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FRANCHISE ASSOCIATION OF NEW ZEALAND

Competition and Consumer Policy
Ministry of Business, Innovation and Employment
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For Cameron Vannisselroy

22nd February 2019

Dear Cameron,

Submission in response to Discussion Paper protecting businesses and consumers from unfair commercial practices (the 'Discussion Paper')

Thank you for your email dated 10 December 2018, providing the Franchise Association of New Zealand ('FANZ') with the opportunity to provide a submission in response to the Discussion Paper.

We now attached our submission and would be very grateful for the opportunity to meet with the Ministry in relation to the proposed law changes and to further develop and discuss aspects of our submission.

Yours sincerely

Dr Callum Floyd
Chairman

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Submission in response to Discussion Paper protecting businesses and consumers from unfair commercial practices (the 'Discussion Paper')

Submitted by:

22nd February 2019

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For Cameron Vannisselroy

Dear Cameron,

Submission in response to Discussion Paper protecting businesses and consumers from unfair commercial practices (the 'Discussion Paper')

About the Franchise Association of New Zealand ('FANZ')

1. FANZ is the peak body representing the franchising community at government and other industry forums. FANZ is also a member of the Asia Pacific Franchise Confederation and the World Franchise Council. FANZ welcomes the opportunity to provide this submission in relation to the Discussion Paper.

2. Founded in 1996, FANZ was established to bring members of the franchise community together to set standards, provide a signal of confidence to potential and existing franchisees, share information and experiences, and, promote good practice in franchising.

3. FANZ has over 140 franchisor members, covering a substantial percentage of active franchise systems in New Zealand. FANZ's members include franchisors, franchisees and approximately 70 affiliate members such as trading banks, law firms, accounting firms, business consulting firms and specialist franchise consulting firms. Members of FANZ are committed to observe the best practice in franchising through adherence to a Code of Practice, Code of Ethics and the Rules of the Association.

Franchising plays a substantial role in New Zealand business

4. Franchising makes a significant and growing contribution to the New Zealand economy. A 2017 Survey of New Zealand franchising, conducted by Massey University and Griffith University in conjunction with FANZ, found that:

(a) There were 631 business format franchise systems in operation in New Zealand;
(b) Those franchise systems account for 37,000 operating units, the majority operated by franchisees;
(c) Business format franchise systems are a major employer, providing employment to more than 124,200 workers; and
(d) Business format franchise system sector turnover was estimated $27.6 billion, being equivalent to 11% of NZ's GDP.[1] These figures are exclusive of the significant additional turnover provided by both fuel retail and vehicle sale sector franchise systems.

5 The vast majority of franchisors, and almost all franchisees, are indeed small businesses (employing less than 20 people). It is *not* the case in New Zealand that franchisors are primarily big businesses – as sometimes suggested. The small size of most participants is an important dynamic of franchising in NZ.

Information about Franchising relevant to our submission

6. Before setting out our response to the Discussion Paper, we wish to first provide some relevant information about franchising, the legitimate interest of the franchisor and franchise agreements generally. We believe this is relevant to understand the unique perspective of the franchise sector and therefore the basis of our submission.

Franchising is a business methodology

7. Franchising, or business format franchising as it is also called, is a method of doing business in which a business methodology (or system) is developed by a franchisor. The franchisor grants franchisees the right to use that methodology, including relevant intellectual property controlled by the franchisor, for the purposes of operating a business for that franchise system. Franchisees are generally granted the right to use the franchise system in a particular geographical territory for a period of time.

Developing the franchise

8. Franchisors invariably invest considerable time and money in developing their franchise system in their franchises. This typically includes their systems and methods, and including developing a suite of operations manuals and policies, and conducting full feasibility studies and pilot operations prior to offering franchises for sale to franchisees. This can take many years of work and involve a considerable investment.

[1] All figures were an increase on an earlier survey, conducted in 2012.

9. To ensure the success of the franchise system, it is important and legitimate that the interest of the franchisor is protected. Therefore, it is an essential part of the model that there are, for example, penalties that apply on termination of the franchise, restraint of trade clauses that apply on termination, restrictions on what a franchisee can and cannot do during the term of the franchise agreement, enforcement measures that can be taken against a franchisee when they do not perform, and, controls given to the franchisor to alter the system and adapt it as the need may arise -from time to time. Any business will always need to change and adapt to changing markets, competition, products, supply structures, technology (such as e-commerce disruption), and so forth. It is important in franchising that the franchisor has the right to introduce changes to the system, for example to respond to technology changes, as the need arises – such changes can prove fundamental to subsequent franchisor *and* franchisee business sustainability.

