



27 November 2008

Review of Franchising Regulation  
Ministry of Economic Development  
PO Box 1473  
Wellington 6140

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Dear Sir/Madam

## **Review of Franchising Regulation New Zealand - McDonald's Restaurants (NZ) Limited ("McDonald's")**

### **1 Introduction**

- 1.1 We wish to make the following submissions on the Review of Franchising Regulation Discussion Document dated August 2008 ("**Discussion Paper**").
- 1.2 We consent to officials contacting us about our submissions to discuss the points raised and confidentiality is not sought on any part of these submissions.

### **2 General Comments**

- 2.1 As a leading worldwide franchisor, McDonald's is not adverse to government regulation of the franchising industry in principle, but questions whether there is a legitimate need for regulation in New Zealand at this time.
- 2.2 We agree that there may be some limited benefits to the franchising industry if regulation was adopted. However, we wish to express our concern that it is apparent that the prime motivator behind the consideration of the need for a greater degree of legislative control, is what appears to be a small number of isolated incidents, ie the Green Acres case (which involved allegations of fraud, currently under investigation by the Serious Fraud Office), that became very high profile and arguably sensationalised by the media. If there are issues with disreputable franchisors who participate in "churning",<sup>1</sup> additional disclosure will still not solve the core issue.
- 2.3 We are of the view that change should only be adopted if there are significant deficiencies within the industry, and the implementation of such a change would benefit the overall position of franchisees and franchisors. We caution that the catalyst for change should not be driven by the desire to improve public confidence in the franchising industry. We do not wish to discount the importance of public perception, or the need to protect the integrity of

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<sup>1</sup> "Churning" is defined as the excessive buying and selling of valueless franchises simply for the purpose of generating revenue from commissions.

franchising as a successful business model. Nor should the many ethical and responsible franchisors be penalised for the actions of a few unscrupulous operators. Further, any additional compliance costs will be ultimately borne by consumers.

- 2.4 Importantly, we believe that the reported cases, were isolated incidents and not indicative of deficiencies within the industry. We believe that the current system is working well. However, we welcome the Discussion Paper and the opportunity to participate in this review (which to our knowledge is the first time a formal industry assessment has been conducted at national and government level).
- 2.5 An important point to note, and which we expand on below, is that, while being a method for organisations to conduct business, franchising it is not an industry in itself, but more correctly, a sector. The issues facing the broad spectrum of industries that use a franchise model are very diverse, as explained further.
- 2.6 If the primary issue faced in New Zealand today within the sector is one of “churning” by disreputable franchisors, then we respectfully submit the law should be applied that currently exist, under existing legislation, for example, the Fair Trading Act.

### 3. Questions for Submitters

- 3.1 For ease, in the table below we have replicated the 10 submission questions and inserted our responses:

<b>Question 1 - Are there any particular features about franchise contracts that mean that potential and existing franchisees require further protection?</b>	
a	We acknowledge that franchise contracts cover a spectrum of industries, products and services. The breadth of the industries involved in the sector are such that it involves many strands of business principles and issues (namely, property and equipment leasing, intellectual property, information technology, product and service distribution, operational issues, business conduct and format issues, staff recruitment and training matters etc). Therefore it is difficult, if not impossible, to extract features particular only to franchising contracts that can be isolated as factors that increase the exposure of franchisees.
b	This leads on to a significant issue of possible regulation (as correctly recognised in the Discussion Paper) namely; <i>How do you accurately capture a definition of franchise?</i>
c	In light of the breadth of franchise contracts and models, any statutory definition would need to be non-specific and wide. However, this needs to be finely balanced against the adoption of a definition that will capture businesses, who are not and do not consider themselves, part of a franchise arrangement. This would alter the landscape of small business, adding another dimension of regulatory compliance, which would, in our view, outweigh any benefit a franchisee may obtain through regulation.

- d At a practical level, we raise the question of what additional “protections” would be introduced that are not already covered within existing law? Franchising is still, first and foremost, a contractual arrangement and accordingly has all of the benefits of contractual protection legislation and common law principles (spread across the following legal spectrum; business, consumer, contract, intellectual property and competition).
- e Another important issue we wish to flag here is the presence of the Franchise Association of New Zealand (“FANZ”), which has the membership of approximately 50 per cent of all franchise systems within New Zealand. Although McDonald’s is not a member (as we have our own internal operational standards and systems), we acknowledge the benefit of the FANZ presence in the sector. This system of optional self-regulation provides a measurable standard and benchmark, with an increasing public profile, providing a “de facto” regulatory benchmark. Public awareness of FANZ is increasing with availability of data and practice codes. Undoubtedly, the current self regulatory regime is valuable and effective, even where membership of FANZ is optional.
- f To summarise our answer to this question; there appears to be no compelling reason to single out franchising, and, more particularly, all the reputable industries and organisations that utilise it, as we cannot identify particular features specific to franchisees that require further protection. We suggest that if there are deficiencies, those deficiencies are apparent right across the SME (small to medium size) business sector. We do not consider that there is any compelling reason to single out franchising from other industries.

