

Franchising gone wrong



Stewart Germann explains why he believes a recent Court of Appeal decision has created 'bad law' in New Zealand

On 2 March 2009, the Court of Appeal released its judgment in the case of *David & Anor v TFAC Limited & Anor* [2009] 3 NZLR 239, which involved a franchising case and an appeal against the judgment of Justice Baragwanath given in the Auckland High Court on 11 December 2007 (*TFAC Limited v David* [2008] NZCLR 38). The Court of Appeal comprised Justices Arnold, Potter, and Harrison, and the reasons were given by Justice Arnold.

The appellant held the New Zealand Master Franchise for James' Homes Services, a successful Australian franchise at the time. Mrs David, the first appellant, whose background was in recruitment, had no experience either in the business of providing home services to the public or in franchising. In March 2005, UAR Limited (the franchisor), of which David was the director, acquired the New Zealand Master Franchise from Rushlyn Pty Limited of Australia. The second respondents, Mr and Mrs Grisdale, had met David at a Franchising Expo in 2005; they incorporated TFAC Limited (the first respondent) on 23 December 2005, and on 11 January 2006, TFAC paid the second appellant \$200,500, which, with the prior deposit of \$2,000, made a total purchase price of \$202,500 for the franchise.

Only two months later, in March 2006, TFAC wrote a letter of complaint to the franchisor, and it

responded with a notice of breach. Subsequently, the franchise agreement was cancelled by TFAC, which issued proceedings against UAR for a refund of all monies paid plus damages. TFAC alleged misleading conduct and misrepresentations in trade against the franchisor and David; a key fact which swayed Justice Baragwanath in the High Court was the pitch by the franchisor that there was basis for belief that the Australian experience was transferrable to New Zealand and that TFAC could rely upon it as an investment with solid prospects for it, when, in truth, the New Zealand market had never been proven. TFAC was awarded \$258,761 including \$26,000 for loss of income from employment plus interest of 7.5 per cent from June 2006.

Key documents were considered by the High Court, and Mr Grisdale relied upon financial information and statements made by David on behalf of UAR. At [77] of the High Court judgment, Justice Baragwanath stated the following: "For that reason there was misrepresentation which as misleading conduct would, disregarding for the moment the disclaimer and other clauses imposing on the plaintiff's obligations of enquiry, entitle them to succeed under the *Fair Trading Act* [1986]."

The franchisor published a disclosure document which stated that the potential franchisee should make

its own enquiries about the franchise and the business, and should go to a solicitor experienced in franchising to have the Regional Master Franchise Agreement and associated Sub-Franchisee Agreement explained, and should also obtain independent accounting and business advice from an accountant and business adviser experienced in franchising.

Subsequently, the Grisdales did take both legal and accounting advice, but they did not consult an independent business adviser. The solicitor who acted for TFAC and the Grisdales completed a Solicitor's Certificate as is commonly required by solicitors for franchisors. However, in evidence, Mr Grisdale "claimed that he received no advice from Miller Bradley about the nature, effect or ramifications of this certificate, before he signed it" (at [86]).

The Solicitor's Certificate was a key part of the appeal. There were three separate Certificates, namely a Regional Master Franchise Certificate signed by Mr Grisdale and TFAC, a Solicitor's Certificate signed by Mr Bradley, and an Accountant's Certificate signed by Bruce Stone. The three Certificates were required by the franchisor, and the essence of them was to give comfort to the franchisor that the franchisee had obtained independent legal and accounting advice, and that the franchisee "has made its own judgement as to the commercial viability of the Regional Master Franchise and further agrees that the National Master Franchisee is not qualified in this regard".

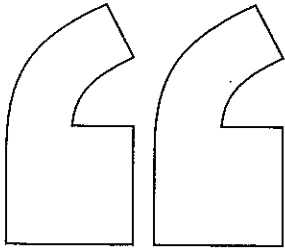
Justice Baragwanath was satisfied that, considering the overall effect of the defendants' conduct, they were in breach of section 9 of the *Fair Trading Act* 1986. He said that the "fundamental point is the pitch that there was basis for belief that the Australian experience was transferable to New Zealand so that the plaintiffs could rely upon it as an investment with solid prospects for them. In truth the New Zealand market was never proved" (at [99]).