10. The franchisor's "legitimate interest" exists not only for the purpose of protecting the brand, the systems and the methodology[2], but also, importantly, for the purpose of protecting the interests of all the other franchisees. The protection of all franchisees, in turn, has the overall effect of preserving and/or strengthening the overall performance of the entire franchise group (encompassing both franchisees and franchisor). Hence, clauses or behaviours that may be perceived by an individual franchisee within a system as overbearing or unfair can, in fact, not only be necessary in the context of the franchise system but beneficial for the wider franchise group.

11. If a franchisor cannot act quickly say, to restrain the behaviour of a franchisee looking to breach a restraint of trade agreement following termination, it is not just the franchisor's business which is affected. The goodwill of all the franchisee businesses is also impacted.

12. It is often said that franchisees are people (many are sole operators or husband and wife teams) who want to be in business for themselves but not by themselves. They often seek an established brand coupled with a proven methodology to follow, coupled with associated franchisor support, in order to generate a profit. They are generally happy with and agree to the level of control that a franchisor will have over them and their business. The model of franchising doesn't work when franchisees refuse to follow the system of the franchisor, look to make their own local changes to that model or refuse to make updates to the system as requested by the franchisor.

[2] As more particularly defined in *Skids Programme Management Ltd v McNeill* [2012] NZCA 314; [2013] 1 NZLR 1

The franchise agreement

13. The relationship between franchisor and franchisee is governed by the franchise agreement which is at the core of the business relationship and in most cases is the key intangible asset of both the franchisee and the franchisor.

14 The franchise agreement records all of the controls and powers given to the franchisor - and all of the entitlements of the franchisee. In conjunction with the operations manuals, the franchise agreement spells out exactly what must be done by the franchisee to operate the system and the consequences of not doing so. Third parties such as financiers and landlords transact with franchisors and franchisees on the basis and assumption that the franchise agreement is signed and is binding on all parties.

15. Franchise agreements are individual to an organisation but also to an extent standard in their form and content. This is to ensure that the parties know exactly where they stand from the outset, to ensure that the legitimate interest of the franchisor is protected and that the franchisee understands exactly what must be done to adhere to the system.

16. In many instances, there may be a level of negotiation between franchisor and franchisee prior to execution of the franchise agreement.

17. As with many business contracts, realistically, there is not a lot in a franchise agreement that franchisors would typically be prepared to negotiate (other than provisions specific to the individual franchisee and site/business).

18. Accordingly, it would not be difficult to characterise franchise agreements as a "standard form" or "take it or leave it" basis. This is because many of the controls and powers in franchise agreements are there to strengthen the overall resilience of the business. Further, the business model revolves around all franchisees being subject to the same terms and conditions and business model. It therefore makes no commercial sense for a franchisor to negotiate individual franchise agreements, with the result that there may be a number of different versions of the agreement in operation, a move away from standardised best practice for the network, potentially different business models that would increase management complexity and the difficulty in responding to market changes, and increased compliance costs.

19. While the new legislation is yet to be drafted, FANZ expects that franchise agreements and franchising will likely be covered by any proposed forms of legislation outlined within the Discussion Paper. Set

out below is FANZ's position on the application of the proposed legislation to franchise agreements and franchising.

Summary of FANZ's response to proposed legislation

20. Members of FANZ are likely to be affected by the new legislation not only in relation to their franchise networks but also in respect of their dealings with other businesses. FANZ is concerned that any proposed legislation would apply to franchise agreements and, for reasons we now develop, considers that franchises should be expressly excluded from the operation of any proposed legislation.

21. Our concern for the application to franchise arrangements is for the following reasons:

a) Instances of unfairness, unconscionability and oppression are not widespread in franchising.

In the 2017 survey on franchising,[3] it was reported that the percentage of franchisees involved in a substantial dispute in the last 12 months was 1.9% (a very low rate), with disputes being handled predominantly by mediation and correspondence via solicitor and with only a small proportion (10% of those in dispute or 0.19% of all franchisees) going on to be dealt with by way of litigation.

