Legal Aspects of Franchising in New Zealand

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A. BACKGROUND

Franchising is developing in New Zealand at a very fast rate. Some people may wonder exactly what franchising is and it is also fair to say that some people use the term loosely and in the wrong context.

Quite simply, franchising is a method of marketing goods and services. It has evolved out of a number of business transactions, methods and practices which have been common and popularly known for many years. As a legal and marketing concept it is not new.

B. METHODS OF EXTENDING THE DISTRIBUTION NETWORK

1. Branches, Multiple Outlets

Most small businesses do not have the capital, the managerial skills or the wish to establish multiple outlets.

2. Agents

There has to be the legal relationship of a principal and agent. A number of shops may offer to display a supplier's goods on their premises, arrange sales and installation and servicing contracts on its behalf, but is there the true agency relationship?

3. Distributors

The sales outlets would buy the products and resell them. The supplier would become a wholesaler, and the distributor a retailer. The supplier would look to the distributor for payment. Distribution agreements can often be for a fixed term but can very often be terminated upon reasonable notice being given. There are many elements in distribution agreements which are the same or similar to franchise agreements. Many of the same principles apply. But the real element which is missing is that the distribution system is not fully exploiting the supplier's full retailing package. It concentrates on the sale of the goods rather than the exploitation of a marketing image.

4. **Licensing**

A supplier could authorise other retailers merely to use its trade mark. It would receive a royalty. But this would not be exploiting the full benefit of the successful retail operation.

5. **Franchising**

The real success of a business is often not limited to the product or service that it sells. It is the package of product, presentation, trade name, trade mark, service mark, the service it provides, the image, the distinctive appearance of the premises, the promotional aspects including get up, logos and the owner-operator enthusiasm and personal attention. It is that business format which can be made available throughout New Zealand to individually owned franchised outlets. All of those elements make up "the business format franchise."

C. DEFINITIONS

Franchisor

This is the person (or company) who owns the business system, the business name and all the rights and who authorises other people to use those rights to establish separate businesses.

Franchisee

This is the person granted by the franchisor the right to set up a business using the franchisor's system and name.

There are **four** basic features to consider:

1. The ownership by one person (the franchisor) of a name, an idea, a secret process or piece of equipment and the goodwill and know-how associated with it.

2. The grant of a licence (franchise) by the franchisor to another person (the franchisee) permitting the exploitation of such name, idea, process or equipment and the goodwill and know-how associated with it.

3. The inclusion in the licence (franchise) agreement of regulations and controls relating to the operation of the business in the conduct of which the franchisee exploits the rights to intellectual property.

4. The payment by the franchisee of a fee or other consideration for the rights which obtained and the services with which the franchisor will continue to provide to the franchisee.

Please note that there will always be a continuing relationship which should provide the franchisee with full support of a comprehensive range of expert knowledge in the operation of the business in the form of the "head office organisation" of the franchisor.

The Franchise Association of New Zealand has a set of Rules which all members must adhere to. Included in those Rules are a number of definitions and the definition of "Franchise" 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 is subject to at least the following obligations or provisions:

- the Franchisor grants to the Franchisee 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 Franchisee is required to conduct 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 Franchisor provides ongoing marketing, business or technical assistance during the term of the Franchise Agreement.

D. FRANCHISE OPERATION

Franchises involve transactions between:

1. Manufacturers and wholesalers;
2. Manufactures and retailers;
3. Wholesalers and retailers;
4. Retailers and retailers.

A franchisee, like anyone involved in small business, must be highly committed, willing to work and must also be able to work in a team situation, taking direction where necessary. Some examples of successful franchises are McDonald's, Just Cuts, LJ Hooker, Bakers Delight, Fastway Couriers, Wendy's Supa Sundaes, Guthrie Bowron, Hollywood Bakery and Cleantastic.

E. WHAT IS A BUSINESS FORMAT FRANCHISE?

The British Franchise Association defines a franchise as:

A contractual licence granted by one person (the franchisor) to another (the franchisee) which:

1. Permits or requires the franchisee to carry on during the period of the franchise a particular business under or using a specified name belonging to or associated with the franchisor;

2. Entitles the franchisor to exercise continuing control during the period of the franchise over the manner in which the franchisee carries on the business which is the subject of the franchise;

3. Obliges the franchisor to provide the franchisee with assistance in carrying on the business which is the subject of the franchise (in relation to the organisation of the franchisee's business, the training of staff, merchandising, management or otherwise);

4. Requires the franchisee periodically during the period of the franchise to pay to the franchisor sums of money in consideration for the franchise or for goods or services provided by the franchisor to the franchisee;

5. Is not a transaction between a holding company and its subsidiary or between subsidiaries of the same holding company or between an individual and a company controlled by him.

