Regulating Franchise Operations in South Africa:

A Study of the Existing Legal Framework with Suggestions for Reform

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ABSTRACT

This thesis analyses the existing legal framework that applies to franchising in South Africa today. The study begins with an examination of the history and nature of the franchise contract, focusing particularly on the nature of the franchise relationship. This study is undertaken in order to substantiate the argument that franchising is a unique method of doing business. There is a need therefore to recognise that the franchise contract is a special contract in its own right, just like contracts of sale, lease, insurance and suretyship.

The study then goes on to examine the problems which are experienced in the sector, as well as the law which must provide solutions to these problems. The research will show that in a modern commercial world the existing legal framework, especially the common law, cannot adequately deal with many of these problems. The complex relationship between franchising and competition law is also explored. A common thread that emerges from franchise disputes is the lack of protection afforded to the interests of franchisees. Franchisees tend to be at the mercy of economically stronger franchisors, hence the belief that there is a need for a stronger regulatory framework.

The study then shifts to proposals for reform. In 2000 the Department of Trade and Industry (DTI) established the Franchise Steering Committee in conjunction with the Franchise Association of South Africa (FASA) to review the regulatory environment. This Committee drafted franchise legislation which aimed to bring the regulation of the sector under the control of the DTI. This legislation has not been implemented and the DTI has

changed its strategy. Instead of dealing with franchising independently, franchising will fall within the scope of consumer protection legislation. Both the consumer protection legislation and the legislation proposed by the Franchise Steering Committee are thoroughly examined and explained. Shortcomings in the proposals are highlighted and an alternative approach is recommended. It is proposed that franchise-specific legislation should be introduced but that this legislation should establish a system of co-regulation between the government and the franchise sector.

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CHAPTER ONE
INTRODUCTION

Good franchising is very good. It is undoubtedly the most efficient, effective distribution system ever invented. It is the greatest invention of Western capitalism since the invention of the corporation. Good franchising is so much better than independent small operations and bad franchising is so much worse.[1]

1.1 Overview of the topic

Franchising is a strategy for expanding a business.[2] In a modern business context, the words franchise or franchising may be used to describe a business, a particular kind of business or even the whole industry.[3] Franchising has become a major sector in the world economy. In 2005 franchising accounted for approximately $1,53 trillion (up from $1 trillion in 2002) of total economic output in America. There were approximately 760 000 franchised outlets in America and 18 million people were employed in franchise networks.[4] Franchising operates in more than 100 other nations including South Africa

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1 Comments made by Professor Andrew Terry before the Australian Standing Committee on Industry, Science and Resources in 1997. The Committee published a report entitled "Finding a Balance: Towards Fair Trading in Australia" (Fair Trade Report) http://www.aph.gov.au/house/committee/isr/fairtrad/report/contents.ht. (accessed on 4 April 2007). Discussed below in 4.3.2.1.

2 Comments made by Wieczorek in his prepared witness testimony to the United States of America (America) Committee of Energy and Commerce in their investigation into the Federal Trade Commission's Report into the "FTC's Franchise Rule: Twenty three years after its promulgation." (2002) ("Prepared Witness Testimony") http//://energycommerce.house.gov/107/hearings (accessed on 27 November 2005). Wieczorek was presenting the views of the International Franchise Association (IFA).The IFA is a trade association of franchisors which was formed in 1960. The aims of the IFA are to speak on behalf of franchising before government bodies and the general public; to provide services to members and those interested in franchising; to set standards of business practice; to serve as a central point for franchise data and information; to provide a forum for the exchange of experience among members; and to offer educational programmes.

3 The word franchise is derived from the old French word "franchir" meaning "to free from slavery". See Brown "Franchising – A Fiduciary Relationship"(1971) 49 *Tex L Rev* 650.

4 See Wieczorek "Prepared Witness Testimony".

where in the last 15 years there has been phenomenal growth in the franchising sector.[5] South Africa is regarded as having one of the fastest growing franchise markets in the world.[6] Franchising has been described as "the single most successful marketing concept ever"[7] and is regarded as the marketing sector which offers the greatest opportunity for growing a new business.[8] Franchising is regularly promoted as a way to encourage the development of small businesses. The South African government has identified franchising as a way of creating jobs, alleviating poverty and promoting black economic empowerment.[9] This is because franchising has the capacity to address many of the problems that make it difficult for a new business to get off the ground. New and often inexperienced entrepreneurs become part of a network in which they are provided with a proven formula for operating a business and they receive support and encouragement. Franchisees appear to be part of a chain with access to all the know-how of the head office but each franchisee is essentially in business for himself, and is therefore committed to his own success. His success in turn develops and builds the network. The idea is that although each person is in business for himself, he does not have to operate by himself.

The relationship between franchisor and franchisee is a unique business

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5 Franchise Advice and Information Network (FRAIN) "Franchise Baseline census 2002" http://www.frain.org.za/papers/census.html (accessed on 6 May 2005). FRAIN is a Department of Trade and Industry (DTI) project. See also Franchise Association of South Africa (FASA) Newsletter 15 January 2005 http://www.fasa.co.za.

6 FASA Newsletter 15 January 2005.

7 Naisbitt *Magatrends* and *Megatrends 2000* quoted by Zaid *Franchise Law* (2005) 2.

8 Franchising is effective for two reasons: First, modern consumers are very reliant on brand names because of their lifestyles. They travel more, tend to be very pressed for time with more women working. They do not have the time to investigate new products. When they see something familiar they know exactly what they are getting. Second, like a chain store, franchising can create brand recognition and can rely on economies of scale but it has the added advantage that each store is operated by an individual who is committed to the success of his own business. See generally Blair and Lafontaine *The Economics of Franchising* (2005) 1.

9 Hendricks "Message by the Deputy Minister of Trade and Industry" in FASA *Franchise Book of Southern Africa 2003* (2003) 8. In September 2006 it was reported that Spur Corporation, owner of the franhchises Spur, Panarottis and John Dory's had opened 34 new outlets in 2006 and had plans to open another 25 before the end of that year. Spur was looking for black franchisees for its new stores and it was targeting, in particular, black senior managers who had participated in a special mentoring program. Spur Corporation secured R30 million from the Industrial Development Corporation to fund black franchisees. See Enslin "Spur to open 25 new restaurants for R62.5m and create 875 jobs" *Business Report* 15 September 2006 3. In August 2007 it was reported that Chicken Licken, a fast food franchise, was considering selling part of its business to a black economic empowerment partner. It was also reported that Chicken Licken has 220 outlets in South Africa and that 60% are owned by black franchisees. See Khanyile "Chicken Licken may do an empowerment deal when it lists" *Business Report* 22 August 2007.

relationship, but South Africa does not have a specific body of law that deals exclusively with franchising. There is a self-regulatory body, the Franchise Association of South Africa (FASA) and there are certain applicable statutes, such as the Consumer Affairs (Unfair Business Practices) Act[10] (which regulates unfair business practices generally) and the Competition Act[11] (which regulates all aspects of business activity in South Africa). But, in general, franchising is treated as a normal commercial undertaking governed essentially by the contract concluded between the franchisor and franchisee.[12]

The existing legal framework for regulating franchising in South Africa consists of: the common law supplemented by self-regulation and the FASA *Code of Ethics and the Business Practices* (FASA Code).[13] Because the franchise relationship is treated by the courts as a normal commercial relationship, the *sui generis* nature of this relationship is not taken into consideration when problems arise. Relying on general business legislation (which does not refer specifically to franchising) to solve franchise disputes often leads to further problems. The purpose of this thesis is to examine the existing legal framework with the specific intention of identifying shortcomings in the law and of making proposals for reform. The research will show that there is a need for the law to recognise that the franchise contract is a special contract just as contracts such as sale, lease, insurance and suretyship are recognised as special contracts. Further, the research will show that franchise-specific legislation should be introduced in South Africa to support the common law.[14] In a modern commercial world the common law of contract and self-regulation are proving to be inadequate when it comes to dealing with many of the problems experienced in the sector.

There has been an attempt to develop and codify South African franchise law. In 2000 a review of the regulatory environment was conducted by the Franchise Steering Committee, a committee established for this purpose by the DTI. Its aim was

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10 Act 71 of 1988. This Act was originally known as the Harmful Business Practices Act. The title of the Act as well as a number of its provisions were amended by the Harmful Business Practices Amendment Act 23 of 1999. The name of the Business Practices Committee (BPC) was changed to the Consumer Affairs Committee (CAFCOM). See also 7.1.2.4 below.

11 Act 89 of 1998.

12 In other jurisdictions such as America, Australia, Malaysia, Canada, Italy and Spain, legislation has been introduced which demands certain requirements from franchisors. This legislation also specifies certain criteria that distinguish a franchise from other business relationships.

13 Information regarding the FASA is available at http://www.fasa.co.za. See also 7.1.2.3 below.

14 See Woker "Franchising - the Need for Legislation" (2005) 17 *SA Merc LJ* 49.

to formulate recommendations for a more effective regulatory framework. Following consultation with various stakeholders in the sector a strategy document was produced. This document was intended to provide guidance to government in its attempts to develop and regulate the sector.[15] Draft legislation was prepared in 2002 but this legislation has not been implemented.[16] The DTI has changed its strategy and instead of dealing with franchising independently, franchising will fall within the scope of consumer protection legislation.

On 27 September 2008 the South African Parliament adopted new consumer protection legislation which will apply to franchising.[17] A new regulatory body, the National Consumer Tribunal has been established in terms of the National Credit Act[18] which will have jurisdiction to hear disputes that fall within the ambit of the Consumer Protection Bill. This thesis will evaluate the new law to see to what extent it will be capable of resolving franchise problems. The research will show that although the Consumer Protection Bill will go some way towards solving problems, significant concerns remain. There continue to be compelling reasons for the introduction of franchise-specific legislation. It is a constant theme throughout this thesis that franchising is a "unique and important economic activity that should not be regulated by laws specifically designed for other economic activities".[19]

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15 "National Strategy for the Development and Support of Franchising in South Africa" (2000) (Franchise Steering Committee Report).

16 The Draft South African Franchise Bill. This Bill is discussed in Chapter Nine and is referred to as the FSC Bill. Freek Potgieter, a previous executive member and legal advisor of the FASA assisted with the drafting of the legislation and he informed a conference held in Johannesburg in May 2004 that legislation would be in place before the end of that year. See also "Franchising Law on the Way" *Business Day* 6 May 2004.

17 The Consumer Protection Bill 2008. There were three drafts of this Bill which were published in 2005, 2006 and 2007. It was expected that the Bill would be signed by the President of South Africa before the end of 2008, however, the National Council of Provinces has raised certain concerns regarding the labelling of genetically modified foods (see Pressly "Delay hits Consumer Protection Bill" *Business Report* 20 October 2008). The decision to re-open the consultation process means that the promulgation of the legislation will be delayed until at least 2009. Once the Bill has been signed by the President it will be a further 18 months before the new law is fully implemented. The delay is to give the DTI time to establish the National Consumer Commission and develop regulations (see Moodley-Isaacs "You won't have to put up with bad service" 26 September 2008 *Personal Finance Weekend Argus* 1).

18 Act 34 of 2005. This Act was enacted to protect consumers in the credit market and to ensure fair marketing practices in the credit industry.

19 Fox and Su "Franchise Regulation - Solutions in Search of Problems?" (Summer and Fall 1995) *Oklahoma City University LR* 242 at 248.

1.2 Context of the research

The need for this research was conceived out of complaints received by the Consumer Affairs Committee (CAFCOM)[20] and the sense of frustration on the part of the members of the CAFCOM at the inability of the Committee to adequately resolve disputes. However, the catalyst was a telephone conversation with an attorney who was seeking advice for a client. His unnamed client had been the owner of a motor vehicle dealership. His client had spent ten years developing a successful business under the mistaken belief that this was his business and, as long as he was successful and complied with all that the manufacturer requested of him, he would continue to operate. When the contract was due to be renewed he was simply informed that the manufacturer would not be renewing the franchise, and that the manufacturer would take over the business as a manufacturer-owned enterprise. The client lost his business and received no compensation. All this was legitimate in terms of the contract he had signed. Research has revealed that the ease with which franchise agreements can be terminated is a matter of considerable concern in the motor vehicle industry.[21]

What appears to be franchisor opportunism from the perspective of a franchisee, is viewed as perfectly legitimate by franchisors. Faced with allegations of unfair conduct, franchisors are adamant that it is never their intention that franchisees should have access to their trade marks and business models indefinitely. They have a legitimate point that at all times franchisors remain owners of their intellectual property. However, this situation is most unsatisfactory for franchisees who may have made a significant contribution to the overall development of the brand. In addition, franchisees are often enticed to choose this business model on the basis that they are purchasing "their own business".

Further, franchisees often complain about franchisor practices which they perceive to be unethical. The investigation conducted by the Franchising Steering

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20 The CAFCOM is established in terms of the Consumer Affairs (Unfair Business Practices) Act. See 1.5.1 and 7.1.2.4 below. The Consumer Affairs Act will be repealed from the date on which the Consumer Protection Act is effective and the CAFCOM will be replaced by the National Consumer Tribunal.

21 Retail Motor Industry Organisation (RMI) Memorandum to the Minister of Trade and Industry "Request for designation by the Minister of the Motor Vehicle Industry in terms of section 10(3) (b) (iv) of the Competition Act, 1998" (August 2002)(RMI Memorandum to the Minister (2002)).

Committee in 2000 was sparked by such complaints. There has also been a spate of recent judicial decisions that have highlighted the need for a better understanding of the franchise relationship.[22] In addition to this litigation, various government bodies such as the CAFCOM and the Competition authorities deal with problems in the sector but resolutions to disputes usually prove to be unsatisfactory.

Problems often arise because there is no common understanding of what constitutes a franchise and any entrepreneur is free to refer to his business as a franchise opportunity. Some such opportunities are very crude and sometimes something that is essentially no more than an idea, dreamed up by an enterprising entrepreneur, is marketed as a franchise by advertising it on a street pole with only a cellular telephone number as a contact detail. These are often nothing more than scams. Unfortunately, the success of some networks such as Spur, Kentucky Fried Chicken and Wimpy has encouraged fly-by-night, unethical and often criminal operators to masquerade as franchisors.

However, even extremely sophisticated franchise opportunities that form part of large national and international organisations are not without their problems. Well established businesses that are household names have seen franchising as an opportunity for expansion. This has had, in some cases, disastrous consequences for franchisees. The time of economic isolation in South Africa meant that the concept of franchising developed slowly without exposure to developments taking place internationally. There was a lack of research into the sector or information available for prospective investors.[23] Franchising in South Africa tended to develop in a vacuum and there have been some serious business failures.[24]

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22 See, for example, *Juglal NO v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* 2004 (5) SA 248 (SCA); *FTCK Consultants CC v Shoprite Checkers Ltd* 2004 (2) SA 504 (T); *Simelane v Seven Eleven Corporation SA (Pty)* 2003 (3) SA 64 (SCA); *Seven Eleven Corporation of SA (Pty) Ltd v Cancun Trading No 150 CC* 2005 (5) SA 186 (SCA) and *Silent Pond Investments CC v Woolworths (Pty) Ltd and Engen Petroleum Limited* [2007] JOL 20088 (D); 2007 JDR 0547 (D).

23 Comments made by Robbins in a letter addressed to the Franchise Steering Committee (10 October 1999). Robbins is a member of Educom Consultants, an organisation responsible for researching and analysing various aspects of business and providing training courses. Franchising forms part of their business activities and they are responsible for a franchise training course.

24 Robbins maintains that the "franchise scene developed into a dreamworld with wild and unsubstantiated claims about low franchisee failure rates and high growth rates which were used to lure people into franchising". In 1999 *Succeed* magazine published a list of 13 franchises that had failed in South Africa, which included O'Hagans, PNA and Boss Glass (Aug/Sept 1999 (No 2)).

A common thread that emerges from franchise disputes is the lack of protection afforded to the interests of franchisees. Even when a genuine franchise opportunity is involved, franchisees tend to be at the mercy of the economically stronger franchisor. Hence there is a growing belief that there is a need for a stronger regulatory framework. The real issue is not, therefore, whether franchising should be regulated but by how much and who should be responsible for this regulation.

1.3 Purpose of this research

The purpose of this research is threefold:

(1) to research the modern business concept of franchising in a legal context in order to develop an understanding of the concept;
(2) to evaluate the law that applies to franchising in South Africa; and
(3) to make proposals for reform.

Legal research into franchising in South Africa is virtually non-existent. In other jurisdictions, such as America and Canada, franchise law, as a distinct practice area for legal practitioners, has been recognised. Law societies sponsor educational programs on franchise law and business seminar companies recognise franchise law as a distinct subject matter in their programs. The American Bar Association has a Forum on Franchising with a mission to "be the pre-eminent forum for the study and discussion of the legal aspects of franchising".[25] The Forum publishes a law journal, *The Franchise Law Journal*, a newsletter and holds an annual forum on franchising. The International Bar Association also has a separate International Franchising Committee.[26]

In order to achieve the South African government's economic goals of job creation and income generation, it is crucial that there is a proper understanding of the concept. An important aim of this thesis will be to identify the true characteristics of a franchise relationship and to recommend that in the business world at least, the word franchising be used only in circumstances where the business relationship fits into this

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25 See http://www.abanet.org/forums/franchising/home.
26 See http://www.ibnet.org.legalpractice/International_Franchising.

particular business mould. Once the true nature of franchising is understood, it is possible to examine an appropriate regulatory regime.

The DTI is of the view that the new consumer protection legislation coupled with competition regulation will be sufficient to control abuses in the sector. In 1998 a new Competition Act was introduced. Many problems in franchising relate to competition matters and so are governed by the Competition Act. The second goal of this research is therefore to consider the existing position, taking into consideration the new legislation, in order to evaluate whether all those developments combined are sufficient to deal with problems. The final goal is to make proposals for reform.

1.4 Structure of the thesis

For clarity about the business concept, I will commence in Chapter Two with an introduction to franchising as a business model. I will consider various definitions of franchising, and franchising will be compared to other business models. I will also consider the advantages and disadvantages of franchising.

In Chapter Three I will focus on the nature of the franchise relationship. I will investigate and substantiate the central theme of this thesis: franchising is a unique method of doing business (which encompasses diverse fields such as economics, law, marketing, sociology and psychology)[27] which should not be regulated by laws that are designed to regulate other methods of doing business.

In Chapters Four and Five I will highlight areas of major concern, namely: misrepresentation and non-disclosure of material information and termination of the franchise relationship. For each concern the problem will be outlined, the existing applicable law will be discussed and I will propose solutions.

In Chapter Six I intend to demonstrate the extent to which problems in the sector can be resolved through the application of competition law. The Competition Act is an important statute which must be considered because many franchisee complaints fall within the ambit of competition regulation.

In the first six chapters of this thesis the nature of franchising and the law that

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[27] See generally Hoy and Stanworth *Franchising: An International Perspective* (2003).

applies to the relationship at present will be examined. In Chapter Seven the focus will shift to proposals for future regulation. I will identify the various models – self control, self-regulation and statutory regulation – in Chapter Seven. In each instance the advantages and disadvantages of each model will be discussed.

The DTI is advocating the use of consumer protection legislation to regulate the sector. I will discuss this in Chapter Eight. I intend to answer two questions; first, whether it is appropriate to consider franchisees as consumers; and second, whether the proposed legislation will provide adequate solutions to the problems highlighted in earlier chapters. This legislation will be signed by the President in the near future and so Chapter Eight will conclude with a discussion of how this legislation will impact on franchising.

The Franchise Steering Committee has proposed franchise-specific legislation. I will examine this legislation in Chapter Nine, and I intend to demonstrate that this legislation, if adopted, would over-regulate the sector. I will advocate an alternative approach based on the Debt Collectors Act.[28] This will also be discussed in Chapter Nine. I will conclude the thesis in Chapter Ten with a summary of the specific findings made in this thesis.

1.5 Methodology

Research was undertaken and information was obtained from the following sources:

- The CAFCOM;
- The Franchise Steering Committee;
- The RMI and the NADA;
- Interviews with franchisees;
- workshops and conferences;
- South African desk-based research; and
- Other jurisdictions desk-based research.

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[28] Act 114 of 1998.

1.5.1 The CAFCOM

The CAFCOM deals with unfair business practices and reports to the Minister of Trade and Industry. It deals with franchising disputes on a regular basis. The CAFCOM has dealt with both franchisors and franchisees in an attempt to resolve disputes. I have analysed some of the reports in order to identify the kinds of problems endemic to the sector. The use of this information has been approached cautiously because there is a secrecy clause in the Consumer Affairs (Unfair Business Practices) Act that prevents the members of the CAFCOM from discussing matters that come before them prior to publication of an investigation in the *Government Gazette*.[29] It is never the intention of the CAFCOM to harm legitimate businesses or the economy. Many complaints arise out of genuine attempts to establish franchise networks and there are usually concerted attempts to resolve disputes. While respecting privacy, it is important to examine complaints in order to identify problems.

1.5.2 The Franchise Steering Committee

The Franchise Steering Committee conducted numerous interviews, held workshops and consulted extensively with those who had an interest in the sector. The Committee produced a report, the Franchise Steering Committee Report, and certain members of the Committee appear to have been involved in the drafting of proposed legislation, the FSC Bill. The drafters of the legislation prepared an Explanatory Report (FSC Explanatory Report) and there is a Memorandum attached to the proposed Bill (FSC Memorandum). The work of this Committee has not been taken any further by the DTI and the present DTI officials appear to be unaware of this research.[30] This is unfortunate because this research provides valuable insight into the sector.

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30 Investigation suggests that much of the impetus for this research came from the FASA and those who were involved in the FASA in 1999, in particular Freek Potgieter. Unfortunately, he left the FASA in 2005 and appears to have emigrated to Australia. Neither the FSC Bill nor the other documents are readily available.

1.5.3 The RMI and NADA

The Retail Motor Industry Organisation (RMI) and the National Automobile Dealers' Association (NADA) are organisations that represent the retail motor industry. The RMI has 8000 members and the NADA has 1 236 members. These organisations represent the interests of vehicle franchise motor dealerships and one of their aims is to facilitate the relationship between franchisees and the motor manufacturers who supply them.[31] These organisations have conducted research into the contracts entered into between manufacturers and their franchisees. Their research has focused, in particular, on the unequal nature of the franchise relationship. The resulting memoranda addressed to the Minister of Trade and Industry contain a number of examples of the contracts used by manufacturers.

1.5.4 Interviews with entrepreneurs

I conducted a number of interviews with entrepreneurs including franchisees and potential franchisees. They were informal interviews and in most instances focused on specific queries regarding problems that were being experienced. These interviewees were aware of the nature of the research that was being conducted and were seeking advice.

I also conducted a case study into the entity Silk by Design CC in order to ascertain whether the nature of the business lent itself to the establishment of a franchise network.[32]

1.5.5 Workshops and conferences

The FASA holds a number of conferences each year. In the last four years a particular focus of those conferences has been franchise legislation and other legislation which impacts on franchising such as the Competition Act. In addition, the DTI held a number

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31 RMI Memorandum to the Minister (2002) and NADA Memorandum to the Minister of Trade and Industry "Pertaining to certain provisions in the franchise motor vehicle dealer, motorcycle dealer and related dealer agreements" (February 2002) (NADA Memorandum to the Minister (2002)).

32 See 2.5 below.

of workshops before the first draft of the Consumer Protection Bill was published in 2005. Since then the DTI has embarked on an extensive consultation process and has held a number of workshops and a conference to discuss the Bill.

1.5.6 South African desk-based research

I investigated available research about franchising in South Africa. There are a limited number of decided cases. In addition, very little research has been conducted into this business model. In a memorandum addressed to the RMI dealing with contractual issues in franchise agreements, a senior legal representative, who represented the Seven Eleven franchisees in their dispute with their franchisor,[33] described the law of franchising as "an undeveloped field in South African law". The FASA has some publications which deal with general aspects of franchising. The chapters which deal with legal issues are restricted to describing the law as it is.

1.5.7 Other jurisdictions desk-based research

To understand the structures and models used elsewhere in the world and to learn from these experiences, I conducted desk-based research into developments in a number of other jurisdictions. Franchise-relevant law in Australia and America has been examined closely because franchising has been well researched in these jurisdictions and, in America in particular, there has been a great deal of litigation. Developments in other jurisdictions are also discussed where appropriate.

Franchising in Australia was originally governed by the law of contract, self-regulation and a code of conduct. This was similar to the present form of regulation in South Africa. In Australia, this proved to be unsatisfactory and so a compulsory code was introduced in terms of the Trade Practices Act, 1974. This thesis suggests that a similar route be followed in South Africa. That is: legislation establishes a monitoring body which regulates the sector and introduces a compulsory code which *inter alia* provides for effective dispute resolution.

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[33] *Seven Eleven Corporation SA (Pty) v Cancun Trading No 150 CC.*

Legal problems faced in South Africa today are similar to those experienced in America in the 1950s and 1960s when franchising as a means of distributing products and services was aggressively pursued. Stories of franchisees who "struck it rich" reverberated through the business community and the popularity and success of franchising was soon exploited by those who saw an opportunity to abuse the model. Many franchises turned out to be schemes to defraud. Until the 1970s, the only law in America governing franchising was the body of law that governed business in general. There was no legislation that dealt exclusively with franchising. Today, however, there is a distinct body of statutory law governing it. America has a federal system and both the federal government and the states can enact laws on various subjects, including franchising. This means, however, that the existence and degree of regulation of franchise relationships vary from state to state and there is no consistent regulatory pattern.[34] This approach has been criticised and there have been attempts to find a more uniform system of regulation in America.[35]

The American approach to franchising has important lessons for South Africa, particularly if the DTI continues in its view that franchising should be regulated by consumer protection legislation rather than by legislation that is franchise-specific. In South Africa, consumer issues are issues of dual competency and so provinces enact their own consumer legislation. This could lead to differences in law and in approach between the national and provincial consumer legislation.

1.6 Conclusion

There is no doubt that franchising can play a significant role in economic development through wealth and job creation and skills development. But research has highlighted that this is a business model that can easily be abused by unethical business people and even criminals. In addition, franchising is by its very nature an unequal relationship and it is prone to deception and abuse.[36] There is a need therefore to develop rules

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34 Fox and Su 1995 *Oklahoma City University Law Review* 242.

35 *Ibid.*

36 See Hunt "The Socio Economic Consequences of the Franchise System of Distribution" (July 1972) 36 *Journal of Marketing* 37 and Carrol and Carter "Negros in Franchising" (Fall 1972) 48 *Journal of Retailing* 85-86.

that are franchise-specific. First, it is necessary to develop the common law so that the unique nature of franchising in a business context is recognised and second, franchise-specific legislation must be introduced to level the playing fields between franchisor and franchisee. Franchisees will be able to make informed business decisions and true franchisors will benefit from increased confidence and certainty in the sector.[37]

The thesis reflects the law as stated in the sources available to me as at 1 November 2008.

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37 Kaufmann "The New York Franchise Act" in *Understanding Franchising: Business and Legal Issues* (2001) 287.

CHAPTER TWO
INTRODUCING FRANCHISING AS A BUSINESS MODEL

OUTLINE

The purpose of this chapter is to introduce the concept of franchising as a model for expanding a business. This chapter commences with a discussion of how franchising developed and the different forms of franchising that entrepreneurs may adopt. Franchising is compared to other methods of doing business and the advantages and disadvantages of choosing this method are examined.

2.1 A short history

Although it has been suggested that franchising-type business can be traced back to a Chinese businessman, Las Kas, who created a chain-store concept for distributing food throughout China around 200BC,[1] today America is generally regarded as the home of franchising.[2] The Singer Sewing Machine Company established a network of sales and service agents in the 1850s and this is usually cited as the pioneer of franchising.[3] This business model was used by General Motors in 1898 and Rexall in

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1 Barnard Jacobs Mellet Private Client Services *Stock Exchange Handbook* (2003) 72.

2 Nevertheless, franchising has been a part of European economic activity since at least the middle ages when a franchise was seen as a privilege. A local lord or even the king would grant someone the right to hold markets, fairs, operate a business or hunt on his land. In other words they would have a monopoly to operate a business. Over time regulations were introduced to govern this type of commercial activity which eventually became part of European Common Law. See Bassuk "The History of Franchising" http://www.franinfo.com/history.html (accessed on 8 August 2006).

3 Loftstrom "Franchising 101: Registration and Disclosure Issues" 2nd Annual Spring Meeting of the Business Law Section and the Intellectual Property Section of the State Bar of California (April 2001) file:///V|/Michael&Rob/calbar/buslaw new/spring2001/lofstrom.htm (accessed on 31 May 2004) and Kaufmann "An Introduction to Franchising and Franchising Law" in *Franchising - Business and Legal Issues* (1992) 11. Singer is reputed to have resorted to this business model because of the logistical difficulty of providing ongoing customer support after the sale of its sewing machines.

1902.[4] Another example of early franchising is Martha Harpur, who opened a second hairdressing salon in 1891. By 1929 there were over 500 Harpur salons.[5] However, it was only after the Second World War that franchising really began to develop into a recognised business method in America. The impetus is said to have come from the soldiers returning from the war. They had interrupted their studies and many of them felt that they were too old to become college students. The American economy was booming and the Veterans Association guaranteed or insured their business loans. This inspired entrepreneurs with good ideas to expand their businesses through franchising.[6]

A number of factors contributed towards growth in this sector in the 1950s and 1960s.[7] These included rising disposable incomes; increased urbanisation; growing demand for consumer goods and services; and rising consumer mobility.[8] This growth slowed down in the 1970s and the boom period came to an end.[9] Franchising had been promoted extensively and the virtues of franchising had been lauded, but at this time the true nature of the franchising relationship was not properly understood and therefore, even when there was a legitimate attempt to establish and sustain a franchise network, problems began to emerge. Also, many of the advantages and socio-economic consequences of franchising did not materialise, particularly the promised benefits for minority groups.[10] Often the extremely attractive profit projections of franchisors were deceiving and franchisees found that purchasing goods from their franchisors was more expensive then buying them on the open market.

A particular problem was that franchisees who had supposedly purchased their own businesses found that their franchise agreements could be arbitrarily terminated

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4 Rothenberg "A fresh look at Franchising" (July 1967) 31 *Journal of Marketing* 53.

5 Barnard Jacobs Mellet Private Client Services *Stock Exchange Handbook* 72.

6 Kursh *The Franchise Boom* New Revised Edition (1968) 6.

7 Donner *An Overview of Franchising in South Africa* (MBA research paper Cape Town 1978) 29.

8 Walker and Etzel "The Internationalization of US Franchise Systems: Progress and Procedures" (April 1973) 37 *Journal of Marketing* 38; Donner *An Overview of Franchising* 29.

9 Hunt 1972 *Journal of Marketing* 33.

10 *Ibid*; Carrol and Carter 1972 *Journal of Retailing* 85-86. In his book, *The Franchising Boom*, Kursh, who was regarded as *the* authority on franchising in America, discussed the opportunities for women "who want to become independent or make their husbands rich". He also detailed the prospects and opportunities for black Americans. He predicted that "real Black power for Negroes will come through this dynamic industry". However, history reveals that these predictions did not materialise.

and their businesses could be taken away as part of the termination.[11] In addition, there were many franchisee failures.[12] These failures led to increased litigation and calls for the introduction of legislation. Franchisors began to have second thoughts about using this business model and many successful franchisors resumed control of their franchises.[13] Nevertheless, despite the fact that the sector no longer attracts the euphoria of early days, franchising continues to play an important role in the business world in America.

The first country to develop franchising outside America was Canada. It then spread to the rest of the world and by 2005 there were franchise trade associations operating in sixty-one countries.[14]

Franchising first appeared in South Africa in 1924 when the motor manufacturing industry and oil companies began distributing their products through independently owned outlets.[15] Coca Cola and Pepsi established subsidiaries in South Africa in 1937 and 1948 respectively. They rapidly established a network of bottlers, many of which were independent enterprises that held the franchise to bottle and sell these products.[16] In the mid-1960s, some of the leading American franchise networks opened outlets in South Africa. Some of these outlets were company-owned while others were owned by South Africans.[17] Steers, which started in 1965, Kentucky Fried Chicken and Wimpy were some of the first.[18]

In 1979, the industry had grown sufficiently for the establishment of the FASA which was originally known as the SAFA.[19] The FASA is a non-profit, self-funding trade organisation which has as its mission the promotion and maintenance of ethical franchising in South Africa.[20] The development of the sector was hampered by trade sanctions implemented during the 1980s when foreign entrepreneurs were reluctant to

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11 Donner *An Overview of Franchising* 30.

12 *Ibid.*

13 *Ibid.* Similar complaints have been raised in South Africa and arbitrary terminations by franchisors have always been a problem. For further discussion see Chapter Five.

14 Zaid *Franchise Law* 2.

15 Charney *Franchising in South Africa - Its present position and potential for development* (MBL dissertation University of South Africa 1975) 84 quoted by Donner in *An Overview of Franchising* 30.

16 Seres *Problems in Decision-making: a South African Marketing Approach* (1978) 304-205.

17 Charney *Franchising in South Africa* quoted by Donner in *An Overview of Franchising* 46.

18 Donner *An Overview of Franchising* 46.

19 Franchise Steering Committee Report 8.

20 Information regarding the FASA is available at http://www.fasa.co.za.

invest in South Africa.[21] Sanctions came to an end with the election of the first democratic government in 1994. At that point an interest in franchising was re-kindled. There was also a recession which contributed to the growth of franchising. Many people were retrenched with packages by parastatals, corporations and the government. This created a pool of potential franchisees.[22]

There are approximately 520 franchise systems operating in South Africa. There are approximately 26 500 franchise outlets and approximately 500 000 people are employed in the sector. The sector contributes approximately 12% of South Africa's GDP.[23] Franchise networks are varied and include small enterprises which may involve franchisees with one or two employees, large listed companies, subsidiaries of international franchisors and franchisors with locally developed systems.

Franchising is also contributing to black economic empowerment. In 2005 the FASA developed guidelines for black economic empowerment.[24] This was in order to assist the industry to meet its obligations as set out in the Broad-based Economic Empowerment Act.[25] The FASA Code requires each franchisor member to furnish the FASA with a rating certificate issued by an accredited agency describing the extent to which its commercial enterprises are Black Economic Empowerment (BEE) compliant. Where the member is not compliant, it is required to submit its BEE strategy, setting out the time period and the manner in which it intends to become BEE compliant.[26]

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21 Franchise Steering Committee Report 8.

22 *Ibid.*

23 Eugene Honey, legal advisor to the FASA and member of the FASA Board, provided this information at the DTI conference "The Consumer Protection Bill and its influence on the South African economy" Johannesburg, March 2008 (Consumer Law Conference (March 2008)).

24 These guidelines are available at http://www.fasa.co.za. In July 2005 it was reported that these guidelines had been presented to the FASA Board for approval and that once this had been obtained they would be taken to DTI for endorsement (see FASA Newsletter 6 July 2005 available at http://www.fasa.co.za/newsite accessed on 9 September 2005). See also FASA "Discussion Document on a Transformation Charter and Scorecard for the Franchise Industry in the Republic of South Africa" (2005). In 2008 the FASA reported that it was launching an emerging franchisor development program to increase the number of affordable franchise opportunities in South Africa. There is a demand for such opportunities (such as the hot dog stand on the street and the shoe shine business) but there is a lack of franchise concepts to meet this demand especially in the emerging previously disadvantaged market (see http://www.fasa.co.za accessed on 24 March 2008).

25 Act 53 of 2003.

26 FASA Code s 7.6.

2.2 Forms of franchise arrangements

A franchise agreement is essentially an agreement or a license between two parties which gives one party (the franchisee) the right to market a product or service using the trade marks of the other party (the franchisor). The agreement may also contain a range of other rights and, depending on the extent of those rights, different forms of franchise arrangements can be identified. Different jurisdictions categorise these relationships differently but a study of the literature reveals that two forms of franchise relationships are most common, and that other relationships are most probably a variation of these two. These are trade name or product distribution franchises and business format franchises.[27] This thesis will focus on these two forms. Trade name franchises involve a very limited relationship between the franchisor and its franchisees, whereas the business format form of franchising involves a relationship that is far more extensive.

2.2.1 Trade name or product distribution franchises

Trade name or product distribution franchises are the oldest form of modern day franchising and occurs when the franchisor (manufacturer) licenses the franchisee (distributor) to act as a non-exclusive authorised dealer for the franchisor's products and the franchisee uses the franchisor's trade marks. Examples of such franchises are motor vehicle and implement dealers, petrol service stations and soft drink dealers. There is only a limited relationship between the two parties. The franchisor does not supply the franchisee with a system for running his business and it is assumed that both parties have equal business skills and access to resources. This assumption can be problematic: mere access to a well-known trade mark is not always sufficient to ensure

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27 The FSC Explanatory Report, for example, refers to distribution franchises which it explains are associations of small and medium businesses that come together to operate as a group. They are usually independent businesses in the same industry which agree to operate under the same trade mark but may include business format franchise systems that also want to obtain the benefits of operating under a bigger system. Examples are certain grocery stores and pharmacies. By combining their buying power they are able to compete against large chains but they maintain their independence. Such franchises are probably a variation of product distribution franchises.

that a business will be successful. Although franchisees have greater freedom to act, this system provides no group cohesiveness, no transfer of business skills and no back-up assistance with the result that the trade mark can suffer. In recent years some franchisors, such as those involved in the motor fuel industry, have converted to business format franchising.[28]

2.2.2 Business format franchising

Business format franchising is similar to trade name or product distribution franchising in that franchisees have the right to use their franchisor's trade name and have access to its products and services. However, in this model franchisors establish a fully integrated relationship with their franchisees. The idea behind business format franchising is that franchisors permit their franchisees to replicate their successful business formulae. Fast food outlets, hotels and convenience stores are common examples of this type of franchising and in recent years most of franchising's growth is attributable to increased business format franchising.[29]

Franchisors are entrepreneurs or entities that have developed successful business models. They allow franchisees to have access to their business know-how by providing them with licenses to use their trade marks, intellectual property, operating and business plans and other proprietary information necessary for the operation of a franchised outlet.[30] Franchisors also provide franchisees with the necessary training,

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28 Illetschko "Becoming a Franchisor" (2003) para 3.2 http://www.frain.org.za (accessed on 24 May 2006).

29 Byers "Making a case for federal regulation terminations - a return-of-equity approach" (Spring 1994) *Journal of Corporation Law* 608 at 614. In 2001 it was established that business format franchising in America operated 4.3 times as many establishments as product distribution franchising, it employed 4 times as many workers, generated 2.5 times the payroll and produced nearly 3 times as much output. See PriceWaterHouseCoopers "Economic Impact of Franchised Businesses" (2004) 11 http://www.franchise.org/files/EIS6_1.pdf (accessed on 5 May 2006) (PriceWaterHouseCoopers Report).

30 The development of business format franchising has been attributed to Ray Kroc, the founder of McDonald's (for information regarding McDonald's see http://www.mcdonalds.com). He was evaluating the success of McDonald's franchised outlets and he discovered that they all operated very differently and had widely varying degrees of success. The franchisees came from different backgrounds and had different strengths and weaknesses. It became clear that simply using the McDonald's trade marks and relying on McDonald's marketing was not sufficient to guarantee success. So he called together various interested parties including those franchisees who were successful and developed an operations manual. He then insisted that those involved in managing the franchise network and franchisees undergo an in-depth training program. See also Kroc *Grinding It Out, The Making of MacDonald's* (1997) and Love *McDonald's Behind the Arches*

support, advertising and marketing assistance that is necessary to promote their particular franchised brand. This enables the brands to penetrate the market and achieve greater brand recognition amongst consumers.[31] In successful franchise relationships, franchisees have the right to operate carefully tested and proven systems and in return they agree to make regular royalty payments to their franchisors.[32] These payments are usually made on a monthly basis and they are usually calculated using the gross monthly revenue of each franchised unit as a basis.[33] These relationships usually last for a specific period of time, such as five or ten years. Alternatively, the contract may stipulate that the parties may terminate the relationship by giving notice. If the contract is silent on the issue of termination, the parties may terminate the relationship by giving reasonable notice. It is never intended that franchisees will have access to the franchise network indefinitely, even though it may be said that franchisees are buying their own businesses.

Typical franchisors may have outlets that are operated by franchisees as well as corporate-owned outlets staffed by employees. Franchisors may be natural or legal persons. Some franchisors may offer single unit franchises in which each franchisee owns and operates a single unit. Other franchisors may offer multi-unit franchises where franchisees operate a number of establishments. Franchisors may also grant master franchises to franchisees in particular geographical areas. These are often international transactions. Such arrangements are particularly useful when there are unique cultures or languages involved or the legal requirements are specific to a geographical region.[34] Master franchisees will have control of particular geographic regions and have the right to establish their own franchises as well as the right to enter into direct franchise agreements with sub-franchisees within that region.[35] A number

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(1986).

31 Wieczorek "Prepared Witness Testimony".

32 The term "royalty" is said to have developed in the time when English monarchs in the 11th century allowed their barons to administer tracts of land and to collect taxes. A portion of the taxes collected had to be paid over to the monarch, hence the term "royalties". See Illetschko *How to Franchise your Business* (2000) 2.

33 Wieczorek "Prepared Witness Testimony".

34 Zaid *Franchise Law* 22.

35 Walker and Etzel "The Internationalisation of US Franchise Systems: Progress and Procedures" (April 1973) 37 *Journal of Marketing* 42.

of franchises which originate in America are run by master franchisees in South Africa.[36]

The African Development Bank has endorsed business format franchising as the form of franchising that should be promoted because it has the best record of promoting small and medium size enterprises.[37] This is because a recognised trade name is combined with a proven methodology of doing business and is backed up by management controls and on-going training that can detect and prevent problems.

2.3 Defining franchising

There is no universally accepted definition of franchising and the term tends to mean different things to different people. The concept is also used in a number of different contexts which can be confusing. Governments talk about a universal franchise in the context of ensuring that all citizens have the vote. There are also franchise structures in sport.[38] There is a need to define franchising in a business context in order to identify the types of arrangements which will fall within franchise-specific regulations. A suitable definition is also important from a common law perspective if franchising is to be recognised as a specific type of contract rather than as an ordinary commercial transaction.

The first state to enact franchise legislation in a business context was California. This state defined franchising as being a contract with three elements:

(1) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and

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36 See, for example, *Cash Converters Southern Africa v Rosebud WP Franchise* 2002 (5) SA 494 (SCA) which involved a franchise that originated in Australia.

37 See generally African Development Bank Group "African Development Report 2000" (2000) . In America in 2001, 76% of the establishments that used the business format model were owned by franchisees; 24% were owned by franchisors. Business format franchising was significant in 10 lines of business (including the automotive industry, commercial and residential services, quick service restaurants, full service restaurants, retail food, lodging, real estate, retail products and services, business services and personal services) and in every industry franchisee-owned establishments outnumbered company-owned establishments (PriceWaterHouseCoopers Report 12).