**Question 2: Have the problems been defined correctly? Are there other problems?**

- a In response to this question, we think that on the contrary, the problems highlighted have been given more weight than they deserve.
- b The Discussion Paper raises the issue of possible fraud in franchising arrangements which suggests the current regime around all types of franchising may be open to abuse. As noted, the release of the Discussion Paper arose due to fraud allegations involving the sale of ‘phony’ Green Acres’ ironing franchises. The allegations are currently under investigation by the Serious Fraud Office. Interestingly, issues surrounding fraud have been largely excluded from the scope of the Discussion Paper, as the Ministry of Economic Development considers protection and mechanisms to deal with fraud are sufficiently covered by existing laws.
- c Other problem areas raised by the Discussion Paper are; information disclosure, dispute resolution, contractual power imbalance, lack of good faith. Again we suggest that these issues do not provide sufficient reason in themselves to encourage the development of a more prescriptive legislative framework
  - i. **Information Disclosure:** We agree that mandatory information disclosure can provide benefits of transparency and a greater understanding of the franchise system. However, just as we use the common phrase in the context of consumers, “let the buyer beware”, there must be an element of

responsibility upon any prospective franchisee to collect all of the facts before entering into a franchise arrangement, just as any potential purchaser of a business, partakes in a process of due diligence. We also note that many franchisors (including FANZ members) commit to full disclosure. Interestingly, often the root cause of problems is not as a result of lack of information, but the accuracy of the information supplied. In these situations, current New Zealand laws contained within the Fair Trading Act 1986 and the Contractual Remedies Act 1979, assist.

- ii. **Dispute Resolution:** The perceived problem of the inability of franchisees to obtain access to adequate dispute resolution (ie, justice) for contractual disputes is inaccurate. We suggest that there is ample access to a variety of dispute resolution mechanisms. Most commercial contracts now include robust processes to encourage resolution of disputes, with the issue of legal proceedings being a last resort.
- iii. **Contractual Power Imbalance:** The complexity of franchise contracts is such that it naturally results in and requires an imbalance of contract power in favour of the franchisor. This was outlined in the Discussion Paper as one of the perceived problems within the industry. We are of the view that the contract power must reside with the franchisor because:
  - A Intellectual property (ie, brand protection, and goodwill in intellectual property) is essential not just for the franchisor but for all franchisees and the system. This is one of the benefits to acquiring a franchise.
  - B There is a need to consider the wider interest of the franchise system, not just the interests between the franchisor and an individual franchisee.
  - C A necessary component of a strong and successful franchise system is the flexibility available to the franchisor through a strong contract position.

This gearing is essential for the protection of the franchise business format itself. A successful franchise has the components of a recognised brand, a proven and uniform operating system, consistency and predictability and, therefore, a very specific formula for business operations. The prescriptive nature of a franchise is the reason it is successful and the reason it is attractive to prospective franchisees in the first place. Regulation would try to adjust any imbalance with negative consequences. Imposing statutory requirements for franchise agreements is contrary to the fundamental principle of freedom of contract. Perceived issues of "contractual imbalance" need be addressed on a case-by-case basis and individual rogue operators need to be dealt with individually.

- iv. **Good Faith Requirements:** The issue of good faith was raised in the Discussion Paper. The counterfactual to this concept is the notion of "unconscionable conduct". This is currently being reviewed by the Ministry

of Consumer Affairs as part of general review of the Fair Trading Act. The issue of "good faith", if up for consideration, should be part of the broader contract law review, not just specific to franchising, and be reviewed and evaluated in accordance with decided cases in the franchising area.

- d As a general comment, we are of the view that problems are rare and there are not specific issues that can be identified, as a recurring problem, and symptomatic of the current system, but for the examples of illegal behaviour by a few franchisors.
- e Where there are problems, it appears that these issues relate to very individual matters ie, specific product or service problems, individual problem operators etc. To some extent, this makes the task of legislating impossible. The reality of business is such that operational problems will always exist.

**Question 3: 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?**

- a We have largely addressed this issue in our response to question 2 but as indicated in the Discussion Paper, we agree that the issues highlighted are not widespread.
- b If problems were widespread then, as a result of the inter-relational nature of franchising and interdependence amongst franchisees created by franchise systems, we would see many more failed franchise systems and more aggrieved franchisees, and those franchisees working as a group to right the wrongs.
- c As previously mentioned, it is impossible to ring-fence problem issues specific only to a franchising model. Any problems are symptomatic of business and business relationships in general.

**Question 4: Which of the options outlined do you favour? Why?**

- a McDonald's supports retention of the status quo, namely the mechanisms of:
  - i Regulation to the extent of existing current commercial laws which, in our view, are sufficient and provide a robust form of protection for franchisees; and
  - ii The continued presence of FANZ in the market place and non-compulsory self regulation regime.
- b This unobtrusive approach is effective, flexible and low cost.
- c We have concerns as to the intention behind regulation. Benefits from legislation would be largely for the public perception of the franchising sector as an "industry". We caution that this is not a reason to regulate.
- d There is no compelling reason to single out the franchising sector from other sectors. The "status quo" system of regulation through New Zealand's existing business laws and FANZ adequately protects the New Zealand's franchising sector.
- e The issue of further education was raised in the Discussion Paper. We cannot

discount the benefit of education and its benefits. We believe education would be a better investment of resources than regulation. Knowledge is all important and problems (across all sectors, not limited to franchising) could be avoided by a better understanding of franchising and the individual aspects of a particular franchise. A consistent and uniform education plan would need to be rolled out and targeted at all groups within the industry. An educated franchise sector is clearly of benefit to society and the national economy as a whole. Greater education of potential franchisees as to the meaning of franchising and its benefits and pitfalls could assist in minimising problems in the franchise sector.

