

MINISTRY OF ECONOMIC DEVELOPMENT

Discussion Paper on Franchising – November 2008

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EXECUTIVE SUMMARY

- Whilst there is no pressing need to regulate, on balance there may be an advantage to have uniform standards in the industry.
- We favour a measured approach.
- Informed education, cooling off, enhanced dispute resolution and some contract regulation are helpful.
- Mandatory disclosure must only be implemented if done in a thoughtful way. Correcting imbalances in understanding is not achieved by insisting that a formidably long and detailed disclosure document is thrust in front of unsophisticated franchise purchasers.
- An independent government body is best to act as regulator.
- Most importantly informed independent advice should be mandated, with a sign off required.

INTRODUCTION

Franchise agreements are now widely recognised as “relational” contracts. The mutual bargain encapsulated by the agreement is strongly dependent on personal interrelationships, in the same way as partnerships or joint ventures. In our view, therefore, prospective franchisees need to understand the dynamics of the relationship as much as they do the contract itself.

In any business purchase a careful analysis by the purchaser of all relevant factors (otherwise known as due diligence) is vital before committing. Recently publicised disasters such as the Greenacres ironing scam could have been avoided if the purchasers had made appropriate enquiries before investing.

In our view any suggestion that we should only feel the need to ensure full documentary compliance without caring whether the prospective franchisee has the wit or the wherewithal to make good use of it is akin to shovelling dirt under a carpet. Any response to a perceived need to regulate ought to first identify the wrongs which need rectifying then undertake the best possible attempt to right those wrongs. If the wrongs identified are uninformed business purchasers getting into difficulty because they did not understand what they were buying then the solution must be to do all possible to ensure they do understand. It is apparent to us, by way of reports from Australia that the mere supply of a lengthy disclosure document is unlikely to achieve this purpose-albeit that it would seem to be the standard response internationally.

As we understand it the Australian experience has been that disclosure documents, which have become formidable literature in their own right, are seldom read and understood by those in greatest need of protection. The sheer size and detail of the documents risks the process becoming a deterrent to correcting the information imbalance, rather than the cure it is apparently intended to be.

We are not suggesting that disclosure as a concept is flawed, but rather that it should be a carefully honed tool which should be used in combination with other initiatives

such as education programmes and compulsory advice. That advice should be given by professionals who have a sufficient understanding of the franchising dynamic to be able to impart useful and practical advice. The process could require a formal sign-off (in much the same way as property relationship agreements) to prove that independent advice has been given. Some franchise systems have compulsory question and answer sections which ensure that franchisees have addressed certain necessary pre-contractual checks. This includes statements about what they do and what they do not rely upon by way of pre-contractual representations. This type of process could be a legislative requirement to help ensure that adequate due diligence is carried out.

One important component of pre-contractual due diligence is the franchisee making contact with existing and past franchisees of the franchise system. This is currently a somewhat contentious issue in Australia, however we know of a number of situations in franchising where unscrupulous franchisors have got away with misrepresenting the health of their system, but would not have succeeded in doing so if other franchisees had been consulted by the prospect. (Recently Fair Go reported an apparent example of "churning", where a territory was repeatedly sold as a new territory despite a number of failures and "repossessions". Undoubtedly other franchisees of this system would have been aware of these failures and, if consulted, could have warned off the purchaser. We are also aware of another system where all the franchisees were in dispute with the franchisor. One however managed to sell out during this time, with the purchaser buying into a dispute they could have been warned off.) This requirement might be limited to recently departed franchisees only, as in larger systems it may be very difficult to keep records of all former franchisees.

Questions for Submitters

(Answers appear in order below)

Question 1 – Are there any particular features about franchise contracts that mean that potential and existing franchisees require further protection?

Often franchise contracts are made between experienced and well-funded entrepreneurs and wide-eyed naïve first-time business owners. The franchisor requires strict adherence to a very fulsome and prescriptive contractual matrix including a franchise agreement, and a franchise manual, which is able to be reviewed from time to time. This seems at first a very one-sided and unfortunate business arrangement, although for uniformity of quality (such as by way of example ingredients and taste of a Big Mac), there does need to be a requirement to stick with the rules. Nevertheless it would on the face of it seem clear that franchising in particular is an area of business where there is potential for an abusive relationship. It should not however be assumed that all participants behave in this way. Many franchisors are well-intentioned and genuinely concerned about the welfare of their franchisees. Sometimes franchisees are in a stronger bargaining position than franchisors, although this would be the exception rather than the rule.

