COMMON ISSUES ARISING IN FRANCHISE DISPUTES
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1. Termination of franchise agreements

1.1 Establishing the right to terminate

The starting point is the agreement. This will dictate when the agreement can be terminated. Franchise agreements will typically contain extensive provisions regarding when and how a franchisor can terminate. Conversely, there will generally be no contractual right for a franchisee to terminate. A franchisee however has its normal rights of termination under the Contractual Remedies Act 1979.[1]

There will generally be two methods of termination provided to the franchisor:

a) Immediate termination. This will generally be provided where there has been a serious event, such as liquidation or bankruptcy of the franchisee, or the termination of the lease of the premises from which the franchisee operates;

b) Termination following non-compliance with a breach notice. The agreement will specify such a method and require compliance within a set timeframe.

Note the similarity with employment agreements, which provide for an ability to terminate on a summary basis where there has been serious misconduct, and for performance management for less serious breaches.

[1] Not the subject of this paper.

1.2 Exercise of a contractual discretion – does a franchisor have to observe good faith when exercising its contractual power to terminate?

When a franchisor issues a breach notice requiring compliance, they generally have a discretion as to whether or not to terminate if compliance does not occur. The question arises whether the franchisor must observe good faith when exercising that discretion.

Consider the following (not uncommon) fact scenarios:

a) A franchisor has formed a strong dislike for a particular franchisee, who it regards as uncooperative, belligerent and a general complainer. The franchise agreement provides that the franchisor may terminate if, after having issued a breach notice for non-payment of fees, there is no compliance with that notice within 7 days of the date of issue. The franchisor issues a breach notice, and payment is not made within 7 days of the notice being issued, but is paid on the 8th day. Technically there is a right of termination. Can the franchisor, heartily sick of the franchisee and simply wanting to get rid of them, terminate?

b) A particular franchisee is repeatedly in breach of the obligation to pay franchise fees on time. The franchisor never does anything about it. The franchisor decides one day they have had enough and, never having previously issued a breach notice before, now does so. The amount of fees outstanding is small and the franchisee does not pay when the breach notice is served, thinking that, like all the previous occasions, nothing bad will happen. Can the franchisor terminate?

c) A franchise agreement contains a clause which enables the franchisee to terminate the agreement if the franchisee is found to have competed during the term of the agreement upon 5 working days' notice being given to rectify. The franchisor issues a breach notice giving the franchisee 5 working days to stop the alleged competing behaviour. It also, during that 5 day period, demands payment of "reparations" of $10,000, as well as all legal costs arising as a result of the alleged breach. It also demands that the franchisee submit a full business plan and accounts for the last financial year. The franchisee disputes that it is competing and instigates dispute resolution under the mediation clause. The franchisor responds by saying there is no dispute because the franchisee is clearly in breach. Can the franchisor terminate?

The answer in each of these scenarios may depend on whether there is any obligation of good faith that arises when exercising the discretion to terminate.

Good faith in franchising generally

If there is an implied term in franchise agreements generally, then, in the postulated fact scenarios, it could be argued that the franchisor will be in breach of that term if it decided to terminate. This is because the termination would be for an ulterior purpose, namely, to get rid of a franchisee with whom the franchisor no longer wishes to deal.

Franchise agreements will sometimes contain express obligations of good faith. But where there is no express obligation of good faith, what is the position at law?

At the heart of many franchise disputes lies an allegation by a franchisee of a lack of good faith. It is a "go to" allegation for franchisees, understandable against the reality of the commercial backdrop where there can often be little to no explicit obligation on a franchisor in the agreement other than to provide a system and regularly update it. When things go pear-shaped from the point of view of the franchisee, it thus becomes almost impossible to point to any specific breach of the agreement itself.

The Privy Council in *Dymocks Franchise Systems (NSW) Pty Ltd v Todd*[2] left open the question of whether there is or should be an implied obligation of good faith in franchise agreements generally. At paragraphs 56 to 57 of their judgment, Their Lordships state:

> ***[56]*** *Their Lordships therefore agree with the Court of Appeal that the Judge erred in the exercise of his discretion in seeking to determine this difficult question of New South Wales law without proper expert evidence. In view of the continuing disagreement between the experts as to whether or not there is an obligation of good faith in a case such as the present, Their Lordships also prefer the course of prudence and do not seek to answer the question since there is some other proper ground on which the appeal can be decided.*
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> ***[57]*** *However, before leaving this issue Their Lordships wish to say a word or two about the Court of Appeal judgment on it. Although the Court of Appeal decided the point on the ground that the necessary expert evidence was not before the Court, they made a number of comments suggesting that "there is no room" for superimposing a general duty of good faith, that to do so conflicts with requirements of certainty in commercial contracts, and that franchise agreements are not analogous to employment contracts (where duties of good faith are implicit).* ***These comments suggest that, in their view, the development of the law so as to make an obligation of good faith implicit in the relationship between franchisor and franchisee (as in the case of partnership and other joint venture agreements) is not desirable. Their Lordships propose to express no concluded view on these comments and wish to reserve their opinion on the suggestion that the implication of an obligation of good faith in the relationship between franchisor and franchisee would be an undesirable development.*** (emphasis added).

