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A case for regulation

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PAUL HARTIGAN, *Evolution of the Species*, 1994, enamel on panel.
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Franchising:

A case for regulation

The lack of specific laws governing franchising in New Zealand is limiting opportunities for franchisors and franchises. The time has come for the lawmakers to make franchising a level playing field.

By Gehan Gunasekara and Alexandra Sims

Franchising promises great benefits for franchisors and franchisees, however, the existing law is ill equipped to deal with problems that arise from time to time in franchises. Appropriate regulation of franchises would help to increase not only the uptake of franchise opportunities but also the quality and viability of those franchise opportunities.

Business format franchising is promoted on a win/win basis. Franchisees (those buying a franchised business) are provided with a ready made and proven business. The franchisor (the person or company setting the franchise up) has through trial and error discovered what works well and what does not. Other features often include ongoing support and training, access to discounts through bulk buying, and advertising and marketing. For a franchisor, the money it receives from the initial franchising fee and the fact that the franchisees themselves pay for all their plant, equipment and premises allows the business to expand rapidly without the franchisor expending its own precious capital or borrowing large amounts of money.

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There is no doubt that franchising accounts for a significant part of New Zealand's economy. In the 2003 Survey of Franchising (organised by the Franchise Association), the sector was found to be worth nearly $7 billion and it employed over 40,000 people.[1] At that stage there were some 350 different franchises operating in New Zealand. And, more importantly for an innovative and entrepreneurial based economy, 74 per cent of the franchises operating were "home-grown" in New Zealand. One of the local stars, Hell Pizza, with over 50 outlets in New Zealand, has plans to extend to the United Kingdom with the initial aim of opening 20 outlets by the end of 2007. Michael Hill Jeweller has already achieved considerable international success, with over 150 stores in Canada, Australia and New Zealand. Franchising, therefore, represents an excellent opportunity for New Zealand businesses to successfully export their intellectual property to the rest of the world. It is in New Zealand's interests, therefore, for franchising to be nurtured and encouraged as much as possible.

To be sure, business is inherently risky. However, it has been argued that the failure rate of franchised businesses is significantly lower than for other businesses, and franchises are often promoted on this basis. The lower failure rate, however, only tells half of the story. Purchasing a franchise is not the same as starting a new business or even purchasing an existing stand alone business. If a person sets up her own business or buys an existing business, she dictates how and where the business is to be run, how long it will run for, and any goodwill generated by that business is retained by that business, whereas in the case of a franchisee it is the franchisor who dictates all those things. This is because franchising is a hybrid between an independently owned business and a vertically integrated company owned operation. It is important to remember that a franchise is a licensed opportunity for a limited time to operate a business using the franchisor's intellectual property. A franchisee of a business format franchise cannot therefore be called the true owner of a business.

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Granted, a "bad" franchisee can cause considerable harm to a franchisor and its brand. But equally unfair treatment, lack of help and advice or poor planning by the franchisor can cause significant harm to the franchisee. Added to this is the fact that the franchisor may gain a windfall on the termination or expiry of each franchise agreement, as well as a healthy chunk of the franchisee's turnover. As Ray Kroc the founder of the modern McDonald's once said:[2]

"There is a basic conflict in trying to treat a man as a partner on the one hand while selling him something at a profit on the other."

In other areas of the law where similar conflicts arise, for example, companies, partnerships and even employment, specific laws and regulations address these concerns. This can be compared to franchising which is not covered by any specific law, rather franchisees and franchisors are left to the general law. As we shall see, franchising is somewhat of a round peg trying to fit into a square hole, with often unfair and unjust consequences. As the Privy Council (which at that time was the highest Court in New Zealand) said not too long ago:[3]

"[Franchise agreements are] not ordinary commercial contracts but contracts giving rise to long-term mutual obligations in pursuance of what amounted in substance to a joint venture and therefore dependent upon coordinated action and cooperation."

In other words, the franchise relationship is symbiotic. The United States, Australia, Canada and China have recognized franchising's special nature and now specifically regulate franchises. Australia, in particular, has developed a mandatory code of conduct: the Trade Practices (Industry Codes – Franchising) Regulations 1998. While the Franchise Association of New Zealand has its own Code of Practice which its members must follow, there is no requirement that franchisors be members of this association.

In this article we argue that regulation of business format franchises is desirable.

Executive Brief

Most overseas regulatory schemes for franchising, such as the one in Australia, contain a requirement that audited financial statements must be supplied to franchisees for all advertising and other cooperative funds. Similarly franchisors have to disclose up-front whether they have an interest in any suppliers from whom franchisees are required to obtain goods or services. They must also disclose whether they receive kick-backs from suppliers and the degree to which these are shared with franchisees.

