Aspects of International Franchising in Relation to New Zealand

SGL
STEWART GERMANN LAW OFFICE
Lawyers, Notary Public

Partner

Stewart Lloyd Germann
B.Com, LLB, FCIS, CFInstD, Notary Public

Ground Floor, Princes Court
2 Princes Street, PO Box 1542
Auckland, New Zealand

Telephone 0-9-308 9925
Facsimile 0-9-308 9922
Email stewart@germann.co.nz
Web www.germann.co.nz

New Zealand is an exciting and fast developing market in relation to franchising. Considering that the population of New Zealand is about 4.4 million and there are over 350 systems, there is one system for every 12,000 people which is very high in my opinion. Why? The answer is because New Zealanders love brands and businesses which succeed and franchising offers people a chance to leave the security of employment and purchase a franchised business which should succeed provided the system is followed.

Legal Position

There are no franchising specific laws in New Zealand. However, as you would expect, there are existing laws which protect franchisees and probably the three main laws which give such protection are the Fair Trading Act 1986, the Commerce Act 1986 and the Contractual Remedies Act 1989. Those Acts focus in particular on misrepresentations and restrictive trade practices. Although New Zealand does not have franchising legislation at this time, the New Zealand Government may be looking to introduce some legislation this year. It is bound to be some law in relation to a mandatory disclosure régime which follows overseas countries like Australia and USA.

There is no mandatory disclosure régime in New Zealand but there is the Franchise Association of New Zealand (FANZ) which was formed in 1996 when New Zealand broke away from the Australian Association.

The FANZ publishes the Code of Practice and the Code of Ethics and all members of it must comply with both Codes. The Code of Practice has four main aims which are as follows:

1. To encourage best practice throughout franchising.

2. To provide reassurance to those entering franchising that any member displaying the logo of the FANZ is serious and has undertaken to practise in a fair and reasonable manner.

3. To provide the basis of self-regulation for franchising.

4. To demonstrate to everyone the positive will within franchising to regulate itself.

The Code applies to all members including franchisors, franchisees or affiliates such as accountants, lawyers and consultants and all prospective new members of the FANZ must agree to be bound by the Code before they can be considered for membership.

In my opinion there are three types of franchisors in New Zealand being:

(a) Those franchisors who belong to the FANZ and agree to adhere to its Code of Practice and Code of Ethics;

(b) Those franchisors who are ethical but who elect not to belong to the FANZ; and

(c) Franchisors who are not ethical and who do not belong to the FANZ. It is this last category of franchisors who need to be stopped and their numbers are diminishing thanks in part to the growth of the FANZ in the franchising grapevine in New Zealand. The public has become far better educated in relation to the purchase of franchises and many potential purchasers are put off now if a franchisor does not belong to the FANZ.

What Does the Code Cover?

1. **Compliance -** all members must certify that they will comply with the Code and members must renew their certificate of compliance on an annual basis.

2. **Disclosure -** a disclosure document must be provided to all prospective franchisees at least 14 days prior to signing a franchise agreement. This disclosure document must be updated at least annually and it must provide information including a company profile, details of the officers of the company, an outline of the franchise, full disclosure of any payment or commission made by a franchisor to any adviser or consultant in connection with a sale, listing of all components making up the franchise purchase, references and projections of turnover and possible profitability of the business.

3. **Certification -** the Code requires franchisors to give franchisees a copy of the Code and the franchisee must then certify that he or she has had legal advice before signing the franchise agreement.

4. **Cooling Off Period -** all franchise agreements must contain a minimum 7 day period from the date of the agreement during which a franchisee may change its mind and terminate the purchase. This is very important and the cooling off period does not apply to renewals of term or resales by franchisees.

5. **Dispute Resolution -** the Code sets out a dispute resolution procedure which can be used by both franchisor and franchisee to seek a more amicable and cost-effective solution. The Code requires all members to try to settle disputes by mutual negotiation in the first instance and this process does not affect the legal rights of both parties to resort to litigation.

6. **Advisers -** all advisers must provide clients with written details of their relevant qualifications and experience and they must respect confidentiality of all information received.

7. **Code of Ethics -** all members must subscribe to the Code of Ethics which sets out the spirit in which the Code of Practice will be interpreted.

All franchisor members of the FANZ must have a Franchise Agreement which contains a dispute resolution clause and a cooling-off provision. In order to resolve disputes, mediation is the favoured method and is working very well in New Zealand. It has a high success rate in relation to franchising disputes and that is probably because both parties respect each other and wish to continue their relationship. However, if mediation does not work then there is always litigation which is certainly at the divorce stage of the relationship.

Definition of Franchising

The definition of "franchise" as contained in the Rules of the FANZ is as follows:

"Franchise" means the method of conducting business under which the right to engage in the offering, selling or distributing of goods or services within New Zealand includes or is subject to at least the following features:

- the grant by a Franchisor to a Franchisee of the right to the use of a Mark, in such a manner that the business carried on by the Franchisee is or is capable of being identified by the public as being substantially associated with a Mark identifying, commonly connected with or controlled by the Franchisor; and

- the requirement that the Franchisee conducts the business or that part of the business subject to the Franchise Agreement, in accordance with the marketing, business or technical plan or system specified by the Franchisor; and

- the provision by the Franchisor of ongoing marketing, business or technical assistance during the term of the Franchise Agreement.