I believe the common law as it applies in New Zealand has some way to go before an obligation of good faith is found to be implied in franchise agreements.[3] A franchising relationship is somewhat different than other commercial relationships where fiduciary duties have been found to arise, for eg, in a true Joint venture relationship or a partnership. In those sorts of relationships, there is an element of working together towards a common purpose and trust and confidence are usually necessary. Further, the "right" cases will be slow to come before the Courts because

[2] [2004] 1 NZLR 289.
[3] After all, franchise agreements are generally complete, full and entered into between sophisticated business parties after the opportunity to take legal advice has been provided and, usually, taken.

the reality is that disputes involving lack of good faith tend to be small disputes,[4] or disputes where access to justice is likely to be denied because the franchisee has run out of money and cannot afford to sue or to defend legal proceedings.

Good faith in the exercise of a contractual power?

Leaving aside the vexed question whether there is an implied obligation of good faith in franchise agreements, there is ample case law which supports the principle that in the exercise of a contractual power a party cannot act in bad faith.

In an excellent article by Kós J[5], he discusses the nature and development of the "default rule" that applies to the exercise of contractual powers, explaining 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."[6] He explains that with contractual powers must come constraint: "otherwise the powers would instead become mechanisms for oppression and neither efficient nor acceptable in a common law jurisdiction."[7]

He distils a locus classicus statement of the default rule from *Abu Dhabi National Tanker Co v Product Star Shipping Co Ltd*[8] as follows:

> *"For the purposes of judicial review the Court is concerned to judge whether a decision-making body has exceeded its power, and in this context whether a particular decision is so perverse that no reasonable body, properly directing itself to the applicable law, could have reached such a decision. But the exercise of judicial control of administrative action is an analogy which must be applied with caution to the assessment of whether a contractual discretion has been properly exercised. The essential question always is whether the relevant power has been abused. Where A and B contract with one another to confer a discretion on A, that does not render B subject to A's uninhibited whim.*
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> *In my judgment, the authorities show that not only must the discretion be exercised honestly and in good faith, but having regard to the provisions of the contract by which it must be conferred, it must not be exercised arbitrarily, capriciously or unreasonably. That entails a proper consideration of the matter after making any necessarily enquiries. To these principles, little is added by the concept of fairness: it does no more than describe the result achieved by their application."*

The *Abu Dhabi* case concerned a Charterparty of a merchant tanker entered into at the time of the 1987 Iran-Iraq war. The Charterparty contained a clause which gave the owners the right to decline to load or discharge where "the loading or discharging of cargo at any…port be considered by the Master or the owner in his or their discretion dangerous." After four voyages, the owners (without warning) refused to

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[4] Often claims for well under $200,000.
[5] "Constraints on the Exercise of Contractual Powers", Kos J, (2011) 42 VUWR 17.
[6] Ibid, at page 20.
[7] Ibid, at page 20.
[8] [1993] 1 Lloyd's Red 397 (CA), at 404, per Leggatt LJ.

permit loading. The trial Judge applied the default rule against the owners, finding that the decision to refuse to permit loading was not warranted because:

a) The owners could not point to any material on which a reasonable ship-owner could have considered that the risks were greater than they were at the start of the contract; and
b) The owners were using the contractual power for a collateral purpose, ie, to resolve a separate dispute under the Charterparty concerning overage insurance.

In his article, Kós J refers to the various other English authorities which have subsequently affirmed and applied the principle stated in *Abu Dhabi.*[9] Whilst not the subject of extensive consideration in New Zealand, New Zealand cases have directly referred to the Kós J article and the *Abu Dhabi* case as correctly stating the law in New Zealand.[10]

An example is *Vero Insurance NZ Ltd v Fleet Insurance & Risk Management Ltd.*[11] The case involved a shareholders' dispute. The Plaintiff and the Defendant were joint venture partners who created a firm known as Axiom. The shareholders' agreement required the parties to seek the other's consent if there was to be a transfer of ownership of their shares in the Company, which consent "the other party may withhold in its absolute discretion or may grant subject to such conditions as that party may consider appropriate at its absolute discretion". A change of control was deemed to be a transfer of the ownership of their shares.

The Plaintiff did not seek consent when there was a change in its control, as it was required to do. That led to the Defendant alleging this was a material breach of the agreement, and moving to put Axiom into liquidation. The Plaintiff then subsequently sought consent, which was declined.

The case came before the Court as an interim injunction application. Asher J, in applying the principle in the *Abu Dhabi* case, said:

> *"Thus the proposition can be put that parties to a contract must, in exercising a broad contractual discretion, be true to the ideal that lies behind the contract. In the words of Lord Steyn in First Energy (UK) Ltd v Hungarian International Bank Ltd [1993] 2 Lloyds Rep 194:*
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> > *"A theme that runs through our law of contract is that the reasonable expectations of honest men must be protected. It is not a rule or principle of law. It is the objective which has been and still is the principal moulding force of our law of contract."*

[9] At pages 22 to 24.
[10] See 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.
[11] CIV 2007-404-001438, Asher J.

