

Submission on Issues Raised in Review of Franchise Regulation in New Zealand Discussion Document August 2008

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	Issue	Comment/Suggestion	Rationale
1	Given the nature of the franchise agreement, do potential and existing franchisees require further protection than what is currently offered by general contract, consumer, competition and intellectual property law?	No – the status quo is sufficient.	<p>The current New Zealand commercial law regime is working well if you consider the number of franchise systems in New Zealand compared with the number of actual disputes giving rise to litigation.</p> <p>It should also be seen as desirable not to unduly interfere with the rights of those in business to contract as they see fit. If legislation is inevitable then there must be adequate protection to existing franchisors and master licensees/franchisees so as to ensure that any retrospective elements of the legislation are excluded or at the very least limited to non-material matters.</p> <p>It is also important to remember that a franchisor is not able to guarantee a franchisee any particular level of income, profit, savings etc. This is because those matters are solely dependent on the franchisee's ability to operate as an independent franchise operator of the franchisor. The franchisor simply provides the franchisee with the tools to establish, operate and maintain the franchised business. It is therefore up to the franchisee and its advisers to decide whether the franchise opportunity on offer is appropriate and/or viable on a case by case basis. Yes, in most instances financial, cost and earnings information is provided by a franchisor. However, each potential franchisee has every opportunity to review and critique that</p>

			<p>information in conjunction with a due diligence investigation by their financial adviser and accountant. If a franchisor has provided inaccurate financial information then at law the franchisee is entitled to bring a claim for misrepresentation against the franchisor.</p> <p>Given the current law and its wide reach (various remedies available under the Contractual Remedies Act, Illegal Contracts Act and broad discretionary powers under the Fair Trading Act) we do not believe that encompassing laws relating to franchising in one Act would necessarily assist franchisees if a dispute arose. Particularly so given that the cost of litigation is expensive and is often prohibitive.</p> <p>Most franchise agreements contain dispute mediation provisions which enable the parties to jointly seek a solution, but which also leaves the franchisor with the right to immediately terminate the franchise agreement if a serious breach occurs. If mediation provisions were to be compulsory and indeed quite lengthy (such that the franchisor was prevented from terminating for serious breach) it could lead to the reputation of the brand being damaged by a rogue franchisee whose franchise agreement will eventually be terminated. This in turn may impact on all of the franchisees in the system negatively. It is therefore essential not just for the franchisor but for all of its franchisees that the franchisor is able to take immediate preventative steps to terminate in order to preserve the goodwill of the system and accordingly protect its franchises in situations of serious breach (e.g. breach of restraint provisions or intellectual property provisions).</p> <p>There is a concern that regulation will result in an increase in costs both legal and otherwise for both franchisors and franchisees. Unlike Australia, most of the franchises in New Zealand are relatively small, meaning that additional compliance costs would be spread over a much smaller number of franchisees. Each franchisee would therefore</p>
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			pay a greater amount and the question has to be asked as to whether they will actually receive any practical benefit from regulation?
2	Do we agree with education initiatives?	Yes, we agree that education initiatives for those who are looking at franchising should be greater.	<p>However, we believe that this is up to the industry as a whole and not for the regulators to provide. Currently there are many portals (e.g. FANZ and franchise business websites and periodicals) that provide a wealth of information as to such matters.</p> <p>It is our experience when advising franchisees that often they have no experience in franchising or even business. It tends to be that people who intend purchasing a business, purchase a franchise business first as it is seen as a half way point in that the system is already established and the franchisor will provide a certain level of support. Greater information for franchisees in terms of guides or booklets would assist our job greatly, as often we are hand-holding the franchisee through the process which can result in a costly invoice for the franchisee. Often too, franchisees feel that they are the only franchisee asking numerous questions. While we try to assure them that they are not, having more educational resources can only be seen as a good thing – especially as franchising can be said to be a relatively new business model in New Zealand.</p> <p>Education would also be wise in respect of franchisors. Often we find that franchisor's use their general practice lawyer to complete their first few franchise agreements. As the franchise system grows however, we often get calls from franchisors seeking specialist legal advice. When we review the franchise agreement and structures put in place, it is often not the best model available and there are numerous amendments to be made. As such, we support any education initiatives aimed at franchisors on the importance of correctly structuring a franchise business and having systems and procedures in place, which includes a fair and workable franchise agreement for the long term.</p>