Of course, there can be instances of unfair contract clauses and behaviours in business, but it is FANZ's view that the data shows this is not widespread in New Zealand franchising.

b) Instances of unfairness, unconscionability and oppression in business to business contracts and in business to business conduct can be addressed by existing legislation and case law.

FANZ is of the view that whilst there might some instances of unfairness, unconscionability and oppression in business to business contracts generally (leaving aside franchise agreements),[4] legislation to address these instances is not warranted, is unnecessary and will not achieve the objectives listed at item 99 of the Discussion Paper, for the reason set out below.

FANZ's legal and regulatory subcommittee who provided input into these submissions includes a number of lawyers who have set out their view below about the sufficiency of the existing statute law. In their view new legislation is not necessary as there is already sufficient protection in the existing laws. Given there is sufficient protection already, there is no gap

[3] referred to at item 5 above
[4] including the contracts themselves and conduct surrounding those contracts

in the law that needs filling by further legislation with the corresponding increase in complexity, uncertainty and compliance costs.

In terms of existing statute law:

- misleading, deceptive, coercive and harassing conduct are dealt with by the Fair Trading Act 1983.
- Misrepresentation is dealt with by the Contract and Commercial Law Act 2017 (previously the Contractual Remedies Act 1979).
- Anti-competitive conduct is dealt with by the Commerce Act 1986.

In addition to those statutory remedies, common law provides a wealth of existing doctrine and case law which can operate to protect businesses (including franchisees) against unfairness. For example, and using franchising by way of illustration:

- the penalties doctrine applies to contractual penalties and franchise agreements that are harsh and unconscionable in comparison with the franchisor's legitimate interest;[5]
- all contracts, including franchise agreements, are already subject to an implied obligation of good faith that arises in the exercise of any contractual power or discretion. This is known as the "default rule," explained by Kos J,[6] as the rule that a contractual discretion must not be "exercised arbitrarily or in bad faith, or unreasonably in the sense that no reasonable contracting party could have so acted."
- Existing case law relating to enforcement of restraint of trade clauses in franchise agreements, which provide ample clarity of the law in this area and scope for franchisees to challenge restraint of trade clauses where there is no legitimate interest of a franchisor or where the restraint of trade clause goes much wider than necessary to protect that legitimate interest.[7]
- existing equitable doctrine of unconscionability

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[5] See *Wilaci Pty Ltd v Torchlight Fund no 1 LP (In receivership)* [2017] NZCA 152. See also "*Franchise agreements and penalty clauses*" Deirdre Watson, Law Talk, https://www.lawsociety.org.nz/practice-resources/practice-areas/franchising/franchise-agreements-and-penalty-clauses

[6] "Constraints on the Exercise of Contractual Powers", Kos J, (2011) 42 VUWR 17. See also for eg, *C & S Kelly Properties Ltd v Earthquake Commission* [2015] NZHC 1690, at paragraphs 67 and 68, *Vero Insurance Ltd v Fleet Insurance and Risk Management Ltd* **(BC200761161,** CIV 2007-404-001438, para 47) and *Quay Park Arena Management Ltd v Great Lakes Reinsurance (UK) Plc* [2014] NZHC 2204, para 130.

[7] see "Enforcing restraint of trade clauses and franchise agreements", Deirdre Watson, Law Talk, https://www.lawsociety.org.nz/practice-resources/practice-areas/franchising/enforcing-restraint-of-trade-clauses-in-franchise-agreements; *Video Ezy International Pty Limited v Red Bond Limited* [2015] NZHC 1636, *Skids Programme Management Ltd v McNeill* [2012] NZCA 314; [2013] 1 NZLR 1, *Health Club Brands Ltd v* ***Colven*** *Botany Ltd* [2013] NZHC 428 and *Mike Pero (New Zealand) Ltd v Heath and Others* [2015] NZHC 2040,

c) The introduction of legislation will add to the compliance costs of franchisors, most of whom are themselves small businesses.