Another way of articulating the meaning of good faith in this context is to say that a discretion, having regard to the provisions of the contract by which it is conferred, must not be exercised arbitrarily, capriciously or unreasonably" [12]

In finding that there was a serious question to be tried, Asher J decided that the refusal to consent for the reason that it could escape an unwelcome contract could be seen as an arbitrary and unreasonable action, not connected to the objects of the contract, and not in accord with what would, on an objective test, be the reasonable expectations of the contracting parties. Such a purpose had nothing to do with the change in shareholding. It had nothing to do with the justified expectations of the parties when they entered into the contract.[13]

Two caveats on the application of the default rule are worthy of mention:
a) Like any other implied term, it cannot stand in the face of an express term; and
b) A sole discretion clause, for eg, "the franchisor can / may in its sole discretion decide to terminate" would be tantamount to an express exclusion of the default rule.[14]

Specifically with regard to franchising, academics, Gehan Gunasekara and Jenny Buchan, have also considered the bounds of contractual discretion. In their recent article[15] they draw an analogy between those wielding administrative power and franchisors. Their hypothesis is there is an inherent power imbalance in franchise relationships, borne of the fact that the franchisor drafts the franchise agreement and the franchisee has very little bargaining power to change the terms of that agreement. They point out (and as any franchise practitioner will know) franchise agreements are top-heavy on franchisee obligation and light on franchisor obligation. Where there is franchisor obligation in a franchise agreement[16], that obligation will often be couched in discretionary phraseology. Conversely, there will be no equivocation or room for discretion in terms of what the franchisee must do.[17]

Their reasoning is not without attraction. Whilst in theory all contracts are a matter of negotiation, in franchising the reality is there is no real negotiation. Franchisees who

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[12] Ibid, paragraph 47.
[13] Ibid, at paragraph 48.
[14] See for eg, *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15, where Giles JA concluded that the relevant contractual powers were not fettered by an implied obligation of good faith and reasonableness, laying particular emphasis on the fact that the power "was emphatically described as a sole discretion."
[15] "Administrative law parallels with private law concepts: Unconscionable conduct, good faith and fairness in franchise relationships" (2015) 36 Adelaide Law Review 541 (Gehan Gunasekara and Jenny Buchan).
[16] For example, the obligation to market the system nationally.
[17] Gehan Gunasekara and Jenny Buchan in "Administrative law parallels with private law concepts: Unconscionable conduct, good faith and fairness in franchise relationships" (2015) 36 Adelaide Law Review 541 write: "Power imbalance has long been the Achilles heel of the franchise model. As a structural weakness it has the ability to make the model less attractive to franchisee investors. It remains problematic for the following reasons. The ability to draft the standard form contract enables franchisors to cast their obligations in discretionary terms, and the franchisees' role in terms of predominantly non-negotiated, iron-clad obligations. Franchisees accept that the blatantly 'unfair' aspects of their franchise agreements are necessary to enable the franchisor to bring rogue franchisees into line and thus to protect the brand, but arguably they are more often used to force franchisees to 'behave'."

want to buy a franchise must sign up to the franchisor's agreement and in reality they have little power to change or amend anything in the agreement.

Gunasekara and Buchan point out that a franchisor's discretionary contractual powers are often worded in identical terms to statutory powers, employing unmistakably discretionary language such as 'may'. They argue that the power imbalance is akin to the same power imbalance in administrative law, where statutory bodies have powers to grant, withhold, suspend or cancel licences and to engage in activity and to approve or withhold approval for particular transactions.[18] The essential tenets of administrative law require decision-making authorities to be 'lawful, to act in good faith, to be [procedurally] fair and to be rational'[19] in the exercise of their powers. Finally, they observe that there have been a number of cases where administrative law concepts have migrated into the private law arena, referring to some of the same cases referred to in the Kós J article.[20]

Although a theory not attractive to franchisors, some contend that the nature of the franchise relationship has marked similarities to the employment relationship and that this is therefore a further reason why there should be good faith implied in franchises. In this regard, it is hard to argue that the following typical characteristics of franchise agreements are not similar to those of employment agreements:

- Overall control by the franchisor of the performance of the franchisee, including a right of termination where performance targets and performance standards are not met.
- A lack of bargaining power at the outset.
- A relationship contract.
- The franchisee works full time in the business and draws a regular revenue from it.
- The agreement gives the appearance of a separate business but, in reality, the franchisor can control every aspect of the franchisee's business through the provisions of the agreement and the operations manual.
- In some franchise systems, money from customers is paid direct to the franchisor, who then deducts fees and makes a payment to the franchisee. The franchisee has little control over the revenue stream.