			<p>Again, as with undertaking any business there are risks and as such a proper due diligence exercise should be carried out by the parties. Whether a due diligence exercise is worthwhile or appropriate depends on the skill and experience of the parties advisers (lawyers, accountants, business advisers). As with this firm there are a number of professional advisers with a high level of skill in franchising and as such access to these experts is in good supply.</p>
3	<p>Considering that we believe the status quo should remain, should the franchising sector be able to develop its own solutions?</p>	<p>Yes, the franchising industry should be able to continue to develop its own solutions.</p>	<p>The franchising industry and its participants have very specialist knowledge and have managed to develop appropriate codes which do not interfere with or slow the growth of franchising in New Zealand (e.g. FANZ).</p> <p>FANZ promotes itself and is recognised by industry participants as providing badges of excellence and authenticity to qualified franchise systems. This is a good thing for the industry and serves as an excellent self-regulatory tool for members and a benchmark for best practice.</p> <p>Accordingly, it is up to a franchisee to decide whether or not it wishes to contract with a franchisor who is not a member. Franchisees must make their own decision as to whether they wish to become part of a system that is not a member. It should also be acknowledged that as part of any due diligence there is nothing stopping a franchisee from asking a non-member for the same type of disclosure provided by a member. There are always options.</p> <p>While some franchisors wish to be a part of the Franchise Association of New Zealand (“FANZ”), others do not and we should value this choice. Generally, we find that some franchisors who are not a part of FANZ have a disclosure statement or similar anyway. We also note</p>

			<p>that as an aside there are a number of franchisors who are market leaders who are not members of FANZ (e.g. McDonalds, Pak 'n' Save, Fresh Choice etc) and yet they are well respected, and offer commercially sound franchise propositions.</p> <p>There is a risk that if a central government agency takes over a FANZ type role the solutions it offers could be very academic as opposed to practical. This could slow the growth of franchising in New Zealand considerably and be seen as obstructive. Any regulation therefore has to be thoroughly considered and created in such a way that it does not hinder the growth of franchising in New Zealand. Consultation with all facets of the industry would be required.</p>
4	<p>If FANZ membership was compulsory or if franchise specific regulation was introduced, what type/level of disclosure should be required from franchisors?</p>	<p>While we support increased disclosure from franchisors we do not believe a certain level should be mandatory. We do however, believe that if FANZ membership became mandatory franchisees should be forced to seek independent legal and accounting advice prior to signing a franchise agreement (or sign a waiver that they were advised to seek independent legal advice but chose not to).</p>	<p>With increased education [through the use of their lawyer or through reading educational material (e.g. publications and materials created by FANZ)], franchisees will be made more aware of the type of questions that they should be asking the franchisor.</p> <p>By requiring a franchisee to see a lawyer, it will force the franchisee to acknowledge that entering into a franchise agreement is a serious decision to make and has long term consequences. As such, the franchisee may be more willing to ask all the necessary questions and ensure that they have all the information available to them, prior to making a decision on whether to enter into the franchise agreement.</p> <p>A lawyer will be able to explain to the franchisee precise terms of the franchise agreement, which the franchisee may not have otherwise understood, or which the franchisee has simply had a cursory glance at. One issue that we see frequently is that renewal of the franchise agreement is not automatic or that the conditions regarding the right to exercise a renewal have not been clearly set out in the franchise agreement. Frequently, we have clients who have been told by the franchisor that they have a right of renewal for their franchise. When</p>

			<p>you look at the franchise agreement however, the clause is so discretionary that there isn't much of a "right" at all.</p> <p>Given that most litigation in terms of franchising is in respect of the amount of income the franchisee is generating, it is important that every franchisee is required to see an accountant to discuss the financial figures prior to entering into the franchise agreement.</p> <p>There exists a common view that the franchisee (as a potential owner of a business) should take some responsibility for getting all the potential information that it needs to assess the business. In reality the franchisee will need an ongoing accountant and lawyer in its day to day business activities, so requiring the franchisee to do this at the beginning of the franchise relationship does not seem to be an overly harsh approach.</p> <p>The risk with a mandatory level of disclosure is the potential of it to be lengthy and over the top, essentially to the point where there is so much information the franchisee fails to understand or comprehend it. The Australian Franchising Code ("Code") is one such example of how regulation can be overly prescriptive. Indeed, franchisors in Australia have argued that the disclosure provisions are too onerous with some disclosure documents needing to be over 80 pages in order to comply with the Code. In addition, the disclosure provisions in Australia do not prevent a franchisor from including misleading information in their disclosure documents (leaving the franchisee to rely on contract law remedies anyway).</p> <p>There has been a further criticism in Australia that the Code does not require the franchisor to make any disclosure about the solvency of related entities which may affect it. If there is going to be mandatory disclosure it must be meaningful in order to justify the compliance</p>
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			<p>costs involved.</p> <p>We also note the recent regulation of Retirement Villages in New Zealand. The Retirement Villages Act, Regulations, Code of Practice and Code of Resident's rights was an initiative the purpose of which was to protect residents on entering into an Occupation Right Agreement and was promoted to operators as decreasing compliance costs (as a result of previously falling within the Securities Act 1978 regime). The industry view is that it has however, resulted in a large amount of information being given to residents which is too much to comprehend. It has also resulted in increased compliance costs for operators and increased legal costs for residents. From those who we have come in contact with, the increased level of disclosure has not assisted residents substantially in deciding whether or not to enter into an occupation right agreement. In fact, it has merely added to the cost of entry for potential residents as the level of risk to the adviser is so much higher. It should also be noted that recently the Retirement Villages Association engaged senior counsel to successfully repeal the Code of Practice on the basis it was overly prescriptive and retrospective to the extent that it sought to interfere in long established pre Retirement Villages Act contractual arrangements. We understand that this caused much uncertainty and to an extent a lack of business confidence on the part of Retirement Village operators.</p>
5	Should a cooling off period be mandatory?	Again, we believe that franchisors should have the option to choose whether to include this in their franchise agreements. If it is made mandatory however, we have no real objection provided that the cooling off period is for a relatively short period of time i.e. 7 days and that franchisors are able to retain money for reasonable expenses	While we understand that the rationale behind the cooling off provision is to avoid pressure sales, we question whether this type of clause is actually ever used by franchisees. In our experience we have not come across anyone who has relied on a cooling off provision in a franchise agreement in order to cancel it. We suggest that this type of clause is not often used and given the difficulties around the refund of money, we do not believe a provision of this type should be made mandatory.