38 Walsh "IPL: Sporting franchise structures: The Indian Premier League" (2008) 6 *Worldsportslawreport* 1.

(2) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trade mark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and

(3) The franchisee is required to pay, directly or indirectly a franchise fee.[39]

This definition has become the commonly accepted American definition of franchising amongst the states,[40] but the Federal Trade Commission (FTC) developed its own definition. The FTC enforces the Federal Trade Commission Act,[41] which prohibits unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.[42] The FTC Act also empowers the Commission to prescribe rules that define with specificity acts or practices that are unfair or deceptive.[43] One such rule is the Commission's Franchise Rule.[44] The original Rule defined "franchise" very broadly to include both franchises and business opportunity ventures. The definition of a franchise encompasses three elements: (1) the franchisor grants permission to the franchisee to use its trade mark; (2) the franchisor exercises considerable control over the franchisee's business or provides significant assistance and (3) the franchisee makes a payment to the franchisor. In 1995, the FTC embarked on a process of updating the Franchise Rule and in 2007 it published an amended Franchise Rule.[45] One amendment was to separate business opportunities from franchising.[46] There is

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39 CAL.CORP.CODE §31005(a); Bus.Franchise Guide(CCH) ¶3050.07.

40 Baer, Carter and Miller "Lessons learned from Three Decades of Franchise Regulation and itigation in the United States" (2003) International Bar Association Conference, San Francisco I. There are minor modifications in different states but the essence of the definition remains the same. For example, in Illinois, Rhode Island and Washington the marketing plan can be "prescribed or suggested" and Oregon uses the words "valuable consideration" instead of "franchise fee".

41 15 USC.

42 The FTC's mission is to protect consumers in America by taking action against unfair or deceptive acts or practices and by promoting vigorous competition. See 4.3 below.

43 15 USC §57a.

44 The full title of this Rule is "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (see FTC16 CFR Parts 436 and 437).

45 See FTC "16 CFR Parts 436 and 437 Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities: Final Rule *Federal Register* vol 72 No 61 30 March 2007 1544 - 15574 at 15447 http://www.ftc.gov/os/2007/01//R511003FranciseRule FRNotice.pdf (accessed on 24 July 2007) (FTC *Franchise Register* 30 March 2007).

46 For a full discussion of these changes and the reasons behind them see Baer "Proposed Amendment to the US Federal Franchise Rule: Uniformity at Last? (1999) 1 *International Journal of Franchising and Distribution Law* 333 and Baer et al "Lessons Learned from Three Decades of Franchise Regulation and Litigation in the United States" 23.

now a separate tailor-made regulation that is specific to franchising and another that is specific to business opportunities.[47] The amended Franchise Rule has retained the three elements referred to above.

In 1985 the Canadian member of the International Institute for the Unification of Private Law (UNIDROIT)[48] proposed that the Institute develop some uniform rules which could be used by national legislators as a base when drafting their own legislation.[49] At the time there had been some unethical practices in Canada and there was concern that these practices would extend to other jurisdictions as international franchising gained momentum.[50] In 2002 a Model Franchise Disclosure Law was presented to the international community.[51]

The Model Law defines franchising as:

> the rights granted by a party (the franchisor) authorising and requiring another party (the franchisee), in exchange for direct or indirect financial compensation, to engage in the business of selling goods or services on its own behalf under a system designated by the franchisor which includes know-how and assistance, prescribes in substantial part the manner in which the franchise business is to be operated, includes significant and continuing operational control by the franchisor, and is substantially associated with a trade mark, service mark, trade name or logotype designated by the franchisor. It includes:

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47 Part 436 of the final amended Rule pertains to franchising and Part 437 pertains to business opportunities.

48 UNIDROIT was established in 1926 under the auspices of the League of Nations. Its purpose is to examine ways of harmonising and co-ordinating private laws such as those that regulate business relationships.

49 UNIDROIT "Model Franchise and Disclosure Law and Explanatory Report" 11 available at http://www.unidroit.org/english/modellaws/2002franchise/2002modellaw-e.pdf (accessed on 31 March 2004) (UNIDROIT Explanatory Report).

50 *Ibid.*

51 See Lord and Munn "Legislation: Help or Hindrance?" http://www.franchise.co.nz/article_display.ph.?ArticleID=195 (accessed on 19 April 2006). See also Peters "Franchising: Recent Legislation and the UNIDROIT Model Franchise Disclosure Law" (January 2004) 5 *Business Law International* 36 and http://www.unidroit.org. This is a model law rather than an international convention. As such, state legislators are free to take into consideration the model when drafting their own legislation and can make changes deemed fit to cope with their own domestic situation. Had this been an international convention contracting states would have been obliged to adopt it more or less as it stood. Model laws are more flexible than international conventions.

(A) the rights granted by a franchisor to a sub-franchisor under a master franchise agreement;[52]

(B) the rights granted by a sub-franchisor to a sub-franchisee under a sub-franchise agreement;

(C) the rights granted to a franchisor to a party under a development agreement.[53]

For the purposes of this definition "direct or indirect financial consideration" does not include the payment of a bona fide wholesale price for goods intended only for resale. This exclusion is also found in all of the American franchise laws. This is to ensure that agency, authorised dealer arrangements and once-off-sale of business agreements are not trapped by these laws. There is no need to regulate schemes in which all the recipient is required to do is pay for goods which are to be resold. The UNIDROIT Explanatory Report explains that it was necessary to make this distinction because of the proliferation of brand merchandising.[54] It is therefore important to be able to distinguish between genuine franchises and other business opportunities. This is a relatively narrow definition because it only applies to business format franchising.

Following an unsuccessful attempt at self-regulation the Australian government introduced a compulsory code of conduct in terms of their Trade Practices Act. This code contains a comprehensive definition of franchising:[55]

A franchise agreement is an agreement:

(a) that takes the form, in whole or part of any of the following:

(i) a written agreement;

(ii) an oral agreement;

(iii) an implied agreement; and

(b) in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or

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52 A master franchise agreement means a right granted by the franchisor to the sub-franchisor to grant rights to third parties (the sub-franchisees).

53 A development agreement is an agreement in terms of which the franchisor grants the franchisee the right to acquire more than one franchise within the same franchise system.

54 UNIDROIT Explanatory Report 19.

55 This definition was adopted by the Franchise Steering Committee in the FSC Bill.

distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and

(c) under which the operation of the business will be substantially or materially associated with a trade mark, advertising or a commercial symbol:

(i) owned, used or licensed by the franchisor or an associate of the franchisor; or

(ii) specified by the franchisor or an associate of the franchisor; and

(d) under which, before starting business or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including for example:

(i) an initial capital investment fee; or

(ii) a payment for goods or services; or

(iii) a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or

(iv) a training fee or training school fee;

but excluding:

(v) payment for goods or services at or below their wholesale prices; or

(vi) repayment by the franchisee of a loan from the franchisor; or

(vii) payment for the wholesale price of goods taken on consignment; or

(viii) payment of market value for purchase or lease of real property, fixtures, equipment or supplies need to start business or to continue business under the franchise agreement.

An agreement which satisfies this definition is covered by the code unless it has been specifically excluded by another provision of the code. A number of provisions provide for exclusions. These include motor vehicle dealerships, employment relationships,

partnerships and leasing arrangements.[56] The code also does not apply to non-resident franchisors where the franchisor is not a resident, domiciled or incorporated in Australia and the franchisor only grants one franchise or master franchise to be operated in Australia. In addition, the code does not apply to franchise agreements that relate to goods and services that are substantially the same as those supplied by the franchisee for at least 2 years immediately before entering into the agreement and the sale of goods or services under the proposed franchise will not provide more than 20% of the franchisee's gross turnover for goods or services of that kind during the first year of the franchise agreement. This provision relates to product distribution franchises. If a franchisor licenses an already established entrepreneur to sell goods or provide services that are of the kind that he is already supplying, the franchisor does not have to adhere to the provisions of the code.

In South Africa the Consumer Protection Bill defines a franchise as an agreement: between two parties, being the franchisor and franchisee, respectively—

> (a) in which, for consideration paid, or to be paid, by the franchisee to the franchisor, the franchisor grants the franchisee the right to carry on business within all or a specific part of the Republic under a system or marketing plan substantially determined or controlled by the franchisor or an associate of the franchisor;
> (b) under which the operation of the business of the franchisee will be substantially or materially associated with advertising schemes or programmes or one or more trade marks, commercial symbols or logos or any similar marketing, branding, labelling or devices, or any combination of such schemes, programmes or devices, that are conducted, owned, used or licensed by the franchisor or an associate of the franchisor; and
> (c) that governs the business relationship between the franchisor and the

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56 The problem with drafting a definition for franchising is that the definition can be over broad and may include relationships which the drafters never intended to be governed by legislation. One solution therefore is to provide specific exclusions such as those found in the Australian legislation. Canadian legislation has adopted a similar approach. This does not however solve the problem because it may become necessary to understand these different types of relationships as well. See Jones and So "Houdini's Franchise Law: Exclusions and Exemptions to disclosure in Canada" Ontario Bar Association 6th Annual Franchise Law Conference (November 2006) http://www.jonesco-law.ca?89/files/pdfs (accessed on 4 July 2008).

franchisee, including the relationship between them with respect to the goods or services to be supplied to the franchisee by or at the direction of the franchisor or an associate of the franchisor.[57]

An examination of the above definitions indicates that there are three main elements to a definition of franchising:

(1) a franchisor grants a franchisee the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system developed and controlled on an ongoing basis by the franchisor;

(2) the franchisee's business is substantially associated with the franchisor's trade mark, trade name, logos, advertising and other commercial symbols; and

(3) the franchisee pays franchise fees for the rights he enjoys.

In all the definitions, the words which refer to the franchisor's right to control the system or marketing plan are most important because it is how these words are interpreted which will determine what constitutes a franchise relationship. If it is only in cases in which the franchisor has a substantial say in the marketing plan that the business system will fall within the ambit of the legislation, many product distribution franchises will not fall within the definition of a franchise. This may be problematic as a product distribution franchisee may rely purely on one product for his business (an example is a motor dealership) and if the right to sell that product is withdrawn he may lose his entire business. In addition, he may have incurred other costs such as keeping a expensive inventory of spares which he no longer has a market for or he may have invested substantially in the development of premises which he no longer needs. However, a wider definition which includes all product distribution franchises has the

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[57] A definition of franchising appeared only in the third draft of the Bill (DTI Final Draft 2007). Originally only a version of (a) and (b) appeared in the definition and during the final amendment process (c) was added. It is suggested that (c) was added to the definition to ensure that not only the franchise sale agreement is governed by the legislation but also the agreement which governs the supply of goods and services on an ongoing basis to the franchisee.

disadvantage of encompassing other business relationships which are not intended to be franchises.

When the FTC was formulating its Franchise Rule it stated that it was having a great deal of difficulty distinguishing between product distribution franchising and producer/distributor relationships that were not franchises.[58] In order to assist with solving this problem the FTC issued a Compliance Guide. This Guide stated that the FTC did not intend to cover product/distribution relationships where no trade marks were involved, and so the Guide advised suppliers expressly to prohibit distributors from using their trade marks.[59] However, even where a trade mark is used, the arrangement will not constitute a franchise unless the franchisor exercises considerable control over the franchisee's method of operation. The FTC also issues guidelines and/or opinions regarding specific business arrangements in order to clarify its approach to control and assistance.[60] "Significant types of control" include: site approval, site design or appearance requirements; hours of operation; production techniques; accounting practices; personnel policies and practices; promotional campaigns; customer restrictions and territorial restrictions.[61] Assistance includes the provision of training programs, establishing accounting services, providing management advice and furnishing a detailed operational manual. Glickman quotes the example of International Consumer Club which was a discount buying club. This club sold its "associates" step-by-step guidance to establishing and operating a club in their area. They were provided with (a) money-making ideas; (b) sample directories of participating merchants; (c) sample contracts and (d) supplies of membership cards.[62] This was found to be a franchise by the FTC.

If the entrepreneur merely licenses another to sell his products or provide services under a trade mark license and there is no further involvement in the franchisee's business, the relationship does not have the same propensity for conflict. In addition, the licencee is more likely to be an experienced entrepreneur who is simply

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58 See Glickman *Franchising* (2002) §2.03 [3] 2-65.

59 Final Guides to Compliance with FTC Franchising Rule 44, Fed 166pp 49966 (1979) quoted by Glickman *Franchising* §2.03[3] 2-66.

60 See generally Jones and So "Houdini's Franchise Law: Exclusions and Exemptions to disclosure in Canada".

61 Glickman *Franchising* §2.02[2] 2-12.

62 Glickman *Franchising* §2.02[2] 2-13.

including these services or products as part of the range of products and services that he already has on offer. He is not in a position in which he requires further assistance from the licensor and therefore it is not necessary to provide such a person with further legal protection.

In conclusion it is suggested that a relatively simple definition be adopted in which the three elements discussed above are clearly specified. Franchising should be defined as an agreement in terms of which

(1) a franchisor grants a franchisee the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system developed and controlled on an ongoing basis by the franchisor; and

(2) the franchisee's business is substantially associated with the franchisor's trade mark, trade name, logos, advertising and/or other commercial symbols; and

(3) the franchisee pays franchise fees for the rights he enjoys.

It is further suggested that the South African authorities adopt the American approach and issue guidelines to assist with the interpretation of the elements contained in the definition. In particular, the level of control or assistance that is required must be clarified. Given the fact that the South African franchise sector is still in the developmental stages, a lesser form of control or assistance than that required by the FTC may suffice. But, an element of control or supervision over the franchisee's business must still be present before the relationship can be classified as a franchise.

The discussion in the next section of other business models will demonstrate that it is sometimes difficult to distinguish franchising from other methods of doing business. Yet the distinction has important legal consequences for the respective parties.

2.4 Comparison with other business models

Franchising is a strategy for expanding a business. Entrepreneurs who wish to expand their businesses have a number of options available to them such as, taking in partners,

establishing a network of distributors, employing agents or contracting with dealers.

It is important to be able to distinguish between franchising and other types of business opportunities because the term is sometimes used to make business opportunities more attractive, and unsuspecting or naive purchasers may find that they have purchased something that does not exist.[63] Further, should legislation be introduced, entrepreneurs may decide to call their arrangement a "licence", "joint venture" or "partnership" in order to prevent the relationship from being a franchise under the law. This particular problem is well-documented in America where entrepreneurs will refrain from calling a business relationship a franchise in order to avoid the sometimes stringent requirements of some states.[64] Kaufmann cites the example of an unreported decision involving a network of karate centres under the name United American Karate Inc.[65] The business claimed that the operators of the karate centres were employees and not franchisees and that franchise fees were payments for shares in the corporation. The New York Supreme Court rejected these arguments, holding that labels do not determine whether a business falls within the jurisdiction of the New York Franchise Act. The court held that the substantive nature of the transaction is what determines whether a business is a franchise and that "if it looks like a duck and it smells like a duck and it quacks like a duck, it is usually a duck".[66] The Amended Franchise Rule has provided clarification on this point.[67] A business relationship will be deemed to be a franchise if it satisfies the three elements contained in the definition.[68]

This particular problem has not yet arisen in South Africa in a franchising context but it is well known in the other contexts. For example, certain types of special contracts may be "dressed up" as other types of special contracts for a specific

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63 See, for example, the warning issued by the FASA regarding the bogus franchise Survival Liqui Seal and other examples discussed below at 4.1.1.

64 Jones and Ho "Houdini's Franchise Law: Exclusions and Exemptions to disclosure in Canada". See also Kaufmann "An Introduction to Franchising and Franchising Law" in *Franchising – Business and Legal Issues* 44 in which Kaufmann discusses a number of decisions decided under the New York Franchise Act.

65 Unreported decision, Index Number 404446/97 (Sup Ct NY City October 26 1998).

66 Transcript of hearing at 78 quoted by Kaufmann "New York Franchise Act" in *Understanding Franchising: Business and Legal Issues* (2001) 231.

67 The FTC points out that this does not involve a change in policy because under the original Rule the FTC staff advised franchisors that this is the approach that the FTC would adopt when interpreting the Rule (see FTC *Federal Register* March 2007 15459).

68 FTC *Federal Register* March 2007 15459.

purpose. Here the rule is firm: the court focuses on the intention of the parties rather than on the form in which the agreement is couched. In other words, "the category to which a given transaction belongs will depend upon the relationship which the parties intended to created, and the name by which they choose to describe the transaction will not necessarily determine the question".[69] As legislation will soon be introduced which applies to franchising, authorities must be alive to the problem of entrepreneurs seeking to avoid franchise classification. The name given to the relationship should have no effect on the legal status of the arrangement if it meets the franchise definition.[70]

Some of these methods of doing business are well-recognised in law, such as agency agreements and partnerships, to the extent that they are defined and have their own requirements, rights and duties. The law then imposes certain obligations on the parties. For example, agents owe their principals a fiduciary duty.[71] It is suggested that, given the prevalence of franchising as a modern business model and its unusual nature, franchising should receive similar specific legal recognition. Franchising should not, therefore, be viewed as a normal commercial arrangement but rather as a special contract with its own definition, requirements, rights and obligations. This is discussed in 3.5 below. Recognising franchising as a specific type of agreement would also make it easier for the authorities to distinguish between franchising and other business models.

The essential difference between franchising and other types of business arrangements is the concept that franchisees are considered to be in business for themselves and they own the infrastructure of their franchises, yet they are part of a network and contribute to the expansion of someone else's brand. In considering

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69 Hackwill *MacKeurtan's Sale of Goods in South Africa* (1983) 269. See also *Zandberg v Van Zyl* 1910 AD 302; *Antonie v Price Controller* 1946 TPD 190; *Commissioner of Customs and Excise v Randles, Brothers & Hudson Ltd* 1941 AD 369 and *Dithaba Platinum v Erconovaal* 1985 (4) SA 615 (T). *Dithaba Platinum* involved an agreement disposing of mineral rights. The respondent argued unsuccessfully that this was an exchange so that the agreement did not trigger a pre-emptive right which related to the sale of the mineral rights. The court rejected this argument, relying on the parties' intention as revealed by the language of the contract.

70 From a franchisor perspective it is not advisable to attempt to avoid regulation. Research in America has demonstrated that trying to avoid being considered a franchise when the elements of a franchise are present is an unwise move. Hart, a franchise attorney, explains that "the costs of having a franchise that has not complied with applicable law can be much greater than the costs of compliance at the outset of the endeavour". Hart "Methods of Business Expansion" http://www.bztm.com/pub_mabe.html (accessed on 3 February 2004).

71 *Transvaal Cold Storage Co Ltd v Palmer* 1904 TS 4 at 24.

whether or not the relationship constitutes a franchise it is necessary to look for the element of independence coupled with a degree of supervision from the other party, whether that party is called a partner, principal or employer. The main alternatives to franchising are as follows:

- vertically integrated chain;
- partnership;
- agency;
- distributorship;
- dealership;
- licensing; and
- direct selling.

2.4.1 Vertically Integrated Chain

This is the opposite of franchising. The initial entrepreneur sets up a vertically integrated chain of outlets instead of franchises. These outlets are managed from a central office and this office has direct control over the operation of the business. The outlets are managed by employees and each outlet is regarded as being part of the central business. The advantage of this is that it is not necessary to pay attention to competition regulation as the various businesses are regarded as being part of the same organisation and are not regarded as being competitors, either horizontally or vertically.[72] By contrast, franchises are regarded as independent businesses and are in fact competing with each other as well as with their franchisor. Therefore, competition regulation is applicable to the franchise network. This creates numerous issues regarding the control which franchisors exercise over their networks.[73]

The disadvantage of a vertically integrated chain is that the stores are managed by employees and so vicarious liability is a concern, as is labour legislation.[74]

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72 See generally Beyer "Considerations in the Development of a Franchise system" *Franchise Law and Practice* (1996) §2:12.

73 For further discussion see Chapter Six.

74 Some franchisees have argued that South Africa's extensive labour legislation should be applied to franchising particularly in regard to the cancelling of franchise agreements. It is not possible to dismiss an employee without following extensive labour law procedures and yet a franchisor

2.4.2 Partnership

Partnership is a contract between two or more parties whereby each contributes or undertakes to contribute towards an enterprise to be carried on jointly by them with the object of making a profit and of sharing it between them. In *Joubert v Tarry & Co*[75] De Villiers JP pointed out that while it is not always easy to determine whether a partnership exists, four essentials should be adopted. First, each of the partners must bring something into the partnership such as money, labour or skill. Second, the business must be carried on for the joint benefit of both parties. Third, the object should be to make a profit and finally, the contract between the parties must be a legitimate contract.[76]

In order to avoid being classified as a franchise, parties may call their arrangement a partnership or a joint venture. For example, the one party may argue that his contribution was the trade name, products and or services whilst the other party contributed money and manpower. For a venture to constitute a partnership each party is required to make a contribution which does not have to be assessed in financial terms,[77] and although all the parties must share in the profits, they do not have to do so equally. It is possible to disguise a franchise as a partnership agreement and it will be necessary to consider the nature of the arrangement in order to ascertain its true legal status.

The legal consequences of a partnership may deter entrepreneurs from forming them. In a partnership, each partner is responsible for the acts and business liabilities of the other. A partner has implied authority to make contracts that bind the partnership and that fall within the course and scope of the partnership[78] but legally partnerships have no separate identity. Partners are jointly and severally liable for debts incurred on

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is entitled to cancel a franchise agreement for a (sometimes relatively minor) breach of contract or refuse to renew a franchise without giving any reasons. The call to apply labour legislation to franchise agreements indicates a fundamental misunderstanding of the franchise relationship but the premature cancelling of agreements or refusals to renew are seriously problematic issues which should be regulated by franchise-specific legislation.

75 1915 TPD 280.

76 This was approved in *Rhodesia Rhys v C of T* 1925 AD 465.

77 *Joubert v Tarry & Co.*

78 *Eaton & Louw v Arcade Properties (Pty) Ltd* 1961 (4) SA 233 (T). Although a partner's right to bind the partnership may be limited by an internal arrangement this will not bind third parties who are unaware of these internal arrangements.

behalf of the partnership.[79]

From a franchisor's point of view structuring the business as a partnership is inadvisable because each partner has the right to take part in the management of the partnership and each has an equal say in this regard, irrespective of his contribution to the partnership or his share of the profits. This may be regulated by agreement between the parties, but as partners, franchisees would expect to have a greater say in the operation of the network, and franchisors could find themselves with many "partners", each with their own management style.[80] The most important consideration, however, is the fact that as partners, franchisees will have the right to become co-owners and share the use of partnership property. Partnership property means the following:

- assets which the partners, either on entering into the contract or subsequently, undertake to contribute to the partnership;
- assets which partners acquire on behalf of the partnership in the course of the business of the partnership;
- assets which partners acquire for themselves in circumstances where they are under a duty to acquire them for the partnership; and
- gains derived from, and increases in value to, assets which have been contributed to the partnership.

A partnership is a relationship based on trust and confidence. The law states that partners stand in a fiduciary relationship to each other and owe each other a duty of utmost good faith. One of the consequences of this duty is that partners may not, without the consent of their other partners, acquire for themselves any benefits, the acquisition of which is within the scope of the partnership business and which it is their duty to acquire for the partnership. If they do obtain such benefits they may be

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79 *Ehrig and Weyer v Transatlantic Fire Ins Co* 1905 TS 506 and *R v Levy* 1929 AD 322.

80 It is always in the interests of the network for the franchisor to have open channels of communication with its franchisees, but ultimately the franchisor is responsible for the overall brand and it is important that it maintains uniformity across the network. This could be difficult if each franchisee saw himself as a partner rather than as a franchisee.

compelled to account for them and transfer them to the partnership.[81]

The acquiring of benefits is an issue that has caused problems within the franchise relationship. Franchisors negotiate deals with major suppliers in order to get favourable prices for their networks. In some instances, franchisors will receive rebates depending on the quantity supplied or for early settlement of their accounts. The question then is, are franchisors, who have received such benefits, obliged to pass these benefits on to their franchisees? If the relationship is one of partnership, franchisors would not be entitled to benefit from rebates without full disclosure to their partners. In a matter involving 7-Eleven franchisees, the Supreme Court of Appeal found that the franchisor did not have to pass over the benefit of rebates or early settlement discounts received by the franchisor from suppliers of goods. The court found that rebates were given for reasons unrelated to the individual franchisees. They were given as a reward because the franchisor had achieved certain targets or because of the growth in purchases.[82] This decision is inconsistent with the idea that a franchise can also constitute a partnership.

Franchisors who term their relationships "partnerships" in order to avoid franchise regulations may lose significant benefits attached to franchising. In particular, they could lose ownership of their most valuable assets, namely their intellectual property such as trade and service marks and business models. It is therefore highly inadvisable for franchisors to avoid the law in this manner. To do so, as pointed out by Hart, could be far more costly to franchisors then ensuring that they comply with franchise requirements from the outset.[83]

Some commentators have, however, referred to franchising as a "unique" partnership between two parties who have a financial stake in the business.[84] It is suggested that in practice many franchisors and their franchisees do see themselves as being in a partner-like relationship, particularly those who are involved in a

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81 See *De Jager v Olifants Tin "B" Syndicate* 1912 AD 505 and Sharrock *Business Transactions Law* 7ed (2006) 464.

82 *Seven Eleven Corporation of SA (Pty) Ltd v Cancun Trading No 150 CC.*

83 Hart "Methods of Business Expansion". See also Jones and Ho "Houdini's Franchise Law: Exclusions and Exemptions to Disclosure in Canada".

84 In *Principe v McDonald's Corp* 631 F2d 303 (4th Cir 1980) 451 US 970 (1981) the court explained that because the business format franchise often emphasises the quality of the operations of the franchised establishments as well as the merits of the products delivered and sold, the success of the system is just as much a function of the franchisee's management and operation as it is a function of the assistance provided by the franchisor.

successful, properly functioning relationship. The significant similarities between partnerships and franchisor/franchisee relationships lends support to the argument that the franchise relationship should have a specific status in law.

2.4.3 Agency

Agents are individuals who have been appointed by others (principals) to act on their behalf.[85] Agents, in the name of their principals, conclude agreements with third parties and in so doing they create contracts between principals and third parties. Agents themselves acquire no rights or duties in terms of the agreements,[86] and they incur no personal liability.

Many so-called franchise relationships are in fact no more than agency agreements, with the representative acting on behalf of a principal, such as a manufacturer, who may even be based in another jurisdiction. True franchise agreements are not anything like agency agreements because franchisees act in their own names and on their own accounts and they bear all the trading risks.[87] But in some instances, in order to avoid being classified as franchise agreements, contracts may be styled as contracts of agency. It is therefore necessary to examine the relationship between the parties and, if so-called agents are required to use the manufacturer's name, conduct their businesses in a particular way, and pay for the privilege of being agents, the businesses may in fact constitute franchises and not agencies.[88]

2.4.4 Distributorship

Manufacturers or importers may establish networks of distributors who will supply the goods to consumers. Traditional marketing channels often consist of loose networks of manufacturers or importers, wholesalers and retailers who "bargain with each other at arm's length, terminate relationships with impunity and otherwise behave

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85 De Wet "Agency and Representation" revised by Du Plessis in Joubert (ed) *LAWSA* (1995) para 100.

86 *Wood v Visser* 1929 CPD 55 at 56 and *Marais v Perks* 1963 (4) SA 802 (E).

87 See, for example, *Pronuptia v Schillgalis* (1986) ECR 353 para 10.

88 Hart "Methods of Business Expansion".

autonomously".[89] Distributors may purchase the goods outright from manufacturers or importers or they may have some other arrangement regarding payment such as purchasing on consignment. Distributors operate under their own names and are not required to follow any kind of business model. They usually set their own prices for products and are not required to pay a fee for the privilege of being distributors.[90] Some distributors may be well resourced with large warehouses and fleets of vehicles whilst others are very basic and may consist of nothing more than a fleet of door-to-door salespeople. A draw back of the distributorship model is that there can be a duplication of effort and inefficiency with the result that the cost of distributing the product may be higher than producing it.[91] From the distributor's perspective this model can be problematic because there is no territorial exclusivity and more than one distributor may be appointed for a particular area.

Networks that are referred to as distributorships may develop into franchises. This will occur if manufacturers dictate the method of doing business or insist on particular marketing plans, there is substantial association with the manufacturer's trade marks and distributors are required to make payments over and above the legitimate wholesale prices of products.[92] In any event, there is considerable overlap between distributorships and product distribution franchises. An entity that is entitled to use particular trade marks when distributing certain products may in fact be no more than a distributorship although it could be referred to as a franchise. This causes confusion especially where the concept of franchising is not properly understood. Franchisees may have certain expectations concerning the relationship which franchisors do not intend to meet. This is one of the reasons why product distribution franchises without the element of franchisor control should not fall within the definition of a franchise.

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89 McCammon "The Emergence and Growth of Contractually Integrated Channels in the American Economy" in Boone and Johnson (ed) *Marketing Channels* (1973) 214 quoted by Donner in *An Overview of Franchising* 11.

90 Hart "Methods of Business Expansion".

91 Davidson "Changes in Distributive Institutions" (January 1976) 40 *Journal of Marketing* 7.

92 The relationship would then contain the three elements of a franchise relationship discussed above.

2.4.5 Dealership

Dealerships are independently owned stores that sell goods manufactured or imported by others. Dealers own their own stores and finance themselves.[93] They may receive some branding and technical training but are not required to follow particular business models. These are common in motor vehicle and equipment industries. Dealers may sell one particular type of product, such as Mercedes Benz, but they are usually not restricted to this. For example, a farm equipment or sporting goods store may sell a wide variety of different products from different manufacturers or importers but all related to their particular industry. If a business is associated with a particular trade mark, dealers are required to adopt a particular business model and are required to pay a fee for advertising, marketing or training materials, the business may in fact be a business format franchise.[94] There is also an overlap between this type of business and a distribution franchise and again confusion may be the result.

On 21 February 2005, the CAFCOM received a complaint from an entrepreneur who had purchased a franchise for a business that produced and marketed re-tread tyres and provided tyre management services. Each franchise cost in the region of R1 million and took approximately 6 months to set up as the franchisee had to equip his factory, employ and train staff and buy raw materials. This entailed additional costs. The franchisee complained that misrepresentations had been made regarding how much money could be made from the business and that the franchisor had not disclosed the number of franchises that had failed.[95] Interviews with the franchisor's representatives revealed that it was not the intention of the franchisor that the franchise should be the only business of the franchisee, but that this should form part of an already established business involved in the repair and maintenance of motor

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93 Itletchko *How to Franchise your Business* 8.

94 Hart "Methods of Business Expansion". In the motor vehicle industry the word franchisee and dealer are used interchangeably (Interview with RMI representative May 2008).

95 The franchisee reported that over the previous five year period most franchisees had stayed in business for one year to 16 months and that 80% of the franchisees had failed. The franchisee stated that had he known this he would never have purchased the franchise. He provided the Committee with a spreadsheet that referred to 43 franchisees. 16 franchises had closed down and 13 were no longer under the same ownership. The owners were asked to give reasons why the franchise had closed, been sold or had been taken over by the franchisor. 13 Franchisees stated that they could not make any money or that the rubber they were contracted to buy was too expensive.

vehicles.[96] Although the franchisor's representatives were unsure of the exact nature of the relationship (they referred to both franchises and dealerships) it emerged that the model was a very limited form of franchise and that franchisees had licences to market and sell products in a specific location or area only. There was no control over the format of their businesses and consequently no other form of assistance was provided. The franchisor supplied the franchisee, an already established business involved in the motor vehicle business, with certain machinery. This machinery enabled the business to re-tread tyres. The franchisee undertook to purchase all its rubber from the franchisor and in return it was entitled to use the franchisor's trade mark. No royalties were paid, no on-going assistance was provided to franchisees and, although the overall trade mark was advertised, no attempt was made to advertise specific businesses. The Committee concluded that many of the problems had arisen because the parties had completely different expectations of the business, and the franchisor was requested to seek expert advice regarding franchising. Establishing who was at fault and pinpointing the reason why the various franchises failed proved impossible. Nevertheless, this was a clear example of miscommunication and a lack of understanding on the part of both parties regarding the true nature of their relationship and franchising in general.

2.4.6 Licensing

This usually applies when entrepreneurs have developed some form of intellectual property and they wish to generate an income by allowing others to make use of that property. Examples are cartoon characters such as Mickey Mouse and the Teletubbies, logos such as Nike, Reebok and Coco Cola or computer software programs such as those produced by Microsoft. Licensors will generally require licensees to adhere to certain requirements that are designed to protect their intellectual property, but they do not provide the marketing or business plans that licensees are required to follow. For example, Coca Cola may allow a clothing company to use its logo and may specify the

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[96] The franchisor's representatives acknowledged that there had been some problems. They informed the Committee that new processes were in place and that the previous difficulties were a thing of the past.

type of clothing on which the logo may appear, but it will not prescribe to that company how the business should operate. However, in order to protect its intellectual property the licensor may start to assume more and more control over the use of that property. As more constraints are placed on licensees (particularly when license agreements are renewed) the relationship may begin to resemble a franchise.

2.4.7 Direct Selling

Direct selling includes classical direct selling, multi-level marketing, network marketing and referral marketing. These are various forms of selling whereby independent marketers distribute goods and services directly to consumers.[97] Direct selling in its classical form occurs when marketers sell their products to a wide customer base and they earn an income from the sales that are made. Multi-level marketing and network marketing refers to a system whereby marketers develop a team of marketers and they earn an income not only from their own sales but also from the sales of their team members. This team is classically referred to as a "down line" and can take a pyramid structure with entrepreneurs occupying different levels in the network. For example, the top of the sales structure or pyramid is occupied by the chief executive officer, below him are a number of deputies, the next level is occupied by regional managers, then district managers and the final level comprises those who are actually engaged in selling the product. Some entrepreneurs will remain on the lowest level, content with selling to consumers, but others will be promoted depending on their experience, sales or training. Direct selling has many advantages because a very personal relationship is established between seller and consumer.[98]

This business opportunity will start to resemble a franchise when the supplier (or person at the top of the marketing structure) develops a marketing plan in terms of which the business must be conducted, the goods or services are promoted under a particular trade mark and others involved in the network pay a fee for the privilege of

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97 In 2004 it was estimated that in the 46 countries that belong to the world wide Direct Selling Association (DSA) there were 50 million independent contractors. See http://www.dsasa.co.za (accessed on 1 August 2006).

98 It has become a very successful means of distributing cosmetics and health products, for example, Justine, Avroy Schlain and Golden Products.

using this trade mark.[99] Using a direct marketing type distribution network is appropriate to franchising, especially for small entrepreneurs. There are no elaborate start-up costs and sales are usually made on a party plan or group presentation basis. Franchisees do not have to invest in expensive real estate and stocks can be ordered as and when they are purchased by consumers. As franchising becomes more regulated it will be necessary for entrepreneurs who adopt the direct selling method of distributing goods and services to ascertain whether their networks are in fact franchises and then to ensure that they comply with any statutory requirements that are introduced. Further, those who do adopt this method of doing business must ensure that they are not contravening existing laws relating to illegal pyramid schemes.

Unfortunately, this business model, particularly when it is in the form of multi-level marketing, is open to abuse and today many multi-level marketing programmes are simply disguised pyramid schemes.[100] Such schemes have been outlawed in many jurisdictions, including South Africa.[101] In order to legitimize such schemes, they may be promoted as franchises. The ease with which an illegal pyramid scheme can be disguised as a franchise has tarnished the image of franchising and, even before America introduced legislation to prohibit illegal pyramid schemes, the IFA stated in its

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99 The fee may be in the form of mandatory training costs or markups on certain goods or services.

100 See Woker "If It Sounds Too Good to be True it Probably Is: Pyramid Schemes and Other Related Frauds" (2003) 15 *SA Merc LJ* 237; Van Druff "Whats Wrong with Multi-level Marketing" http://www.vandruff.com (accessed on 22 May 2002); Fitzpatrick "Is MLM legal" http://www.falseprofits.com (accessed on 22 May 2002); Fitzpatrick "The American Scam" http://www.falseprofits.com/Americans (accessed on 23 August 2005) and Carter "Behind the Smoke and Mirrors" http://www.mlmsurvivor.com (accessed on 22 May 2002). The DSA states that more and more classical direct selling companies are turning to multi-level marketing because it has enormous potential for exponential growth. See http://www.dsasa.co.za (accessed on 1 August 2006).

101 The South African government first attempted to regulate pyramid schemes in 1980 (Regulation 469 *Government Gazette* 6880 14 March 1980). There are no reported decisions involving these regulations and they were generally regarded as being too cumbersome to be of any practical use. In 1999 the Business Practices Committee (now known as the CAFCOM) conducted a general investigation into money making schemes following a number of specific investigations. (See for example: Report 55 "Rainbow Business Club" *Government Gazette* 18531 12 December 1997; Report 56 "Newport Business Club (Pty) Ltd" *Government Gazette* 18292 17 September 1997; Report 60 "Dunamus Marketing CC" *Government Gazette* 18972 12 June 1998; Report 62 "AJ van Rensburg & Associates CC, also known as JVR & Associates CC, trading as Itereleng" *Government Gazette* 19477 20 November 1998 and Report 66 "Omega Trust, Omega Power Marketing, Gerhardus Francois Janse van Rensburg and Jan Frederick Olivier van Zyl" *Government Gazette* 20199 14 June 99). Although there are countless variations, they are all based on the same fraudulent concepts and so the final report was able to identify three basic schemes, namely: pyramid promotional schemes, money revolving schemes and chain letters. These were declared to be harmful business practices and consequently unlawful by the Minister (GN 1135 *Government Gazette* 20169 9 June 1999).

Code of Ethics that "the so-called pyramidal distribution system is inimical to the interests of the consumer, the distributor and the franchise concept, and no member shall engage in this method of doing business".[102] A similar section appears in the FASA Code.[103] It is therefore important to be able to recognise when a particular business model constitutes an illegal pyramid scheme.[104]

Although it is generally accepted that some forms of pyramid selling are illegal, applying the definition of an illegal pyramid to ingenious schemes dreamed up by inventive entrepreneurs has proved to be very difficult. The advantage of multi-level marketing is that distributors are compensated not only for their actual sales but also for the sales that other distributors make. There is, therefore, an incentive to recruit more and more distributors. Added to this, is the fact that commission is sometimes earned for recruiting and not just for sales,[105] resulting in a blurring between illegal pyramid schemes and legitimate multi-level marketing programmes.[106]

Franchisors may sell distributorships using a multi-level marketing approach. The franchisor starts by selling a number of franchises. These franchisees are then encouraged not only to sell their products or services but also to recruit more franchisees, and they are compensated for this as well as for selling products. This starts to resemble an illegal pyramid when the focus shifts from selling products to selling distributorships. The products themselves become secondary to developing a

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102 Fels and Rudnick *Investigate Before Investing* (1976) quoted by Donner in *An Overview of Franchising* 16. Franchise Advice International (an independent international franchising information resource based in the United Kingdom) treats multi-level marketing as pyramid selling and refers to it as a serious fraud (see http://www.franchiseek.com). Others, for example Zaid, recognise that franchisors can adopt a multi-level marketing approach but warn that participants must be aware of those laws which outlaw certain activities associated with illegal pyramids such as compensation for recruiting (see Zaid *Franchising Law* 147 and Dillon "Ontario's Franchise Regulatory Regime: Why Ontario should get active in NASAA" http://www.franchiselaw.ca (accessed on 1 August 2006)).

103 S 7.4

104 See Woker 2003 15 *SA Merc LJ* 237.

105 This is permissible in terms of the Direct Marketing Code of Conduct.

106 Fitzpatrick "Is MLM legal" and Taylor "Product-Based Pyramid Schemes". The way in which individual operators market the products may mean that these marketers overstep the mark from legitimate multi-level marketing and into the realms of pyramid selling. Because they are paid for recruiting, their emphasis may move from selling the product to recruiting. See, for example, Competition Bureau (Canada) "Herbalife Marketers Plead Guilty to Pyramid Selling" http://www.competition.ic.gc.ca/epic/internet/incbbc.nsf/en/home (accessed on 1 August 2006). Participants in the Global Online Systems Inc (GOLS) were selling products marketed by Herbalife Canada Ltd on a multi-level marketing plan. An investigation by the Canadian Competition Bureau revealed that this was an illegal pyramid and GOLS was fined $150 000 by the Federal Court of Canada.

"down line" and the emphasis is on how much money can be made rather than on the merits of the products. The hallmark of a pyramid scheme is that those who participate do not become involved because of the product; they become involved because they have been assured that they will make their fortune. Legitimate multi-level marketing involves real products which are of significant value and, most importantly, the profits for the participants come from the sale of the products to people for whom the products also have value. The distinction between the two is controversial and there are some who are of the view that with very few exceptions, the multi-level marketing industry is composed of pyramid operations.

In addition, evidence suggests that even in the case of legitimate multi-level marketing schemes the majority of participants have little chance of financial success. They certainly will not achieve the outstanding results that are often advertised. Most participants will barely cover costs.[107] Real profits are reserved for a small minority at the top of the hierarchy.[108] Those who commit themselves, sometimes purchasing expensive start-up kits, often discover that the market is already saturated and that there are not enough people in the community who want to buy the usually overpriced product, whether it be washing powder, health products or a website. Participants then

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107 It has been estimated that the average earnings of a distributor in America involved in a legitimate multi-level marketing scheme is $14 per month. This does not take into consideration the amount of money the participant has spent on attracting further participants to his "down line". See,for example, de Leon "A very thin line between multi-level marketing and pyramid schemes" (*Manila Times* 28 April 2003), in which a participant in a scheme in the Phillipines explains that even when he did make money selling the products of a multi-level marketing company that had originated in America, he could not make enough to cover his costs and get back his original investment. See also Haipola "My unlived life with Skybiz" http://www.nci.fi (the consumer awareness site for Finland)(accessed on 2 April 2003). Here a former member of Skybiz warns other consumers against becoming involved with multi-level marketing. In Canada, the Competition Act prohibits certain deceptive marketing practices which are common to pyramid schemes (see s55) and in 2001 Lifestyles Canada Ltd, was convicted under s 55 (2.1) and fined $95 000 for failing to disclose the compensation which participants typically earned. This was a company that sold health products and diet plans using a multi-level marketing plan. Their promotional material stated that participants could earn thousands, even millions of dollars whereas most people earned between $399 and $2000 per year (see Competition Bureau "Competition Bureau's investigation Leads to $95 000 Fine for Multi-level Marketing Company" http://www.competitionbureau.gc.ca/internet/index.cfm?itemID=515&lg=e (accessed on 1 August 2006).

108 In 2000 Avroy Schlain reported to the Business Practices Committee that an advisor (of whom there were approximately 16 000, in 2000) earned in the region of R83 per month. The average for area distributors at that time was approximately R7000-8000 per month. Schlain recommended that multi-level marketers should be obliged to disclose what the real earnings of the average participant would be because very few actually made the huge profits often discussed (even if not contained in advertising material).

resort to purchasing unneeded products themselves or coercing friends and families to purchase.

It is not always easy for unsuspecting entrepreneurs to judge the validity of business transactions and in South Africa, with its social problems, poverty and unemployment there is a fertile breeding ground for opportunists. Investors are sometimes led to believe that they are participating in black empowerment programs or stokvels.[109] This is not only a South African problem. Robert Fitzpatrick, the author of the book *False Profits* and President of Pyramid Scheme Alert[110] states that "[these] schemes have become an insidious, pervasive and corrupting influence in the marketplace and community, causing financial and social harm on a global scale".[111]

2.5 Choosing the correct business model: a case study of Silk by Design

In 2003 the members of Silk by Design CC, a business that imports silk flowers from China, decided that they wanted to expand their business by developing a network of home-based entrepreneurs. For this purpose, a separate close corporation called Silksense CC was formed. The object of this close corporation was to distribute flower arrangements to a variety of clients made from silk flowers imported into South Africa by Silk by Design CC.[112] Initially the idea of a franchise network was mooted. An

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109 A stokvel is a "type of informal credit-rotating association in which a group of people enter into an agreement to contribute a fixed amount of money to a common pool on a weekly or monthly basis or as frequently as the members may agree upon". See generally Schulze "The Origin and Legal Nature of a Stokvel" (1997) 9 *SA Merc LJ* 18 and 153. See also GN 2173 *Government Gazette* 16167 14 December 1994.