Franchisors have little to fear from requirements such as these. On the one hand, they take the sting out of any potential claim by franchisees that they have been exploited. On the other hand, franchisors that require franchisees to purchase from stipulated suppliers for genuine reasons have nothing to hide and disclosure will only reduce the potential for friction between franchisors and franchisees and strengthen the level of trust between them.

SOME OF THE PROBLEMS FACED BY FRANCHISEES

LARGE UPFRONT AND ONGOING COSTS

Franchisees normally incur significant set up costs. The cost of opening the doors of a Hell Pizza franchise has been estimated to be at least $220,000; this includes leasing of premises, purchase of equipment, stock and other expenses. It may be argued that payment of upfront costs is hardly unique to franchises as most businesses have some measure of set up costs. Indeed, franchisee fees are often a relatively small proportion of the overall cost; the Hell Pizza franchise fee in 2005 was only $26,500.

Scratch a little deeper and there are many differences between a person setting up a business from scratch and becoming a franchisee. For example, it is not uncommon for the franchisee to be required to purchase its plant and equipment through the franchisor. Some franchisors have a complete turnkey scheme. The franchisor finds the site, leases the building or builds it, and constructs the entire store. While the franchisee's lack of control is apparent, such a package does considerably simplify matters for the franchisee.

There are many differences between a person setting up a business from scratch and becoming a franchisee.

The differences do not end there. A franchisee is normally required to pay a royalty fee to its franchisor. Royalty fees of between 5 to 15 per cent of turnover are common. This fee is not contingent on making a profit, it is payable regardless. An advertising and marketing fee is also often paid, (normally 2 to 4 percent of turnover, but it can be as high as 6 percent) or it may be a set monthly fee. It is also not uncommon for franchisors or subsidiaries of franchisors to lend money directly to franchisees. Finally, the franchisee is often obliged to purchase goods through the franchisor, with the franchisor clipping the ticket on the way. While many franchisors claim that goods purchased this way are cheaper, due to bulk purchasing power, the claim that such systems result in franchisees being overcharged has been made in many reported cases.[4]

These are all areas where the potential for exploitation or abuse exists. This is particularly the case where the franchisor handles funds on behalf of franchisees, either individually or collectively.

CANNIBALISING OF TERRITORY

Some franchise businesses are sold with exclusive territories. That is, the franchisee has the sole right to operate a franchise business within this area. Others, however, have no such exclusiveness. Or, even if an exclusive territory has been set out, the agreement may include a clause that states:[5]

> "The franchisor shall have the right at any time during the term to reduce the territory if in the franchisor's opinion the franchisee is not maximising or is unlikely to be able to maximise business exploitation of the territory."

It is not unheard of, if a franchise in a particular location has done very well, for the franchisor to start operations itself in the vicinity, or to grant a franchise to another person in that area.

We do not suggest that non exclusivity should be dispensed with altogether in franchising. Rather we believe that cannibalisation of territory merely serves to further highlight the unequal or vertical nature of the franchise relationship. In other areas of the law, those broadly in the position of the franchisor, for example, a company director or a partner in a partnership cannot compete with the company or partnership in this way. Indeed, company directors and partners are unable to set up a competing business even if its get up bears no relation to their company or partnership. Franchising's unequal nature is one of the reasons why we believe that at a minimum, legislation mandating a dispute resolution mechanism needs to be adopted in the franchising sector.

FRANCHISE AGREEMENTS DO NOT LAST FOREVER

Many franchises are for a fixed term, there may or may not be a right of renewal. Thus, unlike a business that a person has started up from scratch, the franchisee does not have a right to continue to operate the franchise for as long as she likes.

After the initial term has expired a new term must be negotiated unless there is a right of renewal and, if successful, a further fee is normally payable. Apart from the requirement to pay an additional franchise fee once a term has expired (a cost not faced by other businesses), there is the real possibility of a franchisor refusing to grant a new term. Why would a franchisor refuse to grant a new term to the former franchisee? It may be that there have been considerable tensions between the franchisor and franchisee (which have not been of the franchisor's making). In such a situation it is reasonable for the franchisor to want to end his or her dealings with the franchisee, and the franchisor should be entitled to do so. On the other hand, it may be that:

At a minimum, legislation mandating a dispute resolution mechanism needs to be adopted in the franchising sector.