Often franchisors and master franchisees are through economic necessity very sales driven and in the case of master franchisees there may be sales targets to meet. There is a hefty "front end" capital requirement to set up a franchise system and it must often be very hard to resist a sale even though the purchaser/franchisee may well be unsuitable. A sales driven culture is highly inappropriate in a franchise support office because the franchising model promotes an ongoing mutually beneficial relationship as a key benefit for franchisees. A quick sale at the expense of a quality ongoing relationship is in our experience too often the outcome of a pressured recruitment programme.

Care does need to be taken however to ensure that protections are prescribed in a thoughtful way. Overprotection would defeat the flexibility needed for effective and dynamic business development. Protective measures should not stifle or overburden the industry with cost. Protective measures should seek to enable franchisees to make well considered and informed decisions. Over-prescriptive compliance regimes would in our view most likely hinder rather than help these goals. Any protective measures which are legislated for should target the most effective rewards for the least cost to the industry.

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

In our view the main problem to be addressed is not so much an information imbalance, as an understanding imbalance. An oversupply of information may not help understanding.

These things could be achieved through emphasising better education and advice, not only about the legal contracts but also more importantly about the business decision, and understanding the best way to make good use of the relational framework of the franchising opportunity.

Another area of concern that should be considered is protection of franchisees where a franchisor has become insolvent. Their needs will be much the same as subtenants when a superior lease is lost-and in fact they will often be subtenants or licensees of the Franchisor or a related company.

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?

It is fair to say that there may be less chance of an imbalance of expertise capital and business intelligence with large and more complex franchise systems (eg McDonalds as compared with Greenacres ironing). However in our experience franchising disasters appear in all sectors. Poor decision-making by prospective franchisees about suitability and capital needs, and a lack of frankness by franchisors more focussed on selling than a longer term relationship are very common causes of failures. In our experience they occur amongst all types of franchised businesses.

In our view there should be no attempt to identify one industry type or size of transaction for assistance in preference to others. It is best to have one regime, so that exceptions do not slip through the net.

Question 4 – Which options of Outline B do you favour? Why?

Although there is a good argument for maintaining the status quo (given that there is not currently a pressing need for reform), there are more reasons to legislate for a standardised regime throughout the industry and if there can be a relatively low impact process to better protect franchisees against poor investment decisions then there is a worthwhile social outcome. So if there are to be reforms we favour a combination of mandatory disclosure (but in the format suggested in answer to question 6 below), cooling off, education, and advice, with some minimum contractual requirements – including disclosure and dispute resolution (mediation). The reasons for these choices appear below and in the introduction to this paper.

In addition to this we would like to see consideration given to ensuring that qualifications are required for independent advisors (both legal and financial). Uninformed advice (as may often result where a less sophisticated or funded franchisee seeks advice from an advisor without relevant knowledge or experience) may often serve the client very poorly. Also there could perhaps be a sign-off in the question and answer format to ensure that effective due diligence measures have been undertaken. This should include interviewing a number of existing and past franchisees selected by the franchisee from a list provided by the franchisor. We are concerned to see that information should not only be provided, but that the franchisee should be helped to make good use of this information.

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

We think that the options and sub-options (but with additional enhancements suggested in Questions 2 and 4) cover the range of options which should be considered.

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

In our view the process of compulsory disclosure of information should be kept as simple and easy to digest as possible. In our experience potential franchisees who are presented with a disclosure statement as formidably long and detailed as the franchise agreement itself are quite likely not to read any of it. An alternative arrangement might be considered:

To capture the attention of a novice there could perhaps be compulsion for a Franchisor to ensure they had supplied an easy to read information sheet, rather than a dry lengthy disclosure document. This sheet might be similar in content and presentation to ACCC information pamphlets with a purpose of informing the reader about effective due diligence, discussing the purchase with other franchisees in the system, and independent legal and accounting advice. They would be told that a detailed Disclosure Statement would be available on request and that its contents are an important component of due diligence. Whilst the franchisor would be obliged to have a disclosure statement available the franchisee could choose whether or not to access it.