Franchisors will immediately need to have their franchise agreements, supply agreements and probably also their operations manuals, vetted to ensure they do not contain any potential "unfair" terms and to change terms that may not be compliant with the new rules. That will come at a cost of approximately $5,000 to $20,000 per franchise system, depending on the complexity of the documentation, plus the franchisor costs of rolling out any changes. Franchisees would also have legal and other costs involved in considering amendments to their franchise agreement necessary to roll out changes. This is aside from the fact any such required changes could fundamentally impact the viability of the business model and value attributed to both franchisor and franchisees businesses.

As we say above, most franchisors in New Zealand are themselves small businesses who are dealing with small business franchisees. Substantial additional compliance costs of this nature are a considerable burden for small businesses and reduce funds available for other purposes.

Additionally, it is expected that a number of the financiers lending to the sector would each want their own advisers to review franchise documentation for financier vetted franchise systems to satisfy themselves that the agreement does not contain potential unfair contract terms. Furthermore, possible changes required to a franchise model could easily make a franchisee and franchisor business "unbankable" and put at risk the investment of not only affected franchisors but also each of their franchisees.

d) The introduction of legislation will create uncertainty in contract, where none currently exists and would be in contraction of the principle of freedom of contract for business to business transactions.

It is noted that the courts generally regard the principle of freedom of contract as essential to contract law. Similarly, to provide contractual certainty, a party is typically deemed to have read and understood anything the parties signed.

These fundamental rules provide a workable framework for day-to-day business dealings and must continue to exist unimpeded. Franchising agreements and franchising relationships are far removed from supplier contracts. Further, the entry into a franchising agreement is not done lightly – it is a serious consideration that necessitates a careful review.

The legislation is, in FANZ's view, likely to encourage litigation and disputes whilst clarification is sought on what amounts to "unfair" or "unconscionable" conduct within the new statutory framework.

e) The introduction of legislation could curtail business growth.

It is expected that banks and other financiers will or may curtail the lending to the franchising sector and that the costs of obtaining finance could substantially increase.

22. FANZ believes that if there is a perceived problem in the area of unfair, oppressive and unconscionable business to business conduct and contract clauses for businesses in New Zealand, the answer to that problem is not to enact new legislation but instead to invest in the areas of:

a) Business advice, education and assistance, especially in relation to small businesses for whom legal advice may not be affordable.

b) Inexpensive methods of dispute resolution and small business disputes, such as compulsory mediation or a free mediation service akin to that provided already for employment disputes.

We will develop this aspect further in our submission below.

23. We now address the questions that have been specifically raised and, to keep our submission concise, we will respond only to those questions that directly relates to the franchise relationship, which is in essence a business to business relationship.

Response to questions specifically asked in the Discussion Paper

1. What types of unfair business to business contract terms are you aware of, if any? How common are these?

In responding to this question we are focusing our responses on franchise agreements.

Using the existing definitions of unfair contract terms provided in the Discussion Paper, there are a number of legitimate and important terms in franchise agreements that might be considered unfair, at first blush.

These include restraint of trade provisions, penalty clauses which apply on termination, and clauses which enable the franchisor to unilaterally alter and update the system where there is commercial justification.

Whilst at first glance, these terms may seem potentially unfair to the average reader who is not familiar with franchising, in each instance, they are crucially and vitally required to protect the legitimate interest of the

franchisor and the underlying business model of the franchisor. These terms are also required to protect the interests of other franchisees in the system. In turn, that legitimate interest in the model supports the value in the franchise brand which, in turn, creates a demand for franchises and allows franchisees to compete against much larger businesses with more resources. When one rogue franchisee is not performing, for instance, by delivering an inferior product, that in turn erodes goodwill in the brand generally and thus affects each and every franchisee in the system.

Thus, in a circuitous way, without these crucial controls, there would not be a franchise system in the first place. If the franchisor could not protect its legitimate interest in the system by way of these controls and allegedly "unfair provisions", then the franchisor would not be able to offer franchises for sale and there would be no franchise business.

Accordingly, FANZ considers it vital for the health of both franchisor and franchisee businesses[8] that either:

- franchise agreements are excluded from unfair contract rules (as to conduct and behaviour); or

- the rules are drafted to allow all *appropriate* restrictions to continue.

2. What impact, if any, do these unfair contract terms have?

In franchising, terms we refer to in our response to question 1 are crucial to the survival of the franchise system. Such terms are of benefit to franchisees because they enable the franchisor to control the behaviour of individual franchisees to ensure there is consistency with the products, services and total customer experience being supplied by the particular franchisee's activities.

