

SUMMARY OF TWO NEW ZEALAND CASES

By Stewart Germann, a franchising lawyer at Auckland, New Zealand

1. **VALDA VIDEO LIMITED AND KIRBY v UNITED VIDEO FRANCHISING LIMITED AND MURRAY DICKINS**, Unreported, High Court, Auckland, CP 123/00, 21 August 2001

Brief Facts

In late 1996 Mr & Mrs Kirby (“the Kirbys”) of Valda Video Limited approached United Video Franchising Limited (“United Video”) about acquiring a retail franchise store, and they spoke with the business manager, Mr Dickins, who subsequently offered the Kirbys a franchise to operate a video store proposed for Whangaparaoa. The Kirbys eventually decided to proceed with the purchase which involved the lease of a new building to be constructed on the site. Through their company, Valda Video Limited, the Kirbys entered into a franchise agreement and lease of the premises and trading commenced in July 1998.

The Kirbys alleged that a number of representations were made to them by Mr Dickins prior to the purchase, the most important of which was a representation that Mr Dickins was confident that the Kirbys “*could do a turnover of \$10,000 per week*” at the Whangaparaoa store. Unfortunately, the turnover of the business was never more than \$4,000 to \$5,000 per week and the Kirbys said that, despite their best efforts, they were obliged to close the business on 23 August 2000 and cancel the franchise agreement. Stewart Germann of Stewart Germann Law Office acted for the Kirbys and after disposal of the business assets the Kirbys sustained a considerable loss.

The plaintiffs claimed damages from United Video and Mr Dickins under the Contractual Remedies Act 1979 and the Fair Trading Act 1986. The defendants denied responsibility and United Video counterclaimed for a small sum for franchise fees. In essence, the defendants said that the critical representation as to turnover was no more than an estimate of possible future earnings and did not amount to a representation of fact. It was also alleged on behalf of the defendants that the documentation included a disclaimer clause and that it was the responsibility of the Kirbys to investigate the proposal themselves and to take appropriate advice prior to entering the transaction.

The Issues

The essential issues were as follows:

- (a) Did Mr Dickins materially misrepresent the business in a way which induced the Kirbys to enter the franchise agreement?
- (b) Was there a disclaimer which would prevent the Kirbys from recovering?

- (c) What losses were sustained as a result of any misrepresentation?
- (d) Was there any basis for United Video's counterclaim?

The Findings

Randerson J heard the case which lasted for five days at the High Court at Auckland and in delivering his judgment he accepted the evidence of the Kirbys that Mr Dickins spoke to them in optimistic terms about the Whangaparaoa store and that the only figures he gave them for that store were those showing a turnover of \$10,000 per week and a net profit before interest and tax of just under \$120,000 per annum. Although the Kirbys were experienced in business, the Judge said that they were entitled to rely on United Video's knowledge and expertise in video franchising and to expect that it would have a proper substratum of fact to back the representations made. The Judge found that United Video represented through Mr Dickins that there was a proper factual basis to conclude that turnover at a level within reasonable proximity of \$10,000 per week could confidently be expected. They had no basis for supposing that a prediction of turnover at that level would be inaccurate by a factor of 50% or more.

In relation to whether a disclaimer in the franchise agreement would save United Video, the Judge said that it would not and under the Contractual Remedies Act, any damages are those appropriate to a breach of contract. The Judge stated that the plaintiffs could recover under the Contractual Remedies Act both lost profits and trading losses. The Judge ruled that Valda Video was entitled to recover the trading losses of \$255,793 and that the Kirbys personally were entitled to recover the sum of \$93,960.

After expert evidence from two independent accountants the figure of \$255,793 was decreased to \$203,237. However, the Judge did not allow any assessment of damages for the capital loss of the business as it was a new business with no prior history. The damages which were awarded in the end were made up as follows:

Trading losses	255,793
Value of Kirbys' time	93,960
Loss of profits	203,237
Total	<u>\$552,990</u>

In relation to the counterclaim by United Video, by reason of the serious misrepresentation as to turnover, the Judge was satisfied that Valda Video was entitled to cancel the franchise agreement. The burden of the contract for the plaintiffs was substantially different from that represented. It followed that United Video had no foundation for its counterclaim for franchise fees and they were disallowed. The Judge also awarded interest on the damages at the rate of 6% per annum from the date of cancellation of the franchise agreement down to the date of judgment. The plaintiffs were also entitled to claim for costs.

What is interesting about this case is that Mr Dickins as the second defendant was also held to be personally liable pursuant to the Fair Trading Act 1986 as it contains a provision stating that employees of a company who personally misrepresent facts which a party relies upon to their detriment can be held

personally liable. A demand was made on Mr Dickins and bankruptcy proceedings were issued and at the eleventh hour a deal was done with Mr Dickins to save him from bankruptcy.

The moral of the case is this – employees of franchisor companies should be very careful about what they say and what they represent for otherwise they can be held to be personally liable if a franchisee suffers loss. The Contractual Remedies Act and the Fair Trading Act in New Zealand are very powerful weapons for franchisees against franchisors who over-sell and over-state the franchise and, thereby, misrepresent figures. Further, the case confirms that franchisees are entitled to rely upon all representations made by franchisors and a disclaimer clause in franchise agreements will not protect franchisors in the end as the Courts are able to “*drive a truck*” through such disclaimer clauses. The conduct of the parties must at all times be truthful and based upon fact.