The purpose of this approach would be to avoid the initial intimidation factor which comes with a weighty document, and hopefully a better understanding of its importance may result.

The Disclosure Statement itself could generally follow the current Franchise Association of New Zealand ("FANZ") model.

Question 7 – What are the benefits of each of the options (including any further options)?

With regard to the options proposed:

Option 1 – Status Quo – Generic legislation and self regulation

In our view there is a lot to be said for maintaining the status quo. We do not see that there is a crisis of any kind. Although there may have been some bad experiences which have recently been publicised in the press, franchising is, by comparison to many other areas of commerce, relatively scandal free. Probably the main downside to the current environment is that the protections offered by FANZ are not universally available. There are many large franchisors who do not believe that there is any great benefit to belonging to FANZ. Also any number of players at the other end of the scale, some perhaps operating on the fringe, may not have the resources or the desire to follow this regime.

Option 2 – Education

We think education is very important. Effective education and proper advice/due diligence would probably have helped prevent the recent Green Acres frauds, though acknowledging the language barriers some information may need to be translated into other languages. We believe there is merit in ensuring that before any franchisee can enter into a franchise contract that they are made aware not only of contractual and legal issues, but more importantly of the nature of the franchise relationship itself.

Option 3.1 – Franchise specific regulation

We see the benefits of franchise specific regulation as ensuring that all franchise systems are required to be part of the same regime. We do however have concerns about the high degree of documentation required to make disclosure and whether that really provides effective protection for franchisees. If inflexibly applied it has the potential to cause an injustice to franchisors. In our view overly detailed disclosure is quite likely to be self defeating, and there should be much emphasis, if this is to be legislated for, on ensuring that only simple key information is required to be provided. A compulsory education framework should be an influential component.

Option 3.2 – Mandatory professional advice

This is in our view one of the most important areas for reform. Whilst there is a cost impact, unless potential franchisees have a clear understanding from professionals who actually understand not only the law but also the nature of the industry, they risk entering into a relationship that they do not fully understand. As a consequence key expectations may be mismatched and that more often than not is a recipe for failure.

Option 3.3 – Cooling off period

We believe that the cooling off process which is provided by the FANZ Code of Practice has real merit, although it is by no means a “cure all”. In our experience however not a great many franchisees cool off within the seven day period. It often takes a bit longer than that. Nevertheless this is an added safeguard, which should not be removed. For contractual certainty however the cooling off period should not be too long. Cooling off might not be necessary if any preliminary agreement entered into had a due diligence condition which allowed the potential franchisee to investigate the offering before committing. We would ordinarily recommend 3 weeks of due diligence.

Option 3.4 – Enhanced dispute resolution

The mediation process provided for by the FANZ Code of Practice also has real merit. As a process for resolving disputes, mediation is, in our experience, often very effective. Having said this, mediation will not resolve a “disaster” situation which might arise where a poor decision has been made at the outset. Mediation is a voluntary process and will not be effective unless both parties genuinely seek resolution. Mediation is useful where there is a franchisor able to buy out a franchisee, or to assist a franchisee to sell. The process very often becomes a forum to facilitate “exit” negotiations. By the time formal mediation is resorted to there is often an irreparable relationship breakdown. There are exceptions to this, but in our experience it is often the case that once franchisor and franchisee get to a mediation table there is no way back for the relationship.

Option 3.5 – Rules for franchising contracts

Statutory minimum requirements in franchise contracts are quite probably a good idea, provided those minimum requirements are sensibly drafted, and there is flexibility built in. As noted there is no suitable “one size fits all” template. Franchise Agreements can be tailored around a template but will always need customising to meet the peculiarities of the relevant industry and offering. Rules could require (as FANZ do) cooling off, mediation, and obligations to comply with the FANZ code. There could be more extensive requirements including a prohibition of certain types of onerous clauses (as in Australia) however care needs to be taken not to interfere too much in the contractual bargaining process.

Option 3.6 – “Good faith”

We have concerns about the concept of “good faith”. It is a very hard concept to define, and probably its meaning differs depending on the perspective of the “beholder”. We would always see danger in requiring either party to always act in good faith, as this type of provision can be inappropriately used as a weapon. (It is then too easy to allege lack of good faith, then justify cancellation based on the claim). Many people confuse behaviour which is not agreeable to them with a lack

of good faith. Unless the term has a very clear and well-defined meaning, in our view its use in contracts is potentially more harmful than useful.