1.3 Practical concerns for franchisors wanting to terminate – getting your ducks in a row

[18] Ibid, page 546. There, the learned authors argue that "A franchise agreement and its accompanying documents create an environment of private regulation with the franchisor acting as both regulator and arbiter."

[19] Chief Justice Robert French, 'Administrative Law in Australia: Themes and Values' in Matthew Groves and H P Lee (eds) Australian Administrative Law: Fundamentals, Principles and Doctrines (Cambridge University Press, 2007) 15.

[20] For example, in *Paragon Finance Plc v Nash* [2001] EWCA CIV 1466, the English Court of Appeal had to decide whether a mortgagee's discretion to vary interest rates was subject to an implied term fettering its exercise. The Court found there was an implied term that the mortgagee was bound not to exercise the discretion 'dishonestly, for an improper purpose, capriciously or arbitrarily'.

Franchisors wanting to terminate need to first ensure they are ready for termination. This involves making considered decisions about the following questions:

a) The agreement will often require telephone and other contact details to be provided on termination. Does the agreement allow the franchisor to go straight to Spark / Vodafone to obtain transfer of contact details?

b) Is there equipment which the franchisor might have the right to buy from the franchisee and take back? What equipment is that, where is it, and does consideration need to be given to seeking an interim order to ensure it does not "disappear" once termination occurs?

c) How easy is it for the franchisee to continue on in business after termination? Can access to the database be cut off or will the franchisee still have access to all details regarding customers? Does the franchisor in fact want the business back? If so, does the franchisor have anyone available to take over running of the business?

Sorting out answers to the foregoing questions and getting the cooperation of the exiting franchisee can make actual termination off-putting. Where a franchisee is hell- bent on continuing to trade or disputes termination, obtaining interim orders and battling the matter out through the Courts can be expensive and produce no winners. In the meantime, the dispute becomes well publicised[21] and there can be consequential damage to the franchisor's brand, as well as unsettling franchisees, even if the franchisor is in the right.

2. Compulsory mediation clauses

In the franchising context, where there is a compulsory dispute resolution provision in franchise agreements, the Courts will enforce this. Parties who decide to include such provisions in their agreements are taken to have accepted this is the way in which their disputes should be resolved. See for eg, *Waterco (NZ) Ltd v Simpson*[22] where a compulsory mediation provision was upheld. Franchisors must mediate where a dispute is raised and should not be permitted to wriggle out of their mediation obligations.

3. Restraint of trade update

Franchising is alive and well as an accepted form of business methodology and growth in New Zealand.[23] Franchising allows successful and proven business concepts to expand and grow, through a network of independent franchisees. Franchisees acquire the right to use the franchise system, in return for which they pay franchise fees and agree to adhere to an operations manual, ensuring consistency across the brand and system.

Franchising is only attractive to franchisors as a method of business expansion if they can retain control over the use of their brand, their system and the way in which

[21] See for eg, *Health Club Brands Ltd v Colven Botany Ltd* [2013] NZHC 428.
[22] [2012] NZHC 2361.
[23] There are over 400 franchises in New Zealand. The industry contributes an estimated $20 billion to the NZ economy.

their products and services are to be delivered. Ensuring franchisees are bound by a restraint of trade clause is an important commercial feature of the control franchisors need to retain over their brand and goodwill.

Three recent cases have shown a robust approach being taken by the Courts to upholding restraint of trade clauses in franchising. Each case concerned a well-established franchise system and a long-standing franchisee.[24] These cases will be leaving franchisors feeling more secure about the enforceability of their restraints, but in this paper I suggest that uncertainty still lingers about the enforceability of restraint of trade clauses in the franchising context.

The diverse nature, size, pathway to growth and extent of development of the many and varied franchise systems in New Zealand necessarily means that a rigorous case-by-case analysis of the "protectable interest" underpinning restraints should always remain the correct starting point when considering the reasonableness of restraints. It should by no means ever be taken as a given that a franchisor can protect its business by a restraint.

The basics

As is well known, contractual provisions imposing a restraint of trade are, prima facie, void and unenforceable. However, where the party seeking to enforce the provision establishes that the restriction is reasonable, it may be enforced. The party attempting to enforce the restraint must show:

a) there is a protectable (otherwise known as a proprietary or legitimate) interest justifying the restraint; and

b) that the restraint goes no wider than is reasonably necessary to protect that interest.[25]

The starting point is therefore that the franchisor must point to a legitimate interest worth protecting.

What is a legitimate interest in franchising?

There was a spate of early cases in franchising where the New Zealand Courts found little difficulty in acknowledging that franchisors were able to establish a legitimate interest in their franchise system and thus protect that interest by a restraint of trade clause. The requisite interest is discussed in these cases as if it was almost a given, or as something which is almost assumed to be in existence in order for there to be a franchise system in the first place.

For example, Hammond J (as he then was) at first instance in *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd*[26] said:[27]

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[24] *Video Ezy International Pty Limited v Red Bond Limited* [2015] NZHC 1636, *Health Club Brands Ltd v Colven Botany Ltd* [2013] NZHC 428 and *Mike Pero (New Zealand) Ltd v Heath and Others* [2015] NZHC 2040.