Some steps which franchisors might take to protect themselves would be:

- Ø Ensure that potential franchisees obtain independent legal and accounting advice;
- Ø Ensure that any verbal representations made are not inaccurate or misleading;
- Ø Provide a separate disclaimer document and get it signed by the franchisee at the beginning of the negotiation process;
- Ø Record any representations made by way of a letter to the franchisee confirming the content of the discussions in which they were made;
- Ø Provide a disclosure document (such as that required by the Franchise Association of New Zealand or under the Australian Code of Conduct) containing only accurate information with no comment or other marketing material contained in it;
- Ø Insist that all staff involved in marketing and selling the franchise system use only pre-approved material containing accurate statements about the franchise;
- Ø Warn staff of the need not to make any misleading or ambiguous statements.

2. **P5 HOLDINGS LIMITED v ELISHA'S WELL LIMITED AND ORS**, Unreported, High Court, Auckland, CIV 2006-404-4067, 27 September 2006 by Williams J and Andrews J.

Brief Facts

This case is an example of disaffected franchisees claiming justification for termination of their franchise agreements on the basis of a failure by the franchisor to meet its obligations. In this case, the Court did not accept the arguments of the franchisees and granted injunctions against them.

P5 Holdings Limited ("P5") being the plaintiff developed a system for the operation of weight loss clinics under the name of the Keto Clinic and it franchised that system territorially throughout New Zealand in terms of a franchise agreement. Elisha's Well Limited and Mrs Moses as the first and second defendants entered into a franchise with P5 for the Central Auckland territory on 1 December 2005, and two other franchisees who were parties to the litigation entered into similar franchise agreements for the West Auckland territory and the North Shore territory.

As the result of a large number of disputes between the parties, the defendants took steps to sever their relationship with P5 and set up competing weight loss clinics in the premises which they leased and in which they had been operating their Keto Clinics using at least some of the intellectual property gained through their operation of the Keto Clinics. P5 accordingly issued injunction proceedings on 14 July 2006 to prevent that.

Prior to the litigation Stewart Germann of Stewart Germann Law Office who acted for the three franchisees interviewed the defendants and concluded that they had sufficient grounds to terminate their existing franchise agreements pursuant to the Contractual Remedies Act 1979. However, the defendants were clearly warned that if they continued in a similar business then they must not use any of the intellectual property of P5 and they must operate separate and independent businesses. It is fair to say that a lot of the information used by the Keto Clinic was freely available on the internet and therefore such information was very much in the public domain. However, some of the products used by the Keto Clinic in relation to the loss of weight were manufactured especially for the Keto Clinic and had a clearly identifiable label.

The Findings

The High Court at Auckland on 28 July 2006 granted P5 injunctions against the defendants to prevent each defendant from carrying on its new business using the plaintiff's property, goodwill, know-how and confidential information. Williams J said that "*the situation may have been different had a means been proposed by which the defendants might operate weight loss clinics from different premises using systems and materials which did not utilise any part of the plaintiff's property, goodwill, know-how and confidential information but no such proposal was propounded*".

Counsel for P5 submitted that the serious question to be tried was whether the defendants' cancellation of the franchise agreements was valid and whether

subsequent to the cancellation the parties' contractual obligations were extinguished under section 8(3) of the Contractual Remedies Act 1979. A third issue was whether the restraint of trade clauses were valid and enforceable. The Judge agreed that P5 had a protectable interest in its registered trade marks and intellectual property, signage, manuals and the like and, in particular, in its ketosis system.

Paragraph 81 of the judgment is worth quoting and it reads as follows:

“While the defendants may be able at trial to make out their case that they were induced to enter into their franchise agreements by misrepresentations actionable at law, they could not – and did not – attempt to argue that they did not issue their notices of termination other than deliberately and on legal advice, no doubt including advice as to the possible consequences for them, including by way of injunction, should they take that step ...”

In my opinion and as solicitor for the defendants, there were ample grounds for valid cancellations of the franchise agreements pursuant to the New Zealand Contractual Remedies Act. Those notices of cancellation were issued solely upon the basis that the defendants were advised that the plaintiff would most likely attack with injunction proceedings. Where the defendants went wrong was that they used some of the plaintiff's intellectual property and confidential information against legal advice. In relation to labels on the product, they merely crossed out “The Keto Clinic” and added “Figurz” which was their new proposed trading name. Such blatant action upset the Judge who had no sympathy towards the defendants and who issued the injunction proceedings accordingly.

Subsequently, the substantive action was settled between the parties but the three defendants lost their businesses, and only one has continued to trade by way of a new business under a new name.

The moral of the case is this – if franchisees wish to cancel their franchise agreements alleging misrepresentation and relying upon the Contractual Remedies Act, they must have strong grounds and, by their action, they cannot subsequently breach the franchisor's intellectual property and carry on a similar business stealing trade secrets and confidential information from the franchisor.

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