear and undisputed position that there is significant failure, and that the least harmful regulatory intervention is considered first.

Definition of Franchising

3.13 Before outlining some of our views concerning specific issues raised in the document, we would also like to briefly mention the need for clarity around the definition of franchising, especially if regulatory changes are made as a consequence of the discussion document.

3.14 The document states that in relation to the definition of franchising, “*Franchising can be viewed as a form of licensing distribution arrangement, but the term is often used loosely to refer to one or more types of these arrangements*”. Therefore, there is no proper definition of what franchising is, given its possible inclusion across a range of business transactions, such as ‘product franchising’, ‘manufacturing franchise’, or ‘business format franchising’. The absence of a definition creates a significant ripple effect if moves are taken by Government towards regulatory action, namely by capturing those who are not meant to be included in the first place.

3.15 For instance, we understand that the Direct Selling Association of New Zealand Inc (DSA) will submit on this document, raising concerns that their members may be included if any subsequent regulatory outcome does not include an adequate definition. In the view of the DSA, there are a number of

reasons why a direct selling distributor and/or independent contractor would not be a franchisee. Using terms such as licensing, distribution or format selling to define for what a franchise is would inadvertently capture operations like the DSA that were not intended to be captured.

- 3.16 Therefore, a properly defined definition of franchising should be an immediate first step if regulatory outcomes are considered, with any work in this area being part of wide public consultation.

Recommendation: That if there is to be a regulatory outcome in regard to franchising in New Zealand, that a proper definition of franchising is worked on and discussed with affected groups.

4. OPTIONS GOING FORWARD

- 4.1 Taking into account the broad economic issues above that must first be considered when examining any need for regulatory outcomes, it is clear that there is little requirement for substantive change. The document outlines three possible ways forward:

- Status quo – generic legislation and self-regulation;
- Education; and/or
- Franchise-specific regulation.

Business NZ wishes to take the opportunity to look at each of these options in turn.

Status Quo – Generic Legislation and Self-Regulation

- 4.2 There are a variety of facts that the document has outlined that tends to warrant a largely status quo option as the best way forward. First, due to isolated incidents that sparked the discussion document in the first place, the Franchise Association of New Zealand (FANZ) has reported an increase in the number of applications for membership, indicating businesses are already taking steps to protect and promote their reputation. Second, any attempt by the Government to take over the core function of a group like FANZ would place significant risks on the Government from the need to provide a knowledgeable and professional body, at least in the short-medium term. Third, there would most likely be no additional compliance costs on the industry, nor extra costs on the Government with the status quo approach.
- 4.3 While the document also notes that there are still a significant number of franchise systems that are not members, FANZ has over 220 members of the roughly 350 franchises that are actively trading.
- 4.4 The document also states that with a self-regulatory model such as the one FANZ provides, franchisees only have the protection of generic law and may face high costs to resolve disputes. Also, FANZ has no teeth with which to enforce its codes. However, any basis for change on these observations misses the point about what self-regulation inherently stands for. Those that do join an association like FANZ have agreed to abide by a set of principles

and rules that send a signal to the market regarding trust, which in turn helps to build their brand.

- 4.5 Overall, while Business New Zealand understands that there may be particular issues that have arisen in certain franchise sectors, at this present time we do not see sufficient evidence that franchising in New Zealand should take a significantly different path in terms of its regulatory settings. Therefore, we would currently favour the status quo option to franchise regulation, involving generic legislation and self-regulation.

Recommendation: That the status quo approach continues to be viewed as the most favourable option going forward regarding franchising law in New Zealand.

5. EDUCATION

- 5.1 Notwithstanding the views expressed in section 3 above, Business New Zealand believes that if there is enough support from other submitters for another option following the review of franchise law, then work around education is the next best step forward.
- 5.2 As the document states, education provides a possible non-regulatory solution to any perceived issues that may exist. Business New Zealand would support further work targeting both franchisees and franchisors to make them aware of issues to look out for and questions they should ask when contemplating a franchise arrangement.
- 5.3 A possible issue that is raised in the document is who would be responsible for designing and carrying out such education initiatives, and in turn who would bear the associated costs. Given FANZ already has a wide range of information on its website in this regard, it would be unwise to essentially “reinvent the wheel” by way of Government compiling similar educational information. Instead, Business New Zealand would prefer the Government to explore the idea of including more links to the specific information available from FANZ on Government websites related to business issues. As one example, the www.business.govt.nz website could include a page devoted to franchising, with links to FANZ, as well as providing further general information.