110 An international consumer organisation dedicated to preventing the spread of pyramid schemes and other types of investment frauds.

111 Fitzpatrick "Is MLM legal".

112 Distributors (or agents or franchisees depending on the business model) would purchase a number of flower arrangements from Silksense. They would then distribute these flower arrangements to clients such as doctors, lawyers, health studios and individuals. Every week the distributor would visit her clients and would swop the flowers around. Every client would, therefore, receive a different flower arrangement every week. Tired and damaged flowers would be replenished by purchasing new stock from Silksense and the distributors were expected to grow their client base and were expected to continually purchase new arrangements from Silksense. If they failed to do this, Silksense reserved the right to appoint further distributors in a particular area. A clause in which one party imposes a duty on another to use his "best efforts" in the development of his territory has proved to be very valuable in America. But, the use of such a clause has led to litigation because the question of best efforts is judged by the supplier's "satisfaction". The supplier has the discretion to decide whether there has been adequate

operations manual was developed which would provide prospective franchisees with guidance regarding the establishment of a successful business. The so-called franchisor (Silksense) intended to provide additional advice on an ongoing basis to members of the network. The business opportunity involved establishing a network of entrepreneurs who would each build their own businesses operating for their own account. These entrepreneurs would enter into lease agreements with individuals and businesses for flower arrangements provided by Silksense. After careful consideration it was decided that the intended relationship between the parties would not amount to a franchise relationship because the members of Silksense did not want to dictate the total terms of how the businesses operated, no royalty was required and ongoing advice and support was limited to informing distributors about updates to the operations manual and answering specific queries, provided such queries were reasonably required for the operation of the business.[113] Silksense did not want to adopt the

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development of a territory. In order to avoid litigation, suppliers may provide objective criteria against which performance can be judged. See generally Kessler "Automobile Dealer Franchises: Vertical Integration By Contract" (1957) 66 *Yale LJ* 1134 at 1136.

113 The relationship was also not one of principal and agent because an agent represents the principal and creates, alters and discharges legal obligations of a contractual nature between the principal and third parties. The agent herself incurs no responsibilities in terms of the final contract. So, in this case, if Silksense were to appoint agents who distributed the flower arrangements the final contract would be between Silksense and the client. Silksense would retain ownership of all the flower arrangements and would be the ultimate entity responsible for ensuring that it got paid. If a client failed to pay their monthly rental fees Silksense would be responsible for enforcing the contract. The agent would have to receive a monthly commission. In this instance, what was required was for the distributors to purchase the flower arrangements from Silksense and to enter into their own agreements with clients. The agreement between Silksense and its distributors was in fact a contract of purchase and sale and so they are distributors of Silksense products rather than agents for Silksense. A clause was therefore inserted into the contract to make it clear that the distributor was not an agent and could not refer to herself as an agent (clause 7). This was to prevent a situation arising in which a client would be misled into thinking that they had the right to hold Silksense liable if any problems arose. See, for example, *Anderson v Turton Dev Inc* Bus Franchise Guide (CCH) ¶ 11,106, 483 S E 2d 597 (Ga App 1997) in which the plaintiff tried to sue a hotel franchisor because he fell on a defective handicap ramp in a franchisee's hotel. In America, franchisees have sometimes been found to be acting as agents of franchisors. Whether a franchisee is an agent is determined from (1) the terms of the contract, (2) the degree of control which the franchisor exercises over the franchisee and (3) whether a reasonable third party would on the basis of the activities of the parties view this as an agency relationship and (4) the benefits which the franchisor obtained from the franchisee's activities (see Glickman *Franchising* § 4.04 (1)). In *Nichols v Arthur Murray Inc* 248 Cal App 2d 610, 56 Cal Rptr 728 (1967) the court found that the franchisee was an agent of the franchisor because the controls which the franchisor imposed on the franchisee deprived him of any independence. The contract stated that the franchisee was solely responsible for all obligations and the franchisor was not liable but the court held that these only applied between the parties and did not affect the rights of third parties. In the *Anderson* matter the court held that although the franchisee was required to construct handicap parking ramps and a suggested design was provided by the franchisor, the ramps were designed, built and maintained by the

hands-on approach that is required of franchisors. It wanted to supply flower arrangements which were purchased outright by entrepreneurs and to give basic advice about how to get started. In particular, business hours, the relationship with other businesses and leasing agreements would be left to participating individuals to negotiate. The contract drafted for this business opportunity made it clear that this was not a franchise agreement[114] in order to discourage distributors from arguing, at a later stage, that their business failed because of a lack of support from Silksense. The contract also made it clear that the success or failure of their businesses rested in the hands of each individual.[115] Individuals were, however, obliged to use the Silksense trade mark and, in the flower arrangements they could use only flowers supplied by Silksense.[116] It would not have been incorrect to have referred to this relationship as a franchise because it resembled a product distribution franchise. Therefore, even though the contract specifically stated that this was not a franchise relationship, the interpretation of an accepted definition of franchising, such as the one that appears in the Consumer Protection Bill, may well lead to such business arrangements being classified as franchises. Each flower arrangement is required to display the Silksense trade mark, the distributor is required to carry business cards which identify her as a Silksense distributor and she is entitled to attach a further mark on her flower arrangement which identifies her as the source of the arrangements and which states that she was an authorised distributor of Silksense.[117] There is some exercise of control over the distributor's business in that an operations manual is provided and updated as and when new innovations are introduced. Significantly there is no royalty payment, and provided distributors do not mix other flowers with those obtained from Silksense,

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franchisee. In addition, the franchisor did not have control over the operation of the hotel and so the franchisor was not vicariously liable to the plaintiff.

114 Clause 4.2. See Appendix "A".

115 Clause 9.

116 These are flowers of considerable quality and the members of Silksense were concerned that if other flowers were used under their trade mark this would have an adverse effect on the trade mark. This requirement does, however, raise certain competition issues. The members of Silksense accepted that any person could purchase their flower arrangements initially and then start using inferior flowers to supplement those that became damaged. An individual could also leave the network at any time and set up a competing business and it would be very difficult to control this. These factors also played a role in deciding not to franchise the business. Errant participants would be required to stop using the trade mark and return the operations manual. They would not receive new information about stock or improvements and Silksense would establish another distributor under their trade mark in the area.

117 Clause 5.

they are free to conduct their business as and when they like. The manual is intended more as a guide than a set of rules for operating. Distributors are however, expected to purchase their replacement flowers from Silksense or Silk by Design and they are expected to increase their client base and would therefore be required to purchase arrangements on an ongoing basis. Nevertheless, it is suggested that the level of control that Silksense has over its distributors is not sufficient for such a business to be classified as a franchise.

2.6 The Advantages of Franchising

There are significant risks to starting a new business. South African statistics suggest that 80% of new business start-ups fail within 3-5 years.[118] Nevertheless, many entrepreneurs want to own their own businesses. Franchising is able to provide a bridge between owning your own business and working for someone else. Franchising has benefits for both parties, and there is research that suggests that franchising is more successful than other small business set-ups.[119]

2.6.1 Advantages for franchisors

Franchising has been described as "an evolutionary business response to the massive amounts of capital required to establish and operate a company-owned network of product or service vendors".[120] The economic burden of establishing a nationwide chain

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118 Barnard Jacobs Mellet Private Client Services *Stock Exchange Handbook* 72. See also http://www.fasa.co.za.

119 *Ibid.* According to an International Trade Commission Report "Office of Industries: International Trade Commission, Industry and Trade Summary: Franchising" (1995) (quoted by Fox and Su 1995 *Oklahoma City University LR* 251-252) the annual gross pretax income of franchisees was at least 25% higher than the median American gross family income. Franchisees also earned more than their independent, sole proprietor counterparts and conservative estimates put the success rate for franchised establishments at a range of 60% as opposed to the overall success of non-franchised new businesses which are estimated to be 40% after two years and 10% after 10 years. There are, however, others who dispute these statistics and argue that franchising is just as risky as starting a new business. See in particular Blair and Lafontaine *The Economics of Franchising* 34-35. Blair and Lafontaine are of the view that this failure rate is not a cause for alarm but is a fact which should be known and understood so that franchisees do not have a false sense of security.

120 Kaufman "An Introduction to Franchising and Franchising Law" in *Franchising - Business and Legal Issues* 13.

is apportioned between franchisors and their franchisees.[121] Franchise outlets are essentially independent businesses with their own capital base, their own employees and their own customers.[122] Most of the start up costs of establishing a distribution network are borne by franchisees who then purchase, and become responsible for, the goods purchased or services supplied.[123]

Franchisees are more than just managers because they are considered to be in business for themselves and will therefore be far more committed to the network than ordinary employees.[124] As Maitland points out:

> [M]any of the time-consuming and costly head office/branch management difficulties are avoided in the franchisor/franchisee relationship. The problem of motivating a manager – with a tricky blend of supervision, discipline, targets, commission, perks and so on – is largely removed. Lateness, long lunches, early leaving and prolonged illness tend to be much removed.[125]

Franchisees are responsible for expanding the network which leaves franchisors free to concentrate on developing brand consciousness amongst consumers. The result of this symbiotic relationship is that expansion can proceed at a much faster pace than would otherwise be possible. Franchisors are much more likely to achieve a wider market penetration and they can benefit from economies of scale.[126] As the network

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121 *Ibid.* See also Maitland *Franchising – a practical guide for franchisors and franchisees* (1991) 3. This does not mean that franchisors do not have to have any finance themselves. They will have to spend a considerable amount developing the franchise network and will be required to train management staff, develop training manuals and embark on marketing campaigns. One reason for the failure of a franchise network is where the franchisor is underfinanced.

122 A common economic theory for the development of franchising is transaction cost theory. In terms of this theory monitoring a business involves costs and businesses are constantly seeking ways to reduce costs. These costs may be reduced by linking in some way to another organisation that is responsible for its own costs. This linking can be done through out-sourcing, joint ventures or strategic alliances. Franchising is another form of linking. See Stanworth and Curran "Colas, Burgers, Shakes and Shirkers: Towards a Sociological Model of Franchising in the Market Economy" reprinted in *Franchising: An International Perspective* 29.

123 The proprietor of Silk by Design, discussed above, indicated that this was the primary reason for considering the franchise method of expansion. She wanted distributors to purchase their stock outright so that she did not have to continue to be responsible for the flower arrangements. Outright purchases by franchisees would assist her cash flow and she would not have to deal with collecting debts from ultimate consumers.

124 Maitland *Franchising* 14.

125 Maitland *Franchising* 15.

126 *Ibid.*

grows, the benefits of size allows the system to profit from "group purchasing, cooperative advertising and promotion, growing name recognition and good will".[127]

2.6.2 Advantages for franchisees

Franchisees operate under the guidance of a tried-and-tested business model and have the use of established trade marks. This effectively means that they get a head start in business and perhaps have a greater chance of success, especially where the franchise is a well established operation. Franchisors that provide ongoing assistance and guidance to franchisees will assist them to avoid many of the pitfalls that are experienced by new entrepreneurs. Franchisors concentrate on building the brand and on developments in the marketplace as a whole.[128] Franchisees can then concentrate on the management of their businesses and on building relationships with their consumers.[129] Franchise associations promote the slogan "be in business for yourself but not by yourself".[130] The ultimate success of the entire network depends on the success of individual franchisees, therefore it is in the interests of franchisors that each and every franchisee should be successful.

Although franchisees are considered to be independent entrepreneurs, they have the benefit of being part of a much larger organisation. This often means that franchisees are able to access business capital which would not be so easy to obtain if they were going into business for themselves. Being part of an already established organisation also means that less capital may be necessary for initial start-up costs, especially when attempting to launch a brand name.

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127 Hart "Franchising a business".

128 Steers provides an example of how franchisors develop and maintain the brand. In May 2005, Steers launched 30 new hamburgers into the market. Kevin Waite, the managing director of Steers, reported that Steers "keeps abreast of what ... customers want; with extensive research we anticipate some of their changing needs and act accordingly". It is highly unlikely that individual entrepreneurs will have the knowledge or the resources to conduct the kind of research to which Waite is referring. See *Business Report* "Steering with confidence into the future" 21 September 2006 4. Waite also reported that staying one of South Africa's top brands "requires a constant process of evolution ... not a week goes by that we don't assess all the aspects of our business including the way we produce our food, the quality of our equipment, the way we market ourselves, how operations can be streamlined and so on". See *Business Report* "Decades of Real Food made real good" 21 September 2006 11.

129 Illetschko "A Brief Introduction to Franchising" in *The Franchise Book of Southern Africa 2001* 17.

130 See http://www.fasa.co.za. and http://www.franchiseek.com.

The economies of scale which benefit franchisors also benefit franchisees. Illetschko explains:[131]

> Group marketing efforts will see to it that the impact of every advertising rand is maximised. By way of example, an advertising spend of R5000 per month, when pooled with similar contributions by, say, 50 members of a network, creates a sizable marketing fund, while R5000 spent in isolation by an independent operator is unlikely to make any impact at all... .
>
> The combined purchasing power of the network will help franchisees to secure preferential deals with key suppliers. Although this will vary from industry to industry, it is not at all uncommon that savings achieved by franchisees through access to bulk deals pay the lion share of ongoing franchise fees.

Finally, there may be substantial advantages in the event of death or disability of a franchisee. Entrepreneurs who operate independent enterprises are at a major disadvantage when such a crisis occurs, especially when they have not trained a successor. This problem is further exacerbated when the business success is dependent on trade secrets. If however, they are franchisees, franchisors are able to step in and assist. Franchisors may provide managers to run the business so that the heirs have something of value to sell or they may provide training to someone (such as the widow) who can then take over the business thereby preventing it from collapsing. In addition, any trade secrets belong to the franchisor and these can be passed on to the successor without any difficulties.[132]

2.7 The Disadvantages of Franchising

There are certain disadvantages to franchising. In some instances, these are inherent in the very nature of the relationship. These problems will be accentuated when the business is not suitable for franchising or when the business is dependent for success

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131 Illetschko "A Brief Introduction to Franchising" in *The Franchise Book of Southern Africa 200117*.

132 Kursch sites this as a major advantage of franchising. See Kursch *The Franchise Boom* 43.

on the personality or unique skills of its founder.[133]

2.7.1 Disadvantages for franchisors

Franchising a business involves a significant change in mind-set for franchisors. They are in fact moving out of their initial businesses, such as selling food or providing entertainment, and moving into the business of being franchisors.[134] Franchisors must therefore be committed to developing and marketing their programs and must be prepared to train and supervise franchisees.[135] They are no longer concerned purely with their own interests but must also take into consideration the interests of their franchisees.

In addition, there will be significant start-up costs for franchisors because they are expected to develop operations manuals, provide training programs and advertising. These costs will only be recouped once franchisees have been operating successfully for a period of time.

A major risk for franchisors is choosing the wrong franchisees. One poor franchisee can tarnish the whole image and so choosing the correct people and motivating them to continue performing well is a critical part of being successful

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133 Hart "Franchising a business".

134 The history of Steers in South Africa illustrates this process. Spiro and Meloma Halamandaris immigrated to South Africa in the early 1900s and opened up a restaurant in Johannesburg. When Spiro died his son, George, took over the running of the restaurant. In 1960 George travelled to America where he learnt about the concepts of flame grilled meat, fast foods and soft serve ice cream. He decided to implement what he had learnt in South Africa and over the years regularly recruited members of his family from Greece to assist him. He started the Milky Lane franchise first (which he later sold) and then he opened the first Spur steakhouse. Consumer demand for fast food in the 1970s led to the development of Steers and in 1984 his son, John, started franchising the fast food concept. John was joined by four of his cousins and they grew the business to become South Africa's leading franchised fast food organisation. In 1994, The Steers Holding group was listed on the Johannesburg Stock Exchange. This later became Famous Brands Group with three divisions: franchising, food services and corporate services. The franchise division includes Steers, Wimpy, Debonairs Pizza, Fishaways, House of Coffees, Brazilian, Market Café, Whistle Stop and ESP Illy Boutique. There are over 1100 franchise restaurants situated in South Africa and in 16 other African countries. The family still maintains a very hands-on approach with two of the cousins still involved in Famous Brands Limited. John and another cousin serve as non-executive directors on the board. In 2005, Steers was awarded Superbrand status by Superbrands, a large international arbiter of brands that recognises, reinforces and rewards the leading brands in participating countries. Brands are nominated by independent Superbrands Councils throughout the world. Criteria for selection are market dominance, longevity, goodwill, customer loyalty and overall market acceptance. See *Business Report* "Steers proudly opens its 400th store in Africa" 21 September 2006.

135 Hart "Franchising a business".

franchisors.[136] It is important that franchisors monitor the entire network on an ongoing basis in order to ensure consistent service.[137] However, franchisees are not employees and cannot be dismissed for poor performance.[138] Cancelling franchise agreements can also lead to poor morale throughout the network (even if cancellations occur for legitimate reasons) and this can impact on the entire organisation. It will never be possible to ensure that every franchisee is successful, but it is important to reduce the risk by selecting them carefully.[139] Further, once a franchise operation has been established it is very difficult to reverse the process and franchisors may be in the position where it is necessary to "buy-back" ailing franchises in order to protect their networks, thereby cancelling out many of the advantages of starting networks in the first place. Franchisors who do resort to cancelling agreements and reclaiming businesses will be faced with many disgruntled franchisees and ongoing legal problems. Nevertheless, weak franchisees can tarnish entire networks and so franchisors must be able to terminate the franchise relationship should the need arise.[140]

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136 McDonald's, probably the best known franchise in the world, requires would-be franchisees to undergo a minimum of 12 months of full-time training before they are granted a franchise. This training follows a lengthy screening process and is aimed at ensuring that the company selects people who are not only familiar with the operation of the business, but who are also prepared to conform to the McDonald's ethos. See Lord "McDonald's – the Myth & The Magic" http://www.franchise.co.za/article_display.php?articleJD=50 (accessed on 19 April 2006). McDonald's runs training courses in the various countries where it operates, or prospective franchisees can choose to go to the Hamburger University in Oak Brook, Illinois for training. Students studying at this university can earn a Bachelor of Hamburgerology as well as credits towards a college degree. Its curriculum is recognised by the American Council on Education. For further information see http://www.mcdonalds.com.

137 In a report given to the DTI, following an investigation into a struggling franchise by a franchise system auditor, the auditor stressed that an area of concern was that there was no definite franchisee profile and franchisees were recruited haphazardly so as to "gain market share". The auditor recommended that the franchisor develop a more formalised selection method to ensure that all franchisees were recruited and selected in the same way. This would also prevent "wrong franchisees" from entering the franchise system. The franchisor was also criticised for being too lenient in dealing with franchisees that did not adhere to the general franchise rules. The auditor maintained that the franchisor was compromising standards and this was causing further damage to the franchise brand.

138 See Maitland *Franchising* 16. He points out that both parties are equals, working together to provide each other with a living. An entrepreneur who is used to employing managers must adopt a completely different approach. He now has to explain and discuss rather than tell and instruct.

139 Illetschko "A Brief Introduction to Franchising" in *The Franchise Book of Southern Africa 2001* 18.

140 Termination is a significant problem area and is discussed in Chapter Five.

2.7.2 Disadvantages for franchisees

Franchising involves a significant surrender of freedom to franchisors, and franchisees must be prepared to take direction from franchisors in a number of areas.[141] It is, therefore, generally accepted that franchising is the very antithesis of entrepreneurship.[142] Holmes explains that there are some entrepreneurs who may be very effective as independents but who would chafe at the restrictions involved in a franchise system and prospective franchisees need to consider personalities very carefully.[143] He goes as far as suggesting that true entrepreneurs should not consider franchising.[144] For the most part creativity is excluded because all franchisees are required to do is copy the successful formulae developed by others.[145]

A particular form of franchising is a conversion franchise. Instead of starting new enterprises, franchisors persuade established businesses to join their networks and operate under the franchisors' trade marks. The advantage of doing this is that the initial start-up costs of a new business are avoided and the existing businesses have established goodwill already. Franchisors establish their presence in existing markets and franchisees acquire all the benefits of being part of larger organisations. There is a downside, however, in that the franchisees were independent entrepreneurs who were used to operating their businesses their own way. Adapting to new management styles is not always easy and this can be a significant source of friction between the parties. Experienced entrepreneurs will be far more confident and will question policies and practices and will demand a much larger say in decision making.[146]

In 2000, the CAFCOM received a number of complaints from franchisees of a large supermarket chain that had established a franchise network of convenience

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141 Holmes "So your client is thinking of becoming a franchisee - a business overview and some practical considerations" (April 2003) Business Law Section of the California State Bar http://www.HolmesLofstrom.com (accessed on 31 May 2004).

142 Hoy and Shane "Franchising as an entrepreneurial venture form" (1998) 13 (2) *Journal of Business Venturing* 91-94 reprinted in *Franchising: An International Perspective* 14.

143 Holmes "So your client is thinking of becoming a franchisee".

144 *Ibid*. Illetschko states that "highly creative individuals who place freedom to act as they please above sound commercial considerations are unlikely to be happy as franchisees" ("Becoming a Franchisor" para 2.1).

145 Shane and Hoy contradict this approach because they believe that there is scope for creativity and that many franchisors depend on the entrepreneurship of their franchisees for their success. See Shane and Hoy *Franchising: An International Perspective* 13.

146 Maitland *Franchising* 17.

stores. At least some of the franchisees had converted their existing businesses to become part of the network and so were experienced in the business of operating convenience stores. One franchisee reported that he had operated a successful convenience store for 24 years and had made a profit of R8 000 per month.[147] This franchisee reported that he had been approached to join the network by the franchisor and was persuaded by the attractive figures that were shown to him.[148] Instead of becoming more successful, the business failed within 12 months.[149]

Discussions with representatives of the franchisor revealed very different management styles, and at least one of the problems experienced between the parties was an inability to adapt to a franchise relationship. The franchisor adopted a very authoritarian approach and appeared to regard the franchisees as employees rather than independent entrepreneurs. The experienced franchisees were used to operating their own businesses and sourcing their own products and found it difficult to take instructions from the franchisor.[150]

These considerations highlight that although franchisees are said to be in business for themselves and they own the infrastructure of their businesses, they are not independents. They are part of a much larger organisation and they are contractually bound to adhere to the franchisor's operational guidelines.[151] Noel O'Conner, one of the founder members of the FASA and the founder of BJ Franchise, gave the following example.[152] He was involved with a major fast food franchise before establishing his own franchise organisation. This fast food franchise, one of the first in South Africa, operates throughout the country. A particular franchisee operating on the KwaZulu-Natal coast decided to introduce crayfish to his menu. He was very frustrated when he was ordered by the franchisor to withdraw this item. The franchisor explained that if a consumer is able to order a particular dish at a restaurant in Margate, when he is on holiday, he will expect to be able to order that same dish when he returns to his

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147 The first complainant and his partners had 14 years retail experience.

148 Providing franchisees with misleading information regarding earning potential is a common franchise problem. See 4.1.4 below.

149 This franchisee reported that as a result of joining this franchise he had suffered damages in the region of R989 250.

150 Inexperienced franchisees, on the other hand, reported that they felt that they had received insufficient guidance from the franchisor. One of the Committee's conclusions regarding this matter was that the franchisor had failed to understand the nature of a franchise relationship.

151 Illetschko "A Brief Introduction to Franchising" in *The Franchise Book of Southern Africa 2001* 18.

152 The example was given at a franchise seminar in Durban, April 2004.

home in Gauteng.

Allowing franchisees to develop their own identity will cause confusion amongst consumers, problems for other franchisees and eventually defeat the purpose of operating as a franchise. This is one of the arguments that is expressed when the question of price fixing is raised. Franchisors are consistent in their view that they should be able to set prices throughout their networks to prevent confusion amongst consumers and problems between competing franchisees. This is, however, regarded as a serious violation of competition law and franchisors who insist on setting prices may find themselves the subject of a competition authority investigation.[153]

Generally, franchisors cannot afford to negotiate separate terms with individuals and this may mean that difficult decisions are made which impact negatively on a few individual franchisees.[154] The strength of franchising lies in a consistent and proven franchise package, but for an entrepreneur who is determined to "go his own way" this can be a source of constant frustration.

Franchisees must be careful when selecting their franchises and it is preferable to buy into a well-established network. A franchise scheme that is relatively new is obviously a greater risk than one that has been in operation for a long period of time. The FASA recommends that a franchisor should have been in business for at least one year before franchising is considered but even so, being the first franchisee still involves significant risk. The franchisor may have a proven business model but it has not yet proved itself as a franchisor.

Franchisees are tied into a much larger organisation and so if their franchisors make poor business decisions, the entire network may break down notwithstanding the fact that individual franchisees are operating successfully.[155] This is a constant dilemma

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153 See Chapter Six. Woolworths had to change its stance when a franchisee complained to the competition authorities because Woolworths was refusing to allow him (a Woolworths franchisee) to reduce his prices in order to compete more effectively with a corporate-owned Woolworths store that was opening close to the franchisee's outlet. See Crotty "Woolworths settles price cuts with Serious Foods" *Cape Times* 19 October 2007.

154 A complaint which is often heard by the CAFCOM relates to the introduction of new computer systems. Franchisors update their systems in order to keep pace with changing technology and to improve efficiency but this involves added expenses for franchisees. Some franchisees, particularly those who are struggling to make a living, find these added expenses difficult to accept.

155 There is of course nothing to prevent successful franchisees from banding together to continue operating but this would entail a complete re-organisation of the business with someone or some entity having to assume the role of franchisor. See Buchan "Franchisor Failure in Australia - Impact on Franchisees and Possible Solutions" Working Paper Series (2008) http://ssrn.com

faced by the CAFCOM. There may be concerns regarding certain franchisor practices and there may be pressure from an individual franchisee or group of franchisees to take action. However, a formal, public inquiry could impact negatively on the entire brand and so the CAFCOM attempts to solve disputes without resorting to a public airing of problems. This usually means a compromise is reached which invariably fails to satisfy disgruntled franchisees, who are often no longer part of the organisation and who have no desire to protect the interests of other franchisees.

The need for compromise was an issue which featured quite strongly in the CAFCOM investigation into the convenience store franchise network. The Committee is obliged to consider the requirement of "public interest" prior to exercising its functions in terms of the Consumer Affairs (Unfair Business Practices) Act. The franchisor's representatives argued that the subject interest of an individual member could not equate to "public interest" or, put differently, the interests of a single person cannot outweigh the collective objective interests of the public which, in this instance, constituted the remaining members.[156] The franchisor's representatives therefore, urged the Committee to consider seriously the effect which an investigation would have upon the remaining members, irrespective of its ultimate findings. It was pointed out that an investigation by the CAFCOM would impact negatively on the trade name and the financial viability of the network. It was argued that the Committee would be acting unreasonably against the interests of the remaining members should it decide to proceed with a public investigation. The CAFCOM is always mindful of this issue and

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(accessed on 6 May 2008).

156 A similar argument relating to competition issues was raised in *Simelane v Seven-Eleven Corporation* 2003 (3) SA 64 (SCA) at 78 in which the franchisor argued that the majority of franchisee's approved of the franchisor's policies so that those of them who had complained to the Competition Commission were simply a dissident minority. The Commission, it was argued should have polled all of them and should then have been guided by the popular will. The Commission responded that it was not its function to conduct a popularity poll, but to investigate and refer prohibited practices to the Competition Tribunal. If conduct contravenes the Competition Act then it is the Commission's duty to refer the matter to the Tribunal. The Supreme Court of Appeal (per Schutz JA) accepted that this was a legitimate stand (at 78). Prohibited conduct is specified in the Competition Act and so even if there is willing participation in the conduct, it cannot be condoned. With unfair business practices, the matter is different. Some franchisees may regard a practice as being unfair and imposing a heavy burden on individual franchisees whereas other franchisees may find that the conduct makes business sense even if, in the short term, there is an increased economic burden on franchisees. It is, therefore, necessary to consider the interests of the entire network and the opinion of a single franchisee or small groups of franchisees cannot decide for the majority. Nevertheless, the fact that the CAFCOM receives a limited number of complaints (or even a single complaint) does not preclude it from investigating further.

this was a major factor which featured in its decision not to proceed with a formal investigation.[157]

2.8 Conclusion

This chapter has sought to outline the basic elements of franchising in order to support the argument that franchising is a new business strategy which is *sui generis* and distinct from other business forms. One of the difficulties with the franchise relationship is that it at times resembles a partnership and at other times an employment contract.[158] In some instances consumer protection issues arise.[159] To date the tendency has been to apply commonly accepted principles for other types of relationships to franchising which often exacerbates problems rather than solving them. There is a need therefore to develop a body of literature that focuses on franchising and to develop rules and regulations that are franchise-specific.

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157 Given the limited nature of the role which the Committee can play in disputes of this nature and the serious negative consequences which a finding of an unfair business practice could have on the entire network, it must be questioned whether the CAFCOM is in fact the most appropriate forum for deciding disputes between individual franchisees (or small franchisee groups) and franchisors. These concerns lend credence to the argument that it would be preferable to have a specialist body designed specifically to deal with such disputes. Disputes could then be resolved without having to come to the negative conclusion that the franchisor was involved in some kind of offensive conduct with the consequent effect that the viability of the entire network is placed at risk.

158 See discussion of restraints of trade in Chapter Five.

159 See Chapter Eight.

CHAPTER THREE
THE FRANCHISE RELATIONSHIP

OUTLINE

The purpose of this chapter is to develop an understanding of the franchise relationship in order to substantiate the submission made in the previous chapter that franchising should be recognised as a unique business model subject to its own rules.

Although on paper the relationship between franchisor and franchisee appears to be relatively unremarkable, it is a highly complex one. It is not an employment relationship, neither are franchisees independent contractors. In order to understand the nature of this relationship there are certain critical features that must be considered. These are:

- franchising is an interdependent relationship;
- the relationship is an unequal one;
- the relationship is ongoing and develops over a period of time; and
- there is a duty of good faith which the parties owe to each other.

A failure to understand these features often lies at the heart of franchise problems and leads, when the franchise contract is treated as a normal commercial contract, to the inadequate resolution of problems. The chapter concludes with the proposal that the franchise agreement be recognised as a special contract with its own definition, essentials and implied terms.

3.1 An interdependent relationship

Although there are a number of recognised definitions of franchising, the exact nature

of the relationship is frequently misunderstood.[1] The idea behind franchising is that entrepreneurs do not have to develop their own ideas. Instead, they buy into a tried and tested model and then receive ongoing support and assistance. From the franchisor's perspective this is a useful model for expanding the business because the gamble is being taken by franchisees and so franchisors do not have to find or risk their own capital.[2] A critical feature of the relationship is the fact that franchisees usually make "sunk" investments and own the assets of their businesses, but it is the franchisor who has the power to determine how the assets are used.[3] This distinction between ownership and control has enormous consequences and leads to a relationship that is "highly intimate and interdependent".[4] It is common to describe the relationship in terms of family metaphors. Hadfield quotes a number of authors who refer to franchising as a marriage or as a parent/child relationship[5] and Louw, a former Executive Director of the FASA, also describes franchising as a form of business marriage.[6]

3.2 An unequal relationship

The metaphors which talk of "father and son" or "husband and virgin" indicate that in many instances the parties are not contracting as equals. In fact, franchising is often embraced as a means of transferring business skills from experienced entrepreneurs to those who are less experienced. This is a fact which is often lost when problems emerge and franchisors blame the difficulties that arise on franchisee laziness, a cavalier attitude or a lack of business acumen.[7] What is forgotten in this argument is that franchisee inexperience often lies at the very heart of franchise relationships.

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1 Other more limited relationships may fall within accepted definitions especially when the concept is broadly defined. See discussion in 2.3 above.

2 See discussion of advantages of franchising in 2.6 above.

3 The cost of buying a franchise is referred to as a "sunk" investment because the assets that franchisees must invest in are usually so closely related to the nature of the franchise that they cannot be used in another line of business. See Hadfield "Problematic Relations: Franchising and the law of incomplete contracts" (April 1990) 42 *Stanford LR* 951-952 and 963 and Kessler 1957 *Yale LJ* 1135.

4 Hadfield 1990 *Stanford LR* 963.

5 *Ibid.*

6 Louw "Understanding franchising" in *The Franchise Book of Southern Africa 2003* 14.

7 Anecdotal research suggests that franchisors seldom, if ever, accept responsibility for the failure of a franchisee.

Problems may not arise simply because franchisees are not performing adequately, but may also be due to franchisors failing to fulfill their side of the bargain. Franchisors may fail to train franchisees properly, the locations selected may not suitable, unsustainable expectations may have been created, the businesses themselves may not be suitable for franchising or franchisors may place unsustainable burdens on franchisees in terms of the purchasing of equipment or royalty payments.[8]

The franchisor-franchisee relationship is an unequal one, and not only in circumstances where franchisees are inexperienced entrepreneurs who may be vulnerable to exploitation. The very nature of the relationship is unequal because of the sunk investment that franchisees make. Once franchisees are committed to a network and have made substantial investments in terms of time and resources, the power of franchisors is substantially increased and they can insist that franchisees comply with their demands.[9] For example, franchisors may increase royalties, levy extra fees, increase advertising costs or increase the price of goods that franchisees purchase from franchisors. Hadfield explains that litigation, popular observation and efforts to obtain regulation indicates that this intimate relationship, and the inequality that is inherent in it, makes it vulnerable to conflict and abuse.[10] It is recognized by those who have studied franchising that the danger of abuse is "inherent in the very structure of franchising".[11] Two issues are particularly relevant:

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8 In August 2007 the *Business Report* carried a story about a possible black empowerment deal that the Chicken Licken franchise was considering. In the report, the managing director of the franchisor, whilst explaining how the franchise had prospered in the previous five years, stated that they had, over that period, "consolidated their stores and let go of about 30 marginal stores". These were stores owned by franchisees. This statement is troubling, particularly in light of the fact that a Chicken Licken franchise costs in the region of R1.8 million to set up. See Khanyile *Business Report, The Mercury* 22 August 2007. Similar experiences were relayed by the RMI representatives. A number of motor vehicle manufacturers, such as Daimler Chrysler and Volkswagen, have in recent times restructured their franchise networks. This has resulted in the closure of a significant number of dealerships in South Africa.

9 Kessler 1957 *Yale LJ* 1138 and Serota "Constitutional Obstacles to State 'Good Cause' Restrictions on Franchise Terminations" (1974) 74 *Columbia LR* 1487 at 1488.

10 Hadfield 1990 *Stanford LR* 965.

11 Hadfield 1990 *Stanford LR* 969. Research in America suggests that the bulk of contractual clauses focus on the obligations of the franchisee. An empirical study regarding a substantial number of franchise contracts in South Africa does not exist, but a study of available information suggests that the South African position regarding franchise contracts is not that different from the American position. This information was obtained from studying the case law, contracts that were submitted to the CAFCOM with franchisee complaints, contracts obtained from the RMI that deal specifically with motor vehicle franchise dealerships, information given to franchisors and franchisees by the FASA and from interviews with franchisees.

- franchise contracts often impose onerous burdens on franchisees; and
- franchise contracts are standard form contracts which franchisors impose on all franchisees without allowing individual variations for specific franchisees.

3.2.1 Onerous burdens on franchisees

As it is the primary responsibility of franchisors to protect and maintain the image of their brands, franchisors place relatively onerous burdens on their franchisees in their contracts. These requirements are imposed to ensure that franchisees conform to certain standards of behaviour.[12] There must be sufficient checks and balances in the contracts to control errant franchisees. Franchisors will, therefore, control matters such as work hours, appearance, quality of goods and location. They will also retain the right to monitor franchisee performance through regular checks, audits and reports. Franchising arrangements must contain an extensive monitoring system in order for franchisors to ensure that the goodwill value of their trade marks and franchise names are retained.[13]

Franchise contracts create a power imbalance between franchisors and franchisees and have been criticised as one-sided documents which enable franchisors to obtain control over the management of their franchisees' businesses without have to assume legal control.[14]

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12 Successful franchising depends on uniformity of performance. Customers want to know that no matter where they are in the world, if they see a recognised trade mark they know they will be getting the same quality and service with which they are familiar. The example that is frequently cited in this regard is McDonald's.

13 Goetz and Scott "Principles of Relational Contracts" (1981) 67 *Va L Rev* 1089 at 1134.

14 Rubin argues that the relationship resembles an employer/employee relationship rather than a relationship between two independent firms. It is his opinion that defining a franchisee as an independent entity is a legal distinction and not an economic one. See Rubin "The Theory of the Firm and The Structure of the Franchise Contract" (1978) 21 *Journal of Law and Economics* 223 reprinted in *Franchising: An International Perspective* 50. Hoy and Stanworth report that according to their calculations, this article is the single most cited article in franchise literature (*Franchising: An International Perspective* 49). This view is also supported by anecdotal evidence which suggests that franchisors do not always accept that franchisees are independent businesses. In a letter sent by a major national franchisor to its franchisees in July 2007, the franchisor expressed concern that many franchisees had not attended a meeting to discuss a particular promotion. The tone of the letter was very peremptory and concluded with the statement that if franchisees failed to institute the promotion according to the franchisor's exact instructions, disciplinary action would be taken. In another instance, a prospective franchisee, interested in purchasing a slimming franchise was informed by the franchisor that she "owned all

In a submission to the Minister of Trade and Industry requesting that the motor vehicle industry be exempt from some of the provisions of the Competition Act, the RMI explained the power imbalance in motor vehicle franchise agreements:[15]

> Franchise agreements are concluded between a powerful multinational motor vehicle manufacturer, on the one hand, and a prospective trader, on the other, the latter typically being a small or medium-sized business. This power imbalance is clearly reflected in the various franchise agreements used by the manufacturers. Even the larger traders have no choice, they sign the same forms.
>
> It has become standard practice for these agreements to contain standard terms and conditions which are onerous in the extreme which terms underpin and define the relationship between dealer and manufacturer making it one of the most unequal relationships in industry today.[16]

The RMI set out certain common terms found in motor vehicle dealership contracts which make the agreements extremely one-sided:

- the manufacturer has the right to terminate the agreement unilaterally by

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the franchises in South Africa". The franchisee expressed concern at this because she was of the view that she owned her own business (discussion with franchisee who was selling her outlet in August 2007). This franchisee expressed concern at the amount of control which the franchisor exerted over the businesses and felt that the information which the franchisor required franchisees to submit on an monthly basis was excessive and constituted an undue interference in the franchisees' businesses. Noel O'Conner, at a franchise seminar conducted by the FASA in Durban (April 2004), related an incident of a director of a major franchisor in South Africa who visited a restaurant owned by a franchisee. This was during the Christmas season at one of South Africa's busiest seaside resorts. He refused to stand in a queue and insisted that the franchisee find him a table immediately. When the franchisee refused to comply arguing that he should stand in a queue, like any other patron, the director left the restaurant. On his return to Head Office after the holidays he attempted to have the franchisee "fired" indicating a complete lack of understanding about the relationship. See also Kessler 1967 *Yale LJ* 1135.

15 RMI Memorandum to the Minister 2002. The RMI reported that it did not receive a response to this request (Interview May 2008).

16 Delmar in an article entitled "New franchisees can get fried" points out that new recruits need to understand that franchise agreements will always favour the franchisor. See *Business Times* 20 August 2008 17.

giving notice:[17]

- termination may take place without any cause;
- on termination of the agreement, the manufacturer has the option, but is not obliged, to repurchase stock and tools;
- should the manufacturer elect to purchase stock and tools, such purchase takes place at certain specified prices;
- the franchisee has no claim for damages against the manufacturer;
- the manufacturer retains the right to transfer the dealer's customer data base to the dealer of its choice, without any compensation or payment for goodwill.

It is extremely difficult for franchisees to challenge franchisor power because, if franchisees show dissent, franchisors can exercise their right to terminate.[18] Between 1988 and 1994 there were ongoing negotiations between various Dealer Councils and their manufactures in the hopes that their respective agreements would be amended. The NADA conducted an in-depth investigation into the issue of franchise agreements and requested that the Competition Commission draft a Dealer Bill of Rights.[19] Over the years certain minor amendments were made to certain agreements but the NADA is of the view that these amendments fall short of making franchise agreements fair and reasonable.[20]

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17 Notice periods vary from between 30 to 180 days. The RMI representative reported that in many instances terminated franchisees are left with the burden of long term leases. Franchisees are often required to make substantial alterations to their premises to make these premises suitable for the franchise, therefore landlords are reluctant to enter into lease agreements unless these are for a substantial period.

18 Comments made by the RMI (Interview May 2008).

19 Dr Brookes, the then chairperson of the Competition Commission, was of the view that the dealers had a justified case and it was hoped that the matter would be investigated in terms of the Maintenance and Promotion of Competition Act, 1979. This Act has subsequently been repealed and a new competition authority established. See Chapter Six. When the present Competition Commission investigated the restructuring of the Daimler Chrysler network the Commission acknowledged the power imbalance between manufacturers and franchisees and that franchisees operate under uncertain circumstances. (Competition Commission "Competition Commission Recommends unconditional approval for Daimler Chrysler to restructure dealer networks" http://www.compcom.co.za/resources/september2002/pages/05_cases.htm). Although the Commission acknowledged that this power imbalance raises "certain issues", the Commission was of the view that these issues were outside the ambit of the merger analysis which the Daimler Chrysler restructuring had raised and that it would be preferable to address the matter from a contractual perspective.

20 For example, some dealers extended their notice period from 30 days to 180 days. See NADA Memorandum to the Minister (2002).

The burdensome nature of franchise contracts is explained on the basis that these controls are necessary to contain franchisee opportunism.[21] Although franchisees and franchisors are working for the good of the network, they have divergent objectives.[22] Franchisees are concerned about maximising their profits whilst franchisors are concerned about maximising the profits of their networks. Franchisees may be tempted to cut costs by economising on quality, cleanliness and choice of products.[23] The interdependence of the relationship means that there are opportunities for cheating on both sides and it is not only franchisors that may abuse the relationship.[24] This is concerning for franchisors because franchisees are buying into the franchisor's business model. An example of franchisee abuse is "free riding". Free riding occurs when one franchisee is able to rely on the reputation of the entire network or on services offered by other franchisees, and does not meet franchisor requirements himself. Kursch quotes a former president of the Mister Donut franchise who stated: "A weak cup of coffee served in one shop can lose customers for the others; a day old donut served as fresh reflects badly on the management of all. The customer does not view the shop he patronizes as one entity; if he is dissatisfied, he is apt to blame the chain".[25] Blair and Lafonteine explain that the errant "franchisee does not bear the cost of the reduced sales at the other outlets, and hence does not consider the cost of its decisions on these other outlets' sales and profits".[26] Franchisees are also sometimes shielded from competition because they are granted a specific area in which to do

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21 See generally Klein "'Transaction Cost Determinants of Unfair Contractual Arrangements" (1980) 70 *American Economic Review* 356.