He went on at [101] to state the following:

"The requirement by the defendants that a lawyer and an accountant should be engaged excludes the gullible and unintelligent element of the test approved in *Marcol Manufacturers Ltd v Commerce Commission* [1995] 2 NZLR 502] in relation to matters which they could reasonably have been expected to discern. But it cannot be said that the plaintiffs or their lawyer or accountant can be regarded as acting quite unreasonably so as to insulate UAR from misleading and deceptive conduct. A defendant who engages in such conduct cannot rely upon the failure of the plaintiffs to find it out by stipulating that they employ a lawyer, an accountant and a business adviser to audit what it has asserted."

Expressing an opinion

The Court of Appeal held that whether or not the system was transferrable to New Zealand, or whether Mr Grisdale could run a successful franchise were matters of opinion; the Court applied the decision in *Premium Real Estate Limited v Stevens* [2009] 1 NZLR 148 (CA), and said at [43]:



At the end of the day, the production of certificates will not save a franchisor who lies to potential franchisees and misrepresents the facts

"[T]he expression of an opinion that subsequently turns out to be incorrect does not, of itself, give rise to liability for misleading or deceptive conduct under [section] 9. However, the expression of an opinion involves at least one and perhaps two representations of fact. The first is that the person expressing the opinion honestly holds it and second is (in some cases at least) that he or she has a reasonable basis for the opinion."

The Court of Appeal said there was no evidential basis for the suggestion that David did not honestly believe the system was transferrable, and, on whether she had a reasonable basis for her opinion, it was wrong in principle for the High Court to resort to retrospective evaluation for describing the New Zealand operation as a "virtually unrelieved failure", when, at the time the agreement was entered into (late 2005), the New Zealand operation had hardly commenced.

This decision by the Court is based, in my opinion, upon an erroneous belief in franchising that an overseas system arriving in New Zealand can just be plugged into New Zealand with little or no modification, and it will be expected to work. That is a long way from the truth. Many overseas systems fail in New Zealand because the overseas franchisor has been lazy and has not undertaken a feasibility study, a competitive analysis, and has not adapted documentation for New Zealand conditions. In reading the various Certificates which TFAC required the Master Franchisee, the solicitor, and the accountant to sign, I can see that they have not been changed from the Australian position and the same wording has been used, which is totally unsuitable in New Zealand. In my opinion, the Court of Appeal has fallen into the trap of accepting that an Australian system can be plugged into New Zealand and that it will succeed, and I think that Justice Baragwanath was correct.

Misleading conduct

Further, the Court of Appeal is also wrong in rejecting the misleading conduct argument. If someone is misled, it is no defence to say that if you had asked someone else you would have found out that the first person you asked was in fact lying to you. There are Australian and New Zealand cases to this effect that do not appear to have been cited to the judges of the Court of Appeal.

Further, in discussing the disclaimer or acknowledgement clauses, the Court of Appeal disagreed with Justice Baragwanath, who decided it was unreasonable to give weight to the independent advice requirement and acknowledgement clauses in this case, because TFAC

and the Grisdales were misled by UAR and David by their misleading and deceptive conduct. From reading the evidence, two franchisees prior to the Grisdales had been terminated, but the truth of these events was not told to the Grisdales by the master franchisor in New Zealand.

Relying upon the documents

As far as I am aware, the case was not appealed to the Supreme Court. Therefore, the current law in relation to franchising is bad in my opinion. The *Fair Trading Act* is there to protect innocent people/investors/franchisees where there is misleading or deceptive conduct or where misrepresentations are told to them by a franchisor or related party. I act for many franchisors who are not sued as they do it properly.

In all cases, the solicitor acting for the franchisee should be requested to provide a Solicitor's Certificate, and a franchisor will want to rely upon that Certificate. An Accountant's Certificate is not necessary in New Zealand and neither is a franchisee acknowledgment. Australian franchisors go overboard and require three certificates, but New Zealand does not require that, and franchising lawyers in New Zealand should resist anything more than a Solicitor's Certificate.

At the end of the day, the production of certificates will not save a franchisor who lies to potential franchisees and misrepresents the facts. I think that the judgment of Justice Baragwanath was robust and fair, and I think the Court of Appeal has missed the boat in this particular case, and the franchisee who was innocent has suffered financially without justification.