- another person wishes to purchase a franchise in that area and is willing to pay more than the current franchisee;
- the prospective franchisee may secure better premises than the existing franchisee and thus be more attractive to the franchisor; or
- the franchise has proven so popular in the franchisee's area that the franchisor decides to set up operations there

While these scenarios at first appear unfair to the franchisee no complaint can be made if, say, the term was for 10 years and that term has expired. That is, after all, what the parties bargained for. If the franchisee took a lease over a building for 20 years when the term of the franchise agreement was clearly for 10 years with no right of renewal, the franchisee has only herself to blame.

TERMINATION OF THE FRANCHISE AGREEMENT

Notwithstanding most franchises are for a fixed term, they can still be terminated early, thus a franchise may be terminated one year into a 10 year term. Termination, however, can only be for breaches of the contract, and serious breaches at that. In other cases, such as where the agreement is for an indefinite time, it is possible for termination to occur on the giving of reasonable notice, but such agreements are not common in any event.

> Legislation should not attempt to deny the right of a franchisor to terminate agreements of franchisees

Franchisors justify the ability to terminate agreements on the fact that bad franchisees can cause considerable harm not just to the franchisor but also to all the franchisees. Thus franchisors should be given wide powers to terminate. Against this is the argument that franchisees should be selected properly: some franchisees should never have been offered a franchise. For example, franchisees who failed to work hands on at the business[6] and franchisees who had very limited business experience.[7] Thus, Hell Pizza which has been reported as wanting only committed people that will work in the store only accepts 10 percent of franchise applications.[8]

While legislation should not attempt to deny the right of a franchisor to terminate agreements of franchisees that slip through the quality net, procedural safeguards must be put in place, such as giving the franchisee the ability to remedy its defects within a reasonable time, where it is possible to do so.

Overseas trends

Most overseas regulatory schemes for franchising have begun with standard disclosure obligations on the part of franchisors. This helps both franchisors as well as the franchisees to whom disclosure of certain core information must be made prior to their entering into franchises. The standard templates used mean that attention must be paid to important aspects of franchise agreements (such as exclusivity of territory, right to sell to another franchisee and the like) at the outset and these must be clearly drafted. Standardisation has advantages in law as well as in commerce.

CONSEQUENCES OF EXPIRY OR TERMINATION

It is common for franchise agreements to provide that upon expiry or termination, no money is payable from the franchisor to the franchisee. Thus the franchisee who has paid a substantial franchisee fee, for say a 10 year term, and the agreement is terminated after five years, will not receive the unexpired five year portion. While this may appear unfair, as we have seen the franchisee fee is often only a small part of the overall outlay. The franchisee will normally have invested heavily in plant and stock, and franchisees are often tied into long leases over their premises. Alternatively, the franchisee may have agreed on a ten year term, with a right of renewal for a further 10 years. While most will renew the agreement, this will not always be the case. There is also the more normal case of the term of the agreement simply expiring and the franchisee having substantial capital which she wants to realise.

There are four possible ways that the franchisee could recover some or all of her outlay at the expiry or termination of the franchise agreement:

- sell the business to another franchisee,
- sell the business to the franchisor;
- continue in business selling similar products but without the franchised trade marks and get up; or
- sell the business to a third party as a going concern.

The first option, selling the business to another franchisee, will depend on the terms of the franchise agreement. Some agreements state that the franchise cannot be sold to a third party, or that while it can be sold, the franchisor must first agree to the sale.[9] Such clauses are often inserted because franchisee selection is of critical importance. If there is a clause preventing the sale, or the franchisor refuses to grant permission, the franchisee will be unable to sell the franchise.

It may be argued that if the agreement specifically states that the franchisee has no right to on sell the franchise to a third party, the franchisee entered into the agreement with her eyes open: if she has made a bad bargain, she only has herself to blame. Against this, is the fact that such clauses operate whether the agreement has gone full term or not. There is a world of difference between an agreement that lasts, for 20 years, compared with one that is terminated after one year.

The second option is the sale back to the franchisor. This is a common scenario, with some agreements providing that the franchisor has the right of first refusal. The difficulty comes with the price. The franchisor will want to pay as little as possible. Because the franchisor is in a strong bargaining position she will normally be able to achieve this.[10] Alternatively, the franchisee may be obliged by the franchise agreement to sell the business to the franchisor, even if the price paid would be viewed by many as unconscionable. In *Video Ezy International (NZ) Ltd v John Jackson & Co Ltd*,[11] the franchisor was able to purchase a business for $1 excluding stock and fixtures. This nominal price did not, however, include the franchisee's liabilities.

> The difficulty comes with the price. The franchisor will want to pay as little as possible.