22 This problem is discussed extensively by Blair and Lafonteine in *The Economics of Franchising*.

23 Love *McDonald's: Behind the Arches* 408. Love quotes from the judgment in one case in which the court upheld McDonald's right to cancel the contract of a non performing franchisee. The court criticised the franchisee heavily:

> [The franchisee] takes this immensely attractive and uniquely American franchise to Paris, he masquerades it as the real thing while delivering a product vastly inferior to what has made it a success in this country, he fools the customers who are attracted by McDonald's name ... he ignores and disregards the critical operational standards he had agreed to uphold, he fleeces his operation in order to enhance his return ...

24 See in particular *Principe v McDonald's Corp*. In the early days of establishing the network, Ray Kroc, the founder of McDonalds, faced a number of legal challenges as he insisted that franchisees conform to his requirements and, when they refused, he terminated their agreements or refused to renew them. Kroc was able to convince the courts that, for franchising to function properly, franchisors must be allowed to control franchisee behaviour and to penalise those franchisees who were not complying with the operating system (Love *McDonald's: Behind the Arches* 408).

25 Kursch *The Franchise Boom* 46.

26 Kursch *The Franchise Boom* 268.

business. When they are content with what they are earning there is no incentive to expand their market. In such circumstances, franchisors suffer a loss of revenue that could have been used to develop their networks further. Therefore, franchisors must exercise quality control over all their franchisees.[27] Frequently, other complying franchisees will insist that franchisors take action against errant franchisees.[28]

These arguments may explain why it is necessary to have a one-sided contract, but they also allow franchisors who engage in opportunistic behaviour to get away with their conduct. For example, the franchisor who has used franchising to test the market will be able to claim back successful businesses, and operate them as part of its chain, with impunity. In recent times a number of motor vehicle manufacturers have rationalised their networks and cancelled many, mostly rural, franchise agreements. This has left many functioning franchisees without their businesses and without compensation.[29]

3.2.2 Franchise contracts as standard form contracts

Another way in which the relationship is unequal is that franchisors operate with standard form contracts on a "take it or leave it basis".[30] They are advised that reputable organisations do not change their standard contracts as this could be taken as a sign of weakness in the network and that they (franchisors) do not understand what elements of their system are critical for success.[31] Franchisees are also warned

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27 In *Kentucky Fried Chicken Canada, a Division of Pepsi-Cola Canada Ltd v Scott's Food Services Inc* (1998) 114 OAC 357 (CA) the Court of Appeal in Canada pointed out that "the most precious possessions of a franchisor are its trade marks and system" (para 32).

28 Love *McDonald's: Behind the Arches* 409-410.

29 RMI Interview May 2008. The RMI representative reported that a motor vehicle dealership can cost in the region of R30 million to set up and that in recent times some dealers have made improvements to their dealerships which cost in the region of R100 million. Dealers who had their agreements cancelled or whose franchises have not been renewed have not received compensation for this expenditure.

30 In *Tamarillo (Pty) Ltd v BN Aitken (Pty) Ltd* 1982 (1) SA 489 (A) the franchisee said that he realised during negotiations that if he wanted the franchise he had to accept the terms of the agreement without modification and so he signed the agreement containing terms which he later came to regard as unfair.

31 Hadfield 1990 *Stanford LR* 961. Although the agreement may be standard to a particular franchise network they are "as varied and as different as the products and services represented in the entire spectrum of franchising" (Kursch *The Franchise Boom* 93). There may be certain clauses that are common to most franchise agreements, such as cancellation clauses and territorial clauses, but there can be no such thing as a standard franchise agreement. Franchise agreements that are not comprehensive are criticised by the FASA and franchisors are advised

to be wary of becoming involved with such franchisors, because franchisors who are willing to compromise may be motivated primarily by the need to sell franchises in order to meet expenses.[32] Franchisees are advised to consider only whether they can live within the proposed framework and that if they regard it as oppressive, they should not enter into the agreement.[33] The FASA also advises that the contract must be a standard agreement that "cannot be open to negotiation".[34] The FASA maintains that franchisors who are willing to negotiate the terms of their agreements are putting the integrity of their whole systems at risk as this will invite constant "bickering by other franchisees which may escalate into expensive legal squabbles". Gertenhaber, a past franchisor of the year in the United Kingdom, advises franchisors that they should:[35]

> Stand [their] ground. Provided that the franchise agreement was written by an experienced franchise lawyer in close consultation with the franchisor, there is no need to make alterations to satisfy the wishes of individual prospects. Such changes, even if minute, will introduce a sense of instability into the system. Prospective franchisees, unwilling to accept this should seek their fortune elsewhere.

Hadfield contends that the refusal to negotiate is a hallmark of the relationship into which the franchisee is buying.[36]

3.2.3 Concluding remarks

At the time of concluding the franchise-buying agreement, the parties (particularly franchisees) do not necessarily anticipate or appreciate that things can go seriously awry. They will enter into agreements without taking into consideration what will

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to rectify this before they are granted FASA membership (comments made by Vera Valasis, chairperson of the FASA, Franchising Seminar, Durban, 11 August 2006).

32 Holmes "So your client is thinking of becoming a franchisee".

33 Hadfield 1990 *Stanford LR* 961.

34 FASA *How to Franchise your Business* 15.

35 Quoted in FASA *How to Franchise your Business* 52.

36 Hadfield 1990 *Stanford LR* 961.

happen if matters do not turn out as anticipated.[37] Once the interests between franchisors and franchisees clash, franchisors will usually (if not always) put their interests first on the basis that they are protecting their networks and cannot consider the interests of a single franchisee (or group of franchisees) over the interests of the whole.[38] It is in the best interests of both parties if the franchisees succeed. However, if an individual franchisee fails, it is unlikely that this will affect the success of the franchisor, and so terminating a particular franchisee may be of little consequence to the franchisor.[39] Protecting trade marks and the interests of their networks is a primary function of franchisors and so it is not always easy, especially for inexperienced franchisees, to judge whether franchisors are justified in their actions or whether they are engaging in franchisor opportunism.

3.3 An ongoing and developing relationship

The relationship between the parties is ongoing and long-term. This means that it is not possible to establish in advance how future events will impact on the relationship. The contract which creates the relationship is therefore drafted in relatively broad terms and important terms are not spelled out as well-defined obligations. Authors refer to such

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37 Although the basis of a contract is agreement between the parties, the law does not establish agreement by considering the subjective intentions of the parties. Instead, it focuses on the manner in which the parties have manifested their intention. In *Standard Bank v Neugarten* 1987 (3) SA 695 (W) Fleming J said:

> The law usually gauges the conclusion of a contract not by the mental attitude which in fact accompanies the overt step which seemingly conveys consent, but by the justified perceptions thereof formed by the other party... The law goes by the signal received and not by the message which the sender thereof was desirous of transmitting (at 705C-D).

So, even when there is no true agreement between the parties, they may find that they are bound by a contract or certain contractual terms of which they were unaware. See also *Smith v Hughes* (1871) LR 6 QB 597. This is known as the reliance theory of contract. A related rule is *caveat subscriptor* or "let the signer beware" (see *George v Fairmead* 1958 (2) SA 465 (A) and *Shepard v Farrell's Estate Agency* 1921 TPD 62).

38 Hadfield quotes from a franchise buyer's guide which reads:

> As long as your interests do not conflict with their best interests, franchisors will indeed help you ... Should your interests fail to converge with theirs, however, any franchisor will look out for itself first.

In answer to the question "Can't I trust my franchisor to do right by me?" the guide states:

> Most franchisors will do right by you, according to their definition. However, their definition is not likely to coincide with your definition of what is right.

See Hadfield 1990 *Stanford LR* 969-970.

39 See generally Brown *Franchising: Trap for the Trusting* (1969).

contracts as relational contracts as opposed to discrete contracts.[40] A relational contract is a contract which requires an ongoing relationship between the parties, for example, an employment contract. Discrete contracts, on the other hand, involve short term, specified arrangements.[41] The rules that apply to discrete contracts are (or can be) easily established and, in many situations, once the contract is performed the parties do not have to deal with each other again. A simple example is buying a newspaper. It is not possible, when dealing with ongoing contractual relationships, to spell out in precise terms what is expected of each of the parties.[42]

Hawthorne equates relational contracts to a marriage because obligations to the relationship grow out of the commitment that the parties have made to one another. She quotes Macneil[43] who has developed the following rules for relational contracts:

> [F]irst, they are not frozen at the initial moment of commitment, but change as circumstances change; secondly, the object of the contract is not primarily to allocate risks, but to signify a commitment to co-operate; thirdly in bad times parties are expected to support one another rather than stand on their respective rights; fourthly, the parties will treat the others' insistence on literal performance as deliberate hindrance; fifthly, in the event of unexpected occurrences causing severe losses, the parties search for equitable ways of dividing losses; and finally, the sanction for bad behaviour is obviously refusal to contract in the future.

In classical contract theory, the law accepts that individuals are entitled to look after their own best interests and do not have to take into consideration what is best for the

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40 Hawthorne "Relational Contract Theory: Is the Antagonism Directed at Discrete Exchanges and Presentation Justified" in Glover (ed) *Essays in Honour of AJ Kerr* (2006)137; Hawthorne "The First Traces of Relational Contract Theory - The Implicit Dimension of Co-operation" (2007) 19 *SA Merc LJ* 234; Hadfield 1990 *Stanford LR* 961; Goetz and Scott 1981 *Va L Rev* 1089 and Harker "The Nature and Scope of Rescission as a Remedy for Breach of Contract in American and South African Law" (1980) *Acta Juridica* 61 at 96.

41 Hawthorne "Relational Contract Theory" in *Essays in Honour of AJ Kerr* 140.

42 See generally Goetz and Scott 1981 *Va L Rev* 1089 and Hawthorne 2007 *SA Merc LJ* 237.

43 Macneil *The New Social Contract: An Inquiry into Modern Contractual Relations* (1980) quoted by Hawthorne "Relational Contract Theory" in *Essays in Honour of AJ Kerr* 143.

other party.[44] This operates effectively in circumstances in which the parties contract, they perform and the relationship is terminated, as occurs with discrete contracts. Hawthorne maintains that where the arrangement is relational, self-interest should be replaced with co-operation.[45]

Franchising agreements are a classic example of relational contracts. The arrangements are long term and highly interdependent and the parties cannot know what will happen in the future or how the other parties will react. The general approach, therefore, is to describe the performance of the parties in general terms. For example, franchisees must perform "according to their best efforts" or their performance must be "satisfactory".[46] In *De Beer v Keyser* the franchisees argued that the agreement was void for vagueness because it stipulated that the franchisor would provide "technical assistance" and "administrative support" without providing any further details. The court rejected this argument on the basis that the purpose of the agreement was to cater for future changing circumstances in which obligations had to be fulfilled over the ensuing years.[47]

The rules enunciated by Macneil apply to typical franchise relationships especially during the initial "honeymoon" period. The parties know that their relationship will be long-term, they expect that circumstances will change and they expect that if difficulties are encountered they will help each other. They would probably even agree that if matters do not work out they will agree to terminate the relationship. Hadfield refers to such contracts as "miniature constitutions".[48] She explains that to write a complete contract would be to attempt to reduce to written form an all-embracing list of all the different business decisions that the franchisor might have to make under all possible future circumstances taking into consideration the "long term vagaries" of a particular industry. The contract would also have to specify how the franchisee was expected to respond.[49]

Because franchising involves relational as opposed to discrete contracts and the

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44 Hawthorne 2007 *SA Merc LJ* 236. Brownsword "Positive, Negative, Neutral: The Reception of Good Faith in English Contract Law" in Brownsword, Hird and Howells (ed) *Good Faith in Contract* (1999) 13.

45 Hawthorne "Relational Contract Theory" in *Essays in Honour of AJ Kerr* 144.

46 *De Beer v Keyser* 2002 (1) SA 827 (A).

47 836 E.

48 Hadfield 1990 *Stanford LR* 979.

49 *Ibid.*

parties are supposedly contracting for their mutual benefit, traditional orthodox contractual principles, which focus on a literal interpretation of contracts, should be replaced by those which apply to relational contracts. Relational contract theory emphasises the interdependence of the parties and focuses on the requirements of trust, mutual responsibility, solidarity and co-operation.[50] Hawthorne suggests that it is justified to deduce that in long-term relational contracts, there is an implied term that contracting parties should not frustrate their counterpart in the performance of their agreement.[51] She then phrases this positively rather than negatively and says that it is in fact a duty to co-operate.[52] The duty to act in good faith, which underlies all contracts, implies, when dealing with relational contracts, that the parties will co-operate with each other.

3.4 The nature of the duty of good faith

The duty of good faith is a principle that is found in the law of contract in most legal systems around the world, whether they are civil or common law systems.[53] However, how this principle is interpreted by the courts and how it is applied to practical situations differs from one jurisdiction to another.[54] The concept of good faith is referred to as an "elusive idea" by learned authors and defining the role which the principle plays in the law of contract has been challenging.[55]

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50 Hawthorne 2007 *SA Merc LJ* 237.

51 Hawthorne 2007 *SA Merc LJ* 242.

52 Hawthorne 2007 *SA Merc LJ* 244.

53 The civil codes found in the continental legal systems (including France, Greece, Italy, Portugal, Spain and Switzerland) all contain a provision to the effect that contracts must be performed and interpreted in accordance with the requirements of good faith (see MacQueen "Good Faith in the Scots Law of Contract: An Undisclosed Principle?" in Forte (ed) *Good Faith in Contract and Property Law* (1999) 5-37). The Principles of International Commercial Contracts published by UNIDROIT provide that in international trade, parties must act in accordance with good faith and fair dealing. Parties may not exclude or limit this duty (see Art 1.7). In America, the Uniform Commercial Code (§1-203) imposes a duty of good faith on all parties. For a South African perspective see Hutchison "Non-variation Clauses in Contract: Any Escape from the *Shifren* Straitjacket?" (2001)118 *SALJ* 720 discussed further below.

54 See Steyn "Contract Law: Fulfilling the Reasonable Expectations of Honest Men" (1997)113 *Law Quarterly Review* 433 at 438.

55 See Brownsword *et al* "Good Faith in Contract" in *Good Faith in Contract* 1, Hutchison "Good Faith in the South African Law of Contract" in *Good Faith in Contract* 213 and Glover "Contract, Good Faith, the Constitution and Duress" in *Essays in Honour of AJ Kerr* 109. See also Lubbe "Bona Fides, Billikheid en die Openbare Belang in die Suid Afrikaanse Kontrakte Reg" (1990) *Stell LR* 7 and Steyn 1997 *Law Quarterly Review* 438.

Hutchison maintains that "there are few issues more uncertain in the modern South African law of contracts than the precise nature and scope of the good faith requirement".[56] Glover explains that the principle of good faith is an "elusive, vague and uncertain creature".[57] Although the South African courts have always regarded the concept as an underlying principle of the law of contract, the principle has not played a particularly prominent role in resolving disputes. Instead the courts have focused on the values of freedom of contract and the sanctity of contract and have frequently held that the courts have no power to modify contracts simply because they operate harshly against one of the parties.[58] Hahlo puts it thus:

> Provided a man is not a minor or a lunatic and his consent is not vitiated by fraud, mistake or duress his contractual undertakings will be enforced to the letter. If, through inexperience, carelessness or weakness of character, he has allowed himself to be overreached it is too bad for him, and it can only be hoped that he will learn from his experience. The courts will not release him from the contract or make a better bargain for him. Darwinian survival of the fittest, the law of nature, is also the law of the marketplace.[59]

The role which good faith could play to balance the sometimes harsh effects of these values has not been effectively explored.

3.4.1 The development of good faith in South African law

In Roman times a litigant who was of the view that enforcing a contract in particular circumstances was unfair could rely on the *exceptio doli generalis*. This was a defence which could be used against a person who instituted legal proceedings well knowing

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56 Hutchison "Good Faith in the South African Law of Contract" in *Good Faith in Contract* 213.

57 Glover "Contract, Good Faith, the Constitution and Duress" in *Essays in Honour of AJ Kerr* 109.

58 See in particular *Bank of Lisbon and South Africa Ltd v De Ornelas* 1988 (3) SA 580 (A); *Weinerlein v Goch Buildings Ltd* 1925 AD 282; *Zuurbekom Ltd v Union Corporation Ltd* 1947 (1) SA 514 (A) and *Paddock Motors (Pty) Ltd v Igesund* 1976 (3) SA 16 (A).

59 Hahlo 'Unfair Contract Terms in Civil-Law Systems (1981) 98 *SALJ* 70. See also *Wynns Car Care Products v First National Industrial Bank Ltd* 1991 (2) SA 754 (A) (the Appellate Division reasserted the stand that "harshness as such does not afford a contracting party the right to resile from his bargain" (760A-B)) and *South African Forestry Company Limited v York Timbers Limited* 2005 (3) SA 323 (SCA).

that these proceedings were inconsistent with good faith.[60] In *Weinerlein v Goch Buildings Ltd*, Wessels JA pointed out that it was clear that under the civil law the courts refused to allow a person to make an unconscionable claim even though his claim might be supported by a strict reading of the law[61] and in *Zuurbekom Ltd v Union Corporation Ltd* the Appellate Division assumed that the *exceptio* existed but that it did not apply in the particular circumstances of the case. The *exceptio* did not, however, assist aggrieved persons when the contract was very clear. This is illustrated in *Paddock Motors (Pty) Ltd v Ingesund.* In this case the court had to decide whether a term in a contract of sale of land should be upheld. This term provided that if a buyer was late in paying an instalment of the price he would be obliged to pay the full balance of the price and the seller could eject him from the property. This, in effect, meant that the seller would be paid the full price for the property but he would maintain ownership of it. The plaintiff argued that it would be inconsistent with good faith for the defendant to retain both full payment and the property. Jansen JA, however, held that the *exceptio* could not be employed to alter the terms of the agreement which was validly entered into by the parties. If the contract conferred a specific right on a party who chose to exercise that right, the *exceptio* could not be relied upon as this would give the courts the jurisdiction to "regulate contractual relationships merely on the ground that the court considered that one party had driven a hard, harsh bargain".[62] Jansen JA concluded that the law did not confer such jurisdiction upon the courts.

The Appellate Division finally dispensed with this defence altogether in *Bank of Lisbon and South Africa (Ltd) v De Ornelas* arguing that it was "a superfluous, defunct anachronism". The matter involved suretyship agreements that had been signed in order to obtain overdraft facilities from the bank. When the loans had been repaid, the bank refused to accede to the respondents' request that the securities be returned on basis that another debt was owed to the bank. In terms of a strict reading of the contract the bank was entitled to keep the securities until all debts howsoever arising had been repaid. The respondents argued that to apply this contract to situations other

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60 See generally Kahn *General Principles of Contract* 36; Lewis C "The demise of the *exceptio doli*: is there another route to contractual fairness" (1990) 105 *SALJ* 644 and Lewis J "Fairness in South African Contract Law" (2003) 120 *SALJ* 330.

61 292.

62 28F. See also *Rashid v Durban City Council* 1975 (3) SA 920 (D).

than the overdraft would be unconscionable or inequitable. The court, however, held that fairness could not override the clear rule of law that contracts must be enforced according to their terms.

Following the demise of the *exceptio*, authors tried to find a new route to contractual equity.[63] To some extent the concept of public policy filled the void but it is only when it would be grossly inequitable to enforce a contract that the courts have declined to do so. The leading example is *Sasfin v Beukes*.[64] In this case Smalberger JA refused to uphold a deed of cession because this placed a doctor's earnings under the complete control of a finance house. The court found that certain clauses were extremely exploitative which, in the public interest, could not be countenanced.[65]

Then, in *Eerste Nationale Bank v Suidelike Afrika Bpk v Saayman NO*[66] Olivier JA, in a dissenting judgement, held that if good faith so requires, a court may refuse to enforce an otherwise valid contract. Accepting this argument would have allowed the courts to intervene in matters even when the clauses themselves are not *prima facie* unfair and there are perfectly legitimate reasons for including them in contracts, but enforcing those terms in certain circumstances would be unfair or unconscionable. This would have amounted to a significant change in the approach of the courts and would have allowed judicial officers far more scope to interfere with contracts based on their own notions of fairness. In *Miller and Another NNO v Danecker*[67] Ntsebeza AJ used Olivier's approach as justification for deciding that he is entitled to deviate from *SA Sentrale Ko-op Graanmaatskappy Bpk v Shifren*[68] which had decided that effect must be given to non-variation clauses and that attempted subsequent variations not in writing are invalid. Following these decisions, a number of commentators were optimistic that the courts would develop the concept in such a way that they could intervene in the unfair enforcement of a contract.[69] Christie opined that there was every hope that when the opportunity presented itself the Supreme Court of Appeal would

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63 Lewis C1990 *SALJ* 644; Van der Merwe, Lubbe, Van Huyssteen "The exceptio doli generalis: requiescat in pace - vivat aequitas"' (1989) 106 *SALJ* 235; Zimmermann "The Law of Obligations - character and influence of the civilian tradition" (1992) *Stell LR* 56 and Limbiris "The exception doli generalis: an obituary" (1988) 105 *SALJ* 644.

64 1989 (1) SA 1 (A).

65 14G-H and 15E.

66 1997 (4) SA 302 (HHA).

67 2001 (1) SA 928 (C).

68 1964 (4) SA 760(A).

69 See in particular Christie *The Law of Contract* 4ed (2001) 19 and the authors to whom he refers.

apply Olivier J's reasoning in *Saayman*.[70] He suggested that, when dealing with the enforcement of contracts, the parties should be required to take into consideration the legitimate interests of the other party and that if this was done, the problem could be addressed in a flexible manner by the courts which are able to adapt, more readily than the legislature, to the demands of public policy.[71]

This optimism was short-lived, however, when the Supreme Court of Appeal in *Brisley v Drotsky*[72] examined the effect of constitutional principles on the law of contract and, in particular, scrutinised the notion that greater contractual fairness could be promoted by recourse to the principle of good faith. The majority referred to Olivier's minority judgement in *Saayman* and subsequent decisions[73] and determined that Olivier's conclusion that a person with full contractual capacity can be excused from liability based on considerations of fairness was drastic and not in accordance with established authority. The court also said that the unqualified acceptance of decisions which deviated from established authorities would create a state of unacceptable chaos and uncertainty in the law of contract.[74] The court did not dismiss the principle of good faith but instead agreed with the view of Hutchison that it is not an independent or "free floating" basis for setting aside contractual provisions. It is a basic principle which generally underlies the law of contract and which finds in expression its specific rules and principles.[75] To use Hutchison's words:

> (G)ood faith may be regarded as an ethical value or controlling principle based on community standards of decency and fairness ... (It) has a creative, a controlling and a legitimating or explanatory function. It is not however, the only value or principle that underlies the law of contract; nor, perhaps, even the most

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70 Christie *Contract* 4ed 19

71 Christie *Contract* 4ed 20.

72 2002 (4) SA 1 (SCA).

73 *Janse van Rensburg v Grieve Trust CC* 2000 (1) SA 315 (C) and *Mort NO v Henry Shield Chiat* 2001 (1) SA 464 (C).

74 12G-19C.

75 15E. An example is the way in which principles of fairness have been used to develop the law relating to rectification. See *Weinerlein v Goch Buildings Ltd*; *Brits v Van Heerden* 2001 (3) SA 257 (C) and *Shoprite Checkers (Pty) Ltd v Bumpers Schwarmas CC* 2002 (6) SA 202 (C).

important one.[76]

The court explained that the principle that freely and seriously concluded contracts must be enforced is also a fundamental value of contract and that the courts are required to weigh up these fundamental values and make any necessary changes gradually. The court held that the notion that a judge can refuse to enforce a contract due to unfairness was contrary to an incremental approach and would give rise to great uncertainty. This approach was reinforced by the Supreme Court of Appeal in *Afrox Healthcare Beperk v Strydom*.[77] In this case the court expressed serious misgiving about the over-hasty or unreflective importation into the field of contract law of the concept of *boni mores*.[78]

The issue of good faith in contract was again examined by the Supreme Court of Appeal in *South African Forestry Company Limited v York Timbers Limited*.[79] Brand JA held that "acceptance of the notion that judges can refuse to enforce a contractual provision merely because it offends their personal sense of fairness and equity will give

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76 Hutchinson 2001 *SALJ* 744. Glover explains that in South Africa "the principle of good faith operates as an 'informing basis' to the substantive law of contract". The principle provides "a moral, or principled jurisprudential justification for the existence of so-many black-letter rules and doctrines that exist in contract law, and which are designed to promote fair dealing and ensure the legitimate expectations of the contracting parties are met" (Glover "Contract, Good Faith, the Constitution and Duress" in *Essays in Honour of AJ Kerr* 114).

77 2002 (6) SA 21 (SCA).

78 At 39C. These decisions have been heavily criticised by commentators. See, for example, Hopkins "The influence of the Bill of Rights on the Enforcement of Contracts" August 2003 *De Rebus* 22; Lewis J 2003 *SALJ* 330; Pretorius "Individualism, Collectivism and the Limits of Good Faith" (2003) 66 *THRHR* 638; Hawthorne "The end of Bona fides" (2003) 15 *SA MerLJ* 271; Hawthorne "Closing of the open norms in the Law of Contract" (2004) 67 *THRHR* 294; Lubbe "Taking Fundamental Rights seriously: The Bill of Rights and its implications for the development of contract law" (2004) 121 *SALJ* 395; Naude and Lubbe "Exemption clauses - a rethink occasioned by *Afrox Healthcare Bpk v Strydom*" 122 (2005) SALJ 441 and Bhana and Pieterse "Towards a reconciliation of contract law and Constitutional values: *Brisley* and *Afrox* revisited" (2006) *SALJ* 123. Lewis J 2003 *SALJ* 331, for example, states that some of the judgments are atavistic and reflect unthinking positivism. The advent of the Constitution with its Bill of Rights created the platform for the courts to take a far more creative approach to the interpretation of contract. This approach did not materialise in the Supreme Court of Appeal. Lubbe 2004 *SALJ* 395 explains that decisions such as *Brisley v Drotsky* and *Afrox Healthcare Bpk v Strydom* entrenched the concept that agreements should be enforced and so he argues for "a closer analysis of what is comprised within the various constitutional values is essential in order to ensure that the potential of the Bill of Rights as stimulus for the future development of the common law is preserved". He maintains that the conclusions reached in these decisions were largely based on the courts' perception that there was no "countervailing constitutional value or underlying consideration of fairness that could be weighed up against, and possibly trump, the public interest in the strict enforcement of agreements".

79 2005 (3) SA 323 (SCA).

rise to legal and commercial uncertainty".[80] He argued that constitutional values, such as dignity, equality and freedom require that the courts approach their task of striking down or declining to enforce contracts with perceptive restraint and that this should only be done within the protective limits of public policy.[81] In this particular case Safcol[82] was asking the court to imply a term by law into the contract under the informative influence of good faith. Brand JA held that a term cannot be implied merely because it is reasonable or to promote fairness and justice between the parties in a particular case. It can only be implied "if it is considered to be good law in general".[83] The court held that if it accepted the new implied term contended for by Safcol this would mean that it would become a term of every contract that parties must not only perform their obligations in compliance with the provisions of the contract, but they would also have to do this in accordance with the dictates of good faith and fairness. This, Brand JA found was in conflict with the established principles of South African law because the question whether parties have complied with their contractual obligations depends on the terms of the contract.[84] Courts have no power to deviate from the intention of the parties simply because upholding the contract or a particular term may be regarded as unfair to one of them[85] because the outcome may very well be dictated by an individual judge's perception of what is fair and just.[86]

In this particular matter, Safcol had the right, in terms of the contract, to seek the opinion of the Minister and to refer the matter to arbitration if no agreement could be reached on the revision of prices. The particular clause under consideration did not expressly impose any duty or obligation on York Timbers but, the court held that the corollary to Safcol's right was an obligation on the part of York Timbers not to frustrated Safcol in the exercise of its rights.[87] So, whilst the court was not prepared to imply a duty on the part of York Timbers to act in good faith, the court did find that York failed to comply with its obligation not to frustrate or delay Safcol in the exercise of its rights. York Timbers was therefore found to be in breach of contract.

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80 339A.
81 339B-C.
82 The South African Forestry Company Limited.
83 339I.
84 340C.
85 340C-D.
86 340F.
87 341 C.

The Safcol decision can be compared to that of *Wynns Car Care Products v First National Industrial Bank Ltd* where the specific rights under consideration were spelt out in the contract. This decision involved a number of contracts concerning the hire, maintenance and service of computer equipment. The hire contract had been ceded to the bank and the appellant had withheld payment from bank because the computer company had failed to service his computers.[88] Whilst the agreement of hire was expressly made conditional upon the conclusion of an agreement of maintenance and an agreement of computer services, it also stated that the customer was not entitled *for any reason* whatsoever to without hold any payment due in terms of the agreement. The appellant argued that this clause was unconscionable, incompatible with the public interest and contrary to public policy because it precluded it from raising the computer company's failure to comply with its obligations in terms of the other agreements as a defense to a claim for rentals, and compelled it to pay rental even when there was no beneficial use of the equipment.[89] The court did not accept this argument and found that there was a readily identifiable reason for including such a provision in the agreement.[90] This clause made it possible for the agreement to be ceded and simply because some unforeseen subsequent eventuality arose which made the provision seem harsh, did not give the contracting party the right to resile from the contract.

The approach of the Supreme Court of Appeal must, however, be re-evaluated in the light of the Constitutional Court decision *Barkhuizen v Napier*[91] although the Constitutional Court did not deal in any detail with the role which good faith should play in the law of contract. The debate focused instead on the question of public policy and how it is given content by concepts such as justice, fairness and reasonableness. This case concerned the constitutionality of a time limitation clause in a short-term insurance policy. This clause prevented the insured from instituting legal action if summons was not served on the insurance company within 90 days. The insured contended that this clause was contrary to public policy and unconstitutional because it violated his right to approach the court for redress. It was also argued that the requirement of good faith precluded the insurance company from relying on the time-limitation clause when it would be unjust to

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88 The evidence showed that the computer company had gone out of business.
89 759 H.
90 760B.
91 2007 (5) SA 323 (CC).

do so.[92] The Constitutional Court held that the courts could decline to enforce terms if such enforcement would result in unfairness or would be unreasonable.[93] This approach requires a person seeking to avoid the consequences of enforcement to demonstrate that in particular circumstances it would be unfair to insist on compliance with a term. This could include an examination into the reason why there was non-compliance with a term. Ncgobo J gave the example of a person who was unable to comply with a term because of factors beyond his control and maintained that it was inconceivable that a court would hold a complainant to a contract in such circumstances. Ncgobo J argued that public policy "recognises the need to do simple justice between the contracting parties".[94] However, Ncgobo J also held that the maxim *pacta sunt servanda* "gives effect to the central constitutional values of freedom and dignity".[95]

The problem with *Barkhuizen v Napier* is that it is extremely difficult to follow the court's reasoning and to ascertain how far the Constitutional Court expects future courts to interfere with contractual relations.[96] So, whilst there is no doubt that this decision has broadened considerably the power of the courts to intervene in contractual undertakings, how far the courts will be prepared to intervene, remains to be seen. Nevertheless, it seems that the Constitutional Court has rejected the conservative approach adopted by the Supreme Court of Appeal and the way is now open to adopt the approach suggested by Christie.[97] The courts certainly have more flexibility to enquire into the legitimate expectations of the parties and if one party uses the contract

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92 This was Ncgobo's interpretation of the applicant's argument. See para 79.

93 Para 70.

94 Para 73.

95 Para 57.

96 For a strongly worded critique of the judgment see Woolman "The Amazing, Vanishing Bill of Rights" (2007) 4 *SALJ* 762. See also Woolman "Category Mistakes and the Waiver of Constitutional Rights: A response to Deeksha Bhana on *Barkhuizen*" (2008) 1 *SALJ* 10. In a radio interview conducted by *SAFM* (May 2008), during which the resignation of the South African soccer coach was discussed, an attorney was asked why the soccer coach was allowed to resign when he had a contract until after the Soccer World Cup to be held in South Africa in 2010. The attorney replied that given the coach's personal circumstances (his wife was extremely ill and wanted him to return to Brazil) it was highly unlikely that the courts would enforce his contract. It seemed that the attorney was relying on the judgment in *Barkhuizen* to justify his arguments. There is no doubt that this judgment has introduced an element of uncertainty into the law of contract in South Africa and it remains to be seen whether other courts (especially the Supreme Court of Appeal) will curtail its effect.

97 Christie *Contract*4ed 20. In his fifth edition, Christie explains that Olivier JA's proposals had not prospered but that the notion of public policy is a "sufficiently flexible and tested concept in South Africa to achieve all the results that could be achieved by the concept of good faith" (at 17).

in a manner that was not contemplated by the parties, the courts may refuse to enforce the contract on the basis that it would be contrary to public policy to do so. This also suggests a defence reminiscent of the *exceptio doli generalis*.[98] Although the Constitutional Court did not use this terminology, the approach adopted by Ncgobo J would perform the same function as the *exceptio doli generalis*.[99]

3.4.2 The role of public policy

The duty of good faith assists parties who are complaining about unfair conduct in circumstances in which the contract is ambiguous or silent on a particular issue. When however, the contract specifically makes provision for particular conduct it may be possible to argue that the agreement is so unfair as to be contrary to public policy. Although the courts have consistently held that they have no power to modify hard contractual terms simply because they operate harshly against one of the parties the courts will intervene when the terms are grossly unfair.[100] Innes CJ in *Eastwood v Shepstone* explained:[101]

> Now this Court has the power to treat as void and to refuse in any way to recognise contracts and transactions which are against public policy or contrary to good morals. It is a power not to be hastily or rashly exercised; but once it is clear that any arrangement is against public policy, the Court would be wanting in its duty if it hesitated to declare such an arrangement void. What we have to look for is the tendency of the proposed transaction, not its actually proved result.

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98 Glover "Lazarus in the Constitutional Court: An Exhumation of the *Exceptio Doli Generalis*?" (2007) 3 *SALJ*. An attempt was made to resurrect the *exceptio doli generalis* in *The Crown Restaurant CC v Gold Reef City Theme Park (Pty) Ltd* (CCT 05/07) but the Constitutional Court declined to decide the matter because the issues were not dealt with in the High Court.

99 See Kerr "Defence of Unfair Conduct on the Part of the Plaintiff At the Time Action is Brought: the Exceptio Doli Generalis and the Replicatio Doli in Modern Law" accepted for publication in the 2008 *SALJ* .

100 *Eastwood v Shepstone* 1902 TS 294; *Sasfin v Beukes* 1989 (1) SA 1 (A); *Baart v Malan* 1990 (2) SA 862 (E) and *First National Bank v Sphinx Fashions* 1993 (2) SA 721 (W).

101 302.

The concept of public policy is not clearly defined[102] and must be determined on a case-by-case basis taking into consideration the prevailing attitudes and social mores of the day.[103] Public policy is a question of fact, not law[104] and will therefore change as the general sense of justice in the community changes.[105] After a study of various decisions, Christie concludes that a contract or a term of a contract may be declared contrary to public policy if its is "clearly inimical to the interests of the community, or is contrary to law or morality, or runs counter to social or economic expedience, or is plainly improper and unconscionable or unduly harsh or oppressive".[106]

The prevailing attitudes and mores of modern South African society are now enshrined in the Constitution. In *Brisley v Drotsky*[107] Cameron JA explained that the prevailing attitudes and mores of modern South African society as enshrined in the Constitution include the right to human dignity, the achievement of equality and the advancement of human rights and freedoms, non-racialism and non-sexism. Therefore "contracts that offend these fundamentals of our new social compact will be struck down as offensive to public policy".[108]

The courts are now "obliged to take fundamental constitutional values into account while performing their duty to develop the law of contract".[109] Before the Constitutional Court decision, *Barkhuizen v Napier,* the leading decision on the question of public policy was *Sasfin v Beukes.*[110] Smalberger JA stated that no court should shrink from the responsibility of declaring a contract contrary to public policy when provisions are clearly "inimical to the interests of the community" or run "counter to social of economic expedience", but he also stressed that the courts should proceed cautiously and should exercise their power to strike down bargains freely negotiated

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102 See *Richardson v Mellish* 130 ER 294. The court described public policy as an "unruly horse" (at 303).

103 See also Corbett "Aspects of the Role of Policy in the Evolution of Our Common Law" (1987)104 *SALJ* 52 at 65. He points out that the courts are often required to make fundamental policy decisions and in doing so they have to weigh up conflicting interests and strike a balance between those interests.

104 Christie *Contract* 345 and *Amod v Multilateral Motor Vehicle Accident Fund* 1999 (4) SA 1319 (A).

105 *Lorimer Productions Inc v Sterling Clothing Manufacturers (Pty) Ltd* 1981 (3) SA 1129 (T).

106 Christie *Contract* 5ed 345.

107 2002 (4) SA 1 (SCA).

108 Per Cameron JA in *Napier v Barkhuizen* 34H-35B.

109 Per Cameron JA in *Napier v Barkhuizen* 6F.

110 1989 (1) SA 1 (A).

"sparingly" only in cases where the element of public harm is obvious.[111] Smallberger JA pointed out that "public policy generally favours the utmost freedom of contract, and requires that commercial transactions should not be unduly trammeled by restrictions on that freedom".[112]

The Supreme Court of Appeal regularly reasserts this approach and in *Barkhiuzen v Napier* the Constitutional Court confirmed that public policy requires, "in general, that parties should comply with contractual obligations that have been freely and voluntarily undertaken".[113] Ncgobo J stated that the maxim *pacta sunt servanda* gives effect to the central constitutional value of freedom and dignity and that even when parties act to their own detriment, self autonomy or the ability of parties to regulate their own affairs is a vital factor that should be taken into consideration when considering "the weight that should be afforded to the values of freedom and dignity".[114]

Nevertheless, the courts have always had the power to consider the terms of the contract and Ncgobo J has pronounced that even where these are objectively in line with public policy, the court may refuse to uphold them on the basis that they are "contrary to public policy in the light of the relative situation of the contracting parties".[115]

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111 *Sasfin v Beukes*; *Botha v Finanscredi* 783 and *Brisley v Drotsky* 18E. In *Tamarillo (Pty) Ltd v BN Aitken (Pty) Ltd* the court found that there was some justification for finding that the contract was one-sided and unfair but it was not so 'offensive as to render enforcement of it unconscionable' (at 436F).

112 At 9E. See also *De Beer v Keyser* which involved a franchise agreement in the micro-lending industry. Several franchisees in Kwa-Zulu Natal had broken away from the national network and were refusing to hand over their royalties. When legal proceedings were instituted against them, one of the arguments raised was that the franchise contract was void for vagueness. In particular they targeted clauses which stated that the franchisor would provide "technical assistance" and "administrative support". The Supreme Court of Appeal reiterated the principle that the courts should not be quick to destroy agreements that parties have seriously entered into and quoted from Lord Tomlin in *Hillas & Co Ltd cv Arcos Ltd* (1932) ALL ER Repo 494 (HL) where he stated that the "dealings of men may as far as possible be treated as effective, and that the law may not incur the reproach of being a destroyer of bargains".

113 *Barkhuizen v Napier* para 57.

114 *Ibid.*

115 Per Ncgobo J *Barkhuizen v Napier* para 59. There were a number of minority judgements, two of which disagreed with the subjective approach to fairness. Moseneke DCJ argued that the proper approach would be to consider a problematic term within the context of the entire agreement 'with a view to assessing whether it evinces a tendency or a reasonable likelihood' of being contrary to public policy. He argued that the personal attributes of the party seeking to escape a term should not matter (para 97) and that "(p)ublic policy cannot be determined at the behest of the idiosyncracies of individual contracting parties" (para 98). See also *Bafana Finance Mabopane v Makwakwa* 2006 (4) SA 581 (SCA); *Sasfin (Pty) Ltd v Beukes; Ex Parte Minister of Justice: in re Nedbank Ltd v Abstein Distributors (Pty) Ltd and Donelly v Barclays National Bank Ltd* 1995 (3) SA 1 (A) and *Eastwood v Shepstone.* Sachs J also disagreed with the subjective approach adopted by the majority arguing that the basic issue is, whether, " objectively speaking, and taking into account of the fact that the clause relied upon was contained in a standard form

The onus is on the person seeking to escape the offending clauses to show reasons why he is entitled to escape the effects of them.[116] The critical issue is what circumstances the court will take into consideration when deciding that it would be contrary to public policy to enforce a term. Ncgobo J gave some idea of this by pointing out that "many people in this country conclude contracts without any bargaining power and without understanding what they are agreeing to".[117] These, he said, are relevant factors when determining fairness. In *Barkhuizen v Napier* the majority upheld the time clause barring an insured from claiming from the insurer on the basis that such a clause is not contrary to public policy, and because the insured failed to provide any reasons why he was unable to comply with the term. There was no evidence before the Constitutional Court that the contract was not freely concluded, that there was an unequal bargaining power between the parties or that the clause was not drawn to the insured's attention. Alternatively, based on this approach, it could be argued that because there was no evidence that the insurer was not acting in good faith when it concluded the agreement or by relying on the term to defend the action, the term should be upheld.

In summary then, a contract which is so unfair as to be contrary to public policy will not be enforced by the courts. In order to determine whether a contract attains this level of unfairness the Constitutional Court has stipulated that there are two questions to be asked.[118] The first question focuses on the nature of the clause itself. If it is shown to be contrary to public policy, the court will not uphold it. However, the enquiry does not end there. If the clause is, in itself, a reasonable clause, it may be contrary to public policy to enforce the clause in the light of the particular circumstances.[119] The two-stage approach adopted by the Constitutional Court does not mean however, that the courts will condemn a contract simply because it is unfair. Public policy also requires that parties who have freely and voluntarily undertaken contractual obligations

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document annexed to but not informing an intrinsic part of what appears to have been the actual negotiated terms of the contract, the enforcement of the time-bar would be consistent with public policy in our new constitutional dispensation" (para 122). Sachs J's discussion of standard form contracts and fine print in contracts is suggestive of an approach in line with the existing principles relating to the reliance theory.

116 Per Ncgobo J *Barkhuizen v Napier* para 58.

117 Para 65.

118 *Barkhuizen v Napier*.

119 *Barkhuizen v Napier* paras 56-58 and 73.

must comply with them.[120] This means that parties can act to their own detriment and "out of respect for each of the parties, the law does not presuppose that it can determine the substance of the agreement which the parties should have reached. It is left to the parties to determine for themselves their own future in as sensible a manner as they each see fit".[121]

3.4.3 Assessing bad faith in the franchise relationship

It is a common franchising complaint that franchisors are acting unfairly or contrary to good faith. Although the concept of good faith is an elusive concept and it has played a relatively limited role in resolving contractual disputes, it must play a role in the interpretation of franchise contracts when such contracts are ambiguous or silent on a particular issue. Therefore, as the parties are expected to act in accordance with the duty of good faith, it is necessary to decide some sort of standard against which the parties behaviour can be judged.