The term "franchise" has no legal meaning in New Zealand. It is a term which is used, and sometimes abused, in a variety of ways. The "business format franchise" is a franchise in which an entire ready-made business format is available.

It is important to understand what is not a franchise. Too often a so-called "franchise" is advertised for sale when all that is being offered is an exclusive sales territory and the use of a trade name. There is much more to a business format franchise than that.

F. INTELLECTUAL PROPERTY PROTECTION

The term Intellectual Property encompasses trade marks, registered designs, copyright and patents. The protection of the rights to Intellectual Property is fundamental to any franchised business.

1. Trade Marks

It is imperative for a franchisor to obtain formal trade mark or service mark protection as a basis for any trading operation. There are 42 classes of goods and services in which trade mark protection can be obtained in New Zealand and of those classes 34 relate to goods and 8 to services. For example, there are 3 food classes and 2 classes covering products such as beer, alcoholic beverages, fruit juices and mineral water.

There is also a service class to protect advertising and business services. The nature and extent of any trade mark protection needs to be considered for each particular case.

Trade marks may comprise any word, brand, label, symbol, device or logo which serves to distinguish the particular goods or services of one party from the goods or services of another party. The Trade Marks Act 2002 governs registration of all marks.

The principal function of a trade mark is to indicate the origin of goods and services. It is important to select a distinctive trade mark in order that the public will associate your goods and services with the unique brand.

Trade marks are protected by registration in the Intellectual Property Office of New Zealand in Lower Hutt. Once you have selected or designed your trade mark then as a precautionary move it is possible to obtain a search of the Trade Mark Register to ensure that it does not conflict with anyone else's mark.

Assuming that the trade mark is available, its protection is afforded by filing an application and paying the requisite fee. This obtains a filing date and application number from the Trade Mark Office.

The benefits of registration are as follows:

(a) It can be used to prevent any competitor from using the same or similar mark on any goods or services in New Zealand.

(b) It serves as public notification of your rights in that trade or service mark.

(c) It can prevent registration of an identical or confusingly similar mark.

(d) Trade mark registration is a valuable business asset.

It is also possible to have common law rights in an unregistered mark which can be protected by the tortious action of Passing Off.

2. Registered Designs

Registered Design protection pursuant to the Designs Act 1953 is available for a wide range of products. Protection may be obtained for novel features of shape, configuration, pattern or ornament applied to an article by an industrial process. The features protected by a registered design must appeal to and be judged by the eye such as design on china and cutlery.

It is possible to obtain a preliminary search in the Designs section of the Intellectual Property Office at Lower Hutt and such a search can provide advice as to whether or not the proposed design is likely to infringe an existing registered design and/or whether it is in fact registrable.

3. Copyright

Under the Copyright Act 1994 the labour, skill and judgment which an author, artist or creator has expended in the creation of an original literary, artistic, musical or dramatic work is protected. Copyright arises automatically in the work. It is not the ideas that can be protected but the tangible form the ideas take such as the manual, the logo or the advertising jingle.

Protection is in the form of a right to prevent anyone else from copying or reproducing the work or a substantial part of the work without the author's permission.

4. Patents

There is a new Patents Act 2013. In broad terms, patent protection may be obtained for inventions (ideas) which are new and are capable of manufacture. Patent rights are granted by statute and the system operates as a reward for technical innovation by granting exclusive monopoly rights for a defined period.

In order to obtain a valid patent, the invention must be new. An invention should not have been used, sold, published or otherwise known in New Zealand by the applicant or any third party prior to the date of application. Hence the importance of confidentiality.

It is essential to have expert advice in the areas of trade marks, registered designs, copyright and patents. This firm has an intellectual property lawyer available to assist you in all of these areas and for advice concerning the filing of patent applications you should contact a Patent Attorney.

G. GROWTH OF FRANCHISING IN NEW ZEALAND

New Zealand has followed overseas where it is clear that franchising is the fastest growing form of retailing. The capital and managerial demands of business expansion have become burdensome and franchising has become a favoured alternative. Just as there is a risk in expanding too fast, there is a risk in expanding too slowly. Slow expansion will allow business competitors to become established using imitative methods. Franchising allows rapid expansion without many of the downside risks.