The third option is for the franchisee to recover her

losses by continuing in business and simply changing the name of the business. Things are not so straightforward, however. Often restraint of trade clauses are included in franchising agreements. A restraint of trade clause means that (provided the clause is reasonable) the franchisee is prevented from competing with the franchisor for a certain period of time. If the franchisee's set up is specialised, for example, making pizzas, washing dogs, or retailing petrol it will be difficult if not impossible to switch to other goods or services during the time the restraint of trade operates. Indeed, a restraint of trade clause for one large pizza franchise purports to prevent the franchisee operating *any* fast food premises during the time the clause operates. While it is, of course, doubtful that such a wide restraint of trade clause will be upheld as it is difficult to see how such a widely drawn clause could be considered to be reasonable, it is of concern that a large franchisor feels under no compulsion to act reasonably towards its franchisees.

One way of looking at a franchise is that it involves the lease of goodwill from the franchisor to franchisee for the duration of the franchise agreement.

Finally, the business could be sold as a going concern under a different name to a third party.[12] Provided the third party is unconnected with the former franchisee, the third party will not be caught by the restraint of trade clause. This option, however, is fraught with difficulties. Goodwill will dictate the price the third party is prepared to pay. Granted that a prospective purchaser will not be purchasing the rights to use the franchisor's trade marks, the property of the franchisor (the goodwill) extends well beyond mere trade marks. It may include customer lists and information. Once customer lists and information are gone, for example, in a video store "the core operation of the business ... is gutted."[13] Thus the price a third party will be willing to pay will not be high. Moreover, the business can be even less attractive to third parties if the lay out of the store is protectable get up[14] as the third party would be required to extensively remodel the store.

LOSS OF GOODWILL

One way of looking at a franchise is that it involves the lease of goodwill from the franchisor to franchisee for the duration of the franchise agreement. This is the case even if the franchisee through its own hard work has achieved a considerable measure of goodwill. This is often recognised by the premium obtained by a franchisee when it sells the franchise to another operator during the term of the agreement. However, in the absence of a clause stipulating that the franchisee may keep its goodwill or sell the franchise to another person, the franchisor can appropriate the effort of its franchisees. While this may seem manifestly unfair, we have seen that the franchisee can harm the franchisor's goodwill. Thus franchisors will argue that if they take the risk of their goodwill, their brand, being harmed, they should stand to gain if it is improved.

PROBLEMS FACED BY FRANCHISORS

THE COURTS' BACKLASH AGAINST FRANCHISORS

As we have seen, franchisees do not legally stand in a good position in respect to franchisors and there has often been high handed behaviour by some franchisors. Although some courts have attempted unsuccessfully to introduce a duty to act in good faith,[15] the courts have been increasingly punishing franchisors that have overstepped the mark.

The potential purchaser of a business will want to know the business's turnover and profit. With the purchase of existing businesses, this information can be provided. Some vendors, however, are less than truthful and many purchasers claim that misrepresentations have been made over turnover and profit levels. The law takes care of this in the form of

The author's recommendations

For all the reasons covered in this article we believe that legislation governing business format franchising should incorporate the following features:

- a definition of what a business format is (thus the definition would not be as wide as the current Australian definition which has been criticised)[23]
- the franchisor and franchisee act in good faith towards one another when performing duties or exercising powers under the contract
- allow franchisees to remedy their defects under the franchise agreement within a reasonable period of time (although if a good faith requirement was introduced, this could be included as part of that requirement)
- a standard template for information that must be disclosed and disseminated to prospective franchisees (such information would include whether the franchisor has any interest in any suppliers from whom franchisees are required to obtain goods or services; whether the franchisor receives kick-backs from suppliers and the degree to which these are shared with franchisees; the basis upon which estimates are made in respect

the Contractual Remedies Act 1979 and the Fair Trading Act 1986. With the grant of a new franchise, however, the franchisor cannot be certain of profit let alone turnover, so estimates must be made. Estimates are inherently fickle. But, there have been cases where even though the estimates could be justified, that is based on sales by other franchisors in different locations and taking into account trading conditions, size of population and so on in the new area, the courts have found against the franchisor. For example, in 2001 United Video was required to pay over $500,000 in damages for misrepresentation.[16] This could be said to be harsh as there was evidence that the estimate was soundly based. For a small franchisor, it is more than likely that those damages (plus hefty legal fees) would be sufficient to force it to close.

If more information had been required to be disclosed, it would have been unlikely that liability would have been incurred. Thus a template for disclosure could be that a statement must qualify all estimates to potential franchisees in new territories: that the estimate is based on a typical territory and may not apply to the territory in question.