In a recent case, the Court of Appeal has now affirmed the position set out in the above case. The case is *PAE (New Zealand) Limited v Brosnahan & Ors* [2009] NZCA 611. It did not involve a franchise agreement which makes it distinctive from the *David* case, but it quotes from it and applies the principles of *David*. The *PAE* decision appears to strengthen the position of franchisors who seek to minimise their liability exposure for pre-contractual representation by including disclaimer clauses in their franchise agreements. It also reinforces the impact of the *David* case. All franchisors should review the disclaimer clauses in their franchise agreements and franchisees should always obtain independent legal advice from lawyers experienced in franchising, and should carry out their own due diligence in a thorough manner before signing any franchise agreements.

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Franchising gone wrong

I found Stewart Germann's article "Franchising gone wrong" (*NZLawyer*, issue 158, 21 April 2011) most informative.

Mention was made of the matter not being appealed to the Supreme Court. With respect, that is not quite correct. Application for leave to appeal was lodged by the respondents; but to the surprise of some, such leave was not granted: *TFAC Limited v David* [2009] NZSC 51.

The Supreme Court held (at [3] and [4]):

"However, assuming without necessarily accepting, that the applicant has correctly identified an error of law by the Court of Appeal, it would not involve any question of general or public importance. It would be simply an error in the application of settled law to the facts of the particular case.

"The applicants also say that there has been a substantial miscarriage of justice but we are not persuaded. The applicants appear to have known very well that the franchise system had only recently begun to operate in New Zealand. The statements made by the defendants were, to the applicants' knowledge, referring to Australian promotional material. It was even necessary for the applicants to go to Australia to observe the Australian franchise operation because there were no New Zealand regional master franchises to observe. It therefore cannot be said that the Court of Appeal has made an apparent error of such a substantial character that it would be repugnant to justice to allow it to go uncorrected in the particular case."



For some franchisees (and their advisers), they saw this as a case of not just involving an error of law of significant general and public importance (as identified by Mr Germann), but also that the Court of Appeal had made such an error of such a substantial character (again identified by Mr Germann) that it would be repugnant to justice to allow it to go uncorrected.

Peter McKnight, barrister

Public Defence Service

As a lawyer who is proud to be a zealous advocate, I value the training in objectivity I received from Otago University, and so I was most interested to see the front page article in *NZLawyer*, issue 158, 21 April 2011.

The word that most drew my attention was "facts". Thinking that there is always another side to the story I read on. I was, however, disappointed. The spokesman for the PDS, Mr Down, provided no facts to dispel the allegations that the young lawyers the PDS have recruited are inexperienced.

I agree with Mr Down that youth have enthusiasm (flair?), intellect, and currency of knowledge, but he will also know that law does not sprout spontaneously from the ether, and a knowledge of how it has developed and why it has changed is important when applying statutory interpretation techniques. This is what experience is and why it is important.

The main issue regarding experience which has been completely overlooked by Mr Down is what appears to be a double standard regarding LSA Category approval.

experience in that area. Namely:

- Duty Solicitor Training Programme;
- Introduction to Criminal Law;
- How to run a District Court Jury Trial;
- Advanced Litigation Skills; and
- Stepping up.

These four CLE courses come at a cost of \$4,726.50, plus another \$1,437.50 for the stepping up course, if a practitioner wishes to practice on his own account.

The costs do not take into account the airfares, accommodation, and meals that are incurred by regional practitioners, which may easily reach another \$2,000. That is not the end, the private practitioner is still further faced with gaining experience by working pro bono with his senior colleagues to gain the practical experience required to progress. I understand that neither the PDS nor its recruits are required to incur this over \$8,000.00 cost, and, in fact, they are not even required to jump through the same approval hoops required of the independent practitioners to prove their competence.

Opposition bid to jail c

BOTH THE Australian Opposition want to voters as tough on violent protests at Opposition propose and the removal of those who protest. Immigration Minister measures proposed were "much stronger" treating a criminal failure to pass the v

Musicians i for radio ca

THE AUSTRALIAN is challenging the Copyright Act 1969. The Phonographic Company of Australia claims the cap on royalties beyond current laws, radio s pay royalties beyond revenue.

'Misreading law comple

SUPREME COURT of Pagone has criticised Court colleagues Bill Hayne in 2004 on a He argues that Part 7 was applied incorrect skewed all subsequent too great a bias in scenarios. Pagone cited Court judgments in Pacific and Noza Holc of the unnecessary a has created.

ASIC setting benchmark i court told

FEDERAL COURT judge is hearing the case against members of the Centre for Financial Investigations brought by the Australian Securities and Investments Commission. The judge alleges breaches of disclosure debt that was not short-term. He representatives of the no contravention of s