[25] *Brown v Brown* [1980] 1 NZLR 484 (CA); *Richmastery Ltd v Richmastery (Central) Ltd*, (HC), Lang J, CIV-2005-470-951; 22, 24 May 2006.

[26] *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* (1999) 8 TCLR 612.

[27] Ibid; (at [275]) and followed in *Richmastery Ltd v Richmastery (Central) Ltd,* ibid, at paragraph 49.

> "… I have no difficulty in holding that a franchisor in a case such as this has a protectable interest. The franchisee is assisted in the startup and running of a business; it borrows expertise and support systems of all kinds. To put it shortly, if a franchisor could not protect its interests after termination, the franchising industry generally would collapse."[28]

See also *Washworld Corp v Reid,*[29] where William Young J said:[30]

> "In terms of the public interest, I see no particular general difficulty with a restraint at least if it is properly limited. In my view a franchisor who has gone to the difficulty and expense of developing a successful business model is entitled to protect its investment in that business model by prohibiting franchisees from exploiting it for their own advantage and in competition with the franchisor and other franchisees."

And further *Mike Pero (New Zealand) Ltd v Exact Solutions Ltd:*[31]

> "I accept that a franchisor such as Mike Pero that has established a successful business model is entitled to protect its investment by means of restraint of trade."

The legitimate interest in these cases was said to arise by virtue of the existence of a business model, the investment by the franchisor in that business model and the provision of support systems. There is little detailed discussion in each of these cases as to what is further meant by "legitimate interest" in the context of each franchise but clearly each of the three systems involved were and / or are well known New Zealand franchise systems.

After somewhat of a hiatus, in four recent cases, *Video Ezy International Pty Limited v Red Bond Limited*, *Health Club Brands Ltd v Colven Botany Ltd*, *Mike Pero (New Zealand) Ltd v Heath and others* and *Skids Programme Management Ltd v McNeill,*[32] restraints of trade clauses were similarly upheld, with the Courts finding, in each case, that the necessary legitimate interest was present. Each of the cases involved franchise systems that were long-standing and well established New Zealand brands. Likewise, the franchisees involved were well established, long-standing franchisees.

In the first three decisions, there is little detailed discussion about the nature of the legitimate interest, possibly because they all came before the Court as interim injunction applications. However, in the fourth case, *Skids Programme Management*

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[28] These comments were adopted by Lang J in *Richmastery Ltd v Richmastery (Central) Ltd* (unreported, High Court Tauranga, 24.5.06) at paragraph 49.
[29] (1999) 8 TDLR 372, at 385.
[30] Ibid, at 385.
[31] (unreported, Miller J, 17.4.07).
[32] *Video Ezy International Pty Limited v Red Bond Limited* [2015] NZHC 1636, *Health Club Brands Ltd v Colven Botany Ltd* [2013] NZHC 428, *Skids Programme Management Ltd v McNeill* [2012] NZCA 314; [2013] 1 NZLR 1 and *Mike Pero (New Zealand) Ltd v Heath and others* [2015] NZHC 2040.

Ltd v McNeill[33] there is a detailed analysis in the decision of what is meant by the term "legitimate interest" in franchising.

The "Skids" franchise system (Safe Kids in Daily Supervision) is a business methodology of after-school services in schools. Franchisees run a standardised after-school care programme, from premises leased within a school. The system is a successful system, well established and with a nationwide presence.

In the *Skids*[34] case, after termination of the franchise agreement, the franchisee in question continued to provide after-school care services, from the same location, to the same customers. There was a restraint of trade provision in the agreement which applied for two years from termination of the agreement. The franchisor sought an interim injunction to enforce the restraint and lost. It did not appeal that outcome but did press ahead with its substantive proceedings. The case eventually came before the High Court as an application for a permanent injunction and then went on to an Appeal.

In the High Court,[35] Woodhouse J concluded that the franchisor was not able to show that the restraint of trade clause was reasonable. He found that there was insufficient protectable interest, finding (relying on concessions from the franchisor) that there was no special difficulty with the running of an after-school care programme. He found that the standard form documents that the franchisor had developed as part of its system did not require a high degree of sophistication.

He also found that there were other provisions, such as the confidentiality requirement, which provided adequate protection for the franchisor. Therefore, a restraint was not needed. He found that the programme offered by the franchisor and other operators provided a valuable social service and it was in the public interest that the service be readily available. He concluded that the restraint of trade provision was not enforceable.

The Court of Appeal disagreed

The case went on appeal and the decision was overturned. In answering the question what is the necessary legitimate interest, the Court of Appeal first looked closely at the franchise arrangement to see what there was to protect. It found that there were a number of features which the Skids franchise system offered, stating:

> *"It offered a name. Certainly by 2009 there was goodwill attached to that name, and those who had worked for Skids would have been associated by customers with that name. The use of the name "Skids" itself was protected by express contractual provisions and the tort of passing off independently of any restraint of trade, but operating under the umbrella of goodwill provided by the franchise gave a former franchisee credibility and a cache of former customers. That background goodwill accumulated by a franchisee was still of use after termination."*

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[33] See fn 10.
[34] *Skids Programme Management Ltd v McNeill* [2012] NZCA 314; [2013] 1 NZLR 1.
[35] *Safe Kids in Daily Supervision Ltd v McNeill* [2012] 1 NZLR 714 (HC).