For franchisees the availability of relevant information enables them to make a truly informed decision as to the merits of their investment and reduces the "had I known…" type of complaint often heard when a franchise investment proves to be a mistake. Thus mandatory pre contract disclosure also better educates prospective franchisees.

to a business turnover and profit and the drawing of attention to important aspects of franchise agreements such as exclusivity of territory, right to sell to another franchisee and the like)

- recourse to an alternative dispute resolution procedure
- the supply to franchisees of audited financial statements for all advertising and other cooperative funds; and
- require that a business must be operated for a minimum period (preferably 2 years) before it can be franchised

In turn this creates a bigger pool of informed franchisees which can assist the growth of franchising and add value to the franchisor's network. The information will also allow prospective franchisees to discern the value of one system compared with another.

GROW TOO FAST, REPENT AT LEISURE

As many people who run their own businesses will testify, running a business is challenging at the best of times, to help others run their businesses only more so. If the franchisor has not perfected their system of business or even tried out their system of business – as after all a franchise essentially is a system of business – how can she possibly franchise that business? The franchisor will be in a very poor position to help a struggling franchisee (as will often be the case if the franchise has not been perfected). In such a case, the franchisee will most likely fail and at best while the franchisor will not fail, the growth of the franchise will be affected. In New Zealand's unregulated environment there is no requirement that a franchisor need operate a business before franchising it. The Franchise Association of Australia suggests that a business not be franchised until the person has operated that business for at least five years.[17]

> Although some courts have attempted unsuccessfully to introduce a duty to act in good faith, the courts have been increasingly punishing franchisors

CONCLUSION

New Zealand businesses generally wish to be free of regulation. Why then impose even more burden on one form of business?[18] From a pragmatic point of view, if franchisors wish to expand into Australia then they will have to conform to the Australian requirements. Experience in Australia has shown that the most common complaints by franchisors about hindrances to growth were:[19]

- lack of suitable franchisee candidates (68 percent)
- increased competition in the marketplace (34 percent)
- leasing restrictions (18 percent)
- difficulties in franchisor obtaining capital to expand (7 percent)
- impediments stemming from the Australian Franchising Code of Conduct (4 percent)

Regulation, therefore, is not seen as a significant problem by franchisors in Australia.

Many of the problems arising from the unequal nature of the franchising relationship can be ameliorated, if not solved, by the introduction of a requirement to act in good faith in business format franchising agreements. While some judges in New Zealand have been sympathetic towards the finding of a duty of good faith in the performance of certain types of contracts (for example, those like franchises involving mutual ongoing obligations)[20] the courts have yet to rule on whether such a duty does exist in a franchise relationship. Indeed, despite contrary views expressed by the Privy Council (which is no longer New Zealand's highest court) in *Dymocks Franchise System (NSW) Pty Ltd v Todd*[21] the Court of Appeal[22] demonstrated a conservative bias against the imposition of such a requirement in contract law. Uncertainty also exists as to whether the duty is additional to that imposed by the existing obligations in the agreement (as opposed

to whether it exists in how they are discharged) and as to whether the duty is found as a matter of law (for example, franchise agreements as a class) or on a case by case basis on the facts of individual agreements.

To conclude, to encourage successful home-grown franchises it makes sense for all franchises to be on as even a playing field as possible. There should be one set of fair rules governing business format franchises, and a properly drafted and implemented law will have the effect of better protecting both franchisors and franchisees than the status quo. The costs associated with regulation will be outweighed by the benefits.

Further reading

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10 See eg *Video Ezy International (NZ) Ltd v Cameron* (2004) 8 NZBLC 101,550.

11 (Unreported, Christchurch HC, 15 April 2005, John Hansen J, CIV2005-409-000499).

12 In *Video Ezy International (NZ) Ltd v Cameron* (2004) 8 NZBLC 101,550.the former franchisee changed the business's name to @Ezi-Vu.

13 *Video Ezy International (NZ) Ltd v Cameron* (Unreported, Christchurch HC, 19 May, Fogarty J, CIV2004-412-000219) para 52.

14 See, for example, *Freeman v Garden Hotel Ltd* (Unreported, Christchurch HC, 22 December 1998, Chisholm J, CP208/97).

15 See for example *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* (1999) 8 TCLR 612 and *Bilgola Enterprises Ltd v Dymocks Franchise Systems (NSW) Pty Ltd* [2000] 3 NZLR 169.

16 *Valda Video Ltd v United Video Franchising Ltd* (Unreported, High Court of Auckland, 21 August 2001, Randerson J, CP123/00).

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