Overseas research has shown a very high failure rate of new independent businesses. Franchised businesses have a very low failure rate. A good franchise will have tried and effective systems which should make success easy. The franchisee is gaining a full package without the “bugs” of a new business.

A franchise can be hard work and it can be profitable. It can also be a disaster. Just as in any other form of business enterprise, there can be failures. Every intending franchisor and franchisee needs expert legal and accounting advice at an early stage.

There are many examples of franchising in New Zealand and the most obvious example is the fast food and set format restaurants. But there are many other examples - key cutting, photocopying and print shops, sport shops, camera shops, clothing shops, sports arenas, rental cars, motels, health and fitness clinics, employment agencies, cleaning services, real estate agencies, automotive services and parts outlets, financial advisory services and many more.

On 2 July 1996 the Franchise Association of New Zealand Incorporated was formed and this firm is a Foundation Member of the Association. A major aim of the Association in New Zealand is to ensure that there are very high standards in franchising.

The Rules of the Franchise Association of New Zealand incorporate the Franchising Code of Practice which provides for a cooling-off period after the signing of a franchise agreement, ensures full disclosure of relevant information to a prospective franchisee and requires franchisors to advise prospective franchisees to obtain legal and accounting advice. It is essential for franchisors to give potential franchisees a Disclosure Document which must comply with the Code of Practice together with a copy of the current form of Franchise Agreement being used by the franchisor.

A number of New Zealand franchisors are now crossing the Tasman to expand their franchising system into Australia. A number of Australian franchisors have come into New Zealand. For example, Just Cuts, Dymocks, Cafe BB’s, Bakers Delight, Coffee Club and many more.

This is good news for New Zealand. Really, the growth has come with a number of innovative people having good ideas, testing their products or services and deciding to branch out by franchising their products or services.

H. PROCEDURE

An intending franchisee should consult his or her accountant and lawyer before buying a franchise. Even before this stage, that person should have had one or two meetings with the franchisor and other franchisees in the system and obtained considerable information.

What usually happens is that when a franchisee expresses an interest to take up a particular franchise, after an initial interview and if the franchisee wants to go further, the franchisor will ask the potential franchisee to sign a Confidentiality Agreement. After that has been done, the franchisor will make available to the potential franchisee a lot more information which will include the operating procedures manuals, the form of Franchise Agreement, detailed information about the particular franchise, financial information and other data.

It is essential for the franchisee to obtain professional advice and his or her accountant should look closely at the financial aspects including whether the franchisee is injecting enough capital into the business, and at the borrowing to equity ratio.

The franchising lawyer must be experienced in this area. He or she must be able to look at and explain the Franchise Agreement, explain the concept of franchising and what may happen to the client, and go through a number of questions with the client in relation to matters which the client may not have even thought about.

The franchisor must be aware of the Fair Trading Act 1986 and must not provide any misleading or deceptive information. The franchisor must also not make any misrepresentations to the franchisee. This whole area is a mine-field which needs close scrutiny.

Both parties must be aware of and understand the Consumer Guarantees Act 1993. Why? Because goods and services are being sold to consumers who have legal rights.

An intending franchisee should really ensure that the franchisor has a good reputation in the market place, is fair and reasonable in dealing with his franchisees, that the franchise itself has a track record, that the initial franchise fee is not excessive, that the royalty payments and the advertising levy amounts are within an acceptable range, that the business is sufficiently detailed in the operating procedures manuals and that the franchisor intends to be around for years to come. I always tell my franchisee clients to ask the question - "What am I getting for the franchise fee and what is the franchisor going to do to benefit me?"

A potential franchisor is strongly advised to seek the assistance of a franchising consultant who will help in writing the operating procedures manuals and with other advice.

I. FRANCHISE AGREEMENT

I now list some clauses which are usually included in a Franchise Agreement:

1. Interpretation
2. Grant of Franchise
3. Territory
4. Franchisee's Obligations
    - 4.1 Promote the Business
    - 4.2 Commence Operation
    - 4.3 Not to Prejudice the Franchisor's Intellectual Property