It is understood that there are some potentially influential case law and legislative references to assist definitions of good faith and its Australian cousin "unconscionable conduct" however we have difficulty with a legislative requirement that has uncertain application. The term might through a process of judicial interpretation achieve greater precision however that process will exact a toll on the "guinea pigs".

Option 3.7 – Co-regulatory regime

In our experience FANZ is operating well for its members. Having had an active part in the Franchise Association for many years, the writer has personally experienced the benefits of this organisation. However compulsory membership, whilst having the benefit of mandating compliance to its rules and Code, may in our view also substantially weaken the value of membership. As a voluntary organisation where members must qualify on the basis of minimum standards, membership is held out as a badge of market credibility. A requirement for membership by all market participants must dilute the average quality of members and negate the value of members holding out membership as a form of accreditation.

Option 3.8 – Other institutional options

Any standards which the Government felt needed to be enforced would in our view best be policed through a statutory body. An institution in the nature of the Commerce Commission or a franchise specific body or branch of the Commerce Commission, operating in a similar way to the ACCC would we believe be much better for the enforcement of industry standards.

Question 8 – What are the costs and risks of each of these options?

For an institutional or co-regulatory option the cost in setting up an appropriate institution could no doubt be substantial.

As the main theme of this submission is the need for limited disclosure, and suitable professional advice, the cost of that advice is certainly a potential barrier. For those lawyers who regularly advise new franchisees the average fee (which is cost recovery only) is usually in the region of \$1,000 to \$1,500. Sometimes more than this where the transaction or documents are particularly complex. Franchise Agreements are by nature long and detailed. They must be read and explained. Advice on due diligence and the nature of the franchise relationship is also essential.

This cost is quite a substantial barrier for a new business purchaser, particularly where it is a low value proposition. However in our view effective advice would likely have prevented the Greenacres debacle. Failure to carry out proper due diligence is the reason for many business failures, not just in franchising.

In our view the risks with the various options set out above are generally as indicated. We do however see a risk in legislating in an over prescriptive way. If a compulsion to provide lengthy and detailed information is the end product then that might be a counter-productive initiative, particularly so for less sophisticated franchisees. Inevitably compliance comes at a cost to the franchisor and is therefore a drain on the financial resources of the industry as a whole. There is criticism of this nature in Australia.

Question 9 - Can you give any estimates of the compliance costs associated with the options?

As above the compliance costs in providing legal advice are generally fairly high. They may at times appear to be out of proportion to the value of the transaction entered into. There can be difficulties for franchisees in paying for this advice, although possibly there could be some form of state funded allowance or subsidy.

Question 10 – With any of the regulatory options discussed are there potential conflicts with any existing law such as Securities Law or Company Law?

It has occasionally been argued that a franchise agreement contract is a “security” within the definition of the Securities Act. This argument has not however found favour amongst the legal fraternity, that we are aware of. In any event a requirement to comply with the Securities Act would be cost prohibitive, and therefore in our view not a very useful development. We do not in any event believe that doing so would provide any significant benefit to potential participants. Other laws and regulations affect franchising in a peripheral way however in our view there are no conflicts with existing laws that would prevent any of the options proposed from being implemented in the manner contemplated.

SUMMARY

In summary we favour a measured approach to regulation. There is an argument for regulating the industry to try to minimise the chances of new franchisees entering into the industry unawares. Education, provided it is well informed, is important. Cooling off, enhanced dispute resolution facilities, and a degree of contract regulation are also helpful ideas. In our view mandatory disclosure can be counter-productive if it is not done in a thoughtful way. Information required should be carefully targeted, minimal and presented in a user-friendly format. However franchisors should still be required to have available a disclosure statement along the lines of the current FANZ format. Any regulations in our view would be best administered by an independent government department (which itself might be advised by industry experts).

In our view the most valuable tool for an inexperienced entrant into franchising is effective professional advice. Informed advice from lawyers and accountants would not only help them understand the franchise contract and financial business modelling but also (more importantly in our view) give them a “heads up” understanding of how best to profit from the unique business relationship they are about to enter into.

For any further clarification or discussion about this submission please feel free to contact Chris Bradley at Duncan Cotterill, contact details being recorded below.