Glover explains that there are three potential models for good faith.[122] The first model allows judicial officers to make decisions based on their perceived notions of good faith. This approach has been expressly rejected by the courts.[123] Even though the Constitutional Court has broadened the powers of the courts to intervene in contractual matters, the decision in *Barkhuizen v Napier* cannot be interpreted to allow courts to impose their own notions of fairness and justice on the parties to a contract. The matter must be decided in accordance with public policy. The second model is a "normative version of good faith" where the legal system imposes a moral standard of contractual justice on the community.[124] Glover maintains that South Africa has adopted the third model which is a contextual approach to the duty. This means that the concept of good faith will differ from context to context and that the parties are "expected to live up to the norms and standards of contracting parties in the particular

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120 Per Ncgobo J in *Barkhuizen v Napier* para 57.
121 Conaglen 1999 *New Zealand Universities LR* 509.
122 Glover "Contract, Good Faith, the Constitution and Duress" in *Essays in Honour of AJ Kerr* 114.
123 See *Brisley v Drotsky* and *Mort NO v Henry Shields-Chiat*.
124 See Wightman "Good Faith in the Law of Contract" in *Good Faith in Contract* 44 and MacQueen "Good Faith in the Scots Law of Contract" in *Good Faith in Contract and Property Law* 6.

contractual community".[125] Van Dijkhorst JA in *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghawano (Pty) Ltd* explained that good faith cannot exist in a vacuum and so "the morals of the marketplace, the business ethics of that section of the community where [good faith] is to be applied, are of major importance in its determination".[126]

In some specific contracts, the duty of good faith is recognised as an implied term or a *naturale* of that contract.[127] A classic example is the duty of good faith that is owed in insurance contracts. This is a very different duty to the general one owed by one business person to another when negotiating the sale of a business. Initially, contracts of insurance were regarded as contracts of utmost good faith until the Appellate Division in *Mutual and Federal Insurance Co Ltd v Oudtshoorn Municipality*[128] pronounced that the term utmost good faith was "an alien, vague, useless expression without any particular meaning in law" because all contracts in South Africa are *bona fides.*[129] It is suggested that the use of the term "utmost good faith" merely serves to indicate the increased standard that is imposed in insurance contracts and should not be taken too literally.[130] This standard is imposed because the insured is in a unique position with regard to knowledge which an insurer needs in order to make an informed decision.[131] An insured who fails to disclose material information, even when not specifically requested by the insurer, is regarded as being in breach of the duty of good faith owed in an insurance context. This duty continues after the contract is concluded and applies particularly in instances when the insured submits a claim.[132] Learned authors have argued that the duty of good faith applies to both the insured and the insurer[133] but the emphasis has always been on the duty owed by the insured to the insurer.[134]

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125 Glover "Contract, Good Faith, the Constitution and Duress" in *Essays in Honour of AJ Kerr* 109.

126 1981 (2) SA 173 (T) 188-189.

127 Glover "Contract, Good Faith, the Constitution and Duress" in *Essays in Honour of AJ Kerr* 112.

128 1985 (1) SA 419 (A).

129 433E.

130 See comments by Milller JA in his dissenting judgment (at 442I-443D).

131 See generally Davis *The South African Law of Insurance* (1993), Reinecke, Van der Merwe, Van Niekerk and Havenga *General Principles of Insurance Law* (2002).

132 *Schoeman v Constantia Insurance Co Ltd* 2002 (3) SA 417 (W).

133 Reinecke *et al General Principles of Insurance* para 174.

134 Van Niekerk "Something to Be Done About Insurer Bad Faith" (1998) 1 *SA Merc LJ* 110. Havenga argues that good faith is, or should be, an implied term of every insurance contract and that if a party breaches this duty the innocent party should be entitled to the usual remedies for breach of contract. See Havenga "Good Faith in Insurance Contracts - Some Lessons from Australia" (1996) 8 *SA Merc LJ* 75.

In order to establish the nature of good faith which is owed by contractants in a particular situation it is useful to consider the model suggested by Conaglen. He advocates placing contractual relationships on a continuum.[135] At one end of the continuum the parties are essentially in an equal bargaining position whilst at the other end the parties are in a relationship which "warrants the imposition of fiduciary duties on one of the parties".[136] Between these two are all other contractual relationships such as partnerships, agency agreements and insurance contracts. As one moves along the continuum the degree of power which one party has over the other increases. The challenge therefore is to consider where, along that continuum, the franchise relationship falls.

3.4.3.1 Franchising as a fiduciary relationship?

Over the years the courts have identified specific relationships in which a fiduciary relationship actually exists. A fiduciary relationship imposes a heavy burden or duty upon the fiduciary to act at all times in the best interest and for the benefit of the other party. In *Lynch v Cruttonden & Co*[137] the court held that a fiduciary duty or confidential relationship is created and exists in law when a person reposes trust and confidence in another and the person in whom such confidence is reposed obtains control over another person's affairs. Examples include attorney and client, bank and depositor, directors and companies and principal and agent or employee.[138] In order to determine whether a fiduciary relationship exists, the courts look at the facts of each individual case and assess each individual relationship.[139]

Some American courts have attempted to limit franchisor power by holding that the franchise relationship gives rise to an inherent fiduciary relationship. Writing in

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135 Conaglen "Duress, Undue Influence, and Unconscionable Bargains - The Theoretical Mesh" (December 1999) *New Zealand Universities LR* 509.

136 Conaglen 1999 *New Zealand Universities LR* 533.

137 (1993) 18 Cal App 4th 802,809,22 Cal Rptr 2d 636, 641-642.

138 See generally Havenga "Breach of Director's Fiduciary Duties: Liability on what Basis" (1996) 8 *SA Merc LJ* 366.

139 *Kudokas v Balkus* (1972) 26 Cal App 3d 744,750 103 Cal Rptr 318. For a fiduciary relationship in a South African context see *Sibex Construction (SA) Ltd v Injectaseal CC* 1988 (2) SA 54 (T). See also *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 in which Innes CJ said that whether a fiduciary relationship is established will depend upon the circumstances of each case (at 180).

1971 Brown argued persuasively that franchisors owe their franchisees a fiduciary obligation, because of the gross disparities in power between the parties.[140] In the then leading American decision, *Arnott v American Oil Co*,[141] the court said unequivocally that "inherent in a franchise relationship is a fiduciary duty". The court went on to state that "out of such a relation, the law requires that neither party exert undue influence or pressure upon the other, take selfish advantage of his trust or deal with the subject matter of the trust in such a way as to benefit himself or prejudice the other except in the exercise of the utmost good faith and with the full knowledge and consent of the other person involved".[142]

Despite attempts by some American courts to define the franchising relationship as a fiduciary relationship, this approach has now been rejected. In *Picture Lake Campground v Holiday Inns Inc*[143] the court held that the fiduciary duty which the court in *Arnott* found to exist was just a misstatement of the duty of good faith and fair dealing that underlies commercial dealings.[144] Courts were also not prepared to find that there has been a breach of a fiduciary duty in circumstances in which franchisors exercise express rights that are specified in their agreements.[145]

Although the notion that the franchisor owes the franchisee a fiduciary duty is an attractive one, it does not accord with the true principles of a fiduciary relationship. In a discussion of English law it has been suggested that there may be a limited application for fiduciary obligations in franchising relationships but that the whole relationship cannot be categorised as a fiduciary one.[146] By definition a fiduciary is someone who must act primarily for the other's benefit and not for his own benefit.[147]

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140 Brown 1971 *Tex L Rev* 650.

141 609 F2d 873 (8th Cir 1979). See also Brown 1971 *Tex L Rev* 650.

142 881.

143 497 F Supp 858,869 (ED Va 1980).

144 See also *Bain v Champlain Petroleum Co* 629 F2d 43 at 47-48 (8th Cir 1982) and *Murphy v White Hen Pantry Co* 691 F 2d 350.

145 In *Carter Equip Co v John Deere Indus Equip Co* 681 F2d 386 390 (5th Cir 1982) the court expressly disagreed with the statement in *Arnott* that a fiduciary duty is inherent in the franchise relationship. See also *Crim Truck & Tractor Co v Navistar Int'l Transp Corp* 823 SW 2d 591, 596 (Tex 1992). In *Bain v Champlain Petroleum Co* the court limited the approach which it had taken in *Arnott* to the facts of that particular decision.

146 Mendelsohn (ed) *Franchising Law* 2 ed (2004) 61.

147 See Walker *The Oxford Companion to Law* (1980) 468 where a fiduciary is defined as "a person in a position of trust or occupying a position of trust or confidence with respect to another, such that he is obliged by various rules of law to act solely in the interest of the other, whose rights he has to protect. He may not make any profit or advantage from the relationship without full disclosure".

The principal is entitled to receive "single minded loyalty" from his fiduciary.[148] In the Canadian decision, *Beaucage v Grand & Toy Ltd*[149] the court pointed out that although the categories of fiduciary duties are not closed, essential to the existence of a fiduciary relationship is a mutual understanding that one party has relinquished its own self-interest to act solely for the benefit of the other. This does not occur in a franchise relationship as the parties operate independent businesses. They are entitled to pursue and protect their own interests notwithstanding the fact that they are interdependent.[150]

3.4.3.2 The duty of good faith in the franchise context

Although the notion of a fiduciary duty in franchise contracts has been discarded, the courts, in other jurisdictions, have been prepared to accept that there is a duty of good faith in franchising which goes further than the general duty of good faith that underlies all contracts.

In Australia the law is not settled as to whether there is always an implied term in contracts to act in good faith, but the Victoria Supreme Court in *Far Horizons Pty Ltd v McDonald's Australia Ltd*[151] proceeded on the basis that there is an implied term of good faith and fair dealing, in franchising matters, which obliges each party to exercise their powers in good faith and reasonably and not capriciously or for some extraneous purpose. The court held that such a term is a legal incident of franchising contracts.[152] In *Bamco Villa Pty Ltd v Montedeen Pty Ltd; Delta Car Rentals Australia Pty Ltd v Bamco Villa Pty Ltd* the court held that the franchisors had breached their obligation to act in good faith when it terminated the agreement because the opportunity to terminate had arisen partly because the franchisor was in breach of the contract. The court held

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148 See Millet LJ in *Bristol and West Building Society v Mothew* [1998] 1Ch 1 (CA) 18.

149 (2001) 17 CPR (4th) 125 (Ont SCJ).

150 *Jirna Ltd v Mister Donut of Canada Ltd* (1975) 1 SCR 2. See also *Bagai v Sure Corp* (2000) 275 AR 370 (QB) and *Beaucage v Grand & Toy Ltd*. In South Africa the Competition Tribunal dealt with the relationship in *Competition Tribunal v Cancun Trading No 24 CC* Case No 18/IR/Dec 99. The Tribunal found that each franchisee is an independent entity and that franchisors and franchisees are to be treated as competitors in the marketplace.

151 (2000) VSC 310.

152 See also *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151 at 191-193; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349 at 368-369; *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703 at 37 and *Bamco Villa Pty Ltd v Montedeen Pty Ltd; Delta Car Rentals Australia Pty Ltd v Bamco Villa Pty Ltd* (2001) VSC 192.

that the termination had no effect.[153]

The Ontario Court of Appeal in Canada, in *Shelanu Inc v Print Three Franchising Corp*,[154] confirmed the Canadian approach that no fiduciary duty exists between franchisors and franchisees and that franchisors may act in their own self interest; however, they are obliged to have regard to the legitimate interests of their franchisees. Franchisors were found to owe a common law duty of good faith to franchisees in *Country Style Food Services Inc v 1304271 Ontario Ltd.*[155] The Ontario Superior Court of Justice asserted that there was a duty on franchisors to act with the utmost good faith toward franchisees. This has been statutorily reinforced in Ontario through the adoption of the Arthur Wishart Act (Franchise Disclosure) 2000. Section 3 of the Act provides that every franchise agreement imposes on each party a duty of fair dealing in its performance and enforcement.[156] In the event of a breach of this duty the aggrieved party can bring an action for damages.[157] The Act provides that the duty of fair dealing includes the duty to act in good faith and in accordance with reasonable commercial standards.[158] Good faith is a subjective concept and it is the relationship between a franchisor and an individual franchisee rather than the relationship between the franchisor and all franchisees that is important. The concept of reasonable commercial standards is an objective standard which can be determined by considering the general competitive market.[159]

In *Machias v Mr Submarine Ltd*[160] the court identified a trend in franchise cases. In these cases the courts referred to the duty of good faith in order to prevent abuse or

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153 See Wiseman "Franchising: An Australian Perspective" (2004) Conference of the International Bar Association, Auckland 17-18 in which the author suggests that this will probably influence New Zealand courts to adopt a similar approach. An example is when a franchisor makes it impossible for a franchisee to perform properly because he has not made certain deliveries and then he uses the improper performance on the part of the franchisee as an excuse to terminate the contract. It could then be argued that the franchisor was not acting in good faith. In a number of matters referred to the CAFCOM franchisees complained that franchisors were not making proper deliveries, deliveries were late, goods were damaged or goods were passed their sell-buy dates.

154 [2003] OJ No 1919 (Ont CA).

155 [2003] OJ No 362 (SCJ).

156 S 3(1).

157 S 3(2).

158 S 3(3).

159 See generally Adler and Zaid "Drafting Franchising Agreements in the 21st Century" Ontario Bar Association (3 February 2003) Third Annual Franchise Law Conference - Franchising in the New World of Disclosure, Toronto.

160 [2002] OJ No 1261 (Ont SCJ) 190.

obvious unfairness in the context of the franchise relationship. The court said further that "a recurrent theme in these cases" was the inherent inequality of bargaining power between franchisor and franchisee, "as well as the unique interdependent relationship between franchisor and franchisee".[161] In considering the rights, duties and obligations of the parties the court stated that although the parties to a franchise agreement are not in a fiduciary relationship, they are in a relationship that imposes upon the parties the duty of utmost good faith. And, in *Country Style Food Services Inc v 1304271 Ontario Ltd* the court held that "the franchisor's duty of care, the duty to act in good faith, while not elevated to the status of a fiduciary, speaks to concepts of loyalty, respect and fair dealing".

Adler and Zaid point out that developments in the case law in Canada indicate that the duty of fair dealing will be assessed by the courts based on the conduct of the parties in performing and enforcing the agreement, but this does not mean that the contract itself has to be fair.[162] The contract can be balanced in favour of the franchisor and this will not contravene the Arthur Wishart Act, but it is how the franchisor chooses to enforce the contract which must be judged according to standards of good faith.[163]

Under general principles of American contract law, there is an implied covenant, that "neither party will do anything which has the effect of destroying or injuring the right of the other party to receive the fruits of the contract".[164] This principle is applied on a case-by-case basis and depends on the facts of a particular case.[165] Zeidman explains that courts have tended to focus on whether one party possesses significant discretion in the performance of its obligations under the contract. If so, its performance must conform to the reasonable expectations of the other party and may not be used to "reclaim" benefits for which the other party has bargained. In *7-Eleven, Inc v McEvoy*[166] the court held that where the contract does not specify a standard guiding the exercise of discretion, the implied covenant of good faith and fair dealing will presume that the parties intended the discretion "to be used reasonably as opposed to arbitrarily and

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161 Para 110.

162 Adler and Zaid "Drafting Franchising Agreements in the 21st Century" 6.

163 The issue of good faith and fair dealing features particularly in matters dealing with termination of the contract and refusal to renew. This is further explored in Chapter Five.

164 *Kirke LaShelle Co v Paul Armstrong Co* 263 NY 79 87 88 NE 163 at 167 (1933).

165 Zeidman "Franchising and Other Methods of Distribution: Regulatory Pattern and Judicial Trends" in *45th Annual Advanced Antitrust Seminar: Distribution and Marketing* (2006) 463 at 603.

166 300 F Supp 2d 352 (D Md 2004).

capriciously".[167]

South African courts should follow the example set in other jurisdictions and recognise a specific duty of good faith in franchising that goes beyond the normal duty that underlies all contracts. It is suggested that franchise contracts should appear close to a fiduciary relationship on Conaglen's continuum and, adopting the approach taken in insurance law, this duty of good faith must be recognised as a mutual duty.[168] Although the parties are independent entrepreneurs their relationship is far more intimate than is found in other business relationships. In many ways, the parties are partners in one another's business ventures. Whilst these are independent businesses, they rely on the success of the other for their ultimate success. A franchise contract must be recognised as a relational contract and the norms of relational contract theory, as opposed to traditional orthodox contract theory, must be applied. Relational contract theory emphasises the interdependence of the parties and focuses on the requirements of solidarity, co-operation and trust instead of focusing on the literal enforcement of contracts which is favoured by traditional contract theory.[169] Parties must be expected to co-operate. Hadfield explains that "the doctrinal tool which is necessary to bring the resolution of contract disputes into line with the realities of the franchise relationship is the covenant of good faith and fair dealing".[170] The courts should therefore look beyond the franchise agreement and examine the relationship between the parties. Franchise contracts are long term contracts which are phrased in broad terms; therefore, not all conduct or future dealings will be specifically governed by written agreements. Because of this the duty of good faith and fair dealing has a central role to play in the interpretation of franchise contracts. The law must expect a higher standard from the parties than is normally expected from other contractants and, in line with the contextual approach to good faith followed in South Africa, the courts must develop a specific duty of good faith which is owed by the parties in a franchise relationship.

However, it is important to note that the implied duty of good faith is only of assistance to aggrieved parties when the agreement is silent or ambiguous regarding

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167 361.
168 This idea is discussed further in 3.5.3.1 below.
169 Hawthorne 2007 *SA Merc LJ 243.*
170 Hadfield 1990 *Stanford LR* 984.

the parties' rights and obligations. In other words good faith "fills in the blanks".[171] Franchisors cannot be accused of acting contrary to good faith if they act in accordance with the terms of their contracts. In *Sherman v Master Protection Corporation*[172] the California Appeals Court held that a franchisor had breached the implied covenant of good faith and fair dealing by the way it phased out its franchise operation in order to replace it with an employee-based business. In these circumstances there was no clause governing this conduct and the court found that the conduct was contrary to the contract's purposes and the parties' legitimate expectations. This decision can be compared to *Rosenburg v Pillsbury Company.*[173] In this case the agreement expressly provided that the franchisor reserved the right to distribute its ice cream products through not only franchises but through any "distribution method which may from time to time be established". This provision the court held "unambiguously" allowed the franchisor to distribute ice cream through supermarkets and convenience stores even when the supermarkets in question were within the franchisee's territory.[174] This refusal to override express contract terms has been confirmed in many other decisions such as *Grant Light & Supply Co v Honeywell Inc*[175] (the court asserted that the implied covenant of good faith did not override a contract provision permitting termination on 30 days notice) and *Patel v Dunkin Donuts of America*[176] (the court held that a franchisor could not be prevented from establishing another outlet within one mile of the franchisee's premises because of an express clause reserving the right of the franchisor to operate additional franchises at its discretion).[177]

The South Africa approach to good faith in contract law is similar to that found in America. As Brand JA in *South African Forestry Co Ltd v York Timbers* pointed out, the duty of good faith plays a role when contracts are ambiguous. The intention of the parties is determined on the basis that the parties negotiated with each other in good faith.[178] But the courts will not imply a duty of good faith if this is inconsistent with the

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171 McLaughlin and Jacobs "Termination of Franchises: Application of the Implied Covenant of Good Faith and Fair Dealing" (Summer 1987) *Franchise LJ* 14 at 15.

172 Cal Ct App Dec 18 2002.

173 718 F Supp 1146 (SDNY 1984).

174 See, for example, *Neuman v Pike* 591 F2d 191 (2nd Cir 1979) in which the court held that it was forbidden from redrafting the agreement with implied obligations (at 194-195).

175 771 F2d 672 (2d Cir 1985).

176 496 NE 2d 1159.

177 1161.

178 340I-J.

express language of the agreement. The aggrieved party may however argue that a particular clause (or enforcing a particular clause in specific circumstances) is contrary to public policy.

3.4.4 Franchising and public policy

It will probably be very seldom that a clause in a franchise agreement will be found to be so unreasonable as to be contrary to public policy. An examination of the few South African franchise decisions indicates that although the contracts may sometimes be harsh or one-sided, the courts have not found them to be contrary to public policy. In *Tamarillo (Pty) Ltd v BN Aitken,*[179] for example, the court accepted that the contract was unfair. The court had some sympathy for the franchisee and stated that it was unfortunate for the franchisee that it could not come to his assistance.[180] In the *Juglal* case, the court upheld the right of Checkers to take over Juglal's franchise as a going concern with the object of finding another franchisee for the business, even though the court accepted that this was a fairly drastic step which could, if abused, inflict hardship on a debtor. Juglal was also prohibited from operating another competing business from the same territory. The court was of the view that the powers which had been awarded to Checkers to secure its debt made commercial sense.[181]

Franchisees have faced similar difficulties in America when trying to convince courts that franchise contracts are so unfair as to be unconscionable. Franchisees are not poor or illiterate consumers, but business people entering into commercial transactions, and they voluntarily enter into these agreements.[182]. Generally, a contract is only regarded as being unconscionable if on the one hand no man in his "right senses" would make such a contract and on the other no "honest and fair man would accept".[183] A franchise contract, *prima facie*, appears to be a reasonable contract and

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179 1982 (1) SA AD 489.

180 436E.

181 *Juglal NO v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* 261J-262A.

182 Byers 1994 *Journal of Corporation Law* 635. See *Blalock Mach & Equip Co v Iowa Mfg Co* 576 F Supp 774 (ND Ga 1983). Similarly in *Juglal NO v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* the court found that the franchisee had "willingly and commercially speaking fairly exposed" himself without complaint to the contract (at 262A).

183 *Restatement (Second) of Contracts* §208 cmt.b (1981) quoted by Byers 1994 *Journal of Corporation Law* footnote 181. See also Hewitt "Good Faith or Unconscionability - Franchise Remedies for Termination" (1973) 29 *Bus Law* 227.

there are often good reasons for the inclusion of certain terms which franchisees may argue at a later stage are oppressive. For example, in *James v Whirlpool Corp,*[184] the court found that the terms of a franchise agreement which limited the franchisee's right to transfer the management and control of the business were not unconscionable because the terms were substantially reasonable and were not oppressive.

When a franchise contract is viewed from the perspective that it is a normal commercial contract, it is difficult to convince the courts that the contract itself is unfair and oppressive. However, in the light of *Barkhuizen v Napier*, it may be possible to convince a court that the enforcement of the contract will be so unfair as to be contrary to public policy "in the light of the relative situation of the contracting parties". The very notion of "freedom of contract" presupposes that both parties are on an equal footing and that both are in a position to protect their rights, but in reality parties are seldom in an equal bargaining position. This is especially so when the general business practice is to make use of standard-form contracts presented on a take it or leave it basis.[185]

The Supreme Court of Appeal, in *Afrox Health Care Bpk v Strydom*, rejected the argument that an exclusion clause in a hospital admission contract is unconstitutional. However, it did accept that inequality of bargaining power is a factor which courts can take into consideration in deciding to strike down a contract on public policy and constitutional grounds. Naude and Lubbe also refer to the position in which a person has no bargaining power, his autonomy is fatally impaired and the other party takes improper and unconscionable advantage of that position.[186] They have gone further

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184 806 F Supp 835 (ED Mo 1992).

185 The common law of contract reflects a profound belief in the concept of freedom of contract which is regarded as the "cornerstone of the theory of the law of contract". *See Osry v Hirsch, Loubscher & Co Ltd* 1922 CPD 531 at 546; *SA Sentrale Ko-op Graanmaatskappy BpK v Shifren* 1964 (4) SA 760 (A); *Olsen v Standaloft* 1983 (2) SA 668 (ZS) at 673 and *Magna Alloys and Research (SA) (Pty) Ltd v Ellis* 1984 SA 874 (A) at 893. This freedom means that parties have the freedom to negotiate the terms of their contract without interference from the state; they have the freedom to negotiate terms that will be given full effect without interference; they have the right to choose with whom they will contract; and they also have the freedom to choose not to contract (see generally Hawthorne "The Principle of Equality in the Law of Contract" (1995) 58 *THRHR* 157 at 163). Once they have exercised this freedom and entered into a binding agreement, their agreement will be upheld by the courts. The key contractual principle that contracts must be upheld is reflected in the Latin maxim *pacta sunt servanda*. The concept of freedom of contract is regarded as a complete myth by certain academic writers especially in the light of the use of standard form contracts. See generally Kahn *General Principles of Contract* 33-36. Kahn describes the standard-form contract as a "depersonalised,... one sided product of an economically superior party, imposing terms that favour him".

186 Naude and Lubbe 2005 *SALJ* 463.

and suggested that the courts should question the legality of a clause that "undermines the relationship of reciprocity existing between the essential undertakings characteristic of the contract".[187] Davis J endorsed this approach In *Mort NO v Henry Shields-Chiat*,[188] arguing that courts must carefully scrutinise the content of the contract, the manner in which the parties created their contractual relationship and their legitimate expectations. After concluding this examination, the court will be able to evaluate whether there was an unreasonable promotion of the interests of one of the parties and whether the principle of enforcing the contract can be trumped.[189]

The aggrieved person must show that he was forced to contract with the other party, on terms that infringed his constitutional rights to dignity and equality in an unconscionable manner.[190] In deciding whether or not to uphold a contract or particular term, the court will balance the right of franchisors to have their contracts enforced against the franchisees' rights to dignity and equality. The extent to which the contracts were freely and voluntarily concluded is a factor which courts will take into consideration. The kinds of evidence which aggrieved parties will have to provide was discussed by Cameron JA in *Napier v Barkhuizen*.[191] Adapting his discussion to be relevant to franchising,[192] it would be necessary to provide evidence regarding the market in different kinds of franchises; whether there were a variety of franchise products available; the number of franchisors and their relevant market-share; whether all franchisors use similar terms. His discussion does indicate that it would, in all probability, be difficult for franchisees to argue that they were not in equal bargaining positions at the time the contract was concluded. No one forces another into a franchise contract and there are a number of other alternatives for franchisees who are unhappy with the terms of their contracts. They could open their own businesses, find other franchises or find alternative employment.

Courts in other jurisdictions have, however, considered the unequal bargaining position as important when this has been coupled with other unacceptable behaviour.

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187 Naude and Lubbe 2005 *SALJ* 442.
188 2001 (1) SA 464 (C).
189 475H-I.
190 As per Cameron JA in *Napier v Barkhuizen* 9C-D.
191 *Napier v Barkhuizen* 9A-B.
192 Cameron JA was discussing the position with regard to an insurance contact.

For example, franchisors have relied on the inexperience of franchisees to ensure that they are able to get away with behaviour which more prudent entrepreneurs might have questioned. In the Canadian case of *Machias v Mr Submarine*,[193] the court found that there was unconscionable behaviour because the franchisor acted recklessly by "creating a grossly misleading picture of the financial viability of the franchise" and there were elements of fraudulent misrepresentation present. In *Mundinger v Mundinger*[194] the Ontario Court of Appeal set out the law regarding unconscionable conduct as follows:

> If the bargain is fair the fact that the parties were not equally vigilant of their interest is immaterial. Likewise if one was not preyed upon by the other, improvident and even grossly inadequate consideration, is no ground upon which to set aside a contract freely entered into. It is the combination of inequality and improvidence which alone may invoke this jurisdiction. Then the onus is placed upon the party seeking to uphold the contract to show that his conduct throughout was scrupulously considerate of the other's interests.[195]

This case was applied in the franchising matter, *Ellis v Subway Franchise Systems of Canada Ltd.*[196] The court said that before a claim of unconscionability can proceed, there must be evidence of fraud, duress or some abuse of inequality of bargaining power.[197] What was important in this case was that the court accepted that franchise terms can be onerous, therefore this fact on its own is not sufficient to set the contract aside. Even though the franchisee was a small businessperson and the franchisor was a large corporation, the court found that the contract was not unconscionable and that the relationship between the parties was a common franchise relationship.

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193 (2002) OJ No 1261 (Ont SCJ).
194 (1968) 14 DLR (3d) 256.
195 Para 8.
196 (2000) 8 BLR (3d) 55 (Ont SCJ).
197 Para 32.

3.5 Suggestions for reforms

The franchise agreement will remain the basis of this unique organisational form, even if franchise specific legislation is introduced, because it will be impossible to regulate the diversity of franchise relationships within a single law.[198] Therefore the common law of contract will remain an important means of regulating the franchise relationship. This law should be moulded to take into account the unique interests and special circumstances that are present in franchise relationships. The franchise contract must be recognised as a special contract with its own definition, elements and implied terms.

3.5.1 Definition[199]

Franchising is a contract in terms of which one party (the franchisor) undertakes, in return for consideration by the other (the franchisee), to grant the franchisee the right to carry on business under a system or marketing plan substantially determined or controlled by the franchisor, and under which the operation of the business will be substantially or materially associated with advertising, a trade mark, a commercial symbol or a logotype owned, used or licensed by the franchsor.

3.5.2 Elements[200]

There are three main elements to franchising:

(1) a franchisor grants a franchisee the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system developed and controlled on an ongoing basis by the franchisor;

(2) the franchisee's business is substantially associated with the franchisor's

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198 Hadfield 1990 *Stanford LR* 939.

199 Discussed in 2.3 above.

200 These are also known as *essentialia*. These are the terms which make the contract a contract of a particular kind. Without these terms there is either no contract at all or a contract of a different kind. See Christie *Contract* 158.

trade mark, trade name, logos, advertising and other commercial symbols; and

(3) the franchisee pays consideration for the rights he enjoys.

3.5.3 Terms implied by law[201]

If the above three elements are present then certain results follow. These results are the *naturalia* of the contract or terms implied by law. *Naturalia* are unexpressed terms of a contract which the law will import into a contract of a particular type as a matter of course unless these terms are expressly excluded.[202] Christie points out that the origin of many of these terms is the idea that honest parties entering into a particular type of contract would want to include such terms in their contract.[203] Terms implied by law can be excluded if they are in conflict with express terms of the agreement.

3.5.3.1 The duty of good faith

The duty to observe good faith has several aspects. The most important of these from a franchisee perspective is that there is a duty on franchisees to avoid free riding. On the other hand franchisors have a duty to avoid opportunistic behaviour. It is suggested that it can be assumed that neither party would enter into a franchise contract if restrictions on such behaviour were not part of the agreement. The parties would not expect the other to act in such a way as to undermine their legitimate expectations. Because of the nature of the relationship courts must expect a higher standard of conduct than may be required in other business relationships.

Recognising that franchisors owe their franchisees a specific duty of good faith does not mean that franchisors will lose their right to control their networks. Nor does it mean that the continued imbalance in the relationship between the parties will be eliminated. Franchisees must recognise that this is inherent in the very nature of franchising. If they are not prepared to subject themselves to the control of a

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201 Kerr refers to such terms as residual terms (*Law of Contract* 6 ed (2002) 344).

202 Christie *Contract* 159 and *Alfred McAlpine & Sons (Pty) Ltd v Tvl Provincial Administration* 1974 (3) SA 506 (A) 531.

203 Christie *Contract* 160.

franchisor, they must consider another form of business venture. However, recognising a special duty of good faith in franchise matters means that franchisors will be required to be far more specific in their contracts. Where specific conduct is not regulated courts can interpret contracts in such a way as to ensure that the legitimate expectations of the parties are not undermined. *Silent Pond Investments CC v Woolworths (Pty) Limited and Engen Petroleum Limited*[204] illustrates this point. The franchisee had a small Woolworths outlet situated within the premises of his Engen petrol station. When Woolworths attempted to establish a fully-fledged-corporate owned Woolworths 200 meters away situated at a new shopping complex, the court found that Woolworths was acting contrary to good faith. The franchisee was assisted by a specific clause in the contract which required the parties to act in utmost good faith and not to do anything that might prejudice the interests of the other party.[205] It is suggested that even if there was no such clause the court could still have found that Woolworths was acting contrary to good faith because, by establishing a fully fledged Woolworths store so close to the franchisee's outlet, the franchisor was undermining the legitimate expectations of the franchisee. However, if the contract had stated that the franchisee did not have an exclusive territory, or that Woolworths reserved the right to establish other outlets in the same vicinity, the franchisee would have been aware of this possibility from the day he purchased the franchise. He could not therefore have argued that Woolworths was acting contrary to good faith.[206]

3.5.3.2 The duty to provide expertise and management advice and the duty to comply with franchisor directives

Franchisors are expected to provide expertise and management advice because franchisees are purchasing far more than just the right to use a particular trade mark or advertising signs. The whole basis of a franchise agreement is that the franchisee

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204 [2007] JOL 20088 (D); 2007 JDR 0547 (D).

205 Clause 41.4 provided: "In implementation of this agreement, the parties hereto undertake to observe the utmost good faith and they warrant in their dealings with each other that they shall neither do anything or refrain from doing anything which might prejudice or detract from the rights, assets or interests of the other of them".

206 Cf the American case *Patel v Dunkin Donuts* of America. The issue of territorial exclusivity features strongly in franchise disputes and also raises the issue of competition regulation, discussed in 4.1.5 and 6.6.4 below.

is purchasing the franchisor's expertise and management advice. The corollary of this duty is the duty on the part of franchisees to comply with franchisor directives. Franchisors need to protect their trade marks and the interests of other franchisees. Therefore franchisees are obligated to commit themselves to the network and that means taking others' interests into consideration. This is a mutual arrangement which requires commitment on the part of both parties.

3.5.4 Incidental terms

These are the additional terms which the parties expressly agree upon in their particular contracts. These terms make up the bulk of any contract and set out the respective rights and duties of the various parties. The parties are free to include any terms provided they are not illegal or contrary to public policy. As stated above, the courts will not interfere merely because a clause is particularly onerous or unfair; however, franchisees may be able to establish that in the particular circumstances of the case, a nevertheless reasonable contract or clause should not be upheld. This may be especially important in the case of a long term arrangement in which the existing business relationship bears little resemblance to the original agreement concluded by the parties.[207]

The Constitutional Court, in *Barkhuizen v Napier,* has given the courts more flexibility to enquire into the legitimate expectations of the parties and if one party uses the contract in a manner that was not contemplated by the parties, the courts may refuse to enforce the contract on the basis that it would be contrary to public policy to do so.

3.6 Conclusion

The traditional approach to franchising disputes – that the contract is a normal commercial transaction concluded between two equal parties – does not reflect reality. First and foremost the relationship is an unequal one and it is an ongoing one which

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207 See the discussion of termination in Chapter Five.

develops over time. Franchising therefore provides a particular challenge in which having to rely on the good faith of the other party is a very real issue.[208] This is because it is impossible for the parties to cater for every eventuality in their contracts and very often contractual terms are couched in wide language. The written contract may provide guidance to the court in resolving disputes, but it cannot embrace the entire relationship between the parties. It is necessary therefore for the courts to have due regard to the actual relationship which exists between the parties in order to establish the true nature of their bargain. The courts must understand the relational structure of franchising and develop an alternative, relational approach to the resolution of franchise disputes. This must be done so as to give effect to the reasonable expectations of the parties.[209]

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208 The concept of good faith and fair dealing becomes even more important if the state is to succeed in its vision of using franchising as a means of transferring scarce business skills to inexperienced entrepreneurs.

209 See generally Steyn 1997 *Law Quarterly Review* 433 and Hadfield 1990 *Stanford LR* 990-992.

CHAPTER FOUR
MISREPRESENTATION AND NON-DISCLOSURE

OUTLINE

Unethical selling techniques and deceptive practices have tarnished the image of franchising throughout the world. Such practices include outright scams such as describing a pyramid distribution scheme as a franchise, the non-disclosure of material facts, and inflating profit potentials. The purpose of this chapter is to examine franchise complaints relating to misrepresentation and non-disclosure using case studies from both South Africa and other jurisdictions. In addition, the existing state of the law will be examined and solutions proposed.

4.1 The problem

Because franchisors are in the business of selling franchises, they may be inclined to extol the virtues of their product and play down the risks involved. Franchising guides also tend to portray franchising as a "fail safe" business model which encourages the belief amongst franchisees that they will never fail. An example is the article, published by *The Mercury, KZN Business Network*,[1] entitled "Business format franchising proves its value to entrepreneurs" in which an American Department of Commerce Report is quoted. This report maintains that franchises have an average success rate of 90% over a 10 year period. Quoting such statistics in South Africa is misleading because franchising here operates in a very different regulatory climate. But even in America franchise failure rates have always been a source of much debate, particularly in the 1990s when it was suggested that government and academic studies of statistics were being manipulated to

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[1] 23 August 2006.

enhance the image of franchising.[2] The history of franchising has shown that even though there are many advantages to franchising there is still the risk of failure and that an investment in a franchise is not necessarily safer than an investment in other new businesses.[3]

In the 1970s the FTC identified certain types of misrepresentations or omissions which were widespread deceptive practices in the franchise sector.[4] These practices[5] led to the introduction of the original FTC Franchise Rule. The investigation conducted by the UNIDROIT Study Group on Franchising found that "90 percent of franchise disputes involved allegations of incorrect or misleading information".[6] Without an empirical study it is difficult to state how widespread the problem is in South Africa. However, a study of the available data supports the notion that such practices are a common problem in franchising.[7] In 2007, Mandisa Manjezi, the Chief Director of the Enterprise Development Unit in the DTI, reported to the US-Southern Africa Franchise Forum[8] that misrepresentation and non-disclosure accounted for a substantial number of complaints received by the DTI. Franchisees complain that misrepresentations are made or important information is withheld about:

- the nature of the franchise;
- the viability and success of the franchise;

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2 See Bates "Survival patterns among newcomers to franchising" in *Franchising: An International Perspective* 31 and Buchan "Franchisor failure in Australia - impact on franchisees and possible solutions". Buchan says that studies in America have suggested that more than two-thirds of companies that engage in franchising will themselves fail within 5 to 12 years and that there is no reason to believe the situation is materially different in Australia (at 1).

3 Blair and Lafontaine *The Economics of Franchising* 35 and 52-53.

4 FTC *Federal Register* 30 March 2007 15451. See also Beales "Prepared statement of the FTC on the Franchise Rule" before the Subcommittee on Commerce, Trade, and Consumer Protection of the Committee on Energy and Commerce, United States House of Representatives Washington DC (June 25 2002) http://www.ftc.gov/os/2002/06/020625bealesfranruletest.htm (accessed on 26 October 2005) (Prepared Statement on the Franchise Rule).

5 These practices included misrepresentations about the franchisor and the franchise system; the costs involved; contractual terms; success rate and financial viability.

6 Peters 2004 *Business Law International* 34.

7 The data studied included the few South African cases, information from the CAFCOM and the DTI, documents received by the Franchise Steering Committee and interviews conducted with franchisees and the RMI.

8 Johannesburg (May 2007).

- the products and equipment to be supplied and the costs involved;
- the earning potential of the franchise; and
- territorial protections that will be afforded to franchisees.

4.1.1 The nature of the franchise

Misrepresentations are often made about the nature of the business relationship which franchisors are seeking to establish with their franchisees. A franchisor may create the impression that its business is "tried and tested" when instead it is a scheme to defraud, or an enthusiastic entrepreneur may set up a network without being aware of the complexities involved. Although establishing a network is a relatively inexpensive way of expanding a business, franchisors still need funds to develop and implement a proper marketing program and to recruit and train management and support staff. A financial commitment (often a substantial one) is required if franchisors are to perform their functions properly. Costs also include the costs of drafting a franchise agreement and disclosure document, costs of assessing suitable sites, travelling costs, payment of support staff and other overhead expenses.[9] Franchisors who may have failed to make this initial investment pose a substantial risk to franchisees who will be unaware that the support and infrastructure that they are relying upon to be successful does not exist.

The history of franchising in America illustrates some of these problems. In the 1950s and 1960s enthusiastic entrepreneurs who had developed successful businesses and who wanted to expand their enterprises saw franchising as a means of realising their ambitions, because they did not have to risk their own capital. Unfortunately, a large proportion of these entrepreneurs lacked the experience or managerial skills to manage an expanded system and many of these businesses failed.[10] In addition fly-by-night, unethical, and often criminal, operators who had read newspaper reports of the success

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9 Maletz "Legal and Business Considerations of a Franchise Development Program" in Davis, Jones, Keller and Wiesen (eds) *Massachusetts Business Lawyering* Chapter 24 (2003) vol 2 and Maitland *Franchising* 17.

10 See generally Maletz "Legal and Business Considerations of a Franchise Development Program"; Maitland *Franchising* and Brown *Franchising: Trap for the Trusting*.

of franchising decided to exploit the market.[11] In 1980 the Attorney General of New York reported to the Senate Consumer Protection Committee that from 1972-1979 14 000 New Yorkers lost in the region of $40 million through franchise fraud.[12]

There is no doubt that similar problems are occurring in South Africa where the term franchise is used to describe a number of different business relationships without giving proper thought to what such a relationship entails. In 2001, the CAFCOM received a complaint about a business called Print Glass which was involved in the selling of mirrors shaped as business cards. Business particulars were printed on mirrors, as well as on other mirrored products. These products were used for promotional purposes. The proprietor advertised in newspapers throughout South Africa that he was selling franchises for R50 000 each. The Committee interviewed the proprietor[13] and it became obvious that no franchising infrastructure was in place, that of the numerous "franchises" that had been sold, only one was still operating, and that most of the proprietor's income was derived from the sale of these franchises rather than from the sale of the products themselves. At no stage were prospective "franchisees" informed that virtually everyone who invested in the business lost their R50 000. Although the proprietor had a legitimate business, the demand for his products was not substantial and it was agreed that the products would be sold by agents who earned commission from sales and who did not have to pay a large upfront fee.[14]

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11 Kaufmann "The New York Franchise Act" in *Understanding Franchising: Business and Legal Issues* (2001) 203.

12 *Ibid.* See also Bennet "Franchise Regulation: Past Present and Future". Kursh reports that in the decade following the publication of the first edition of *The Franchise Boom* he "received enough letters and telephone calls which if recounted even briefly in a single volume, would make the Biblical plight of Job seem like a trip through an ice cream parlour". He goes on to state that "[t]hese were communications telling me, pleading with me, to do something about some particular type of deception or fraud in franchising. Even if I was a lawyer willing to give all my time without charge, not in an entire lifetime could I have done anything to have helped a fraction of the hapless victims" (Kursh *The Franchise Boom* 128).

13 On 24 January 2001.

14 After a short investigation, it was agreed that the proprietor would enter into a section 9 arrangement with the Committee. In terms of s 9 of the Consumer Affairs (Unfair Business Practices) Act the Committee may at any time negotiate with any person, with a view to making an arrangement which in the opinion of the Committee will ensure the discontinuance of an unfair business practice which exists or which may come into existence and which is the subject of an investigation. In terms of this arrangement, the proprietor agreed that he would cease selling rights, whether the rights were referred to as agencies, dealer principals, dealerships, distributorships, franchises, licensees or

In September 2005, the FASA reported that it had been informed of a bogus franchise called Survival Liqui Seal. Franchises were sold for R108 000 and once the money was paid the two promoters disappeared.[15] The CAFCOM regularly receives such complaints but in most instances it is impossible to trace the originators of these businesses. This is usually because they rely on mobile phone numbers and post office boxes for contact.

4.1.2 The viability and success of the franchise

Although a franchise network taken as a whole may be successful, this could be misleading because not all outlets may be financially viable. A single outlet may change owners on a regular basis because the franchisor takes control of it or it is resold to another franchisee.[16] Prospective franchisees may assume that the particular outlet is successful because it has been operating from the same premises for a long period of time. The fact that the franchisor owns a number of outlets could be an indication that the network may be experiencing difficulties. Whilst franchisor-owned outlets are not unusual, franchisors are in the business of selling franchises, they are not in the business of providing goods and services to consumers. If the network has a number of franchisor-owned outlets, franchisees should examine the business further.