The Court found that there were low barriers to entry for franchisees but noted the evidence of the franchisor that there were various benefits offered to franchisees as follows:

> *"These included: a full-time dedicated franchise support person to assist in training and development; national marketing for the business, including the maintenance of a website; regular conferences and meetings; an online enrolment facility; monthly training opportunities for franchisees and their staff; discounted rates for insurance; and an accounting package for new franchisees. Skids had all the OSCAR accreditation information and had worked out techniques to obtain accreditation. The fact that the former franchisee had paid a sum for the franchise benefits is not an answer, as the payment was for the use of the franchise benefits for the duration of the franchise, but not thereafter.*
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> *[46] Skids franchisees were provided with material including an operations manual, a policy and procedures manual, onsite manuals, a pricing structure, employment documentation, enrolment documentation, and programme modules amongst other things. Materials that were provided were subject to ongoing revision. Specialised material was made available to enable franchisees to obtain CYFS accreditation. While the base material that constituted the inputs to franchise documents was widely available, the standard documents could not have been created without work and thought."*

As to the low barriers to entry, the Court noted that:

> *"In particular, in an area where no particular trade or professional skills are offered, the franchise systems, by instantly conferring these benefits, enable a franchisee to gain an advantage over competitors who are starting or have started from scratch.*
> *[48] While an assiduous competitor might be able to accumulate a body of such material itself over a period, to do so would take considerable time and effort. We do not think the issue is only whether the knowhow and material is widely available. It is about the opportunity and immediate knowledge given by the franchisor to the franchisee, which equips the departing franchisee who intends to compete with an immediate significant advantage over any other start-up competitor."*

The Court concluded that due to the provision of all these benefits, it did not matter much that the particular franchise system was not sophisticated and did not involve particular technical know-how. It was nevertheless prepared to find there was a protectable interest.

Conclusions to be drawn from the cases on the question of legitimate interest

Many would suggest that the cases now provide ample authority in support of a legitimate interest in franchising. Are we at a stage where, in franchising, the existence of a protectable interest can almost be assumed?

The cases where the Courts have been prepared to uphold restraints each involved successful well established systems with a strong network of franchisees. The question arises, what if the “business model” and “support systems” have not been updated and (objectively speaking) are of no value or assistance or if the system itself is a dying system where growth is receding? This is not an uncommon scenario in franchise disputes because a lack of updating will lead to disgruntlement by franchisees and fuel a desire to exit the system. The other scenario which often arises is where the system is a new one but is simply not working. Alternatively, it is an old system that is in its dying mode and exiting franchisees are not being replaced. I believe it could be argued in these cases that there is not an adequate “protectable interest” justifying a restraint.

These questions seem all the more pertinent when one remembers there are over 400 different franchise systems in New Zealand, each with their own definition of system, goodwill and methodology and each with their own pathway to growth. Not all of them are destined for success. Some will collapse through simply being a fad business concept. Others will never reach maturity in that they are unable to attract sufficient franchisees. Others will fail because they are simply not a good investment for their franchisees in that the franchisees do not make a reasonable return on their investment.

It is these borderline cases which are more likely to lead to the question being asked of legal advisers about enforceability of restraints in the first place. The franchisee will gradually come to realise that with a system that is shrinking or simply not providing it with an adequate return, it is better off on its own. If it is not bound by a restraint, then the solution can often seem obvious: de-badge and have a go at making it on your own.

Such a situation arose in an Australian case, *BB Australia Pty Ltd v Karioi Pty Ltd*,[36] where Blockbuster, the franchisor, entered into two franchise agreements with the Defendant to operate two video outlets in Queensland. The Defendant was, prior to becoming a franchisee, already operating two video stores. At the expiry of the term of the franchise agreement, the Defendant simply rebranded and continued to operate its video stores as before.

There was a restraint of trade clause in the franchise agreement which prevented any competitive activity for three years from termination and within a radius of 30 kms from any Blockbuster store.

The Court found:

- The Plaintiff had no legitimate interest in the precise location of the stores, given the leases were not in its name;
- The Defendant had built up its own goodwill in the stores prior to becoming a franchisee;
- The Plaintiff’s IP was adequately protected by other protections in the franchise agreement.

[36] *BB Australia Pty Ltd v Karioi Pty Ltd* [2010] NSWCA 347.