Consideration should also be given to the definition of a Franchise Agreement which "means a contract, agreement or arrangement, whether express or implied, whether written or oral, between two or more persons by which one party to the agreement ("the Franchisor") grants, authorises or permits the other party to the agreement ("the Franchisee") the right to operate a Franchise. Any contract, agreement or arrangement which purports to be a Franchise Agreement shall be deemed to be a Franchise Agreement for the purpose of this definition, notwithstanding that it may lack any or all of the requirements or attributes referred to in the definition of "Franchise".

International Aspects

New Zealand encourages and welcomes overseas systems whose current master franchise agreements or unit franchise agreements usually need minor amendments. For example, the restraint of trade clause, legislation and the governing law clauses are the usual areas where changes need to be made.

Professional taxation advice should be obtained and New Zealand has Double Tax Agreements with numerous countries overseas, including USA, UK and Australia. These Agreements generally limit the taxing rights of each country (depending on the type of income derived) as well as helping to reduce double taxation. For example, most Agreements limit the foreign country's tax on royalty payments to 10%. Accountants have a key role to play in relation to franchising.

Good Faith

Contract law governs the legal relationship between the parties to a franchise agreement. The Courts in New Zealand may be willing to imply a duty of good faith into franchise agreements which stems from an overseas trend to imply such a duty because of the special relationship between the parties. Since the Dymocks case in the High Court and the subsequent appeal cases to the Court of Appeal and the Privy Council in 2004, a number of legal writers have argued whether the contractual relationship between the franchisor and the franchisee is of such a special nature that a duty of good faith and fair dealing can be implied. Hammond J put this view forward in the High Court but it was firmly rejected by the New Zealand Court of Appeal. It was discussed briefly by the Privy Council on final appeal but the judgment of their Lordships did not require them to make any final decision in respect of that issue. However, Lord Browne-Wilkinson when commenting on the Court of Appeal suggestion that "*there is no room for superimposing a general duty of good faith, that to do so conflicts with requirements of certainty in commercial contracts*" stated:

> "*These comments suggest that, in their view, the development of the law so as to make an obligation of good faith implicit in the relationship between franchisor and franchisee (as in the case of partnerships and other joint venture agreements) is not desirable. Their Lordships proposed to express no concluded view on these comments and wish to reserve their opinion on the suggestion that the implication of an obligation of good faith and the relationship between franchisor and franchisee would be an undesirable development.*"

In Australia there was a recent Court of Appeal decision *Esso Australia Resources Pty Limited v Southern Pacific Petroleum NL* which stated that no general duty of good faith arises in commercial contracts and such a duty would only arise where it is necessary to protect a vulnerable party from exploitative conduct. However, the franchising relationship is different and, like New Zealand, the Australian Courts are ready to imply a duty of good faith and fair dealing.

Recent Cases

The majority of franchising litigation in New Zealand involves where misrepresentations have been made and it is the Contractual Remedies Act 1979 and the Fair Trading Act 1986 which greatly assist in this area. In *Cornfields Limited v Gourmet Burger Co Limited* (2000) the High Court Judge rejected a claim under the New Zealand Fair Trading Act that exclusion clauses should be upheld by saying that they had been "*overwhelmed by express assurances*". It was apparent that the franchisee was on unequal terms with the franchisor and was far less sophisticated in business affairs and less well-resourced than the franchisor.

In *Jackson v Lehmann* (2001) the franchisor had provided false promotional material to the franchisee. It was held that the projected income of the business had no factual basis and that the representations had been made both negligently and fraudulently. The plaintiffs were held to be entitled to relief under Section 9 of the Contractual Remedies Act. The franchising company had not traded for several years, a fact which had not been disclosed to the franchisees and this misrepresentation by silence had created an entirely misleading picture of the franchise.

The brand *King Pie* came to New Zealand from South Africa about 1996. In *Phillips & Ors v King Pie New Zealand Limited* (1999) the franchisor had made misrepresentations which included statements regarding gross profit, turnover and net profits; statements regarding the franchisor's alleged expertise; statements as to projected budgets and projections; and assurances as to the suitability of business locations for the franchise. The franchisor concealed a number of major facts from the franchisee including the fact that the franchise was failing in Australia; that some of the franchises had poor trading results; that the franchisor had grave doubts about the viability of a number of the franchises; and that other franchises were trending downward in their measure of profitability. The plaintiff pursued King Pie using the provisions of the Fair Trading Act and alleging misrepresentation and the plaintiff won a substantial damages award.

In *Newport v Coburn*, the franchisor company set up a franchise for the installation and repair of electronic accessories for cars. Mr Newport represented that there was a heavy demand for a Wellington franchise and that customers were waiting to give it business. An employee from the franchisor company also represented that there was a heavy demand for business in order to persuade a prospective franchisee to sign the Franchise Agreement and the franchisee was supplied with fabricated turnover figures. The claims of misrepresentation were successful and the case focussed on the liability of directors and an employee for misleading statements which were made on behalf of the franchisor company.