Non-disclosure of a history of business failure, as illustrated in the Print Glass example discussed above, appears to be a general problem.[17] At a workshop held to discuss the Consumer Protection Bill,[18] an official of the DTI reported that she was of the

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wholesalers. He also agreed to stop advertising in a misleading fashion. The proprietor was informed (and it became part of the agreement) that if he breached the agreement the Committee would immediately consider a formal investigation into his and Print Glass's business practices. The Committee has received no further complaints about this business.

15 See FASA Newsletter 2 September 2005 http://www.fasa.co.za/news (accessed on 9 September 2005).

16 A South African attorney, who is a commercial specialist, informed a franchisee who had invested in a failed franchise that "many franchisors do not make money from royalties, but from selling and re-selling bad franchises" (Delmar "New franchisees can get fried").

17 Reports have even been received of franchisors who sold franchises at a time when they were aware that they were in the process of closing down their networks or of abandoning them.

18 Pretoria (October 2006).

view that this was a particular problem with petrol station franchises. The failure to disclose franchisee history was *the* factor that had motivated her to support the inclusion of franchisees as consumers in the Consumer Protection Bill.

In addition, franchisors may make misrepresentations about their businesses in order to make it appear more attractive to prospective franchisees. Although Print Glass was not a scam, certain aspects of the business did concern the Committee. For example, exaggerated claims regarding possible earnings were made in advertisements which also stated incorrectly that the mirror card was a registered patent, that the business operated internationally and that Print Glass was the "winner of the 18th International Award as the best trade mark in the world". Print Glass had apparently received this award from an organisation know as The Trade Leaders' Club. The Committee regarded this as a rather obscure entity and so concluded that to state that Print Glass was the best trade mark in the world was misleading. The proprietor disputed this and it was agreed that he could continue to use the words "Awarded the best trade mark in the world in 1993 by the Trade Leaders Club".

4.1.3 Products and equipment to be supplied and costs involved

Franchisees are often ill-prepared for the costs that are involved to set up their franchises or for the cost involved to operate their outlets on an on-going basis. This appears to be the reason why many franchisees simply abandon their franchises or allow franchisors to assume control of their outlets.[19] Common complaints revolve around the upgrading of computer systems, the changing of decor and even substantial investment in

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19 Comments made by the DTI officials at a workshop to discuss the Consumer Protection Bill (October 2006). In March 1999 the CAFCOM received a complaint from a franchisee who purchased a fast food franchise called "Beach Café" for R391 000. The complainant informed the Committee that the franchisor had told him that the landlord would assist him with R50 000 to establish his outlet. This did not materialise. In addition, the franchisee had signed the lease agreement with the landlord, a third party, for five years. The franchise was not successful and so he had to find someone to take over his lease. In order to do this he had to cancel the franchise agreement and he lost his franchise fee.

infrastructures.[20] These are added burdens, which many franchisees cannot afford or do not perceive to be necessary. This is not a simple issue, however, because it is the role of franchisors to keep franchisees up-to-date with modern developments.

During one CAFCOM investigation a franchisee, who was requesting an investigation into a tyre-retreading franchise,[21] reported that during the negotiating process many promises were made to franchisees that simply did not materialise. He supplied an affidavit from an ex-franchisee which read:

> When I negotiated in 1999 with [the franchisor] to open a franchise they were very happy to have a black franchisee.... The managing director ... promised me to get rubber from them at special prices, get rebates, pay for the advertising boards, pay for the training of my staff and even pay for some of their salaries. As a previously disadvantaged franchise holder I was also promised to get all government contracts. I was told that I did not need to employ a rep to get the business for me but [the franchisor] would send their rep.... None of these promises were kept .... The result was that I lost my business and all my money.

The franchisor disputed that such promises were made to franchisees and the contracts were silent on the matter.

A franchisee who had purchased two video store outlets reported that over time the franchisor made many promises to its franchisees which failed to materialise.[22] This franchisee often requested that the franchisor put the promises in writing but her requests were always refused. When her franchises eventually failed she consulted an attorney who informed her that as she had nothing in writing, the promises were contrary to express

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20 Members of the RMI reported that this was a substantial problem in the motor dealer sector. Some members had invested in the region of R100 million in the development of their showrooms. They were instructed to update their showrooms in 2005-2006 because South Africa "had the fastest growing new motor vehicle sales in the world". The market changed dramatically at the end of 2007 (reportedly due to the down turn in the economy, increased interest rates and the introduction of the National Credit Act) so their improvements constituted wasted expenditure. These comments were made at the Consumer Law Conference (March 2008).

21 Discussed in 2.3 above.

22 Interview 5 October 2007.

terms of her contract and because her contract contained a non-variation clause she would find it very difficult to prove that these promises had been made. This franchisee also reported that despite the fact that many outlets were failing the franchisor was continuing to sell franchises.[23] She stated that new franchisees experienced financial difficulties from the outset.[24]

Similar problems were experienced by the franchisee in *Shoprite Checkers (Pty) Ltd v Bumpers Schwarmas CC*.[25] In this case the franchisor promised orally to arrange for a lease agreement on the same terms and conditions that the previous franchisee had enjoyed. This assistance never materialised. Fortunately for the franchisee, there was sufficient evidence on which the court could draw an inference that in fact such a promise had been made.

Another example is *Academy of Learning (Pty) Ltd v Hancock*,[26] which involved the purchase of a franchise to set up a training college. The franchisee was obliged to establish her college from "scratch" and to source all the infrastructure necessary to operate the college. The contract did not stipulate the amount that was required to do this, so she relied on an assurance from her franchisor that she would need R120 000. The final cost was more in the region of R180 000. This meant that the franchisee and her husband's financial resources were "placed under severe pressure".[27] The franchisor later purchased a 50% interest in a distance-learning entity and it required the franchisee to become involved in this venture. The franchisee was assured that she would see her profits increase substantially and so she incurred further costs to set up the distance

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23 The franchisee alleged that the failures were because the franchisor had failed to keep up with technological developments and because the market had changed so that the demand for video rentals had depreciated substantially.

24 On 26 August 2008 the franchisee sent an email which read:

> We as ex franchisees consist of two groups - one group is trying extremely hard to stop [the franchisor] from continuing on the destructive path they are on, whereby the money he is now making is coming purely from the opening of new stores and the subsequent closing down and attachment of personal assets of that particular franchisee. The second group is made up of ex franchisees who have been closed down and are now trying to claim damages from [the franchisor] ... believe it or not we have been approached by a Cape Town franchisee who has been operating for a year, at a loss.

25 See Chapter Three note 67.

26 2001 (1) SA 941(C).

27 947H.

learning system. The ultimate increase in fees did not cover these costs and instead the college suffered substantial losses.[28]

The video store franchisee reported a similar problem. The initial franchisee fee covered the cost of setting up the video store and franchisees were "stretched to the limit" when they had paid this amount. The franchisor did not explain that from the moment they started to operate their businesses they would have to invest in the ongoing purchase of new videos. Many consumers who frequent their outlets would have seen most of the "old" videos and so it was necessary to keep purchasing the latest releases on an ongoing basis. The franchisee alleged that these costs were not adequately explained to franchisees with the result that many franchisees found it difficult to keep up with the latest releases and they lost customers, thereby compounding their financial problems.

The FTC reports that a motivating factor for promulgating the original Franchise Rule was the harm to franchisees which resulted from misleading cost representations.[29] Its investigation revealed that information regarding the cost of purchasing the franchise and operating it was necessary to avoid franchisees over-extending themselves. Franchisees need information regarding the cost of purchasing or leasing things such as inventory, signs, supplies and equipment and they need to know what costs will be involved on an ongoing basis.

4.1.4 The earning potential

Not only is franchising frequently portrayed as a fail-safe form of doing business, franchisors also provide prospective franchisees and financial institutions with inflated or unsubstantiated financial projections about the feasibility of the franchise system or a particular outlet. These projections are often made through marketing materials and other initiatives to attract franchisees. The final contract, signed by franchisees, will probably include a clause that excludes reliance on any representations not included in the agreement. In one matter investigated by the CAFCOM, prospective franchisees were

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28 948C.

29 FTC *Federal Register* 30 March 2007 15450.

provided with a feasibility study which indicated the kinds of profits that could be made. The study seemed to be a specific review of a particular outlet. It later turned out that an agent, who the franchisor had employed to promote its franchise division, had developed a standard model which was used for all outlets and which bore no resemblance to the factual position of individual outlets. This seems to be a common problem. Glickman reports that "salesmen's promises and representations are a leading source of fraud actions in America".[30] The video store franchisee also reported that feasibility studies supplied to franchisees did not relate to particular outlets and the franchisor made no real attempt to ascertain the market in which the particular franchise was to be established, despite making representations that he had in fact done so.

But even when there is no fraud involved and franchisors make honest projections, problems can arise. A study of the American literature reveals that statements about the possible earnings of a business lead to substantial problems when these profits do not materialise. No matter how specific franchisors are about making franchisees understand that there are no guarantees that their businesses will make substantial profits, and that projections are based on a number of factors, franchisors tend to paint a best-case scenario. Franchisees will then assume that this is the minimum amount that can be made. If the businesses fail to attain these levels of profitability, franchisees frequently allege that there has been a misrepresentation.[31]

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30 Glickman *Franchising* §8.06[5] 8-61. See also FTC *Franchise Register* 30 March 2007 15451 in which the FTC reports that "false or misleading misrepresentations about the success of franchise systems and business opportunities were perhaps the most prevalent misrepresentations identified in the original rule making record. These included misrepresentations about: the number of franchisees, the expected growth of the system, and, most important, the financial performance of existing franchisees.

31 Notwithstanding the difficulties associated with earnings claims, franchisors and legal advisors report that the first question franchisees usually ask when seeking to purchase a franchise is: How much money can I make? This is understandable because franchisees are often giving up secure employment in order to become franchisees and they need to know that they are, at the very least, going to replace their existing salary.

4.1.5 Territorial protections for franchisees

It is a very common franchisee complaint that franchisors award new franchises or establish company-owned stores too close to existing franchises.[32] Even McDonald's Corp has experienced problems in this regard. In the mid-1990s franchisees became increasingly concerned as the franchisor opened up thousands of new outlets which led to a significant decrease in the profits of existing franchisees.[33] This, coupled with some other decisions, led to a great deal of conflict between the franchisor and its franchisees and even some litigation. In 1998 McDonald's Corp acknowledged that it had made some decisions that were not in the best interests of its franchisees. These poor decisions had led to its franchisees becoming demoralised and had affected the overall performance of the network. One solution was to slow down expansion and many low volume restaurants were closed.[34]

In some instances franchisees may allege fraudulent behaviour on the part of the franchisor on the basis that representations were made to them during the negotiation process. For example, the franchisor "promised us an exclusive territory" or they "promised they will not expand into the territory". Alternatively, where no promises are made and the contract is silent on the issue, franchisees may assume that their territory will be protected from competition from other franchisees. When encroachment occurs franchisees are unanimous that franchisors are not acting in good faith.[35]

Although encroachment can have a devastating effect on franchisees who are not granted territorial exclusivity,[36] the granting of exclusive territories is regarded as an anti-

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32 Bennet "Franchising Regulation: Past Present and Future" *The Wallstreet Startup Journal,* available at http://www.startupjournal.com (accessed on 26 October 2005); Rust "Regulating Franchise Encroachment: An Analysis of Current and Proposed Legislative Solutions" (Fall 1994) *Oklahoma City University LR* 489.

33 Rosenberg "Chain Reaction: lessons from franchising financial models and the role chief financial officers play" 1999 *CFO, The Magazine for Senior Financial Executives* available at http://www.findlawarticles.com/cf_0/m3870/2_15/53723814 (accessed on 30 September 2003).

34 *Ibid.*

35 See for example *Silent Pond Investments CC v Woolworths (Pty) Limited and Engen Petroleum Limited* discussed above in 3.5.3.1.

36 FTC *Federal Trade Register* 30 March 2007 15491.

competitive practice by competition authorities.[37] Because of this, from a legal standpoint, it is difficult to demand that franchisors grant such territories, even though most franchisees tend to expect this. Glickman reports that "[n]o issue has been more hard fought in the franchising field than the issue of restrictions on dealer territories and locations".[38] The FTC reports that, during the Franchise Rule amendment proceedings, some franchisees and their advocates urged the Commission to ban encroachment as "an abusive and unfair trade practice".[39] One franchisee reported that when the company opened a franchisor-owned outlet in a shopping mall within two miles from her store, her profit was reduced by 50%.[40]

4.2 The law in South Africa

4.2.1 The nature of misrepresentations

Misrepresentations are usually statements regarding some matter to do with the contract that are made by one party to another before or at the time of contracting.[41] These statements induce a false impression in the mind of other contracting party but they do not form part of the contract.[42] Misrepresentations may be fraudulent, negligent or innocent. Statements are made fraudulently when representors know that the statements are false, or foresee that the statements may be false but are reckless as to whether or not they are false.[43] Negligent misrepresentations occur when the representors do not know that their statements are untrue, but a reasonable person would have realised this.[44] Innocent misrepresentations occur when the representors do not know that the statements are untrue

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37 For a more detailed discussion see 6.6.4 below.
38 Glickman *Franchising* §4.03[2].
39 FTC *Federal Trade Register* 30 March 2007 15491.
40 FTC *Federal Trade Register* 30 March 2007 15491 note 491.
41 Misrepresentations can also be by conduct or omission. See below at 4.2.2.1.
42 Kerr *Law of Contract* 267
43 *Ex Parte Lebowa Development Corporation* 1989 (3) SA 71 (T) 103F-I and *Absa Bank v Fouche* 2003 (1) SA 176 (SCA) 181D.
44 For an example of a negligent misrepresentation see *Bayer South Africa v Frost* 1991 (4) SA 559 (A).

and a reasonable person would not have realised this. Aggrieved parties are entitled to rescind their contracts provided the elements of misrepresentation are established regardless of whether the misrepresentations are honest or not. In other words, contracts induced by misrepresentation are voidable at the instance of innocent parties. However, if aggrieved parties wish to claim damages for any loss suffered they must first establish fault in the form of intention or negligence.

4.2.2 The elements of misrepresentation

In order to establish an actionable misrepresentation, franchisees must prove that the following elements exist:

- a false representation;
- as to a fact;
- which was material;
- made before or at the time of contracting with the intention of inducing the contract; and
- which induced the contract.

4.2.2.1 False representation

The representor must have acted in such a way as to create a false impression in the mind of the representee. A misrepresentation may be in the form of words or conduct or both,[45]

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45 *Trotman and Another v Edwick* 1951 (1) SA 443 (A). See generally Christie *Contract* 313 and Kerr *Law of Contract* 276. Active concealment occurs when a person makes a statement which he honestly believes to be correct. At a later stage it is discovered that the statement is incorrect or that circumstances have now changed. The other party must be informed that the position has changed. See *Mayes v Noordhof* 1992 (4) SA 233 (C), where a seller became aware, during negotiations for the sale of a property, that a squatter camp was to be established in the vicinity. It was held that the seller had left the purchaser under the false impression that there was no squatter problem and that in the circumstances the seller had acted dishonestly and fraudulently. Designed concealment occurs when information is deliberately withheld in order to induce the contract. This amounts to a misrepresentation when there is a "duty to speak".

but silence does not usually amount to misrepresentation. Non-disclosure is a major concern in the context of franchising. One of the most frequent complaints is that important information was not disclosed, and franchisees state that had they known certain facts they would not have contracted. A common example is the non-disclosure of a history of franchisee failure.

A measure of non-disclosure in business dealings is permitted if this is merely part of keen bargaining and as the court in *Absa Bank v Fouche* pointed out "it is not the norm that one contracting party need tell the other all he knows about anything that may be material".[46] But when negotiations reach the point at which the non-disclosure degenerates into "trapping" or blatant dishonesty, the law will regard the non-disclosure as fraudulent misrepresentation.[47]

Aggrieved franchisees must establish that their franchisor acted unlawfully in that it failed to speak in circumstances when there was a "duty to speak". It is not always easy to establish when there is a duty to speak and in each case the courts use "the legal convictions of the community as a touchstone".[48] The courts have said that this duty only arises when information falls within the exclusive knowledge of one party and the information is such that the other party's right to know that information would in the circumstances be recognised by honest people.[49] One test which has been suggested is: would the person from whom the information has been withheld, reasonably be entitled to regard himself as having been swindled?[50] Non-disclosures are usually only actionable where information has been deliberately withheld. However in *Bayer South Africa (Pty) Ltd v Frost* the court held that there could be liability on the basis of negligence and in *Absa Bank Ltd v Fouche* the court extended this to negligent non-disclosure.

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46 181A.

47 See for example *Marais v Edlman* 1934 CPD 212; *Dibley v Furter* 1951 (4) SA 73 (C); *Cloete v Smithfield Hotel (Pty) Ltd* 1955 (2) SA 622 (O); *Pretorius v Natal South Sea Investment Trust Ltd* 1965 (3) SA 410 (W) 418.

48 Per Conradie JA in *Absa Bank Ltd v Fouche* 180I.

49 See Millner "Fraudulent Non-disclosure" (1957) 74 *SALJ* 1977; *Dibley v Furter; Pretorius v Natal South Sea Investment Trust Ltd* and *Absa Bank Ltd v Fouche*.

50 See *Hulett and Others v Hulett* 1992 (4) SA 291 (A).

4.2.2.2 Of fact

Generally the misrepresentation must be one of fact. Therefore it is important to distinguish between statements of opinion and puffing or "advertising speak".

- ***statements of opinion***

Honest statements of opinion, even when they turn out to be incorrect do not constitute misrepresentations.[51] This means that when franchisors honestly express their opinions about matters such as financial projections or the viability of their networks, and these statements turn out to be incorrect, they cannot be held liable for misrepresentation. However when franchisors falsely express their opinions, they may be making actionable misrepresentations. In *Van Heerden v Smith*,[52] when the seller of a business stated that the business would yield a good profit in the future, Grobler J had this to say:

> A dishonest and erroneous opinion about an event which is to take place in the future, may ... in my opinion, form the basis of an action for fraudulent misrepresentation, but in such a case the cause of action will be the dishonesty of the person about the state of his own mind when he gave expression to the erroneous opinion, and not the mere fact that the opinion afterwards proved to be wrong.

Feinstein v Niggli[53] provides a useful illustration. The facts were as follows: Feinstein sold his restaurant, the Copper Kettle, to Niggli and Dunky.[54] During negotiations he made certain statements about the restaurant's profitability and said that the net income from the business would be sufficient to pay the instalments on the purchase price and would also cover their living expenses. The new purchasers took over the business in October 1975

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51 *Lamb v Walters* 1926 AD 358.
52 1956 (3) SA 273 (O).
53 1981 (2) SA 684 (A).
54 He sold his shares in and loan account against a company that owned the Copper Kettle.

but in February 1976 they repudiated the contract on the basis of fraudulent misrepresentations. By then the business was insolvent. The matter raised several issues relevant to franchising:

(1) were the statements about the future profitability of the business statements of opinion or were they misrepresentations?
(2) by continuing to operate the business after the purchasers became aware of the fact that Feinstein had not been honest with them, were the purchasers precluded from rescinding the contract?
(3) as the purchasers were unable to restore a properly functioning business to Feinstein, did this preclude them from rescinding the contract?

In dealing with the question of the statements of opinion that turned out to be incorrect, the court found that Feinstein had a "direct and intimate knowledge of its profitability" about which the purchasers knew nothing. The court found further, that in making these statements Feinstein intended to convey two representations of existing facts: (a) an implied representation that at its present level of turnover it was earning substantial profits and (b) an express representation that he believed that if that level of turnover was maintained its net income would be sufficient to cover the purchasers' outstanding debt and living expenses. The court examined the facts and found that there was no way that Feinstein could possibly have believed that what he was telling Niggli and Dunky was true. Trollip JA pointed out that when a person makes a statement of opinion or forecast about the future success of a business, he is making a representation about his present state of mind.[55] The representor must at the very least believe that what he is saying is correct.

- ***puffing***

Puffing is an allowable form of exaggeration that franchisors will make in order to sell their franchises. Franchisors will extol the virtues of their offerings and the law has always taken

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[55] See also *Van Heerden v Smith* 1956 (3) SA 273 (O).

a fairly robust approach to advertising and sales talk.[56] The following statements probably constitute "puffing" rather than actionable misrepresentations: "XYZ franchise is a proven leader in the South African fast food market", "For quality and value acquire a steak in ABC steak house, the original and still the best" or "the most exciting franchise available in South Africa". The hall-mark of a puff is that nobody is supposed to take it seriously. This does not mean, however, that franchisors are free to make completely irresponsible statements. If, for example, a franchisor tells potential franchisees that the franchise network is the "best in the world", the statement is not entirely meaningless. It signifies that a network exists and that it is sound. If it later turns out that there is no well-established network or that the franchisor does not provide any assistance to franchisees, liability for misrepresentation may arise.[57]

The problem is that it is not always easy to decide whether statements are puffs or misrepresentations.[58] Each case must be decided on its own merits.[59] The right to a remedy will depend on the court's perception of whether or not any advertisement or sales talk constituted a misrepresentation.[60] Franchisees who rely on statements made during the negotiation process have to accept that there is no remedy when the court decides that the statements were mere puffs.

The purpose of the Consumer Protection Bill[61] is to promote fair business practices

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56 See generally Woker *Advertising Law in South Africa* (1999).

57 For an example, see the CAFCOM investigation discussed above regarding Print Glass. See also *Post Newspapers (Pty) Ltd v World Publishing and Publishing Co Ltd* 1970 (1) SA 454 at 461G and *Elida Gibbs (Pty) Ltd v Colgate Palmolive (Pty) Ltd* 1988 (2) SA 350 (A) at 359.

58 O'Donovan *Mackeurtan's Law of Sale of Goods in South Africa* 5 ed (1984) 142-144.

59 In *Phame (Pty) Ltd v Paizes* 1973 (3) SA 397 (A) Holmes JA stated:

> Whether a statement by the seller goes beyond mere praise or commendation will depend on the circumstances of each case. Relevant considerations would include the following: whether the statement was made in answer to a question from the buyer; its materiality to the known purpose for which the buyer was interested in purchasing; whether the statement was one of fact or personal opinion; and whether it would be obvious even to the gullible that the seller was merely singing the praises of his wares; as sellers have ever been wont to do.

60 In *Milne NO v Harilal* 1925 CPD 84, a builder/seller was asked whether the house he had built was well built. He replied, "Yes in every detail". In fact the house had been constructed on unsuitable ground and its foundations had subsided. Gardiner J held that the statement was merely one as to degree of quality, and none but a credulous person asking such a question could expect anything but an affirmative reply. The judge in this instance failed to take into consideration that the builder had ignored established building regulations.

61 Also discussed in Chapter Eight.

and to protect consumers from unconscionable, unfair, unreasonable, unjust and otherwise improper trade practices and deceptive, misleading, unfair or fraudulent conduct.[62] It also purports to give effect to certain consumer rights. Included are the right to fair and responsible marketing[63] and the right to fair and honest dealing.[64] These sections are obviously designed to target problem areas such as advertising practices and the information that is provided to consumers in order to induce them to contract. Advertisers will have to be far more careful about the extent and nature of the claims that are made in their promotional material. It must be accepted that the introduction of the word "fair" gives the courts a far greater margin for interference in commercial relations. In the past the courts have always been reluctant to decide matters on the basis of fairness alone and have only interfered in matters when the conduct has been unconscionable. However, it is suggested that to a large extent the Bill simply codifies the common law and, if called upon to interpret it, the courts will continue to refer to decided cases. Franchisees will therefore continue to face the problem of proving that the statements went beyond acceptable puffing.

4.2.2.3 Which is material

A misrepresentation is usually regarded as material if it would have induced a reasonable person to enter into the contract. This means that the test for materiality is an objective test.[65] This approach is problematic when a franchisor exploits the gullibility or inexperience of its franchisees. In *Central Merchant Bank Ltd v Oranje Benefit Society*[66] Van Winsen J quoted from Williston on *Contracts* with approval:[67]

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62 Part B.
63 Part E.
64 Part F.
65 *Lourens v Genis* 1962 (1) SA 431 (T). This case was disapproved in *Otto v Heymans* 1971 (4) SA 148 (T) 158-160. See also *Orville Investments (Pty) Ltd v Sandfontein Motors* 2000 (2) SA 886 (T) at 915H-I.
66 1975 (4) SA 588 (C).
67 594G-H.

> The growing trend and tendency of the courts will continue to move toward the doctrine that negligence in trusting in a misrepresentation will not excuse positive wilful fraud or deprive the defrauded person of his remedy. Especially where there is a relation of natural trust and confidence, although not strictly a fiduciary relation, the failure of the defrauded party to exercise ordinary prudence or vigilance will not deprive him of this redress.
>
> And so it is where one party has peculiar or superior knowledge of the facts which enhance the reliability of his statements. Nor does the fact that the representation concerns a matter of public record exonerate the defrauder from liability. [68]

In the more recent case of *Orville Investments v Sandfontein Motors,* Lewis AJ said that the objective test did not apply in the case of fraudulent misrepresentation and that an innocent party is not precluded from suing even if a reasonable person would not have been misled by the misrepresentation. As this approach has not been confirmed by the Supreme Court of Appeal, it cannot be regarded as settled in our law. It is suggested that a better view would be to regard the issue of materiality from the point of view of whether a reasonable person would have regarded the fact to be important in deciding whether or not to enter into the contract. This approach would avoid the possible consequence of an inexperienced person being without a remedy against the other person who dishonestly induced him to enter into the contract. Whether or not it was reasonable for the franchisee to believe the misrepresentation would have evidentiary value in order to establish that the misrepresentation induced him to contract.

4.2.2.4 Made with the intention of inducing the contract

The franchisor must make the statement or withhold the information in order to induce the franchisees to contract. Simply providing incorrect information or telling a mere lie which is

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[68] See also *Novick v Comair Holdings Ltd* 1979 (2) SA 116 (W).

"foolishly acted upon by others" does not constitute an actionable misrepresentation.[69] The franchisor must have intended, from the circumstances in which the statement was made, that the statement should be acted upon.[70] The statement may be made fraudulently, negligently or innocently, but the franchisor provides that information in order to induce the franchisee to enter into the agreement.

4.2.2.5 Which did induce the contract

The misrepresentations must have induced the franchisees to contract.[71] If, by the time the franchisees enter into their agreements they are aware of the facts, they cannot complain that the statements are incorrect.[72] In *Seven Eleven Corporation of SA v Cancun Trading No 150 CC*[73] the franchisee alleged that the franchisor had made certain misrepresentations about discounts and rebates to which he (the franchisee) believed he were entitled. The court found, however, that the franchisee had not relied on this information when he concluded the agreement because he was fully aware that other franchisees were complaining about this issue. He had also received training from another franchisee who was "vociferous in his complaints" about the franchisor and yet he still went ahead and purchased the franchise.

4.2.3 Remedies

4.2.3.1 Rescission and restitution

When the elements discussed in 4.2.2 are established the contract is voidable and

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69 *Tait v Wicht* (1890) 7 SC 158 at 164. See also *Ex Parte Lebowa Development Corporation Ltd* 1989 (3) SA 71 (T) 103F-J and *Absa Bank Ltd v Fouche* 181D.

70 *Tait v Wicht* 164.

71 *Bird v Murphy* 1963 (2) PH A42 (D).

72 *Poole and McLennan v Norse* 1918 AD 404.

73 2005 (5) SA 186 SCA.

franchisees are entitled to the contractual remedies of rescission and restitution.[74] Franchisees may therefore elect to rescind their contracts or abide by them. Once the election is made aggrieved parties must abide by their decisions and are taken to have waived their rights to the other alternative.[75] If they elect to rescind, they must not do anything to lead franchisors reasonably to believe that they intend to abide by their contracts. Franchisees must, therefore, communicate the fact that they wish to rescind their contracts to their franchisors within a reasonable time.

In addition, aggrieved franchisees who wish to rescind their contracts and claim return of what they have performed, must themselves make restitution. This rule is founded on equitable principles and applies even in circumstances in which fraudulent misrepresentations have been made.[76] If this were not the case, aggrieved franchisees may be unjustifiably enriched or franchisors may be unjustifiably impoverished.[77]

It is easy to comply with this rule when aggrieved parties still have the goods in their possession. A problem arises when they cannot restore what they have received. They may lose their remedies. In *Rau v Venter's Executors,* the court said that merely to tender back a remnant of a thing voluntarily disposed of will not suffice.[78] Nevertheless, an inability to restore is not always fatal. If the thing has perished due to the defect,[79] or the thing has been disposed of in the manner contemplated and its proceeds were offered to the other

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74 The contracts are only voidable if franchisees establish that had they known the true facts they would not have contracted. See generally Christie *Contract* 286 and Kerr *Law of Contract* 285. Some commentators divide fraud into causal fraud and incidental fraud. If the fraud is causal, in that the innocent party would not have contracted at all, the contract is voidable. However, if the fraud is incidental in that the innocent party would have contracted but on different terms, the contract is not voidable but the innocent party may claim for any damages suffered. See De Vos "Skadevergoeding en terugtrede weens bedrog by kontraksluiting" 1964 *Acta Juridica* 26. This distinction is criticised by Kerr *The Law of Contract* 286 and by Seligson AJ in *Hunt v Van der Westhuizen* 1990 (3) SA 357 (C). In some circumstances, the misrepresentation may be so fundamental that there is no true consent at all and so the contract is *void ab initio*. These arguments will however, bring an aggrieved party into conflict with principles relating to the reliance theory of contract and more specifically, in most instances, the *caveat subscriptor* rule (see Chapter Three note 37).

75 Waiver is discussed in 4.2.4 below.

76 *Feinstein v Niggli* 700.

77 *Ibid.*

78 1918 AD 482 at 500.

79 *Marks Ltd v Laughton* 1920 AD 12.

party,[80] or the thing was partly destroyed when attempting to establish its quality,[81] or the thing has become lost and valueless because it was used in the manner contemplated by the parties,[82] the courts have allowed the aggrieved parties to claim rescission and restitution, notwithstanding their inability to restore.[83]

Nevertheless, the general rule is that a party seeking rescission must tender restitution and in all the cases where the exception was allowed, failure to restore was not due to the fault of the aggrieved party. Niggli and Dunky faced this problem in *Feinstein v Niggli* because the business was insolvent when the contract was cancelled. The shares and loan account which they had received were worthless. Feinstein also argued that the depreciation in value was due to the way in which they conducted the business.[84] Fortunately Niggli and Dunky were able to show that they had worked very hard to make the business work. They had changed the menu, increased the working hours, increased the number of tables, cut staff numbers, endeavoured to eliminate wastage and pilferage, advertised in the local newspaper, put more money into the business, made repairs and done renovations and devoted all their time to the business. A regular customer testified that the food and service had remained equally good, the prices were the same and the atmosphere had improved through Niggli's personal touch. An unsolicited article from *The Argus* praised the restaurant's food, service and atmosphere and a building inspector for the landlord was very impressed with the cleanliness of the premises after the new owners had taken over. On the other hand, Feinstein led no evidence to show any mismanagement. The court found that the depreciation in value of the loan account and

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80 *Rau v Venter's Executors* 1918 AD 482.

81 *Theron v Africa* (1893) 10 SC 246.

82 *Atlas Organic Fertilizers & Associates v Seiling* 1949 (2) SA 131 (W).

83 See, for example, *Harper v Webster* 1956 (2) SA 495 (FC) and *Extel Industrial (Pty) Ltd and Another v Crown Mills (Pty) Ltd* 1999 (2) SA 719 (SCA) in which Nienaber JA pointed out that this requirement might place an impossible burden on a person with a legitimate grievance (at 732F-G).

84 The argument relied on *Van Heerden v Sentrale Kunsmis Korporasie (Edms) Bpk* 1973 (1) SA 17 (A) where the facts had been very similar. An aggrieved party sought to return the shares and loan account of a company in circumstances where the value of the company's assets had deteriorated considerably since the date of the sale. In *Van Heerden* the seller argued that the purchaser was not entitled to rescind the contract because the purchaser could not restore what had been received and the deterioration was due to the purchaser's fault and negligence. The purchaser sought to have this argument dismissed, but the court refused on the basis that the purchaser had to restore what had been received or provide an explanation as to why this could not be done.

shares occurred in the ordinary course of business and was due to the inherent weakness of the business not being sufficiently profitable, and was not due to any fault on the part of Niggli and Dunky.[85] The court concluded, therefore, that they did not have to compensate Feinstein for any depreciation in the value of the assets of the business.

These decisions demonstrate that a franchisee who is left with a failed business which he believes has failed because of inherent weaknesses in the business, or because the franchisor has not been entirely honest with him, could be faced with extensive litigation in which he has to show that the failure of the business was not due to his fault.

4.2.3.2 *Damages*

Damages are awarded in terms of the law of delict when misrepresentations induce aggrieved parties to contract and the misstatements are not incorporated into the contracts as terms.[86] Delictual damages are damages which aim to place aggrieved parties in the economic position they would have been in had the misrepresentations not been made. The delictual measure of damages is sometimes called "out of pocket loss". In other words, aggrieved parties are entitled to be compensated for any financial loss which representors caused them. The actual amount is therefore dependent on the facts of each case.

Sometimes, even though the misrepresentations induced the contracts and the representees are entitled to rescission, they elect to abide by their contracts. In such circumstances, representees may recover an amount of damages representing the difference between the value of what they gave and the value of what they received under the contracts. In addition, they may claim the amount of any additional loss which they suffered as a consequence of the misrepresentation.[87] The court, in *Hulett v Hulett*,[88] held that aggrieved parties were entitled to "recover all the losses which they ... sustained as a

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85 *Feinstein v Niggli* 702H-703A.

86 Where representations are incorporated into the contracts as terms or warranties, the contracts take precedence and contractual remedies will apply (*Trustees, Two Oceans Aquarium Trust v Kantey & Templer (Pty) Ltd* 2006 (3) SA 138 (SCA) and *Thatcher v Katz* 2006 (6) SA 407 (C)).

87 *Trotman v Edwick and Another* 1951 (1) SA 443 (A).

88 1992 (4) SA 291 (A).

direct consequence of having been induced by fraud to enter into the contract ... What must be restored to them is the amount by which their patrimonies have been diminished".[89] The appellants were therefore entitled to the difference between the price that they had received for the shares which they had been induced to sell to the representor who had withheld crucial information from them, and the shares true market value at the date of the sale. Market value, the court said, is the price commanded in a fair market – the price determined as between a seller willing but not compelled to sell and a buyer willing but not compelled to buy.[90]

When the misrepresentations are not material but rather incidental, aggrieved parties are entitled to an amount of damages equal to the difference between the value of what they gave under the contract and the value of what they would have given had the representation not been made, plus the amount of any additional loss sustained as a result of the misrepresentation. This requires that the courts try to arrive at the price one party would have offered and the price the other party would have accepted had no misrepresentation been made.

When a statement is made honestly and a reasonable person would not have realised that the statement was false, the misrepresentation is an innocent one. This does not amount to a delict as there is no fault (in the form of intention or negligence) and so aggrieved parties are not entitled to claim delictual damages.

It is, in general, possible to contract out of liability for negligent and innocent misrepresentation. It is quite common for "standard form" contracts to contain a clause excluding a party from liability for misrepresentation. Such a clause appeared in the franchise contract in *Seven Eleven Corporation v Cancun Trading NO 150 CC*. This meant that the franchisee, to succeed in a claim based on misrepresentation, had to prove fraud.[91] The clause cannot cover fraud because of the general principle of law that nobody can

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89 311F.

90 *Ibid.*

91 The franchisee may be able to show that the clause could not be relied upon because the misrepresentation prevented the parties from reaching consensus on a material part of the contract. In such circumstances the entire agreement would be void. See *Allen v Sixteen Stirling Investments (Pty) Ltd* 1974 (4) SA 164 (D).

contract out of liability for his own intentional wrongdoing.[92] Proving fraud is a heavy onus for franchisees to discharge, as is demonstrated in the *Seven Eleven Corporation* case. The franchisees alleged that the franchisor had fraudulently failed to disclose certain rebates and early settlement discounts that the franchisor received from suppliers which were not passed on to franchisees. The court found that there was no proof that the franchisor had told the franchisees that all discounts obtained by the franchisor would be passed on to the franchisees, neither was there proof that the franchisor had acted deliberately in order to deceive, nor was there a duty on the franchisor to disclose all the information about the rebates. Rather, the court ruled, the franchisor believed that a distinction could be drawn between the various rebates that the franchisor received from suppliers and that only some of these had to be passed on to franchisees. The court concluded, therefore, that there had been no fraudulent misrepresentation.

The general principles of the law relating to damages appear to be relatively straightforward,[93] but the practical issues involved are usually far from simple and an in-depth examination of the conduct of both parties is required. A further complication arises when franchisees allege that the franchisors have made misrepresentations and they are also in breach of contract because undertakings made in the contract have failed to materialise. The issue here is whether the claim is one for delictual damages or contractual damages or both. The law regarding whether to claim for contractual or delictual damages has developed in a rather haphazard fashion, and plaintiffs have not been required to show whether they are claiming on the basis of the law of contract or the law of delict.[94] A claim for damages for misrepresentation and a claim for breach of contract may be combined in the same action.[95]

This issue seems to have been settled in the recent decision of *Trustees, Two Oceans Aquarium Trust v Kantey & Templer*. However, it is suggested that this decision

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92 Christie *Contract* 293; *Wells v SA Alumenite Co* 1927 AD 69; *Reeves v Marfield Insurance Brokers CC* 1996 (3) SA 766 (A) 775C-H and *Seven Eleven Corporation of SA v Cancun Trading*.

93 For a full discussion see Kerr *Law of Contract* 737-831and Christie *Contract* 295-300.

94 Christie *Contract* 559.

95 *Pocket Holdings (Pvt) Ltd v Lobel's Holdings (Pvt) Ltd* 1966 (4) SA 238 (R). See also Christie *Contract* 559.

has placed a virtually impossible burden on ordinary contractants whose level of understanding of the law does not match those of experienced lawyers. This case dealt with misrepresentations made in the pre-contractual stage with the intention that the relationship would be governed by a contract. If the contract had not come into being there would have been no relationship between the parties and so neither party would have been in a position to suffer any losses. The court held that where a contract is entered into, the parties should protect themselves against the risk of harm due to the other party's negligent conduct by inserting the appropriate contractual stipulations into the contract. In other words, if one party makes representations prior to the contract being concluded, the other party must ensure that these are included into the contract as terms. This will enable the aggrieved party to sue for breach of contract in the event that the representations are false.[96] This decision can be compared to *Thatcher v Katz*.[97] In this case the misrepresentations were incorporated into the contract as warranties. The aggrieved party was, therefore, entitled to a contractual remedy and the court held that there was no need to afford him a remedy in delict.

The Supreme Court of Appeal has substantially limited the right of an aggrieved party to sue in terms of the law of delict when the relationship between the parties is governed by a contract. The court, in *Two Oceans Aquarium Trust*, referred to *Lillicrap, Wassenaar and Partners v Pilkington Brothers (Pty) Ltd,*[98] in which Grosskopf AJA maintained that as the contract will lay down their reciprocal rights and obligations, the parties will define the nature and quality of the performance that is required from each party.[99] The aggrieved parties argued unsuccessfully that the "insertion of appropriate contractual provisions would require a great deal of wisdom before the event".[100] The court rejected this argument because the aggrieved party was represented by "able trustees" and "professional project

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96 Such an approach was alluded to in *Hamman v Moolman* 1968 (4) SA 340 (A). For a long time damages for negligent misrepresentation causing pure economic loss was a controversial subject but such damages were finally recognised by the Appellate Division in *Bayer South Africa (Pty) Ltd v Frost.*

97 2006 (6) SA 407 (C).

98 1985(1) SA 475 (A).

99 Quoted by Brand JA in *Trustees, Two Oceans Aquarium Trust v Kantey & Templer* 149H.

100 149B.

managers".[101]

Franchise disputes may be distinguishable when franchisees are not experienced and do not have the assistance of professional advice and when standard form franchise contracts drafted by franchisors are used. Nevertheless, there are substantial hurdles for franchisees to overcome if they are to be successful in their claim for damages and lengthy and expensive litigation will have to be undertaken.

4.2.4 Waiver of rights

Those who wish to set contracts aside and claim restitution must act within a reasonable time otherwise they may be taken to have waived their rights.[102] They will then have to abide by their agreements and their only remedy will be one for damages.[103] But they may even lose their rights to damages if they fail to act timeously.[104] The reasonableness of the time taken to make a decision is judged by whether representors are entitled to assume that the contracts will continue or whether there are any third parties involved who may be prejudiced should the contracts be rescinded. Problems arise when third parties acquire rights before problems have been discovered. Aggrieved parties will then have to abide by their contracts.[105] Once aggrieved parties decide to rescind their contracts they must abide by their decisions and cannot "approbate and reprobate".[106]

In *Laws v Rutherfurd*[107] Innes CJ explained that the onus is on representors to prove that the aggrieved parties have waived their rights to rescission and that they with full

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101 149C.

102 *British Diesels Ltd v Jeram and Sons* 1958 (3) SA 605 (N) at 608F. However, it must be stressed that there is no principle in law (apart from prescription) that states that a right may be lost through mere delay to enforce it (per Hefer JA in *Mahabeer v Sharma* NO 1985 (3) SA 729 (A) at 736D). A failure to act timeously may justify an inference that the right was waived or there may be some other defence. The lapse of an unreasonably long time forms part of the material which is taken into account in order to decide whether the party entitled to cancel should or should not be permitted to exercise his right. But *per se* it cannot bring about the loss of the right. See also *Alfred McAlpine & Son (Pty) Ltd v Transvaal Provincial Administration* 1977 (4) SA 310 (T) at 325F-G.

103 *Bowditch v Peel and Magill* 1921 AD 561 at 572; *Frost v Leslie* 1923 AD 276 at 279.

104 *Frost v Leslie* 279.

105 *Toffee v Prudential Building Society* 1944 WLD 186.

106 *Bekazaku Properties (Pty) Ltd v Pam Golding Properties* 1996 (2) SA 537 (C).

107 1924 AD 261.

knowledge of their rights, decided to abandon them whether expressly or by conduct that is plainly inconsistent with an intention to enforce them.[108] He stated further that there must be an "unequivocal" intention to waive, that it is necessary to consider the facts in order to establish this and that whilst the onus is only on the balance of probabilities, the quality of the evidence must be high to establish such a waiver.[109] In *Thomas v Henry*,[110] the seller of a business argued that the purchaser had waived his right to cancel the sale and restore the business to the seller on the grounds of misrepresentation because he had continued to operate the business after he had tendered to restore it. He was still operating the business at the time of the hearing. The purchaser explained that had he simply closed the business, the goodwill would have been lost forever and that in terms of his lease agreement the business had to remain open. He argued that there would have been substantial damage and prejudice if he had lost the lease and he would not have been able to restore the business to the seller in the same condition that he received it. The purchaser explained also that he was continuing to operate the business for the benefit of the seller. Fleming J, in the Witwatersrand Local Division, rejected this argument on the basis that he did not have a legal duty to continue trading, and held that the purchaser's conduct was irreconcilable with an intention to cancel the sale. The court found that he owed the outstanding balance on the purchase price. This decision was overturned on appeal when Van Heerden JA held that it could not be said that the purchaser's conduct, viewed in the light of his explanation, was such as to justify a rejection of his allegation that he did not intend to confirm the sale or that his explanations were unreasonable or unworthy of belief. The Appellate Division found that it was clear that if the purchaser had simply closed the business, the goodwill, which represented a substantial part of the purchase price, would have been lost.[111] The purchaser would also have run the serious risk of the lease being cancelled which would have made it very difficult (or impossible) for the seller to re- open the business. The court concluded that the purchaser was operating the

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108 263. See also *Hepner v Roodepoort-Maraisburg Town Council* 1962 (4) SA 772 (A); *Borstlap v Spangenberg* 1974 (3) SA 695 at 704 and *Feinstein v Niggli*.