5.7 Promote Good Relations Between Franchisees
5.8 No other Franchises
5.9 Grant Access
5.10 Manuals
5.11 Promotional Materials
5.12 Stationery
5.13 Intellectual Property
5.14 Assistance with Premises and Fit-out
6. Marketing
7. Liquor Licence
8. Intellectual Property
9. Books of Account
10. Assignment by Franchisor
11. Assignment by Franchisee
12. Transfer After Death
13. Illness of Franchisee
14. Indemnity by Franchisee
15. Impossibility of Performance
16. Termination
16.1 Immediate Termination with No Opportunity to Remedy
16.2 Termination After Opportunity to Remedy
17. Action Upon Termination or Expiration
18. Restraint on Competition
19. Notices
20. Time Shall Be of the Essence
21. Non-Waiver
22. Partial Invalidity
23. Corporate Franchisee
24. Directors' Guarantees
25. Legislation
26. Exclusion of Warranties
27. Right of Renewal
28. Holding Over
29. Franchise Advisory Council
30. Website
31. Social Media
32. Compliance with the Codes
33. Governing Law
34. Dispute Resolution
35. Set-Off
36. Amendments to this Agreement
37. Cooling Off
38. Solicitor’s Certificate

J. QUESTIONS TO ASK

It is important for any potential franchisee to find the right sort of franchisor so a franchisee must find satisfactory answers to the following questions:

1. Will the franchisor last the distance?

2. What term are you being granted?

3. Have you got the premises or do they have you?

4. Are the Franchise Operating Procedures Manuals adequate?

5. Can you identify all the fees payable?

6. Is your territory exclusive or non-exclusive?

7. Where do you obtain products and services?

8. What training and supervision will you receive?

9. What operational assistance will you receive?

10. Have you checked out all the insurance requirements?

11. What reports must you submit?

12. How can the franchise be terminated?

13. What post-termination restrictions will be placed on you?

14. Can you sell the franchise?

15. How are franchise disputes resolved?

K. TERM

The term of a franchise agreement varies. Franchises are usually for terms of 10 years but some are for 5 years with rights of renewal.

A franchisee must have the right to sell the franchised business at any stage although some franchisors impose a two year non-assignment provision which locks in the franchisee for the first two years. This is a matter of negotiation and contract.

L. PICKING A FRANCHISEE

Before a franchisor goes into business, the franchisor must do his homework. He or she should already have one or two outlets in operation and be successful. It is really no good for a franchisor to try to find a franchisee when there is no proven successful business. The hardest thing that a franchisor has to do is to pick the right franchisee. This may sound strange but a franchisor really has to be like a psychologist.

If the franchisor picks the wrong type of person to be a franchisee then the business will not be a success and there will be major problems. It is no good picking as a franchisee a person who is not used to discipline and having to abide by rules. Some self-employed people who have been in business on their own account for 10 years or more may not make good franchisees.

M. TAXATION ASPECTS

It is important to remember that in New Zealand you must comply with the Goods and Services Tax Act 1985. GST is payable on all goods and services supplied in New Zealand. Where goods and services are supplied by a non-resident, the goods or services will be deemed to be supplied outside of New Zealand unless the goods are situated in New Zealand at the time of supply or the services are performed by a person in New Zealand.

The ongoing royalty on sales would constitute royalties and be subject to non-resident withholding tax. An Australian company would be able to obtain a tax credit in Australia for withholding tax paid in New Zealand. Where a New Zealand company is therefore incorporated this company will have to register for GST on the franchise fee, royalties and promotional fees.

It is important to decide on the most appropriate structure and it is always necessary to review the transactions to ensure that no unexpected GST issues may arise.

The initial franchise fee is subject to GST at the rate of 15%. Similarly, the royalty payment and the advertising levy are also subject to GST. Where a New Zealand company is incorporated to act as a franchisor, all franchise fees, royalties and contributions to promotional work will be assessable income in New Zealand. However, the company would be able to claim deductions for expenses incurred in deriving such income. These deductions will include charges from the Australian company in respect of services provided.

Alternatively, where no New Zealand company is incorporated, all taxable income would be generated in Australia. Even though business profits may be derived from New Zealand, these profits will only be taxed in Australia pursuant to the Australian / New Zealand double tax agreement unless the Australian company has a permanent establishment in New Zealand. Where no presence in New Zealand exists, the Australian company will only be taxed in New Zealand on dividends, interest and royalties sourced from New Zealand.

N. PUBLICATIONS

The Franchise Association of New Zealand (FANZ) has a number of excellent publications available including:

1. New Zealand Franchisor’s Guide.
2. New Zealand Franchisee’s Guide.
3. Profitable Partnerships.
4. The Franchise E-Factor.
5. Improving Field Visits.