Recommendation: That notwithstanding the recommendation above, education initiatives are viewed as the next best step in terms of providing useful material to both franchisees and franchisors.

6. FRANCHISE-SPECIFIC REGULATION

- 6.1 Option 3 in the document outlines a range of choices regarding franchise-specific regulation. These have been identified as potential forms of regulation and grouped in relation to the perceived issue they address. Business New Zealand wishes to make comments on some of the options outlined.

Mandatory Information Disclosure

- 6.2 The option of requiring franchisors to give certain information to potential franchisees before an agreement is entered into to ensure proper due diligence may, in Business New Zealand's view, lead to regulatory creep as disclosure requirements will undoubtedly grow significantly over time. This has already occurred in Australia, with concerns from franchisors that the compliance costs associated with the requirements are too onerous (rising from an initial 20 to 50 pages following the latest review). Such outcomes are unfortunately often the norm, as there is a need to 'gold plate' regulatory requirements to cater for the most extreme cases. In reality, 'gold plating' can often be completely redundant and/or imposes further costs on the vast majority of franchisors.
- 6.3 We agree with views expressed in the document that first, the FANZ code already addresses disclosure. Second, there is every chance that compliance costs will increase, and third, significant questions regarding who would be responsible to disclose information when multi-franchise systems are involved would have to be addressed.
- 6.4 The document also raises what we believe to be a valid point that with the best will in the world in terms of providing extensive information, a potential franchisee will not necessarily understand or even go through with proper due diligence when looking at signing into a franchise agreement. While Business New Zealand believes that in terms of proper business practice, a franchisor should provide information that is relevant to the franchisee, all franchisees as part of responsible business practices must take all measurable steps regarding due diligence.

Recommendation: That at this point in time, any steps directly leading to mandatory information disclosure does not proceed.

Mandatory Professional Advice

- 6.5 Just like the points above regarding mandatory information disclosure, Business New Zealand takes a similar view that questions the need for mandatory professional advice. Simply put, we would assume that it is common sense that any business agreement entered into will involve outside professional advice, although we do accept that in reality this is not always the case.
- 6.6 While Business New Zealand believes this could be something on a checklist via education options that a potential franchisee could tick off when going through all proper procedures, we would find it difficult to take a stance that proposes regulation around common sense. Therefore, until such time that there is widespread evidence of professional advice not being undertaken by franchisees in general, we do not support regulation regarding mandatory professional advice.

Recommendation: That until such time there is widespread evidence of professional advice not being undertaken across most franchise sectors, any steps towards mandatory professional advice is not required.

Cooling Off Period

- 6.7 The document asks whether a cooling off period, designed as a safeguard to allow someone the opportunity to change their mind after entering into a contract should be made mandatory. The FANZ code of practice currently has a seven-day cooling off period, and is mandatory in Australia. Overall, Business New Zealand believes that the inclusion of a cooling off period may make sense with many contracts, as it is impossible to foresee issues that arise which dramatically change the viability of being involved in a franchise. As an example, there may be a case where an extreme event such as the death of a family member who was going to be instrumental to the franchise operation may warrant the contract to cease soon after being signed (although one could equally argue that this could occur at any stage during which a franchise is running).
- 6.8 At this stage, Business New Zealand would have questions around any direct moves towards introducing a mandatory cooling off period, namely that it could end up interfering with processes already underway to physically establish a new franchise operation. For instance, there may be costs associated with delivery of shop display materials, stock etc that the franchisor has begun immediately after the contract is signed, which may not be able to be recouped unless there is an initial deposit by the franchisee, with funds not returned to take into account the extra costs. Also, one could say that if the potential franchisee has taken all proper steps regarding due diligence, then a cooling off period would not really be necessary.
- 6.9 While potentially not as interventionist as the mandatory information disclosure and professional advice could be, Business New Zealand believes there are unintended consequences that would need to be fully investigated and understood if any further work is done regarding mandatory cooling off periods. It may well be the case that this issue remains something that is discussed during contract negotiations between franchisors and franchisees on a case-by-case basis.

Recommendation: That until such time as potential unintended consequences are fully examined, moves towards mandatory cooling off periods does not proceed.