There are benefits also to the end customer. From the point of view of the customer, when they purchase from a franchise, they do so with the confidence that they know the products and services purchased will be the same standard as products and services sold by any franchisee or company unit across the system.

3. Is government intervention to address unfair business to business contract terms justified? Why/why not?

In FANZ's view Government intervention is *not* required because there are already extensive existing laws which address unfair business to business contract terms.[9]

[8] comprising 11% of New Zealand's GDP
[9] See item 19 b) above

FANZ wonders whether the issue for small businesses in New Zealand is not the availability of statutory relief for "unfair" business to business conduct but rather the affordability of justice. Disputes – even small disputes that can be resolved in the Disputes Tribunal for low cost without lawyers - involve a considerable time and emotional cost. Many businesses are likely to decide not to enforce their rights given these costs unless the numbers involved are high. FANZ considers that adding new legislation will not address this issue – it will add compliance cost and risk without materially benefiting those businesses who receive the benefit of the additional protection.

We further address the question of dispute resolution below.

4. What types of unfair business to business conduct are you aware of, if any? How common is this type of conduct?

FANZ is not aware of widespread unfair business to business conduct in franchising that would not be able to be addressed by existing legislation and case law.

5. What impact, if any, does this conduct have?

N/A

6. Is government intervention to address unfair business to business conduct beyond existing legislative protections justified? Why/why not?

FANZ believes that no government intervention is required because there are already existing laws which address unfair business to business conduct.[10]

7. What types of unfair business to consumer conduct are you aware of, if any? How common is this type of conduct?

As this submission focuses only on franchisor/franchisee arrangements, we have not addressed this question.

8. What impact, if any does this conduct have?

As this submission mainly focuses on franchisor/franchisee arrangements, we have not addressed this question.

9. As a government intervention to address unfair business to consumer conduct beyond existing legislative protections justified? Why/why not?

[10] see item 19 b) above.

As this submission focuses on franchisor/franchisee arrangements, we have not addressed this question.

10. Do you agree with our proposed high-level objective criteria for assessing any potential changes to the regulatory framework governing unfair practices? If not, why not?

Yes, we agree with the criteria to assess any potential changes to the regulatory framework; in particular, that the law is predictable for business and that compliance costs are reasonable.

In relation to unfairness in business in New Zealand generally, FANZ believes that where unfairness in business exists, the reason that unfairness is most often not remedied, is not because there is not an existing piece of legislation or case law to provide a remedy, but rather, because small businesses:

a) are often not well educated enough and do not have sufficient legal advice to enable them to understand contracts entered into; and
b) do not have the financial resources or other wherewithal to seek access to justice when a problem arises.

In the franchise context, many franchisees are operated by "mum and dad" "operators". Some will struggle to afford lawyers to resolve a dispute.

As MBIE will know, even medium-sized and large businesses struggle with the considerable internal and external cost of litigation for other than disputes involving large numbers. This also applies to franchisors, many of whom are also small businesses.

Better access to lawyers or to other commercial advice to help businesses to understand their rights before entering into a contract and to seek a remedy if there is a dispute would go a long way to reducing unfairness in business.

The problem, if (as is suggested in the Discussion Paper there is one in business in New Zealand generally) is not one that is remedied by enacting further legislation, it is one that is remedied by giving victims of unfair conduct better access to information and resources.

Many small businesses are unsophisticated and can have unrealistic or uncommercial views. Having an experienced business person available as a mentor or sounding board could assist avoiding many disputes. We would be interested in developing our thoughts about this with you further in a meeting.

FANZ considers that there is an opportunity for a government organisation to provide an inexpensive:

- education for businesses and business owners;
- a government funded alternative dispute resolution service to help and support small business by:
    - providing a sounding board and guidance;
    - advocating on their behalf; and
    - providing information and tools to help minimise disputes.

FANZ considers that there would be a substantially greater benefit to small business in New Zealand - and lower cost to New Zealand business if an organisation with similar aims to the Victorian Small Business Commission was introduced into New Zealand. This would help small businesses to access the many remedies that are already available.

In Australia, compulsory mediation in the franchising arena has been reported to provide a resolution at 80% of disputes.