109 722G.

110 1985 (3) SA 889 (A).

111 898I-J.

business for the seller.[112]

The issue of waiver also arose in *Feinstein v Niggli*. Feinstein's first defence was that Niggli and Dunky, "with full knowledge of the relevant facts" relating to the fraudulent misrepresentation, elected to abide by the contract. In support of this argument, he relied on the fact that they had made a part payment of the first instalment and that they had instructed an agent to sell the business for them. The court reiterated the principle that the onus rests on the representor to show that the other party had full knowledge of the rights when he allegedly abandoned them. A party can only be said to have waived a right if he had full knowledge of the existence of such a right in the first place. So, he must have full knowledge of the material facts that constitute the misrepresentation and partial information of certain discrepancies between what has been said and what is in fact the case that leads to a suspicion will not suffice.[113] Niggli said that at the beginning of November 1975 it became obvious to them that the business was not making the profits that Feinstein forecast and that they were beginning to have their suspicions. But, she said, they trusted him and relied on his assurances and hoped that a busy November and December would lead to higher profits. When they still did not make the profits they hoped for, they thought it might be because of the change of management or because they were doing something wrong. It was only in February 1976, when she requested the effective balance sheet of September 1975, that she became aware of the true state of affairs. Niggli and Dunky immediately repudiated the contract. The court held that merely because they may have entertained some suspicions about the reliability of Feinstein's assertions, this was insufficient to discharge the onus resting on Feinstein of proving that they had the "requisite full or complete knowledge of all the relevant, material facts relating to his fraud".[114]

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112 898H-899C. In this particular matter the purchaser was clearly in a quandary. He had tendered to return the business and his tender had been rejected. If he had then simply closed the business he would have been faced with the argument that, as he could not return the business in the same condition as he had received it, he was not entitled to restitution. Now he was faced with the argument that as he continued to operate the business he had waived his right to rescission. What saved him was the fact that at the outset he had clearly stated in a letter to the seller that he wanted to cancel the contract and had tendered to return the business. The Appellate Division found that his conduct, in continuing to run the business, was reasonable in the circumstances.

113 699A.

114 700D.

The issue of waiver is particularly problematic for franchisees because franchisees make a considerable financial and emotional commitment when buying their franchises. They see this as a way of obtaining their own businesses and there is usually a lot of enthusiasm at the time that the agreements are concluded. Because of this it is often difficult for franchisees to admit that they have made a mistake. In one interview with the CAFCOM, a disenchanted franchisee reported as follows:[115]

> The franchisor identifies an individual with enough funds, makes a whole lot of promises which they say are based on the years of experience and tell them that they can 'print money'... In the negotiations ... [the franchisor] is exceptionally flexible when it comes to verbal promises... [The franchisor] did not tell me of the vast rate of failed franchisees in our negotiations or afterwards. I only found this out during the latter part of last year when I began my investigations into [the franchisor's] harmful business practice. Had they told me the truth, I would not have entered into a franchise agreement with them... The contracts were written in such a way that one is enthusiastic and unworried about the franchise agreement believing in the bona fides of [the franchisor] and usually businessmen in this stage are busy equipping the factory, employing staff, buying raw materials and training. It will take 6 months to set up the franchise. . . The franchisee realises after six to nine months that the figures given to him are not correct or don't allow him to make money ... After 9 to 12 months the franchisee is working out that he is losing money and cannot pay his bill. [The franchisor] will say: we'll keep you, you just raise more money and we give you special terms and then we are keeping up on all the promises we made to you. The franchisee is so deeply indebted by this time, that he may as well work for [the franchisor] because he financed the business and put all the money in, but he does not really have a say anymore. He either supports it with other businesses he has and then after 5 years walk away from this, or as I could establish over the last couple of years, usually the franchises will be liquidated and individuals will lose

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115 This has been taken from a document submitted by the franchisee requesting an investigation into a "harmful business practice".

everything they have. In one particular case one person even committed suicide.

In the interview with the video store franchisee, the franchisee explained how, when she had approached the franchisor for assistance because she was struggling to maintain financial viability with the first outlet, the franchisor suggested that she purchase another outlet. Then her costs could be divided between the two outlets. She explained that because she was so anxious to succeed she "stupidly followed this advice". This decision led her ultimately to financial ruin.[116]

It may well be that franchisees continue to operate their failing businesses until the point is reached where they are said to have waived their rights. In *Thomas v Henry* and *Feinstein v Niggli*, the aggrieved parties acted relatively quickly to cancel the agreements. In *Thomas,* the purchaser's attorneys wrote a letter cancelling the agreement ten days after the purchaser had taken possession of the business and in *Feinstein* the agreement was cancelled four months later. The fact that franchisors will have to show that franchisees continued operating after they were aware of all the facts will obviously assist franchisees to deal with the argument that they had waived their rights. However, the nature of a franchise network is very different to a once-off sale of a business. In a franchise relationship the parties continue to work together and their relationship is on-going. Inexperienced franchisees may be reluctant to confront their franchisors and will continue to work within the network until it is too late to raise the issue of misrepresentations inducing their agreements or breach of contract.

4.2.5 Concluding remarks

Non-disclosure of material information or actual misrepresentation is a common complaint amongst franchisees whose businesses have failed. The usual response from franchisors is that the franchisees have unfortunately proved to be poor entrepreneurs and this is the reason why the businesses failed. Deciding who is at fault involves the consideration of

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116 Interview (October 2007).

complicated factual and legal issues. The American franchise dispute involving Minuteman Press International Inc is an example of the kind of litigation franchisees may have to embark upon.[117] This matter concerned the sale of print shop franchises and sign making franchises. The franchisor made false claims about the earnings franchisees could expect to make and also failed to disclose that significant training and transfer fees were imposed on franchisees who decided to sell their franchises. The court awarded the franchisees $3,47m but this was after two years of discovery proceedings and a trial lasting six months. There were 70 witnesses which included 40 franchisees and a number of undercover investigators. Fortunately for the franchisees, earnings claims in America are governed by the FTC Franchise Rule which prohibits franchisors from making earnings claims unless they can be substantiated. The Franchise Rule is enforced by the FTC and not private individuals. The advantage of this is that the Federal Government can take action against errant franchisors in circumstances where it is highly unlikely that franchisees, even if involved in group action, will have the resources to fight the matter themselves.

Undertaking litigation in South Africa is beyond the financial means of most franchisees.[118] Franchisee problems are further compounded when they have other commitments such as loans from financial institutions, rental agreements, outstanding stock accounts and employee contracts which they cannot simply abandon. In addition, if their contracts are for a fixed period of time, franchisors may hold them liable for the outstanding period of their agreements.[119]

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117 *FTC v Minuteman Press* US District Court, Eastern District of New York http://www.ftc.gov/os/1998/10/minuteman (accessed 18 September 2006). Also discussed by Grant and Germann "Franchising Update 2003" (2003) Auckland District Law Society, Auckland.

118 Franchisees have at times reported to the CAFCOM that franchisors are well aware that their franchisees are unable to engage in litigation and so they can get away with anything. One franchisee reported that when he had asked a representative from the franchisor why he was behaving so unreasonably he replied that he was "God and there was nothing [the franchisee] could do".

119 Lazarus reported to the US-Southern Africa Franchising Forum Johannesburg (May 2007) that the Industrial Development Corporation (IDC) regarded franchising as a good vehicle to grow the SME sector of the South African economy and that the potential for black economic empowerment means that the IDC is prepared to get involved with providing finance to franchisees. The finance is provided in two ways: the IDC either forms a partnership with franchisors who take loans to enable franchisees to purchase their franchises or loans are made directly to franchisees. These loans are for R1 million or more. The franchisees are required to provide security for these loans and one form of security is a personal suretyship agreement. Another alternative is for franchisees to obtain loans from financial institutions to purchase their franchises and also for general running costs. A number of

Misrepresentation and non-disclosure is a general franchise problem which features regularly in research and litigation in other jurisdictions. These jurisdictions have attempted to solve by problem by taking steps to avoid the problems arising in the first place. It is useful therefore to consider how other jurisdictions have dealt with the problem before proposing solutions for the South African franchise sector.

4.3 Comparative Study

4.3.1 America

Research in America in the 1970s demonstrated that there was widespread deception in the sale of franchises and many franchisees were misinformed about franchise offerings. There was also a significant amount of fraud in the sector because offerings were advertised as franchise opportunities which either did not exist or were very poorly structured. This led to the introduction of pre-sale disclosure requirements in many states and in some instances franchisors are required to register their offerings with a state body before they can offer them to the general public.

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financial institutions such as Absa and Standard Bank have specialised divisions for franchise financing. This means that even if franchisees cancel their franchise contracts, they will still be obligated to repay their loans. Reclaiming their franchise fee is seldom an option because the contract will have continued for a period of time during which time the franchisee will have been operating the business, purchasing goods from the franchisor, selling them on to consumers, paying employees and rent and possibly drawing some form of income. Deciding how to resolve the issue of who owes what to whom is extremely difficult. Franchisees, invariably, want every debt settled by the franchisor and they expect their franchise fees to be returned. On the other hand, franchisors will usually be able to show that they are owed substantial fees for outstanding goods and services supplied. See, for example, *Juglal N0 v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* 2004 (5) SA 248 (SCA). In this case, the franchisee owed a substantial liquidated debt to the franchisor for which he was being sued. He attempted to raise the fact that he believed that the franchisor owed him damages because of certain breaches of contract. The court, however, refused to entertain these counter claims because the amounts were unliquidated. Franchisees in this position would have to embark on lengthy and difficult litigation to prove their damages.

4.3.1.1 Disclosure requirements

California was the first American state to introduce legislation.[120] The California Franchise Investment Law[121] focused on disclosing what investors should know before committing themselves to franchise relationships so they could make informed decisions.[122] The law requires that franchisors reveal a list of 22 items to each prospective franchisee. Information includes the franchisor's financial background, its litigation history, what is expected of the franchisee and what products the franchisee is expected to purchase. California's example was followed by fourteen other states.[123] These laws are commonly referred to as franchise disclosure laws.

In order to promote uniform franchise regulation, the North American Securities Administrators Association (NASAA)[124] developed and encouraged the adoption, amongst those states that had franchise legislation, of the Uniform Franchise Offering Circular Guidelines. These guidelines were adopted between 1993 and 1995 by all the state franchise regulatory authorities as the recommended format for franchise disclosure documents at state level. The disclosure document is known as the Uniform Franchise

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120 Bennet "Franchise Regulation: Past Present and Future".

121 California Corporations Code Div 5 Parts 1-6 Sections 31000 et seq.

122 Bennet "Franchise Regulation: Past Present and Future".

123 These are Hawaii (Hawaii Franchise Investment Law, Hawaii Rev Stat Title 26 Ch 482E, Sections 482-E1 et seq) Illinois (Illinois Franchise Disclosure Act, Illinois Laws, Ch 85-551, as amended by Laws of 1988, Public Act 85-1361) Indiana (Indiana Code, Title 23 Ch 2.5 Sections 1 et seq) Maryland (Ann.Code of Maryland, Article 56, Sections 345 et seq) Michigan (Michigan Franchise Investment Law Michigan Compiled Laws, Ch 445, Sections 445.1501 et seq) Minnesota (Minnesota Statutes, Ch 80C.01 et seq) New York (New York General Business Law, Art 33 Section 860 et seq) North Dakota (North Dakota Franchise Investment Law, North Dakota Century Code Ann Title 51 Ch 51-19 Sections 51-19-01 et seq) Rhode Island (Rhode Island Franchise and Distributorship Investment Regulation Act, General Laws of Rhode Island Title 19 Ch 28 Sections 19-28-1 et seq) South Dakota (South Dakota Franchises for Brand-Name Goods and Services Law, South Dakota Codified Laws, Title 37 Ch 37-5A Sections 37-5A-1 et seq) Texas (Texas Business Opportunity Act, Rev Civ Stats of Texas Title 79 Ch 16 Arts 1601 et seq) Virginia (Virginia Retail Franchising Act, Virginia Code Title 13.1 Ch 8 Sections 13.1-557 et seq) Washington (Washington Franchise Protection Act, Revised Code of Washington, Title 19 Ch 19 100 Sections 19.100.010 et seq) and Wisconsin (Wisconsin Franchise Investment Law, Wisconsin Stats, Ch 553, Section 553.01 et seq).These references have been obtained from Kaufman "An Introduction to Franchising and Franchise Law" in *Franchising - Business and Legal Issues* notes 11-25.

124 This is an organisation of 50 state securities agencies that are responsible for investor protection and the efficient functioning of capital markets at consumer level. Many of the agencies that administer and enforce state franchise rules are members of NASAA.

Offering Circular (UFOC).

In October 1979 the FTC issued its Franchise Rule[125] which requires franchisors to make full pre-sale disclosure to prospective franchisees in a prospectus. The Franchise Rule has the full force and effect of federal law. The main purpose of the Rule is to ensure that franchisees are able to make informed decisions before purchasing franchises.[126] The format of the prospectus is set out in the FTC's Compliance Guide and it must be provided to prospective purchasers at least 10 business days before they pay any money or make any legal commitments. The Franchise Rule requires franchisors to make detailed material disclosures in the following categories:

- the nature of the franchisor and the franchise system;
- the franchisor's financial viability including a fully audited financial statement of the franchisor and its litigation history;
- the cost involved in purchasing and maintaining a franchise outlet;
- the terms and conditions that govern the franchise relationship, that is, the responsibilities the franchisor and franchisee will have to each other including termination and renewal rights; and
- the names and addresses of current franchisees who can share their experiences within the network.

Franchisors that make earnings claims must have a reasonable basis for such claims and they must be able to substantiate them. They must also disclose the basis and assumptions that underlie such claims.

The Franchise Rule disclosure requirements are similar to those required by the states that require the UFOC and the FTC will accept a UFOC as an alternative to the FTC franchise disclosure document.[127] However, the FTC disclosure document is not acceptable

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125 See generally Beales "Prepared statement on the Franchise Rule" and FTC *Federal Register* 30 March 2007.

126 Garlick "The Franchise Relationship: Counseling Potential Franchisors and Franchisees" in *Franchise Law and Practice* (1996) chapter 3.

127 Per Beales "Prepared statement on The Franchise Rule" footnote 8.

in all the states and franchisors that have completed the FTC document may find that they have the additional expense of completing a UFOC disclosure statement if they want to franchise in one of the states that has its own disclosure requirements.[128] The Franchise Rule preserves the rights of states to adopt their own rules regarding franchising provided that these provide protections that are equal to or greater than those provided in the Rule.

The Rule relates purely to pre-sale disclosure and does not regulate the substance of the terms of the contract that governs the relationship between the franchisor and franchisee. The FTC believes that once franchisees have sufficient information in order to make an informed decision "the market is the best regulator of franchise sales".[129]

In the early days of franchising, many franchisors were of the view that legislation was unnecessary to protect franchisees and they were opposed to the disclosure process. However, the legitimate franchise community in America has come to accept that the pre-sales disclosure process is necessary.[130] The Franchise Rule was amended in March 2007 following an extensive review process.[131] The aim of the review was to establish whether there was a continuing need for the Rule, and if so how it could be improved in the light of changes in the sector since the Rule was first introduced. The FTC concluded that pre-sale disclosure continues to be an important means of preventing fraud. The pre-sale disclosure requirements have been retained in the amended Franchise Rule.[132]

Requiring disclosure has meant that the position in America has improved substantially since the 1970s. In 2002, Beales reported that the FTC was receiving very few complaints about franchising. An analysis of the 4,512 complaints received from consumers between 1993 and 2001 established that only 6% of the cases related to traditional franchise arrangements.[133]

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128 Garlick *Franchise Law and Practice* §3.28.

129 Beales "Prepared Statement on The Franchise Rule".

130 See IFA *Code of Ethics* available at http://www.franchise.org/welcome about/code.asp.

131 The Rule amendment proceedings began with a regulatory review of the Franchise Rule in 1995. The FTC received numerous comments and held public workshops. See generally FTC *Federal Register* 30 March 2007 15445.

132 *Federal Register* 30 March 2007 15445.

133 The rest of the complaints related to business opportunities. The FTC has now separated business opportunities from franchises and has developed a separate rule to deal with business opportunities.

4.3.1.2 Registration requirements

When California introduced its disclosure laws, it also made it unlawful for persons to sell franchises unless their franchise networks are registered or have been exempted from registration.[134] The application for registration must be accompanied by a proposed "offering prospectus" that contains all the information that franchisors are required to reveal to franchisees. Those states that followed California's example also provide (except for Oregon) for some form of registration or filing with state authorities before franchisors can engage in franchise sales activity. In these states, franchise disclosure documents are reviewed by state personnel called franchise examiners who are trained to identify fraudulent or unlawful franchise offerings. The FTC does not require registration of disclosure documents nor are they scrutinised or approved by the FTC. In other words, the FTC does not police the accuracy of these documents and it is up to potential franchisees to review them for inaccuracies or illegalities.[135]

4.3.2 Australia

4.3.2.1 Disclosure requirements

Franchising is an important part of the Australian economy. In 2000 it was estimated that the annual turnover in the franchising sector in Australia was $81 billion.[136]

Despite having a voluntary code of conduct for franchising from 1993-1997, Australia found that there were many problems in the franchise sector, the most common dispute

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134 Corporations Code sections 31100-31109.1 make provision for exemption from registration. A franchise may be exempted if the franchisor complies with certain requirements in terms of minimum net worth (for example the franchisor has a net worth of not less than $5 million), experience (for example the franchisor has at least 25 franchisees conducting business throughout the five year period immediately preceding the offer and sale of the franchise), and disclosure and notice filing requirements. The franchisor must file a notice of exemption with the Commissioner of Corporations and pay the required fee.

135 Garlick *Franchise Law and Practice* §3.2.

136 Franchise Policy Council "Review of the Franchising Code of Conduct" (May 2000) Office of Small Business Australia (Franchise Policy Council Report).

relating to allegations of misleading and deceptive conduct.[137] In 1997, the Office of Small Business concluded that many of the problems experienced in franchising could be traced back to insufficient information flows between franchisors and franchisees, and especially to inadequate up-front disclosure.[138] The Reid Committee, a House of Representative Standing Committee on Industry, Science and Technology, was requested to investigate the problems experienced by small business entrepreneurs and to focus particularly on franchisees because this was an areas in which repeated calls for action against unfair conduct had been made.[139] This Committee reported that franchisees were often disadvantaged in their deals with big business.[140] The focus was on the imbalance of power in the franchising relationship. The franchise relationship was classified as an unequal relationship, and it was recognised that franchisors have considerable market power, particularly when it comes to individual franchisees.[141] The result was amendments to the Trade Practices Act. In particular, a section was introduced which allowed industry-designed codes of practices to be legally underpinned and mandatory under the Trade Practices Act and enforced as breaches of the Act. In 1998, the mandatory Franchising Code of Conduct (Code) was introduced as a Regulation made under the Trade Practices Act. The Code is administered by the Australian Competition and Consumer Commission (ACCC) and a Franchise Policy Council has also been established that is responsible for reviewing the Code and advising government.

A key feature of this Code is the requirement that franchisors must disclose 23 categories of information to prospective franchisees including: information regarding franchisor business experience, litigation history, fees, royalties, promotional expenses,

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137 See generally Franchising Policy Council Report.

138 *Ibid.*

139 Reith "New Deal: Fair Deal - Giving Small Business a Fair Go" Statement by the Minister for Workplace Relations and Small Business, the Hon Peter Reith MP 30 September 1997 available at http://www.nml.csiro.au/assets/documents/itrinternet/OSB_fairtrading_sept_1997.pdf (accessed on 4 April 2007).

140 Australian Standing Committee on Industry, Science and Resources "Finding a Balance: Towards Fair Trading in Australia" (Fair Trade Report) http://www.aph.gov.au/house/committee/isr/fairtrad/report/contents.ht. (accessed on 4 April 2007).

141 Fair Trade Report Chapter 3. See also Department of Workplace Relations and Small Business "Giving Small Business a Fair Go" http://www.nml.csiro.au/assets/documents/itrinternet/OSB_fairtrading_sept_1997.pdf (accessed on 4 April 2007).

renewal and extension conditions and training of franchisees. Franchisors are required to ensure that their information is kept up to date. The Code was amended in 2001 following recommendations contained in the Franchising Policy Council Report. Small networks, that is, those whose businesses have an expected annual turnover of AU$50 000 or less, can supply a short form disclosure document.[142] This short form disclosure document only requires that information be provided in 11 categories. However, any franchisee is entitled to request information on the remaining categories and so it is questionable whether this short form disclosure document is of any real practical use. Franchisors must keep all information (as required by the longer form disclosure document) up-to-date and available in case franchisees request it. The amendments have also made it mandatory for franchisors to provide franchisees with current information "that is material to the running of the franchised business". Franchisors must, therefore, go beyond the information that is stipulated and provide any further information that may be regarded as material.

Following the introduction of mandatory requirements, a study revealed that a large number of franchisors were obliged to alter their disclosure practices.[143] In 2002 the ACCC reported to the Franchising Policy Council that the level of disclosure had increased substantially. Most franchisors offer the disclosure documents to prospective franchisees 14 days prior to entering the agreements.[144] Failure to comply with the disclosure requirements of the Code may lead to cancellation of the agreement and to franchisees receiving a refund of any money paid out.

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142 There had been numerous complaints that the long form disclosure document led to increased costs which were not justified when the network involved small businesses.

143 The study "The 1999 National Survey of Perceptions of the Franchising Code of Conduct", reported that 66% of franchisors investigated reported that they had changed their disclosure requirements. The study was conducted by Lawler Davidson Consultants Pty Ltd for the Office of Small Business, Canberra and is available at http://www.industry.gov.au. It is also quoted in the Franchise Policy Council Report 35.

144 Franchise Policy Council Report 35.

4.3.2.2 Registration

The Fair Trade Report recommended that Australia require that franchisors be registered,[145] but Australia has not adopted a registration process. In 2006 the Motor Traders Association of Australia (MTAA) recommended to the Franchising Policy Council that franchisors be required to lodge a copy of their current disclosure document with the ACCC on an annual basis. The MTAA is of the view that this would ensure that franchisors are, at the very least, encouraged to maintain up-to-date disclosure documents.[146] There appears to be a concern that franchisors are not keeping information up-to-date. Requiring franchisors to submit annual documents would be an incentive to franchisors to regularly review their documents. There is no suggestion however, that the ACCC should scrutinise these documents.

4.2.3 Other jurisdictions

Malaysia is reputed to have one of the most comprehensive disclosure and registration laws in existence.[147] The Malaysia Franchise Act 1998 requires that all franchises that are sold in Malaysia must be registered with the Ministry of Entrepreneur Development. Franchisors, including foreign franchisors, are required to deliver their franchise agreements, disclosure documents, operations manuals, training manuals and latest audited statements to prospective franchisees at least 10 days before the agreement is concluded.[148] Franchisors must provide franchisees with financial forecasts relating to the franchisees' prospective businesses. They must disclose all legal actions filed against them. Disclosure documents must be updated whenever a material change is made and this amendment must be filed

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145 Recommendation 3.3.

146 MTAA "Submission to the Review of the Franchising Code of Conduct" (2006) Canberra. The MTAA is the most important representative organisation for the retail, service and repair sector of the Australian automotive industry. It represents 100 000 businesses in a sector that has an annual turnover of $120 billion and employs 316 000 people.

147 Mazero and Scott "The Role of Franchise Regulation in International Expansion" (2003) International Bar Association Conference, San Francisco.

148 S 5.

with the Registrar.[149] Franchisors are also required to submit an annual report to the Ministry of Entrepreneur Development. This report must contain an updated disclosure document, current financial statements, a report on the annual turnover of all outlets (including the turnover of foreign outlets), a current list of the franchisor's shareholders, number of outlets and employees.[150]

There is very little franchise-specific legislation in Europe. Only Italy, Spain and Belgium have franchise laws. France does not have franchise-specific legislation and the relationship is governed primarily by general laws relating to contract. However, it has a law of general application[151] which requires franchisors to provide franchisees with information and a copy of the draft franchise agreement 20 days before the contract is concluded.[152] This law applies to the signing of any contract as well as to the renewal of contracts even if the contract is automatically renewed. Delforge reports that French courts often cancel contracts for non-compliance sometimes years after the contract was concluded. The French Franchise Federation also promotes the European Code of Ethics for Franchising enacted by the European Franchise Federation (EFF) in order to prevent franchise specific legislation from being enacted.[153] The EFF is of the view that their pro-active approach to promoting ethical franchising practices is one of the reasons why there is so little franchise-specific legislation in Europe.[154]

There is no federal statute that governs franchising in Canada, but four provinces,

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149 S 11.

150 S 16.

151 The Loi Doubin of December 1989, referred to by Delforge as the "French Disclosure Law".

152 The Italian, Spanish and Belgium franchise-specific laws are similar in purpose to the French Loi Doubin. Networks that operate in Spain (whether foreign or national) are required to be registered in a franchise registery. See generally Mendelsohn *Franchising Law* 385 - 413.

153 Delforge "Recent Developments in French Franchise Case Law" (2003) International Bar Association Conference, San Francisco. The European Franchise Federation, a self-regulatory body, founded in 1972, has its offices in Brussels, Belguim. Its mission is to promote ethical franchising in Europe and to enhance an understanding of this form of conducting a business. See generally http://www.eff-franchise.com. All national franchise associations in Europe can apply for membership. The Code of Ethics is a short document (5 pages) framed in relatively broad terms. It states that "the franchise agreement shall set forth without ambiguity, the respective obligations and responsibilities of the parties and all other material terms of the relationship" (clause 5.3). The Code does not specify what these material terms should be. It also sets out certain minimum terms which the agreement must contain (clause 5.4). This is not as comprehensive or as specific as the American or Australian approach.

154 See generally http://www.eff-franchise.com.

Alberta,[155] Ontario,[156] Prince Edward Island[157] and New Brunswick[158] have franchise-specific legislation.[159] These Acts focus on pre-sale disclosure, they impose a duty of fair dealing on the parties and they grant franchisees the right to associate.[160] The four provinces take different approaches to the format and detail required in the disclosure documents. This has led to calls for uniformity.[161] The Uniform Law Conference of Canada has developed a model franchise act which focuses on disclosure for use throughout Canada.[162]

Other jurisdictions that have issued franchise laws include Indonesia (where franchisors are required to submit a disclosure document to a government body) and Mexico (where franchisors are required to submit a disclosure document to a government body for registration and approval). In Japan franchising is regulated under its Medium-Small Retail Business Promotions Act which contains a general duty of disclosure.[163] In April 2002, the Japan Fair Trade Commission which is the Japanese competition authority, published guidelines on franchising. These guidelines provide for the disclosure of necessary information at the time of the offer of a franchise.[164]

Neither the United Kingdom nor New Zealand has franchise-specific legislation and in both these jurisdictions franchising is governed by general laws relating to business and self-regulation. There is no duty to supply franchisees with a disclosure document, but if franchisors are members of the self-regulatory body this is a requirement in terms of their

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155 Franchises Act, RSA 2000. Alberta first enacted franchise legislation in the 1970s.

156 Arthur Wishart Act (Franchise Disclosure) 2000.

157 Franchises Act SPEI 2005.

158 Franchises Act (New Brunswick) 2007. This Act is slightly different to the other provincial legislation in that it also makes provision for dispute resolution. See Westlake "New Brunswick follows other provinces" *Franchise Update* 21 August 2007 http://www.franchise-update.com/article/319 (accessed 3 March 2008).

159 See generally Zaid *Law of Franchising*.

160 Manitoba is also considering franchise-specific legislation. See Manitoba Law Reform Commission "Franchise Law" available at http://www.gov.mb.ca/justice/mlrc/reports/2007-05franchise-legislation.pdf (accessed 3 March 2008).

161 See Pozios "Canada needs uniformity in franchise legislation" *The Lawyers Weekly* http://www.lawyersweekly.ca/index.php?section=article&articleid=667 (accessed on 25 September 2008).

162 Uniform Franchises Act [The Model Bill] http://ulcc.ca/en/us/uniform _franchises_Act_En_pdf (accessed on 3 March 2008).

163 Law No 101 of 1973.

164 Kozuka "Legislation and Regulations Relevant to Franchising - Japan" available at http://www.unidroit.org/english/guides/1998franchising/country/japan.htm (accessed on 11 October 2004).

respective codes. Commentators in New Zealand are divided about whether franchise-specific legislation should be introduced.[165] In the United Kingdom the franchise community remains committed to self-regulation and there appears to be no move to introduce any form of franchise-specific legislation.[166]

4.4 Proposals for reform in South Africa

Although South Africa has a developed common law to deal with misrepresentations and non-disclosures, the law does not always provide adequate solutions to deal with franchise-specific issues. This coupled with the practical concerns that make it difficult for franchisees to enforce their rights means that, without legislative intervention, non-disclosures and misrepresentation will continue to plague franchising in South Africa. Franchising has powerful economic potential and therefore legislative intervention is desirable to ensure that franchise-specific issues are adequately dealt with.[167]

4.4.1 Disclosure requirements

The most important development in those jurisdictions that have introduced legislation is the requirement that franchisors disclose information to franchisees. This will enable franchisees to make informed decisions before they purchase their franchises. Other jurisdictions that are governed primarily by self-regulation also focus on disclosure. Adopting a pro-active approach to avoiding problems in the first place is important because, even where franchisees believe that they have been the victims of fraudulent conduct, it is extremely difficult for franchisees to set their contracts aside and be restored to their original

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165 See generally Grant and Germann "Franchising Update 2003" Report to the Auckland District Law Society.

166 Interview conducted with a representative of the British Franchise Association (BFA) (23 July 2008). However, franchisees are not members of the self-regulatory body. Further information regarding the BFA can be obtained from http://www.bfa.co.uk.

167 The proposed Consumer Protection Bill is also criticised because, whilst it requires sellers and service providers to disclose material information, it does not specify what constitutes material information. See Chapter Eight.

position.

Studies in America and Australia have revealed that requiring franchisors to make pre-contractual disclosures has proved to be beneficial for both parties. Franchisees enter into the agreements with a far better understanding of what the relationship entails and, because franchisors are expected to make full and detailed disclosure, those that are not properly prepared for franchising or are fraudsters, are removed from the industry. The consequence has been that there are fewer business failures and the image of the sector has improved substantially.[168]

Specifying the type of information that should be provided to franchisees ensures that franchisors do not limit their disclosure to information that is favourable to them.[169] Further, by establishing a uniform, minimum set of required information, there is proper competition in the marketplace because franchisees are able to compare competing franchise offerings properly.[170] The IFA, in its Code, states that IFA members believe that the information provided during the pre-sale disclosure process is "the cornerstone of a positive business climate for franchising and is the basis for successful and mutually beneficial relationships". Those jurisdictions that have introduced comprehensive disclosure requirements, in particular America and Australia, have ceased to debate whether or not disclosure is necessary. The debate focuses instead on the extent and efficiency of regulation.[171]

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168 See FTC *Federal Register* 30 March 2007 15447. The Report quotes Kaufmann: "Both the Rule and ... state franchise laws have gone a long way towards eradicating massive franchise frauds and, by doing so, have restored franchising's reputation for integrity and thus cleared the marketplace for the offerings of legitimate franchisors" (footnote 33). For a discussion of the position in Australia see Franchising Policy Council Report and MTAA "Submission to the Review of the Franchising Code of Conduct".

169 This is discussed further in Chapter Nine. The chapter also includes a proposed Disclosure Document (see 9.10).

170 See IFA Code of Ethics.

171 Baer et al "Lessons learned from three decades of Franchise Regulation and Litigation in the United States" and Franchising Policy Council Report.

4.4.2 Registration

The issue of whether franchisors should be required to register their franchises before offering them for sale is not as well supported as disclosure requirements. Many are of the view that this leads to unnecessary costs and delays. Entrepreneurs may therefore be deterred by these costs from choosing franchising as a method of expanding their businesses.

Whilst all the American disclosure states, other than Oregon, require some type of registration or filing, the FTC does not have a registration or filing procedure and does not review disclosure documents. In the beginning all the registration states reviewed the disclosure documents filed with them, but over time five of the fourteen states have opted out of the review process.[172] In California an office policy decision was made to move to a system of risk-based review of all franchise filings. The idea is to give all filings a short review but to only give a longer review to those that are regarded as high risk filings.[173] Another example is Wisconsin, which moved away from being a review state to being a notice filing state because "it could no longer conclude that the benefits of a comprehensive review of nearly every filing outweighed the cost of staffing and administering the program".[174] Cantone points out that Wisconsin borders both Illinois and Minnesota and that both these states continue to review franchise disclosure documents. Non-reviewing states are therefore benefiting from the efforts of reviewing states. In 2001 Indiana became a notice filing state.[175] The reason for this revision was so that the state department could redirect its limited resources away from the lengthy franchise application review process in favour of enhanced enforcement efforts.

There are opposing views about whether the franchise sector has benefited from the registration process.[176] Baer argues that at one time this may have been a necessary

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172 These are Michigan, Wisconsin, Indiana, South Dakato and Hawaii.

173 Holmes "California plans to move to "Risk-Based Review" of Franchise Filings" (Spring 2003) 6 *The Franchise Lawyer* 1.

174 Conohan and Struck "Modified State Disclosure Regulation: The Wisconsin Experience" (Fall 2000) 4 *The Franchise Lawyer* 7.

175 Petersen "Indiana Becomes a Notice Filing State" (Summer 2001) 5 *The Franchise Lawyer* 3.

176 Petersen 2001 *The Franchise Lawyer* 18.

adjunct to the disclosure process but that all registration does is provide a central filing system for franchisors selling in a state and an opportunity to obtain comments from the state on whether the franchisor has made proper disclosure.[177] In Baer's opinion states can avoid fraud or prevent other improper conduct without having to resort to registration. Dale Cantone, the Deputy Securties Commissioner for Maryland and the Chair of the Franchise and Business Opportunities Project Group of NASAA, has an opposing view. Cantone argues that states regularly receive registration applications from unsophisticated franchisors who have not resorted to legal advice and that these franchise offerings do not begin to approach compliance with the UFOC Guidelines. He says that for these franchisors and their prospective franchisees the review process is critical.[178]

There is no doubt that introducing registration requirements will result in additional costs for the franchising sector in South Africa. This may be particularly problematic when the sector is trying to encourage the development of very small franchise offerings to promote black economic empowerment. The extent of these costs will depend on whether registration only is required or whether a review process with fraud inspectors is adopted. It is suggested that South Africa should adopt some form of registration process.[179] This will involve extra costs but this must be weighed against the benefits of eliminating fraudulent and unprepared offerings from the marketplace. A similar approach has been adopted in the financial service industry where financial service providers are now required to register with the Financial Services Board before they are entitled to provide financial advice to consumers.[180] They are also required to meet certain standards of education and behaviour. In addition, debt collectors are required to register with the Debt Collectors Council,[181] and credit grantors are required to register with the National Credit Regulator.[182]

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177 Baer et al "Lessons Learned from three decades of Franchise Regulation and Litigation in the United States".

178 Cantone "State Review of Franchise Offering Circulars: A Continuing Cost Benefit Assessment" (Spring 2001) 4 *The Franchise Lawyer* 1-8.

179 See Chapter Nine.

180 Financial Advisory and Intermediary Services Act 37 of 2002. The rationale behind the Act is consumer protection and to professionalise the financial services industry (Malimabe "Presentation to the Financial Services Consumer Advisory Panel" Pretoria 10 April 2003).

181 Ss 8-12 Debt Collectors Act.

182 S 40 National Credit Act.

There is therefore precedent for such a process in South Africa.

4.5 Conclusion

This chapter has highlighted the difficulties that franchisees must overcome when faced with misrepresentations and non-disclosures. Attempting to resolve these disputes in a court is not an option for most franchisees with their limited resources. It is therefore suggested that the most appropriate approach is to attempt to avoid these difficulties before any agreements are concluded. In other words, franchisees need to be properly informed before they purchase their franchises. It is not possible to legislate against poor decisions and market forces; however, franchisees must be in a position to evaluate the risk of purchasing their franchises properly. Simply relying on the common law, which requires that franchisors provide material facts, is insufficient to minimise the risk of future problems because the debate surrounding what constitutes a material fact will continue. It is necessary therefore also to stipulate what information must be disclosed. Requiring franchisors to register their franchises with a recognised authority before offering them to the general public would also help to eradicate unprepared or fraudulent offerings from the market.

CHAPTER FIVE
TERMINATING THE RELATIONSHIP

OUTLINE

Franchisees are often enticed to purchase franchises on the basis that they are buying their own businesses. This is even reflected in the FASA slogan, "In business for yourself, but not by yourself". Yet, it is never intended that franchisees will own the intellectual property that makes a particular business part of a network. This fact may be over-looked by franchisees, who may view their businesses in the same light as stand-alone businesses in which they own not only the infrastructure but also the intellectual property. They may not grasp that they do not own their franchise completely and that the relationship between franchisor and franchisee will eventually end. The purpose of this chapter is to consider the issue of termination of the relationship and the consequences of termination.

5.1 The problem

Franchisees who believe that they are investing in their own businesses will make substantial investments in those businesses, both in terms of time and resources. This is one of the reasons why entrepreneurs choose franchising as a means of expanding their operations. However, this is not the same as the purchase of stand-alone businesses because, whilst franchisees may own the assets of their businesses, the most important aspect, the intellectual property, is owned by franchisors. The intellectual property forms the foundation of the franchise system because franchisees are paying for the right to use recognised trade marks and they have access to manuals, advertising, patents and general know-how. Once the relationship is

terminated, franchisees can no longer continue using this intellectual property.[1] The right to terminate gives franchisors a considerable amount of power over franchisees and the mere threat of non-renewal or termination can ensure compliance on the part of franchisees even where the instructions are unfair or very onerous.[2] Emerson points out that "paradoxically, the more frequently a franchisee accedes to a franchisor's demands, the greater the investment the franchisee stands to forfeit by refusing a subsequent command. In effect the power to terminate a franchise typically is also the power to destroy the franchisee's business".[3] Termination or refusal to renew is often an "economic death sentence" for franchisees.[4]

Every franchise contract will contain clauses that concern three matters that are

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1 A case which vividly demonstrates the importance of the intellectual property is *Cash Converters Southern Africa v Rosebud WP Franchise* 2002 (5) SA 494 (SCA). This matter involved two agreements concluded between a master franchisor and a master franchisee. One agreement was for the sale of a business opportunity which involved the right to grant franchises in the Western Cape for a limited period of time. The other agreement was a submaster franchise agreement that regulated the manner in which the business acquired in terms of the sale agreement was to be conducted. In particular, this franchise agreement transferred certain intellectual property rights to the master franchisee and without these rights it was impossible for him to exploit the business opportunity. Each contract was a separate document although they were concluded on the same day and each document had its own breach provisions. The franchise agreement provided that it could be terminated for "any reason whatsoever" provided three months notice was given. When terminated, the right to use certain intellectual property and other rights reverted back to the master franchisor without any compensation being paid to the master franchisee. The master franchisee was unable to fulfil his obligations in terms of the franchise agreement. He did not appoint enough franchises in the Western Cape and so the franchise agreement was terminated. Without the rights provided for in the franchise agreement, the master franchisee was unable to exploit the business opportunity that he had purchased. Comrie J, in the Cape Provincial Division, held that as the cancellation of the franchise agreement made the sale agreement valueless, termination of one agreement terminated the other and so the purchase price for the business opportunity had to be returned. Comrie J opined that the parties could not have intended that the business would continue to operate when it had no commercial purpose or function and stated that in the absence of "clearest language", he could not accept that the parties would have intended such an "extraordinary result". In other words, the parties could not have intended that the master franchisor could in effect reclaim the business and keep the money. The Supreme Court of Appeal did not agree and said that this was exactly what was intended if the master franchisee failed to meet his obligations in terms of the franchise agreement. Navsa JA held that the master franchisee must have been aware that if the agreement was terminated he would not be able to operate the business opportunity and found that he had consciously undertaken this as a business risk. In a dissenting judgment, Lewis AJA pointed out that the sale agreement must have terminated when the franchise agreement was cancelled because "its entire reason for existence would have ceased to exist". She relied on principles relating to implied terms and argued that a term can be implied into both contracts that if either was terminated the other could also come to an end. This, she maintained, made business sense.

2 Emerson "Franchise Terminations: Legal Rights and Practical Effects when Franchisees Claim The Franchisor Discriminates" (Summer 1998) *American Business LJ* 559 at 571.

3 Emerson 1998 *American Business LJ* 574-575.

4 Kessler 1957 *Yale LJ* 1147.

closely related to terminating the relationship:

- the franchisee's right to transfer the franchise;
- termination and renewal of the contract; and
- restraint of trade.

At the time the contracts are concluded, franchisees do not adequately apply their minds to the implications of these clauses because the idea is that franchisees are entering into a lengthy relationship in terms of which they will develop their own businesses. However, these are probably the most important clauses in the contracts because they usually come into operation only a number of years later when franchisees have developed substantial assets through their own time, effort and financial resources.[5] Termination of the relationship could render these assets worthless.[6] Nicholson explains the problem:

> [F]ranchisees who, having invested their life savings in building up a business, find upon termination, that all they can take out (if they are lucky) is their original franchise fee. The plight of the franchisee may be especially pitiful when he is subject to a restrictive covenant which prohibits his re-entry into the only business he knows. He may be left with a "distinctive" piece of real estate – say a hamburger stand shaped like a donut which may not be used to sell hamburgers (or donuts). Under these conditions, the sale of equipment and real estate at a "fire-sale" evaluation (perhaps, back to the franchisor) may be the only alternative for the franchisee .... The assumption seems to be that all goodwill is solely traceable to the franchisor's own trade mark.[7]

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5 See generally Brown *Franchising Trap for the Trusting* and Gellhorn "Limitation on Contract Termination Rights - Franchise Cancellations" (1967) *Duke LJ* 465 at 466.

6 Termination of the relationship is of significant concern in the motor vehicle industry and submissions have been made to the Minister of Trade and Industry. See NADA Memorandum to the Minister (2002) and RMI Memorandum to the Minister (2002). The RMI reports that it did not receive a response to its submission (Interview May 2008).

7 Nicholson "Some Observations and Reservations about Franchising" *Franchising: Second Generation Problems* (1969) 128 at 148-149. The tenuous position of franchisees is illustrated in the story of Frederick Bauer, who had his beer distributorship cancelled in 1956 (hearings before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, 89th Cong 2d Sess pt 2 at 690 (1966) quoted by Gellhorn 1967 *Duke LJ* 467 note 5). When

5.1.1 The right to transfer the business

Much of the success of a franchise network rests on the ability of the franchisor to manage the system effectively and part of this is to ensure that suitable franchisees are chosen. As discussed in Chapter Two, an errant franchisee can affect all the other franchisees. For this reason franchise contracts will place restrictions on the rights of franchisees to transfer their outlets freely.[8] Some agreements specify that if franchisees wish to sell their outlets, franchisors have the first option. The price may even be set or a formula for calculating the price may be pre-determined. Franchisees may be bound to a price lower than that which they could obtain on the open market.