6	Should an alternative dispute resolution process be mandatory?	As discussed above, most franchise agreements contain this type of clause in them so as to make alternative dispute resolution mandatory. The issue is essentially the type of process that must be gone through and the timing and cost of this. Likewise, the franchisor must always retain the right to immediately terminate for serious breaches where there is no legitimate dispute.	<p>If the alternative dispute mediation process is expensive and is not completed in a timely manner both the franchisor and franchisee will find themselves in a stalemate position where relations may deteriorate significantly prior to mediation actually taking place. The cost may also be prohibitive for the franchisee, especially as mediation only works if the parties can agree on a solution. Often, we see that if a franchisee is at the dispute resolution process the relationship with the franchisor has already broken down and even if a solution is agreed upon, the relationship of the franchisor and franchisee in the long term will not succeed. As such, it may be best to leave each franchisor to decide in respect of its own system whether an alternative dispute resolution clause will be inserted into its franchise agreement. Franchisees can then decide whether the alternative dispute resolution clause suits them or not. If it doesn't sit well with the franchisee then they can choose not to enter into the franchise agreement.</p> <p>The Disputes Resolution process promoted by FANZ through its Code is generally accepted as providing an effective and cost efficient means to resolve disputes. The FANZ process requires mediation as a starting point as a way of encouraging parties to amicably resolve those issues between them and so as not to allow issues to drag on and expand. Immediate relief can be sought by a party for very serious breaches of the franchise relationship.</p>
7	Should a good faith provision be inserted into franchise agreements?	Perhaps in the future but not while the New Zealand courts are still reluctant to imply a duty of good faith into franchise agreements.	<p>To insert this type of clause into franchise agreements, while the term "good faith" is uncertain, could lead to potential arguments that could not be easily solved.</p> <p>We agree that this area of law should develop in New Zealand on a case by case basis. Generally, it is our impression that franchisors as a whole will treat franchisees fairly and will not seek to create a dispute where there is none, especially so given that the reputation of the franchisor's brand is the most important asset that the franchisor has. If a dispute with a franchisee is not resolved in an amicable way,</p>

			<p>there is always the risk to the franchisor that the matter will be placed in the public sphere by media. When a “good faith” term is not specifically mentioned in a franchise agreement it does not mean that the franchisor will not treat the franchisee in good faith generally.</p> <p>Furthermore, case law has established that an obligation of good faith may be implied where specific powers are exercised under a relational contract (e.g. a franchise agreement cannot be terminated without just cause and that the power to terminate must be exercised reasonably). Again, it is our view that a <u>general</u> obligation of good faith should not be made mandatory but should be left to develop on a case by case basis through the New Zealand courts.</p>
8	Should a co-regulatory regime be implemented?	While we believe that the status quo should remain (given that any advantage of regulation does not outweigh its costs), if some form of regulation does go ahead, we suggest that a co-regulatory model may be the best and most cost effective option.	<p>We hold this view as flexibility of rules is important and we agree that there are a number of professionals within the franchising industry who have a vast amount of experience. We also believe that this model would be the least expensive and if action is going to be taken we suggest that the Code of Practice be made mandatory (provided it does not change substantially from its current form). Throughout the discussion document it appears as though the main issue is one of disclosure and perhaps making the Code of Practice mandatory is the first step to resolving this. Whether this equates to making FANZ membership mandatory is.</p> <p>Perhaps the best option, if regulation is deemed necessary, is for FANZ to work in association with an independent regulatory body in order to create appropriate franchising laws. For example, the Retirement Villages Association works closely with the Department of Building and Housing in terms of developing regulation for the retirement villages industry. In addition, a Franchising Commissioner could be appointed to oversee the operation of the regulators and perhaps take on a watch-do role for industry problems, with a team of people under him (one such person being a representative of FANZ).</p>