This is a phenomenal success rate and MBIE will also be aware of the success rate of mediation in employment disputes.

Many franchise disputes have much the same characteristics as employment disputes albeit the sums involved will be larger.

FANZ believes that money invested by the government in a form of compulsory and inexpensive mediation service, able to be accessed without using lawyers, would solve many business disputes, including those arising as a consequence of unfairness.

11. Should a high-level prohibition against unfair conduct be introduced? Why/why not?

FANZ believes there is already existing law which adequately protects business against unfairness and, for the other reasons referred to at point 21 above, FANZ believes there should be no high-level prohibition against unfair conduct.

12. What are the advantages and disadvantages of options 1A, 1B, and 1C? Which option, if any do you support?

FANZ supports none of these options.

13. If unconscionable conduct were prohibited (Option 1A), should a definition of unconscionability be included in statute, and, if so, how should it be defined?

If there was to be the enactment of a prohibition against unconscionable conduct, there should be a definition included in statute which is broader than the equitable doctrine of unconscionability.

It should be targeted towards taking into account the bargaining positions of the parties and whether or not either party used a lawyer prior to executing the contract.

It should not seek to make conduct unconscionable where a party is simply acting to protect its legitimate interests.

14. Is it appropriate to require businesses to act in good faith (as per option 1C)? Are there situations in which doing so could have negative economic outcomes?

See paragraph 21 (b) above and cases cited. There is already existing law which provides that it is an implied term of the contract that a party will not exercise contractual discretions or powers in bad faith.

FANZ does not consider that there is a need in New Zealand business for a general obligation of good faith. Almost all New Zealand businesses and business people act to what they consider to be high moral standards. We cannot see how adding an uncertain term will improve standards in New Zealand businesses. The term good faith is not understood in any detail by anyone other than a relatively small number of lawyers. And even lawyers argue about what it means – and how to apply it to a given fact scenario.

15. Are there any other variations on option one that we should consider?

None.

16. If a version of option one is selected, should it also extend to matters relating to the contract itself?

No.

17. Should any protection against unfair conduct apply to consumers only, consumers and some businesses (and if so, which ones?) or all consumers and businesses?

Protection against unfair conduct should apply to consumers only.

18. If the UCT protections are extended to businesses, do you agree that the current consumer UCT provisions should be carried over without major changes? If not, why not?

FANZ agrees that in the interests of consistency with the current consumer UCT provisions, there should be no major changes. However, there would need to be careful consideration of exceptions (for example taking into account the bargaining positions of the parties and whether or not either party used a lawyer prior to executing the contract).

19. If the UCT protections are extended to businesses, should the FDA's "grey list" for consumer UCT be carried over "as is"? Are there any existing examples of unfair terms that should be removed from the list or any new examples that should be added?

Business to business is very different from business to consumer. It would be critical for a careful analysis to be undertaken before simply applying consumer laws to business or there could be unforeseen consequences.

20. Should the protections against UCT's apply to consumers only (as at present), consumers and some businesses (and if so, which ones?), or all consumers and businesses?

Protection against UCT's should apply to consumers only.

21. If the protections against UCT's are extended to businesses, should a transaction value be introduced, above which the protections do not apply? If so, what should the threshold be?

If UCT's were to be introduced then in principle, FANZ may support a transaction value. That said, a transaction value is not always a perfect determinant of sophistication. For example, there are low investment executive consulting and other types of franchises that may have a very low investment – but attract a sophisticated franchisee, and vice versa.

We do not comment on what that transaction value should be.

22. Should there be penalties for breaching any new provisions regarding UCT's, and should there be civil remedies available, even if unfair terms have not previously been declared by a court to be unfair? How should any penalties and remedies be designed?

FANZ does not agree with civil or other penalties flowing from a finding that contract terms are said to be unfair. There should first be a declaration from the Court to that effect, given the erosion of freedom of contract that UCT provisions would allow for.

Further, the substantial uncertainty with the interpretation of any such legislation, is a reason to ensure the effects and consequences of UCT legislation is introduced gradually.

23. Are there any other options to address unfair conduct or unfair contracts that we should consider? If so what are these?

Yes, consider providing a better access to justice and business education for parties and at low value contracts as referred to above.

See our comments under question 10 above.