There was a similar negative outcome for the franchisor in a Canadian case, *MEDIchair LP v DME Medequip Inc.*[37] In this case, the Ontario Court of Appeal refused to enforce a restraint clause because it was demonstrated that the franchisor did not intend to open a franchised store within the restricted territory. The Court concluded that the restraint clause must only protect the "legitimate interest of the franchisor" and could not extend beyond that. The Court found that because the franchisor did not intend to open a competing store in that location, it had failed to establish a protectable interest in that territory. The court noted that "by deciding not to operate in Peterborough, [the franchisor] effectively acknowledged that it had no legitimate or proprietary interest to protect within the defined territorial scope of the covenant."[38]

It is the author's view, given the large and ever-growing numbers of franchised businesses in New Zealand, and the likely continued emergence of restraint of trade disputes, that it is more important than ever that the existence of "legitimate interest" should never be assumed, but should however be closely examined on a case-by-case basis. The diverse nature, size, pathway to growth and extent of development of the many and varied franchise systems in New Zealand necessarily means that a case –by-case analysis of the "legitimate interest" underpinning restraints should always remain the correct starting point when considering the reasonableness of restraints. It should by no means ever be taken as a given that just because a business is franchised, a franchisor can protect its business by a restraint.

Does the restraint of trade clause go wider than necessary to protect the "legitimate interest"?

This is the second important question that arises in the context of enforceability of restraints. It is one which receives little judicial attention because of course the majority of cases in this area of law come before the Court by way of interim injunctions.[39]

Restraint of clauses will typically be restrictive as to:

a) competitive activity within a certain geographical location;
b) competitive activity for a certain period of time;
c) the type of trading activity (eg a restraint on soliciting custom or dealing with certain customers, or a wider more restrictive restraint generally on any type of competitive activity).

In the *Skids* case, the restraint clause provided that the franchisee would be restrained for 2 years from competitive activity upon termination. In the High Court, the Court was of the view that in the event there was a protectable interest, three

[37] 2016 ONCA 168. The franchisor operated a network of ovations that sell and lease home medical equipment and the franchisee had had a franchise located in Peterborough, Ontario, a relatively small town, for about 20 years.
[38] Ibid at paragraph 47. And see also *Groupe Sportscene Inc v 2639-6564 Quebec Inc* 2013 QCCS 17, to a similar effect.
[39] There is also the ability, in New Zealand, to modify unreasonable widely worded restraints by recourse to the Illegal Contracts Act 1970.

months would have been a sufficient period of time to protect that interest. That finding was not overturned by the Court of Appeal.

In an Australian case, *Murray Pest Management Pty Ltd V A & J Bilske Pty Ltd,*[40] the Northern Territory Supreme Court found the restraint of trade clause too wide because the clause prevented the franchisee from having any interest in a similar pest control business in not only its own territory, but also the territory of other franchisees as well as within a 5 km radius of those territories. Effectively what this meant was that the franchisee could not compete anywhere for thousands of kilometres from the territory.

In *Cafe2U Pty Ltd v Bishambu Pty Ltd,*[41] the franchisor was a franchisor of mobile coffee vans in Australia. The franchise agreement contained a restraint of trade on competition for a period of 12 months with a clause which cascaded down to 3 months within the territory of Australia, which then in turn cascaded down to within any Cafe2U territory. The Defendant franchisee decided to commence operation of a similar business, branded Cafe Metro. He even purchased product from the franchisor to be used in the operation of that business. The franchisor terminated the franchise agreement and then sought to enforce the restraint within the territory for 6 months, which was successful.

Advice to drafters

The franchisor needs to ask itself, when these clauses are drafted, what is it really trying to protect and what restraint does it reasonably (and realistically) need to achieve that end? In relation to what period of time should apply, a relevant question is what period of time would it take to enable a new franchisee to enter the territory and build up its own franchised business, free from competition from the exiting franchisee?

It is important to remember that franchising is not a one-size-fits-all approach. It is imperative that drafters understand the history and nature of the franchise before even embarking on the process of drafting a restraint of trade clause.

It is also important to ensure that the agreement contains very strong protection against misuse of confidential information and IP in the event the restraint fails, as well as other protections such as providing that the franchisor can elect to purchase parts of the franchisee’s business and to take over its lease premises, telephone and contact details.

4. Complaints about the quality of the services provided by the franchisor

These types of complaints are common, however all too often there is no comeback against a franchisor because the way in which the obligation on the franchisor to do anything at all is very weak. Further, discretion is reserved to the franchisor to make decisions which affect the franchise. In theory the two businesses are separate but in

[40] *Murray Pest Management Pty Ltd v A & J Bilske Pty Ltd* [2012] NTSC 05.
[41] *Cafe2U Pty Ltd v Bishambu Pty Ltd* [2013] FCA 191.

practice, important decisions affecting the franchisee's business are made by the franchisor.

The well-publicised *Club Physical* case[42] has been helpful in that it has taught lawyers advising franchisees to exercise caution when guiding them through the minefield of franchisee disputes. The case highlights the difficulty franchisees face when complaining about the "performance of the franchisor" and not thinking through alternative courses of action to deal with such complaints before resorting to cancellation under the Contractual Remedies Act 1979.