A Mandatory Mediation Process

- 6.10 The document points out that FANZ currently provides a mediation resolution process, essentially because resolution via arbitration or litigation can often be too expensive, while the adversarial processes via these mechanisms are not always the best way to resolve disputes.
- 6.11 First, Business New Zealand would find it difficult to support any moves by the Government to create its own mediation process, as this would simply be a

duplication of a process already established in the private sector. Second, if there is strong support from other submitters regarding a mandatory mediation process, any moves towards such a process should involve the views of FANZ, who would obviously be in a position to ensure any mediation process is still kept within the private sector.

- 6.12 As the document rightly points out, the success of the mediation process is not guaranteed, as mediation is only successful when both parties can agree on an outcome. Therefore, we would be concerned if motives to introduce a mandatory mediation process involved putting this up as a 'straw-man', so that a few unsuccessful attempts at mediation could cause the Government to believe stronger regulatory actions were required.

Recommendation: That after sufficient consultation, any moves towards mandatory mediation process is introduced in association with FANZ, and is given an appropriate period in which to succeed before any follow-up options are considered.

Contractual Power Imbalance

- 6.13 Regarding the option of imposing statutory minimum requirements on matters such as transfer, termination or renewal of a franchise agreement, the document rightly points out that this option should only be seriously considered if there is a problem of contractual power imbalance with franchise agreements generally. At this point in time, Business New Zealand does not take the view that there is a contractual power imbalance of a general nature, although we would welcome any further evidence that may clarify this. Therefore, at this stage this option should not be considered if such imbalance of power only resides within a particular sector or size of franchisor. Also, the risk of 'one size fits all' could potentially be inappropriate in this regard.
- 6.14 Along these lines, paragraph 45 states that *"This issue has been raised specifically in relation to the petrol retail and motor vehicle dealing industries ... others in the franchise sector indicate that this issue may be specific to the petrol and motor vehicle industries, and is not something that affects the franchise sector or business format franchising as a whole"*. Certainly, there may be instances when stronger clarification of franchising contracts would probably be a step in the right direction, particularly where the same issues have arisen with certain contracts. While Business New Zealand is not in a position to provide further information on which industries may need improved structures, any general rules for franchising in this regard would not be warranted due to the lack of sufficient evidence. Instead, there is the opportunity for those associated with specific industries to explore ways in which to correct any perceived issues relating to a contractual power imbalance. We would support further moves by the Government to properly identify those industries that have generally been identified as problematic, and discuss possible options for change with industry representatives.

Recommendation: That given the current lack of evidence regarding contractual power imbalances with franchise agreements in general, no widespread statutory minimum requirements are introduced. Also, any specific sector issues at this stage should involve further discussions between the Government and industry representatives.

Good Faith

- 6.15 Some may view the imposition of an obligation of good faith on franchisors in relation to their post-contractual conduct as a way in which to provide an additional safeguard for franchisees after a contract has been signed. However, any moves along these lines need to take into account some of the valid points to the contrary that the document outlines. We agree that any moves down the path of a compulsory good faith clause could create uncertainty and confusion in the law, as the courts have yet to define the exact meaning of good faith (and it may be that a strict definition is not possible). Also, there could be better mechanisms by which to ensure 'good faith' as a principle could be achieved, especially via upfront disclosure and a mediation process.
- 6.16 If the option of good faith is to be further examined, Business New Zealand would welcome additional work and consultation by Government towards alternative options that may mean steps towards mandatory good faith provisions are not required.

Recommendation: That alternative options are fully explore before any moves towards mandatory requirements for contracts between franchisors and franchisees to include 'good faith' provisions are considered.

APPENDIX

7. Background Information on Business New Zealand

- 7.1 Business New Zealand is New Zealand's largest business advocacy organisation.
- 7.2 Through its four founding member organisations – EMA Northern, EMA Central, Canterbury Employers' Chamber of Commerce and the Otago-Southland Employers' Association – and 70 affiliated trade and industry associations, Business NZ represents the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.
- 7.3 In addition to advocacy on behalf of enterprise, Business NZ contributes to Governmental and tripartite working parties and international bodies including the International Labour Organisation, the International Organisation of Employers and the Business and Industry Advisory Council to the Organisation for Economic Cooperation and Development.
- 7.4 For this particular submission, we wish to point out that one of our affiliated trade and industry associations - the Motor Trade Association of New Zealand (MTA) - wishes to disassociate itself from Business New Zealand's submission. They will instead provide their own submission on the discussion document.