**Question 5: Have all the options (and sub-options) been identified? Are there other options (and/or sub-options) that should be considered?**

Yes, we believe that all of the issues were adequately raised in the Discussion Paper.

**Question 6: If information disclosure is to be introduced, which classes of information should be required to be disclosed?**

- a As an introductory comment to this question, we would suggest that the information should be required to be presented in a manner that can be easily read and understood by a wide range of people.
- b Information disclosed should be similar to the process of disclosure given during a typical due diligence, ie, a combination of historical information, details of the franchisor, financial data, future projections etc.
- c For example, in our Australian business there is a need to disclose in accordance with the Franchising Code of Conduct which is mandated by the Trade Practices Act. This disclosure requires considerable information, most importantly about the business experience of the franchisor.

**Question 7: What are the benefits of each of the Options (including further options)?**

- a As McDonald's has a preference for the status quo, we specify the benefits for the status quo as follows:
  - i. This is seen as the simplest option in the future.
  - ii. It does not create any additional cost to government or the franchise sector.
- b One issue of note is that, given the economic climate, it would not be a good time to add an extra level of regulatory requirements, which ultimately soak up added resources. Such costs ultimately are borne by the franchisee and, in turn, the consumer.

**Question 8: Costs and risks of each option**

- a Status Quo:
  - i. This option brings with it no additional cost.

- ii. The risks are that standards within the franchise sector in terms of documentation, pre-contract disclosure and dispute resolution are varied and subject to current business law practices, but on the other side, this is no different to any contractual negotiation or arrangement.
- b Education:
  - i. Costs need not be large if standardised information for dissemination to franchisees were used, eg standard due diligence check lists and plain English franchising guides. Costs would include preparation and dissemination of materials.
  - ii. Risks relate to poorly targeted education inappropriate for the parties and situations involved. Potential franchisees with poor education, business understanding or language skills may miss the opportunities available through education without greatly increased cost and effort. Education needs are also often specific and general information may not suffice.
- c Franchise specific legislation:
  - i. Any new franchise specific legislation will result in compliance costs for all members of the sector, which will largely be passed on to franchisees and then, ultimately, to consumers. Costs would be incurred in documenting compliance systems, professional advice in achieving compliance and increased compliance costs presumably including paying for sector compliance monitoring.
  - ii. The risks of franchise specific legislation include:
    - poor targeting due to a 'one size fits all' approach given the range of industries involved
    - uncertainty as to compliance requirements and enforcement at least initially
    - a sector slowdown at least initially due to uncertainty but possibly ongoing
    - ongoing amendment to regulation in response to specific concerns, perhaps in one industry, increasing cost and uncertainty.
- d Enforcement cost and risk:
  - i. A co-regulatory regime would require its establishment, ongoing operation and scrutiny all at a cost which may well be beyond the ability of most franchisors to fund. A co-regulatory regime has the greatest ability to meet sector needs and to be responsive to those needs as they change. However, there are risks of sector 'capture' of such a regime and resulting in poor public confidence in such regulation.
  - ii. A public enforcement regime is quite possibly the least costly option if an

existing public sector agency such as the Commerce Commission was tasked with such a function. Additional resources would be required by such an agency but only within an existing organisational framework.

**Question 9: Compliance cost estimate**

Recently, in Australia there was a review of the disclosure provisions in the Franchising Code of Conduct. This resulted in amendments to the Code in March 2008. The simple costs incurred in updating the Disclosure Document which was the result of these changes resulted in a cost to McDonald's Australia of some \$150,000. Given the franchise sector in Australia has some 1000 franchisors, the overall cost to the sector was significant. If this was to be done from scratch in New Zealand, the costs would be relatively expensive.

**Question 10: Potential conflicts of law for each regulatory option with existing laws such as those applying to securities and companies.**

- a Potential conflict areas include:
  - i. **The Financial Advisors regulatory regime:** Care would need to be taken to ensure that the activities of franchisors in selling franchises and generally advising franchisees on their business operations would not be covered by laws relating to financial advisors.
  - ii **Securities Act 1978:** Existing exclusion of franchise system schemes from the disclosure requirements e.g. the Securities Act would need to be considered and maintained.

**4. Conclusion**

- 4.1 McDonald's does not consider there is any need for specific laws to govern franchising in New Zealand. Any implementation of new regulatory requirements in this current economic climate may cause more harm in the short-term, due to added costs and the uncertainty of a settling in period associated with any new regime.
- 4.2 Although there may be some benefits to legislation, the overall benefits are not of sufficient magnitude to warrant a change at present.



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