The franchisee, somewhat boldly, pointed to breaches of the franchisor's obligation to provide assistance as grounds to cancel the franchise agreements[43] under the Contractual Remedies Act.

The franchisee's case was that the franchisor breached the obligation: "To provide ongoing business development assistance and advice in relation to the operation of the Club Physical Franchise including a site visit to the Premises at least four times in each financial year."

The allegations leveled by the franchisee against the franchisor merit some consideration because they are the sort of typical complaints that franchisees raise.

The defendant alleged that Mr Richards (of the plaintiff) refused to provide "ongoing business development assistance and advice in relation to the operation of the Club Physical Franchises" in the following respects:

> a) First, it was alleged the plaintiff refused to evaluate the group's pricing in light of intense competition from other low-cost gyms starting up in the Auckland region, and even forced the defendant to shut down initiatives he had introduced to become more competitive. At the same time, it was alleged that the plaintiff's own Club Physical gyms were undercutting prices across the rest of the group, which created confusion in the market place about the Club Physical offering and undermined the defendants' attempts to gain new members.
> b) Secondly, the defendant complained of poor marketing systems.
> c) Thirdly, the defendant claimed that attendance at fitness classes provided by the franchisor, and charged separately to the franchise fee, was very low. The defendant said that attendance at classes was falling because Health Club Brands did not refresh the nature of the classes. This meant that the defendants' gyms lost customers to their low-cost competitors.
> d) Finally, the defendants said that site visits were supposed to be carried out by the plaintiff at least four times every year, whereas the plaintiff only visited sporadically.

The defendant duly cancelled the franchise agreements without warning under the Contractual Remedies Act, arguing it was entitled to cancel the franchise agreements under that Act because there was a breach of an essential term

[42] *Health Club Brands Ltd v Colven Botany Ltd* [2013] NZHC 428.
[43] The franchisee had three Club Physical franchises.

(obligation to assist) and/or the effect of the breach was substantial (lack of assistance leading to near insolvency of the franchisee).

Winkelmann J did not accept the arguments of the franchisee, finding:[44]

> *"Having reviewed the evidence, I am satisfied that the defendant's case that breaches of contract by Health Club Brands justified cancellation is poorly supported. Mr Holder's evidence is, in significant part, confused and contradictory. He complains that, despite promises of assistance and support being made, Mr Richards did not visit the clubs or provide them with any direct assistance or training, and that he offered a "total lack of support". But in his affidavit he also states that there were in fact monthly marketing meetings, that he had numerous meetings with Mr Richards in which he raised pricing issues with him, and that Mr Richards caused disruption by "continuing to exert influence over the gym" through Health Club Brands' sales manager, Ms Miles (who is also Mr Richards' sister-in-law). He says that Ms Miles visited the Three Kings gym nearly every day. The extent of the influence exerted was so great that Mr Holder advised the Three Kings' staff not to discuss in-house matters with Ms Miles or Mr Richards, and asked staff to sign confidentiality agreements. In light of this evidence, and even had Mr Richards not responded to the allegations made in Mr Holder's affidavit, it would be difficult to conclude that Health Club Brands had failed to offer "ongoing business development assistance and advice". Mr Holder may not have liked the business development assistance and advice, but it seems he received it."*

In the event, the franchisee in that case had set off on a course of action which led inexorably to colossal failure. It cancelled, rebranded, but only to then be found to be in breach of its restraint of trade obligations with dubious grounds of termination.

The outcome of the Club Physical decision was the only sensible decision to be reached, in my view. The effect of a franchisee, without warning, cancelling and rebranding can be devastating on a franchise system, not only for the franchisor but also for the other franchisees who are all looking to the franchisor to do something to pull the renegade franchisee in line. The Club Physical case was well publicised when it hit the Courts and there would have been damage to the goodwill of the brand, regardless of the outcome. Had the position of the franchisee been upheld, it could well have led to a plethora of cancelations of franchise agreements by franchisees in the Club Physical franchise system, and also in other franchises.

The franchisee had other courses potentially open to it. Other (more cautious) courses of action could have included raising grounds of termination, reserving the right to terminate whilst mediation and dispute resolution were first invoked. The other option was to issue proceedings to recover the losses they were alleging they had suffered as a result of the franchisor breaches.

<u>Conclusion</u>

[44] Ibid, at paragraph 43.

The law relating to franchising may well one day be affected by legislation. Unlike Australia, New Zealand has no specific franchising legislation. This may of course change in the future.

With little being written about the topic, and little case law, advising franchisors and franchisees needs to be handled delicately and cautiously. Because most franchise disputes involve smaller sums of money, they are channelled to mediation and often suffer from a lack of funding (especially where a franchisee has already run out of money by the time they approach their lawyer about a dispute), in my view a body of case law will be slow to develop.

Although franchise agreements are contracts (and therefore subject to normal contract law), franchise agreements are also a relationship contract in which both sides carry a huge (often emotional) investment. For franchisees, their franchise will often be their livelihood and sole means of receiving family income. Their position is not unlike employees.

Deirdre Watson
Barrister
August 2016