O. DISPUTE RESOLUTION

Disputes between franchisors and franchisees can and do arise. It is important that any disputes are dealt with quickly and effectively. The last thing that the parties want is to get into expensive and protracted litigation. Alternative Dispute Resolution or ADR is gaining in popularity and usage both in New Zealand and Australia. Stewart Germann has completed the LEADR course and is qualified to act as a mediator in franchise disputes. Stewart is on the Panel of Mediators of the FANZ and is also a member of the Arbitrators' and Mediators'

Institute of New Zealand. Mediation is strongly recommended as an alternative to litigation which should be viewed as the last resort.

P. STATISTICS

In 2010 a survey of New Zealand franchising was conducted by Massey University, Auckland and Griffith University, Queensland, Australia, and some highlights from that survey are as follows:

- The number of business format franchise systems operating in New Zealand has steadily increased over time with 423 business format franchise systems operating in New Zealand.

- The number of units operating with business format franchise systems has also increased with an estimated 23,600 units compared with 12,300 in 2003.

- There are an estimated 80,400 employees of New Zealand business format franchise systems, up from 40,915 in 2003, with 72% of employees estimated to be in permanent full time employment.

- Franchising covers a wide range of industry categories and sub-sectors. Predominant sectors included "other services" (25%), "retail trade" (24%), "accommodation and food services" (17%) and "administration and support services" (13%).

- A retail site or kiosk was the most common (43%) franchise unit location.

- The median total start-up cost for a franchisee was $96,000 with $242,000 for retail and $76,750 for non-retail.

- The median initial franchise fee was $30,000. The median ongoing royalty was 6% (typically based on sales).

- Most franchise agreements (88%) provided for a fixed initial term and the most common initial franchise term was five years (53%). Most franchisors provide further renewal options.

- Twenty two percent of franchisors reported *all of their franchisees* were operating profitably. Franchisors generally estimated 80% of their franchisees were earning profits over and above all wages and salaries.

- More men (62%) than women (29%) were the primary franchisee. Almost 50% of franchisees encompassed spouse/partner ownership.

- The majority of franchisees (71%) were aged between 30 and 50 years of age. Less than 4% of franchisees were under 30 years of age.

- The median franchisee tenure, for companies involved in franchising over 5 years, was 6 years and 55% indicated their average franchisee tenure to be between 6 to 10 years.

- The overall level of disputation per franchise unit was low (less than 1.5%). Only 19% of franchisors experienced a substantial dispute with a franchisee within the last 12 months. The most common cause of dispute was system compliance (67%) and the most common action was correspondence via a solicitor (76%). There was little incidence of mediation (8%) or litigation (17%) where substantial disputes occurred.

The next survey in 2011 was robust and detailed and key results are as follows:

- 423 systems and 23,600 units in New Zealand.
- NZ$14 billion turnover from franchising.
- Employment is provided for an estimated 80,000 individuals nationwide with 72% on permanent full-time employment.
- 92% growth in the last seven years.
- 61% of franchisors have been operating for 10 or more years.
- More men (62%) than women (29%) are the primary franchisee.
- 20% of franchisors are planning to franchise overseas within the next 12 months.

The latest survey in 2012 showed the key results as follows:

- There are approximately 446 business format franchisors in New Zealand in 2012, compared with 423 in 2010.
- It is estimated that franchised businesses contribute between $19.4 billion and $21 billion to the New Zealand economy.
- Franchised businesses account for just over 5 per cent of New Zealand small and medium-sized enterprises.
- 88 per cent are Kiwi born enterprises.
- Most business format franchisors operate in service industries, followed closely by retail franchises.
- System growth has been static in 2011 and 2012.
- Just over half the systems report increased sales activity but a significant number experienced pressure on profit margins.
- There are fewer units operating in business format franchises (22,400 in 2012 compared to 23,600 in 2010), but employment numbers have increased (employing over 100,000 people in 2012, compared to 80,400 in 2010).
- There is increasing but still constrained use of information technology.
- A small percentage of franchises actively use sustainable business practices.

Q. CONCLUSION

I predict that franchising will continue to develop and expand at a very fast rate in New Zealand. Such has been the case in Australia, the United Kingdom, Asia, Canada and the USA in recent years. Franchising really is exciting but the proof is in the success of the franchise. It should always be remembered that both the franchisor and the franchisee must be winners.

Finally, it is imperative for franchising industry in New Zealand that very high standards are displayed and maintained by everyone involved in it. If the industry itself is not self-regulating, then specific legislation would be a distinct possibility in the future. This is to be avoided if possible so whatever your role is in franchising, please carry it out properly and follow very high standards at all times.

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