There is considerable academic debate as to whether directors and employees can be individually liable for misleading and deceptive conduct under the Fair Trading Act 1986. The Court of Appeal upheld a finding that directors and employees can be personally liable under the Act and I agree with that position.

A case which clearly illustrates the dangers of the parties not having clear terms in their Franchise Agreement is *Video Ezy International (NZ) Limited v Cameron* in 2004. This case involved injunction proceedings by the franchisor to prevent the franchisee from carrying on a competing business after the term of the Franchise Agreement had expired and to deliver up confidential material. After considering the terms of the Franchise Agreement at some length, the Judge refused to grant the injunctions. During the course of the negotiations for the original franchise agreement, the parties had made some changes to the agreement. Clause 6.3 had been amended by partly striking out the original clause and gluing over an amended part of that clause. The clause contained several references to "*the Franchised Business*" and in other clauses of the agreement there were also references to the term "*Franchised Business*". That term was not defined in the agreement. Clause 6.3 had not been drafted with care and was ambiguous and the Judge said that "*this contract is a muddle, as a result of 6.3. It is a muddle of the parties own making. I do not think an equitable remedy should be available taking sides in this muddle*".

Choose the Party Carefully

It is important to make sure that all parties are correctly described. It is quite common for a franchisor to operate under more than one company so, if that is the case, you should ensure that the company which is described as the franchisor is the one under which the franchise is operated and also that it is the company which has the rights to franchise. Where the franchise system has originated from overseas, it is important to ascertain that the franchisor named in the agreement is the company carrying on the business in New Zealand and that it has authority to do so. A 2003 case called *Electrical Holdings Limited v Contractor Success Group Limited* illustrates the sort of issues which can arise where overseas companies are involved in the franchise system but are not parties to the franchise agreement. Contractor Success Group had been granted a master licence by a US company, Mr Electric, which is owned by the Dwyer Group. In marketing the franchise system to the franchisees, the New Zealand master franchisee used publicity material provided by the US franchisor and part of that material suggested that the franchisees would become part of a worldwide network of businesses backed by the corporate strength of the Dwyer Group which was described as "*the world's premier service business franchisor*". The franchisees argued that they should have recourse against the Dwyer Group and on the basis that Contractor Success Group and Mr Billington who was the director and shareholder of that company acted as the agent of the Dwyer Group in making the representations on which they relied in buying their franchises. Justice Goddard found against the franchisees and refused to allow them to join the Dwyer Group as a defendant. That case illustrates the need for any franchisee and their advisors to ensure that the parties with the perceived expertise and financial power and on whose reputation they are relying in respect of the franchise system they are entering into are parties to the agreement. If not, the strength of the franchise system may not be as good as it would have first appeared.

Confidentiality

The issue of confidentiality is very important and the confidentiality provisions of most franchise agreements are expressed to apply after expiry or termination of the franchise agreement. Failure to make such a provision could prevent the franchisor from enforcing the confidentiality provision after the expiry or termination of the agreement.

In *P5 Holdings Limited v Elisha's Well Limited*, a 2006 case in the High Court at Auckland, the Court granted injunctions to prevent the defendants from using the franchisor's confidential information. Clause 33.1 of the franchise agreement contained a standard confidentiality clause which read as follows:

> "*The Franchisee acknowledges that the system is confidential and is the sole property of the Franchisor. The Franchisor shall not during this agreement or afterwards use, divulge or communicate to any person any confidential information concerning the practice, dealings, transactions or affairs of the Franchisor which may have been acquired by the Franchisee pursuant to the performance of its responsibilities under this agreement."*

The defendants had purported to terminate their franchise agreements alleging misrepresentations by the franchisor. They subsequently each set up their own businesses which largely replicated the business of the franchise system. The Court accepted the franchisor's arguments that the defendants had basically appropriated the system with one or two minor changes which were not significant enough to distinguish their new businesses from the original franchised businesses.

Franchisor Dangers

It is crucial for franchisors, whether they be New Zealand franchisors or franchisors based overseas, not to overstate the financial position and success of their franchised businesses in New Zealand. Existing laws which cover misrepresentation are robust and dangerous and great care must be taken. As I said earlier, franchisors who belong to the FANZ must publish a disclosure document to give to prospective franchisees before the franchise agreement is executed. It is acceptable for overseas franchisors to give the New Zealand master franchisee or the unit franchisee, whichever is the case, a copy of the disclosure document being used or the UFOC if it is a US franchisor. However, if this course of action is followed then there should be a caveat provided to the New Zealand master franchisee or franchisees along the lines that the overseas disclosure document or UFOC of the franchisor is being provided by way of background information only, it has not been amended for New Zealand conditions and it must be read in that light.

New Zealand is a sophisticated market and is fairly deregulated in relation to small to medium sized business. The FANZ is very successful by promoting self-regulation and high standards in franchising, and its Code of Practice is widely understood and accepted by the majority of franchisors in New Zealand.

Stewart Germann
Stewart Germann Law Office
Auckland, New Zealand

stewart@germann.co.nz
www.germann.co.nz