In successful franchise systems it is unlikely that franchisors will deny franchisees the right to sell their outlets. However, because franchisors must be able to terminate errant franchisees, there is scope, in every franchise relationship, for franchisor opportunism. Franchisors may refuse permission to transfer the outlets or

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Bauer's contract was cancelled by his franchisor he operated two closed corporations. The one owned real estate and motorised equipment and the other owned inventory and related merchandising equipment. In 1946, he started out with capital amounting to $10 000. At the time of cancellation, the real estate corporation had a net worth of $200 000 and the distributing company one of $185 000. Over the previous ten-year period of operation the net profits of the two corporations averaged over $100 000 annually. When the contract was cancelled he lost the right to sell a going concern for a price which such earnings would have justified. He lost future earnings, the goodwill value of the business and also had to accept a fire-sale valuation for real estate and equipment because his warehouses and equipment could not be used for another business. He testified that he had no alternative but to accept otherwise he would have been "left with nothing more than two piles of brick and mortar and a junk yard of motorised equipment". A former Baskin Robbins franchisee told a similar story when he testified thirty three years later, to the American House of Representatives, in support of the Small Business Franchise Bill (9 November 1999 http://www.franchisee.org?SBFA.htm (accessed on 5 November 2005)). The franchisee appealed to the American Government to address the imbalance in the relationship between franchisor and franchisee through legislation and concluded his testimony by stating:

> I am one franchisee of many that are so frustrated in the way we are literally forced to do business. Many franchisees I know have lost their businesses, are going to lose their businesses or are just plain hanging in there because there's nothing else they can do ... others suffer from intimidation, [and are] afraid to stand up and say anything, for fear that they will be strong-armed into submission as Baskin-Robbins has attempted to do to me. Please give us the tools that we need to survive in this giant corporate world, so that us little guys can continue making those big guys who they are.

The Small Business Franchise Bill, introduced to the House of Representatives for the second time in 1999, was intended to establish uniform standards of behaviour in franchise and small business relationships. See generally Greco 2001 *Southern Business Review* 1. To date this Bill has not passed into legislation. There were objections from the American Bar Association (Antitrust Section) the American Chamber of Commerce, the IFA and the franchisor community. One of their objections was that this Bill would destroy centuries of contract common law.

8 See generally Kaufmann "Structuring a franchise network" in *Understanding Franchising: Business & Legal Issues* (2001) 29 at 47.

impose such onerous conditions that franchisees are unable to sell. This will give franchisors the opportunity to reclaim at no expense the outlets which they can then re-sell, thereby earning further franchisees fees. The franchisees, on the other hand, may be left with nothing.

5.1.2 Termination and refusal to renew

Franchisors must be able to terminate the relationship because, as Kaufmann points out "the worst of all worlds for a franchisor is to be stuck with a 'bad apple' franchisee".[9] Franchisors may terminate the relationship because:

- the franchisee is in breach of contract; or
- the contract contains a termination clause; or
- the contract period is over and the franchisor elects not to renew; or
- the franchisor decides to withdraw from its obligations.

5.1.2.1 Termination for breach of contract

Franchisors may terminate the relationship because franchisees are in breach of the agreement. One of the most important franchisor functions is to monitor the performance of each of the franchisees and franchisors must be able to terminate those franchisees who are not performing. Indeed, other complying franchisees may insist on this. In one McDonald's matter, the Paris franchisee had his franchise terminated because he was not complying with the required standards. Food was served cold, the store was unclean, standard ingredients were not used for the hamburgers and food was held for a long time. Franchisees from around the world asked that action be taken against the Paris franchisee because they were receiving complaints from their customers who had visited Paris. The president of McDonald's in Canada insisted that it was "time to remove this cancer".[10]

A franchisee who is not performing the obligations which have been imposed on

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9 *Ibid.*

10 Love *McDonald's: Behind the Arches* 409-410.

him by the contract is in breach of contract. As Christie explains:[11]

> The obligations imposed by the terms of a contract are meant to be performed, and if they are not performed at all, or performed late or performed in the wrong manner, the party on whom the duty of performance lay (the debtor) is said to have committed a breach of contract.

Once a breach has been committed the innocent party has various options depending on the nature of the breach.[12] The contract itself is not automatically cancelled even if the contract contains a cancellation clause. The contract only comes to an end if and when the innocent party cancels it. In addition, the innocent party is only entitled to cancel the contract if the breach is sufficiently serious to warrant cancellation.[13] However, the contract may contain a clause that empowers the innocent party to terminate the contract for any breach of the terms. The aggrieved party may then terminate for even trivial breaches of contract.[14]

Clauses that allow for termination in the event of breach of any of the terms of the contract are common in franchise contracts. The FASA has the following advice for franchisors:[15]

> The termination clause should be comprehensive in the best interests of the entire franchise system and/or other franchisees. In addition to standard provisions such as timeous payment, the clause should include provisions

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11 Christie *Contract* 495.

12 These include an order for specific performance, cancellation, damages or an interdict. A full discussion of the principles relating to breach of contract is beyond the scope of this thesis but see generally Christie *Contract* 495-519 and Kerr *Law of Contract* 669-735. The focus here is on cancellation of the contract because the chapter deals with termination of the relationship.

13 In *Singh v McCarthy Retail Ltd t/a McIntosh Motors* 2000 (4) SA 795 (SCA) Olivier JA stated that the "test whether the innocent party is entitled to cancel a contract ... entails a value judgment by the Court. It is, essentially, a balancing of competing interests – that of the innocent party claiming rescission and that of the party who committed the breach. The ultimate criterion must be one of treating both parties fairly under the circumstances, bearing in mind that rescission, rather that specific performance or damages, is the more radical remedy. Is the breach so serious that it is fair to allow the innocent party to cancel the contract and undo all its consequences" (at 803).

14 In *Oatorian Properties (Pty) Ltd v Maroun* 1973 (3) SA 779 (A) the court said that if the contract contains such a clause, "the materiality of the breach is irrelevant and the Court will not enquire into the conscionableness or unconscionableness" of cancelling the contract (at 785).

15 Honey "The Franchise Agreement" in *Franchise Book of Southern Africa 2003* 32.

entitling the franchisor to cancel the Agreement if the franchisee fails to act in accordance with the operations manual, performs inadequately or maintains poor quality standards. Further, if there is any challenge on the proprietorship of the franchised intellectual property, this should also be a ground for possible termination of the agreement.

In 2000, the CAFCOM received a number of complaints regarding a large supermarket chain in South Africa that had started a franchise network of convenience stores. Some of the complaints related to termination of franchise agreements and freezing of supplies from suppliers. A perusal of the franchise agreement revealed that the franchisor was entitled to cancel "membership forthwith if the member committed any breach of, or failed to comply with the membership agreement or to make any payment on due date". It was also entitled to cancel forthwith if the member objected to the procedures and directives of the franchisor. Membership could be terminated at any time by notice from one party to the other and there was no obligation to supply reasons for this termination. Alternatively, the franchisor was entitled to suspend, at its discretion, membership or any of the benefits or facilities arising from membership for such period and on such conditions as the franchisor may decide.

Cancellation of a contract is a drastic remedy that can result in substantial hardship for franchisees. This is demonstrated in a report carried by *Carte Blanche*, a South African investigatory television program, on 1 August 2004 entitled "Bad Oil". This was an investigation into certain restaurants in order to establish whether they were abusing their cooking oil. Included in the investigation were certain Something Fishy franchises. Some of these franchises were found to be re-using oil that was well past its prime and which was unhealthy for consumers. This was contrary to instructions issued by the franchisor and was obviously a means of cutting costs for franchisees. The franchisor's response to this program was to terminate the relationship with the most errant franchisee (who owned two franchises) and to put the other franchisee onto a monitoring program. Given the facts that a Something Fishy franchise cost R500 000 in 2001,[16] that the maximum fine which has been imposed by a criminal court for abusing oil is R400 and that the authorities will only close down an independent

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16 FASA *Franchise Book of Southern Africa 2001*.

business after repeated offences, the penalty imposed by the franchisor appears to be particularly harsh. The report stated that the most errant franchisee was being investigated for other contraventions of the franchise agreement, but these were not specified.[17]

The serious consequences of refusing to comply with franchisor demands can be seen in *Unilever SA Ice Cream (Pty) Ltd v Jepson.*[18] Jepson refused to comply with the franchisor's demand to sell a competitor's product. The result was that the franchisor cancelled his franchise agreements and claimed damages. The court upheld the cancellation and awarded the franchisor R315 680,72 plus his costs on an attorney and client basis.[19]

5.1.2.2 Termination in terms of the contract

Where there are terms dealing with termination, franchisors are entitled to terminate the relationship provided they comply with such terms.[20] Parties are not required to provide reasons for termination and franchisors can terminate even when franchisees have not had sufficient time to recoup their initial investments. Their losses may be substantial, particularly when they have invested in fixtures and fittings that cannot be used in a similar business or where they have also agreed to a restraint of trade clause.

Although a clause which gives either party the right to terminate on the basis of notice appears to be fair to both parties, in most circumstances it tends to be meaningless as far as franchisees are concerned. Franchisors tend to be the parties that profit from such a clause because franchisees must protect their investments and

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17 A full report is available at http://www.carteblanche.co.za (accessed on 25 July 2006).

18 [2007] 3 All SA 294 (C) also discussed below at 5.1.2.4.

19 The contract stipulated that costs must be awarded on an attorney and client basis.

20 This is a common problem in franchising in many jurisdictions. See, for example, *Emile State Inc v Commodore Machines Limited* (1988) 19 CCEL xxix (Ont.CA) which dealt with the right of a franchisor to terminate an agreement without cause. The contract provided that either party could terminate the relationship on thirty days notice. The Ontario Court of Appeal held that the termination clause was clear and unambiguous therefore the franchisor did not have to provide reasons for terminating the relationship and also did not have to give any further reasonable notice. In *Peters Auto Sales Ltd v Chrysler Canada Ltd* (1990) 63 Man R (2d) 295 (QB) the franchisee tried unsuccessfully to convince the court to imply a term into the contract that the franchise agreement was for an indefinite duration and could only be terminated if the franchisor showed good cause. In this instance the franchise agreement had run its course.

cancelling the contract invariably means losing everything that has been invested.[21] The fact that franchisors do not have to compensate franchisees for goodwill is particularly unfair. Franchisors can terminate a successful business without giving reasons and an asset in the franchisee's estate is lost. In *Tamarillo (Pty) Ltd v BN Aitken (Pty) Ltd* the agreement provided that if the franchise agreement was cancelled or terminated "for any reason whatsoever" any sub-lease agreement that was signed between the franchisor and franchisee would also be automatically terminated with the result that the premises would revert to the franchisor. This also applied to any lease agreement between the franchisee and a third party. Even when the franchisee had signed a lease directly with a third party, he was obliged in terms of the contract, and to transfer the lease to the franchisor in the event that the franchise was cancelled. This meant that the franchisee would not only lose the right to use the franchisor's trade marks, he would not be able to continue operating from those premises under his own name. On the other hand, the franchisor would be free to establish another franchisee at the same premises. Any goodwill that the franchisee had built up would become the property of the franchisor or the new franchisee. The court in *Tamarillo (Pty) Ltd* found that the clauses were designed to protect the goodwill in the trade mark[22] but no mention was made of the contribution which the franchisee had made to developing that goodwill.

Franchisors who terminate at will may be engaged in opportunistic behaviour. In some instances franchisors resort to franchising in order to "test the market" and it has been suggested by some theorists that franchising is merely a temporary stage in the development of a business and is not a genuine stand-alone business model.[23] Franchisors who are uncertain about how successful their businesses will be can rely

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21 The video store franchisee would, however, have benefited from such a clause because she signed agreements that endured for 10 years. The franchisor insisted that franchisees pay monthly royalties for the full period notwithstanding the fact that many franchisees had failed. In the case of her second franchise, which failed after two years, the landlord had cancelled her lease agreement because she could no longer afford the rental. She has abandoned the franchise and is simply hoping the franchisor will not pursue her for the amount owing for a further eight years. She reported that in other instances franchisees had negotiated settlement amounts with the franchisor (Interview October 2007).

22 438H.

23 See Stanworth and Curren "Colas, Burgers, Shakes and Shirkers: Towards a Sociological Model of Franchising in the Market Economy" in *Franchising: An International Perspective* 29 in which they quote numerous authors who have addressed this issue.

on franchisees to take the gamble. When the business proves to be successful the franchisor may take it back to operate it as a company-owned store or the franchisor may resell it in order to obtain a significantly higher franchisee fee, thus benefiting from the franchisee's gamble.[24] Luxenburg, a vehement critic of franchising, suggests:

> For many chain builders franchisees serve as cannon fodder, foot soldiers to be expended in battle. If the company thinks there might be a market for a product in a certain area it can find operators who will invade the community. If the experiment fails and the franchisees go bankrupt, well, that's too bad – in business there are always risks. In this way tens of thousands of individuals lose their investments. As long as some outlets survive, the chain can continue trying new areas. It is out of the trial and error financed by many franchisees that a few successful chains and franchisees emerge.[25]

Because of this problem, Oxenfeldt and Kelly argued, in 1968, that franchising only appeals to franchisors who are in the early stages of developing a network and, if the franchise network is successful, the outlets are reclaimed by franchisors who then establish wholly owned chains.[26] Hoy and Stanworth state that although this article is provocative and its theories are not universally supported, it is cited in most modern-day franchise works published by serious writers and researchers.[27]

On 24 July 2006 the *Business Report* published an article entitled "Dunhill doubles its Chinese sales growth". Miller reported that Dunhill, the British leather goods and men's fashion retailer owned by Richmont, had doubled its sales growth in China

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24 See, for example, *Burger King v Family Dining* 426 F. Supp 485 (ED Pa), 566 F.2d 1168 (3d Cir 1977).

25 Luxenberg *Roadside Empires* (1985) 259 quoted by Hadfield 1990 *Stanford LR* 969. An example is Avis-Rent-A-Car Inc. In the 1950s Warren Avis expanded his business through franchising but today this is a mature company that no longer focuses on expansion. Although it still has some franchises, these play a secondary role in the business and most of the outlets world-wide are company owned. See Rosenberg "Chain Reaction: lessons from franchising financial models and the role chief financial officers play" 1999 *CFO, The Magazine for Senior Financial Executives* available at http://www.findlawarticles.com/cf_0/m3870/2_15/53723814 (accessed on 30 September 2003).

26 Oxenfeldt and Kelly "Will Successful Franchise Systems Ultimately Become Wholly-Owned Chains" (Winter 1968-9) *Journal of Retailing* 44 at 69 reprinted in *Franchising: An International Perspective* 213.

27 Hoy and Stanworth *Franchising: An International Perspective* 213.

by taking back 63 franchise-owned boutiques and by closing others. What this rather bland report fails to take into consideration is the effect this had on franchisees, many of whom were probably under the impression that they owned their own businesses.

5.1.2.3 Refusal to renew

Franchises are sometimes granted for a specific period of time such as five or ten years. Once this period is over the franchise contract comes to an end and there is no obligation on franchisors to renew contracts or to compensate franchisees for any goodwill.[28] The fact that franchisors are under no obligation to renew lends itself to franchisor opportunism.[29]

Golden Fried Chicken (Pty) Ltd v Sirad Fast Foods CC[30] involved two parties who forgot that their agreement had come to an end and so they simply continued as they had for the previous decade. The agreement provided that the contract was to endure for ten years but that it could be extended provided the franchisee gave the franchisor notice that he wanted to renew the franchise six months before the contract expired and a new agreement was executed. The expiry period came and went without notice and without a new agreement being concluded. The franchisee continued to trade under the same conditions as before and it appears that the franchise was operating successfully. The franchisor even gave the franchisee instructions to renovate his premises and he complied. Ten months later the franchisor, relying on the fact that the contract had expired, gave the franchisee instructions to cease trading as a Chicken Licken franchise. The court a quo decided against the franchisor on the basis of estoppel and unconscionable conduct. In the appeal, the Supreme Court of Appeal confirmed the decision but on a different basis. It therefore declined to deal with estoppel and unconscionable conduct.[31] The Supreme Court of Appeal found that the parties conducted themselves in "a manner which gave rise to the inescapable inference that both desired the revival of the former contractual relationship on the same terms as before". The court, therefore, held that the facts established a tacit

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28 Byers 1994 *Journal of Corporation Law* 614.
29 Byers 1994 *Journal of Corporation Law* 621.
30 2002 (1) SA 822 (SCA).
31 826G.

relocation of a franchise agreement and that a new agreement had been formed between the parties. The court compared this to a tacit relocation of a lease agreement. When a lease expires and the tenant remains in occupation of the premises with the tacit consent of the landlord, the parties are deemed to have entered into a new contract.[32] *Doll House Refreshments (Pty) Ltd v O'Shea* concerned the renewal of a lease, and here the court pronounced that where the relocation of the lease is tacit, there is a presumption that "the property is re-let on the same rent and those provisions that are 'incident to the relation of landlord and tenant' are renewed. But provisions that are collateral, independent of and not incident to that relation are not presumed to be incorporated into the new letting".[33] Usually therefore, the lease is deemed to be a periodic lease and if the rent is payable on a monthly basis, it can be terminated on one month's notice. This approach was adopted by the court in *Golden Fried Chicken (Pty) Ltd*. Although a new contract came into being on the same terms, this did not mean that every term of the initial contract formed part of the new contract.[34] The court could not make a finding regarding the duration of the new contract because of the paucity of evidence on this issue. The parties themselves do not appear to have addressed the question of duration of the new contract with any certainty. The franchisee first suggested that the period should be five years because this was the renewal period stated in the first agreement. He then suggested that it should be ten years because this was the period of the first agreement.[35] The franchisor did not address the issue at all but the franchisor could have solved its problem by arguing that although there was a new franchise agreement, this became an agreement which was terminable by the giving of reasonable notice.[36] The court did state that the best position for the franchisor was that the period was an indefinite one in which event a

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32 *Doll House Refreshments (Pty) Ltd v O'Shea* 1957 (1) SA 345 (T); *Fiat SA v Kolbe Motors* 1975 (2) SA139 (0) and *Shell South Africa v Bezuidenhout* 1978 (3) SA 981(N).

33 348F-H.

34 Terms incidental to the franchise agreement included the right to use the trade marks and get-up of Chicken Licken and the duty to pay royalties.

35 825H-I.

36 In *Juglal NO v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* the court stated that because the franchise agreement neither specified the duration of the franchise nor provided specifically for its termination, on general principles the franchise was terminable on reasonable notice to the franchisee. In this case, the franchisee had spent R1,4 million equipping the premises and R2 million on the initial stock of products.

reasonable period of notice had to be given.[37] What constitutes reasonable notice in such a situation has yet to be decided but the analogy of a lease agreement may lead the courts to decide that one month, or a few months, is reasonable. The problem in this case was compounded by the fact that the franchisee had just renovated the business when he was given notice to vacate. This, it is surmised, is the reason why the court a quo found that the behaviour of the franchisor was unconscionable.

5.1.2.4 Franchisor withdrawal

There is always the risk that the franchisor may choose not to continue promoting the franchise. In *Tamarillo (Pty) Ltd v BN Aitken (Pty) Ltd*, for example, one of the franchisee's complaints was that the franchisor had decided to discontinue expansion of one of the two trade marks that was crucial to the franchisee's business. The court found that there was nothing in the contract that obliged the franchisor to continue promoting the trade mark because the contract simply stated that the franchisor was entitled to advertise and promote the products as it may in its sole discretion determine.[38]

Then, there is the risk that the franchisor will withdraw from the franchise network altogether. In *Picture Lake Campground, Inc v Holiday Inn*,[39] Holiday Inn decided to withdraw from the business of promoting its Trav-L-Park system in which franchisees had recently invested. This raises the question whether franchisors are obliged to maintain their systems and whether they have a duty to disclose to prospective franchisees that the business may be in financial difficulty or that they have other plans for their businesses. Franchisors may also decide to sell networks to new franchisors who then want to introduce changes to the way in which the networks operate. Some of those changes may conflict with the interests of existing franchisees. This is what happend to the franchisee in *Unilever SA Ice Cream (Pty) Ltd*. The original franchisor of Milky Lane outlets transferred the franchise network to a new franchisor, Unilever, which owned the Ola brand. Unilever created a new recipe for the ice cream and

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37 See also Kerr *The Law of Sale and Lease* 248 and 452.
38 435C-D.
39 497 F Supp 858 (ED Va 1980).

changed the get-up of the products to include both the Ola brand and the Milky Lane brand. The franchisee resisted these changes on the basis that he was now obliged to do business with a direct competitor, which would lead to the demise of the Milky Lane trade mark. But the contract provided that it was the prerogative of the franchisor to determine from time to time the trade marks, get-up, manual, core products and suppliers to be used. The court held, therefore, that the franchisor was entitled to act as it did.

5.1.3 Restraints of trade

The success of franchise networks is based on their operating systems, know-how and products that they produce. It is therefore necessary for franchisors to protect this information and their intellectual property. Accordingly, they will introduce restraints of trade into their contracts in order to restrict the things that franchisees are entitled to do. There are basically two kinds of restrictions; the first will restrict franchisees from engaging in a similar trade, business or occupation that will compete with the franchise during the relationship (also referred to as in-term non-competition restraints) and the second will restrict franchisees from competing with the network for a period of time after their contracts are terminated (post-term non-competition restraints). In-term restraints are essentially tying or exclusive arrangements which stipulate that franchisees are bound to purchase their products from certain suppliers.[40] From a franchisee perspective, post-term restraints are particularly problematic because franchisees who are trained in a specific type of business may find that they are unable to work in the same area for a specific period of time after the franchise relationship is terminated. Such clauses may also provide franchisors with a further tool to ensure that franchisees comply with franchisor demands. Restrained franchisees face even greater economic hardship when the relationship is terminated in that not only do they lose their business, they can also no longer engage in their trade.[41]

Generally speaking a restraint of trade is acceptable if it is intended to protect

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40 See discussion in 6.6.2 and 6.6.3 below.

41 Byers 1994 *Journal of Corporation Law* 647-648.

a legitimate interest.[42] In *Magna Alloys v Ellis*[43] the Appellate Division held that a restraint of trade is prima facie valid, but the court will not enforce it to the extent that enforcement would be contrary to public policy.[44] The rules laid down in *Magna Alloys v Ellis* were refined in *Basson v Chilwan*[45] where the court in the majority judgment suggested that four questions should be asked:

- Does the claiming party have a protectable interest?
- Is this interest being prejudiced by the other party?
- If so, is this interest such that, when weighed qualitatively and quantitatively against the interests of the other party, the latter should be rendered economically inactive and unproductive?
- Whether the interests of public policy are such that the restraint should either be enforced or voided?[46]

These questions raise two issues as far as franchising is concerned, namely: who is the claiming party and what interest is the restraint seeking to protect.

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42 A full discussion of the principles relating to restraints of trade is beyond the scope of this thesis but see Kerr *Law of Contract* 181-235; Sharrock *Business Transactions Law* 7 ed 101-107 and Christie *Contract* 361-377.

43 1984 (4) SA 874 (A).

44 *Magna Alloys* also held that the onus of proving that enforcement of the restraint would be contrary to public policy is on the person alleging it. This approach was questioned in *Canon KwaZulu-Natal (Pty) Ltd v Booth* 2005 (3) SA 205 (N). In this case the Natal Provincial Division held that because a restraint of trade constitutes a limitation on a person's constitutional right to earn a living it was no longer correct to impose the onus of proof on the restrained party. The court held that the restraining party has to establish, in addition to invoking the contract and proving the breach that the restraint was reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom (see Tait "Who should bear the onus in restraint of trade disputes" (2004) 25 *Obiter* 488. The Supreme Court of Appeal has avoided this debate (see *Automotive Tooling Systems (Pty) Ltd v Wilkens* 2007 (2) SA 271 (SCA) and *Reddy v Siemens Telecommunications (Pty) Ltd* 2007 (2) SA 486) and in the most recent decision, *Digicore Fleet Management v Steyn* (722/2007)[2008] ZASCA 105 (22 September 2008), the court held that it is trite that provisions in restraint of trade are enforceable unless shown by the person wishing to escape an undertaking to be unreasonable and hence contrary to public policy (para 7).

45 1993 (3) SA 742 (A).

46 467G-H.

5.1.3.1 The claiming party

Franchisors, seeking to ensure that restraints are upheld, are not acting merely to protect their own interests, but also the interests of everyone involved in their franchise networks. Non-rogue franchisees have a considerable interest in ensuring that their franchise systems are protected.[47] In Germany, for example, non-competition clauses are, as a rule, not considered unfair provided they *inter alia* serve to protect the legitimate interests of the franchise system.[48] Similarly in France, the courts have said that non-competition clauses are justifiable provided they are designed to protect franchise networks without imposing undue restraints.[49] A report regarding an American dispute involving Dunkin' Donuts indicates that the thrust of the franchisor's argument was that a reasonable restraint was necessary in order to preserve the franchising system and to protect the interests of Dunkin Donut's other franchisees.[50] In the same matter, the IFA submitted a "friend of the court" brief. This brief referred to the rights of both franchisors and franchisees and suggested that other franchisees, being non-litigants, were also entitled to protection because they have invested substantial amounts in the franchisor's trade mark through their businesses.[51]

An examination of South African decisions suggests that the courts tend to approach disputes by considering only the interests of individual franchisees. This is problematic because, as is pointed out in a number of decisions,[52] franchisors and franchisees are not in the same business. Franchisees are in the business of providing products or services whilst franchisors are usually in the business of selling franchises. This was central to the decision in *Pam Golding Franchise Services (Pty) Ltd v Douglas* which involved an estate agency franchise. The contract contained a restraint clause

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47 Rogers and Wasyliw "Restrictive covenants in Franchising - Drafting and Enforcement" (2001) http://www.davis.ca. (accessed on 3 May 2004).

48 OECD Report on Competition Policy and Vertical Restraints: Franchising Agreements (Franchise Report) http://www.oecd.org/dataoecd/34/53/1920326 47 (accessed on 12 October 2004).

49 *Mourat-Natalys* Paris Court of Appeal (1989) quoted in OECD Franchise Report 148.

50 *Dunkin Donuts v Boulanger* Masschusetts June 2003 reported by Sparks *IndusBusiness Journal on line* http://www.indusbusinessjournal.com/news/2004/05/15/FranchiseHospitality.

51 Sparks 2004 *IndusBusiness Journal on line* 3.

52 See *Pam Golding Franchise Services (Pty) Ltd v Douglas* 1996 (4) SA 1217 (D) and *Kwik Kopy (SA) (Pty) Ltd v Van Haarlem* 1999 (1) SA 472 (WLD). See also Woker "Franchising and Restraints of Trades – Restraining Ex-franchisees from competing with the franchise network" (2005) 26 *Obiter* 1.

which provided that the franchisee would not during the existence of the contract and for a period of two years after the termination thereof, be concerned in any business similar to or competitive with that carried on by the franchisee in the area. A dispute arose between the parties and so the franchisee closed the premises where she had been trading. She moved to another office where she managed another franchise under the name of a different estate agent. When the franchisor attempted to interdict her from acting in contravention of the restraint, the franchisee argued that the restraint was contrary to public policy because it was an unreasonable restriction on her freedom to trade. The court focused on the fact that the franchisor was not operating as an estate agent. The franchisor's trade was that of franchising the use by others of the name and other indicia of the specific operation to which the goodwill of that operation adhered. In addition, it made available to franchisees its expertise and information which would facilitate their trading under the name Pam Golding.

The court found that the interest which could be protected was the franchisor's interest in protecting and enhancing the Pam Golding name. Therefore, as long as the franchisee was operating under a new name, she could not be prevented from doing so.[53] The court maintained that whilst the franchisor had the right and obligation to ensure that the goodwill of the business was not in any way diminished by competition under the same name, it was not entitled to protect the business of a subsequent franchisee against competition in general.[54]

It is not possible to speculate whether the ultimate decision of the court is correct because the focus of the enquiry was too limited. The franchisor has an interest to protect the whole network and, therefore, the interest of the network as well should have been considered. If the franchisor could have shown that the financial stability of the entire network was prejudiced when franchisees disregarded their restraints the matter might have been decided differently. There is nothing in the judgment to suggest that the interests of the other franchisees were considered.

A similarly narrow approach can be found in *U-Drive Franchise Systems Ltd v Drive Yourself Ltd*.[55] The franchisor contended that the parties had contemplated that

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53 1224G-H.
54 1225D-E.
55 1976 (1) SA 137 (D).

the franchisee would build up a business using the franchisor's name and, that on termination of the franchise agreement, the business so built up would belong to the franchisor. In addition, the franchisor was entitled to be protected against competition by the franchisee for a reasonable period. The court did not accept this and held that whilst the franchisor was entitled to the protection of trade connections built up by itself, the customer connections built up by the franchisee even whilst using the franchisor's name remained the property of the franchisee.[56] This approach, it is submitted, is too narrow because it ignores or makes no allowance for the goodwill that attaches to the franchisor's trade marks and name. In a successful franchise operation goodwill is contributed to by all franchisees. A person living in Pretoria, for example, may patronise a particular restaurant when on holiday in Kwazulu-Natal because she recognises the trade name, is aware of its reputation and because she frequents the restaurant in Pretoria. All successful franchisees contribute to the development of goodwill. Therefore, the interests of the network as well as individuals must be considered when deciding whether or not to enforce a restraint.

5.1.3.2 The protectable interest

The problem with franchising is that it does not fit neatly into one of the more commonly recognised categories of restraint, namely those found in sales of goodwill and those in employment contracts. Franchisees do not sell businesses with attached goodwill to franchisors and neither do they work for their franchisors. A study of the few South African cases that deal with this difficult issue indicates that the parties and the courts have struggled to identify exactly what interest the restraint is seeking to protect, and so have found the restraints to be unenforceable. One difficulty with these decisions is that the arguments have centered on the principles relevant to the sale of goodwill and employment contracts, neither of which has proved to be satisfactory.

Where the sales of businesses or professional practices are involved, purchasers wish to protect themselves from future competition by sellers in the same geographical areas for a certain period of time and, by including restraint clauses in the

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[56] 142E-F.

sale agreements, sellers create a saleable asset, namely the goodwill of the business.[57] Usually the parties are contracting as equals and, because the restraint is for the benefit of both parties, the courts tend to view such restraints more favourably than when dealing with those found in employment contracts. As far as franchises are concerned, franchisors sell their business models to franchisees. Franchisees then exploit and enhance the goodwill attached to the trade mark. When franchisees leave networks, franchisors seek to prevent ex-franchisees from capitalising on that goodwill any further, despite the fact that franchisees have not been remunerated therefore. The difficulty for franchisees is that their contracts may terminate without their businesses being sold to new franchisees and franchisors do not compensate those that leave. It is, therefore, difficult to apply the principles found in cases dealing with goodwill restraints to franchise matters, mainly because ex-franchisees are restrained from competing but are not compensated.[58]

Dealing with employment contracts, employers may use restraints to prevent their employees from competing with them once the employment relationship is terminated. The courts view these restraints far more strictly because it is usually assumed that the parties are not in an equal bargaining position. Unlike in the case of goodwill restraints, mere competition as such cannot be restrained as it is clearly against public policy to prevent a person from earning a living.[59] However, an employer can validly restrain employees from using confidential knowledge such as trade secrets or special processes or confidential knowledge about clients or customers acquired

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57 The goodwill of a business is a combination of all the factors which help to attract customers or clients to that business. Often the main elements of goodwill will be the name and location of the business. Especially where the personality of the previous proprietor of the business plays a part, the purchaser of the goodwill has an interest in excluding the seller from opening or taking over or conducting a competing business where his personality will play a part, until after a lapse of that reasonable period. This period is necessary for the purchaser to establish his own relationship with the customers of the business. The goodwill of a business has a separate identity and can be valued apart from the material assets of the firm. See, for example, *Diner v Carpet Manufacturing Co of SA* 1969 (2) SA 101 (D) and *Cowan v Pomeroy* 1952 (3) SA 646 (C).

58 From the franchisor's point of view, the ex-franchisee has had the benefit of gaining experience and developing that goodwill whilst using the name, symbols and know-how of the franchise system. The "break-away franchisee" syndrome can be a problem for the entire network as the franchisor will lose revenue and it may be difficult to sell to new franchisees when "old" ones continue to operate a similar business in the same area. The financial stability of the franchise could be threatened. The breakaway franchisee syndrome refers to the unilateral termination of the franchise agreement by franchisees. See generally Beyer *Franchise Law and Practice* §2.47.

59 *Highlands Park Football Club v Viljoen* 1978 (3) SA 191 (W).

during employment.[60]

When franchisees, by virtue of their association with a network, have had access to protectable information confidential to the franchisor and the franchise network and, objectively speaking, there is a reasonable possibility that franchisees may use these trade secrets in a new business, the courts will, in all probability, uphold appropriate restraints.[61] However, employers cannot restrain employees simply because they learned their trade and acquired certain skills whilst working for their employers.[62] Neither can employers argue that they spent time and resources training employees.[63] When it comes to franchising, the core of the franchisor's business is its method of doing business. One of the advantages of franchising is that entrepreneurs who are inexperienced in a particular business method are "mentored" by someone who has developed a successful business model.[64] The franchisor in *Kwik Kopy (SA) (Pty) Ltd v Van Haarlem*[65] failed to persuade the court to recognise that this know-how was a protectable interest.[66] The court accepted that trade secrets and confidential information such as secret processes, special recipes and methods of preparation in the food industry may be protected, but not training a franchisee to become successful in business. The court found that the franchisor did not have a protectable interest despite the fact that the franchisee had reaped the benefit of being a franchisee with Kwik Kopy and could now continue trading in a similar business without having the obligations of a franchisee.

The *Kwik Kopy* approach can be compared to the approach adopted by the EU Court of Justice which has recognised this concept of know-how.[67] In *Pronuptia v*

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60 *Thompson v Nortier* 1931 OPD 147 (T); *Rawlins v Caravantruck (Pty) Ltd* 1993 (1) SA 537 (A); *Paragon Business Forms Pty Ltd v Du Preez* 1994 (1) SA 434 (SE); *Walter Mc Naughtan (Pty) Ltd v Swartz* 2004 (5) SA 381 (T) and *Reddy v Siemens Telecommunications (Pty) Ltd.*

61 In *Reddy v Siemens* the court held that, in deciding whether or not to uphold a restraint, the court adopts an objective test; namely, is there a reasonable possibility that an employee will reveal trade secrets. An undertaking by the employee that he will not use or reveal trade secrets to his new employee will not, therefore, assist an employee to avoid the implications of a reasonable restraint of trade.

62 See in particular *Highlands Park Football Club v Viljoen* and *Automotive Tooling Systems (Pty) Ltd v Wilkens.*

63 *Highlands Park Football Club v Viljoen* and *Basson v Chilwan.*

64 See arguments of the IFA in *Dunkin' Donuts v Boulanger.*

65 1999 (1) SA 472 (W).

66 486E.

67 OECD Franchise Report 83.

Schillgalis[68] it held that certain restrictive covenants are not anti-competitive because:

> [Franchising] is a way for an undertaking to derive financial benefit from its expertise, without investing its own capital ... [and] gives traders who do not have the necessary experience access to methods which they could not have learned without considerable effort and allows them to benefit from the reputation of the franchisor"s name ... Such a system, which allows the franchisor to profit from his success, does not in itself restrict competition.[69]

The court pointed out that for a franchise system to work "the franchisor must be able to communicate his know-how to the franchisees and provide them with the necessary assistance in order to enable them to apply his methods without running the risk that the know-how and assistance might benefit competitors, even indirectly".[70] As a consequence, the court held that provisions that are necessary to ensure that the know-how and assistance provided by franchisors does not benefit competitors and provisions which establish the control necessary for maintaining the identity and reputation of the network do not constitute restrictions on competition.[71]

In seeking to protect this know-how franchisors must be able to show that the franchisees have had access to information which actually belongs to them (the franchisors). This know-how is not an interest that accrues to franchisees, as they develop their skills and knowledge.[72] In *Aranda Textile Mills (Pty) Ltd v Hurn*,[73] Kroon J explained:

> A man's skill and abilities are a part of himself and he cannot ordinarily be precluded from making use of them be a contract in restraint of trade. An employer who has been to the trouble and expense of training a workman in an established field of work, *and who has thereby provided the workman with knowledge and skills in the public domain,* where the workman might not

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68 (1986) ECR 353.
69 Para 15.
70 Para 16.
71 *Ibid.*
72 *Automotive Tooling Systems (Pty) Ltd v Wilkens* 278C.
73 [2000] 4 All SA 183 (E) para 33.

> otherwise have gained, has an obvious interest in retaining the services of the workman. In the eye of the law, however, such an interest is not in the nature of property in the hands of the employer. It affords the employer no proprietary interest in the workman, his know-how and skills. Such know-how and skills *in the public domain* become the attributes of the workman himself, do not belong to the employer and the use thereof cannot be subjected to restriction by way of a restraint of trade provision. Such a restriction, impinging as it would on the workman's ability to compete freely and fairly in the market place, is unreasonable and contrary to public policy.

Making the distinction between know-how that belongs to franchisors and skills and knowledge that becomes part of an individual franchisee's expertise is very difficult to delineate. However, franchisors can take certain steps which may assist the court in reaching a decision. For example, all information given to franchisees must be labelled as confidential. Franchisors must take steps to ensure that their business models do not become public documents and are only made available to a defined group of people. Franchisees must sign confidentiality agreements. Such steps will not guarantee that courts will find that information constitutes trade secrets worthy of protection, but at least franchisors will have signalled that they regard the information as such. One of the reasons why the court did not uphold the restraint in *Automotive Tooling Systems* was because there was no evidence that the processes and methods that Automotive Tooling Systems used were treated as confidential. On the contrary, it appeared to the court that all employees, clients and sub-contractors had free access to the information.[74]

The concept of know-how may be difficult to define but it is fundamental to understanding the whole concept of franchising. The idea behind franchising is that a successful entrepreneur who, through trial and error, has established a successful business model, then uses the knowledge that has been gained to train other, less experienced business people to establish their own successful businesses. It is this know-how that is communicated to others and it is this know-how that is of commercial value. The transfer of know-how and the supply of technical skills to franchisees is the

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[74] 282C-D.

most important defining characteristic of business format franchising.[75] This knowledge and those skills are developed over time and through the investment of substantial effort and resources. Franchisors often experiment with a number of different business methods and through their own ingenuity they develop something that is successful. Franchisees do not have to go through the same process. It is this know-how that franchisors trade in and it is, therefore, suggested that it be recognised, in a proper case, as a protectable interest. Franchisors should be allowed to limit unauthorised use of know-how.[76] This is particularly important when the franchisor's know-how concerns "experiences in conducting business something especially difficult to protect in more standard ways, for example, by the use of patents or licensing agreements".[77] This would also give franchisors an incentive to share their skill and knowledge with others. Limits on franchisee rights to compete after the franchise agreements have been terminated can be justified and many jurisdictions have decided to allow post-termination restrictions.[78]

5.2 The law

The law that applies to termination of the relationship is the law of contract.[79] The parties are regarded as equals and, therefore, the contract will be enforced according to its terms. This is what the parties agreed when the contracts were concluded. On the face of it, clauses dealing with termination of the relationship will appear to be

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75 OECD Franchise Report 53.

76 *Ibid.*

77 *Ibid.*

78 OECD Franchise Report 176. The report examines the law in Australia, Belguim, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Japan, New Zealand, Norway, Portugal, Spain, Sweden, United Kingdom, United States and European Community. In most instances the period is limited to one year. Since the introduction of the Constitution, there have been a number of cases where restrained parties have attempted to rely on the Constitution in order to show that a restraint should not be upheld. The primary argument has been that a restraint of trade is contrary to public policy because it restricts the right of an individual to earn a living as guaranteed in the Bill of Rights. The courts, however, decided that "'a restraint that is found to be reasonably required for the protection of the party who seeks to enforce it, in accordance with the test that has been laid down in the cases, is constitutionally permitted" (*Reddy v Siemens Telecommunications (Pty) Ltd* 495D). The question of who bears the onus of proof is discussed in note 44 above.

79 The basic principles of contract that apply to the various headings discussed above have already been outlined and therefore will not be repeated here.

relatively neutral and/or to the benefit of both parties. However, the general principles of contract fail to take into consideration the emotional and financial commitment that franchisees make to building a brand. In particular, it is enormously problematic that franchisees can lose their entire investment and often without any compensation.

It is not unconscionable, in terms of the common law, for the contract to read that either party may cancel the contract by giving notice, nor is it wrong to decline to renew an existing contract. Indeed, these are specific areas of consumer complaint. Many consumers are enticed into entering long term service contracts which they have to continue paying for long after they have ceased to require the service. Such contracts are also frequently renewed without consumers even being aware that renewal is automatic. In order to protect ordinary consumers, the Consumer Protection Bill makes provision for consumers to cancel long term agreements.[80] However, in a franchising context, the fact that the parties may cancel an agreement by giving notice is highly problematic.[81] Further, a franchisor who enters into a contract, accepts the upfront payment for the franchise, and then cancels the contract by giving notice is clearly acting in an unconscionable manner.

In America, many states have statutes the prohibit the termination of franchise agreements without "good cause".[82] Good cause is usually defined as the franchisee's failure to comply substantially with his contractual obligations.[83] However, where there is no such statute, terminated franchisees must rely on the franchise contract. In many cases franchisees, in America, have turned to the duty of good faith and fair dealing which underlies all contracts, in order to argue that as a matter of public policy there is "a broad-based requirement that good cause is necessary for termination".[84] This duty has been recognised by the American courts because of the goodwill that has been created by the franchisee's efforts, and because of the reasonable expectations of the parties.[85] In *Atlantic Richfield Co v Razumic*[86] the court held that it was consistent with

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80 S 14(1)(b)(i)(bb). The cancellation may be subject to the payment of certain penalties but the nature and extent of these penalties have not yet been determined.

81 Discussed in 8.2.3.3 below.

82 McLaughlin and Jacobs "Termination of Franchises: Application of the Implied Covenant of Good Faith and Fair Dealing" (Summer 1987) *Franchise LJ* 14.

83 *Ibid.*

84 McLaughlin and Jacobs 1987 *Franchise LJ* 15.

85 Byers 1994 Journal of Corporation Law 634.

86 390 A.2d 736 (Pa 1978).

the parties reasonable expectations to presume that termination would not be abrupt and arbitrary when the franchisee has exerted substantial efforts to develop a local market for the franchisor's products. The court in *Kirke La Shelle Co v Paul Armstrong Co*[87] explained that the duty of good faith and fair dealing "meant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract".[88]

However, the courts do not recognise that failure to renew or termination is contrary to good faith when this is in accordance with the express terms of the contract.[89] McLaughlin and Jacobs explain that the "scope of the implied duty of good faith and fair dealing is derived from the contract between the parties and that the clearly expressed intention of the parties as to the circumstances in which termination may occur must guide the resolution of any subsequent 'wrongful termination' claim".[90] Therefore, it is where the contract is silent or ambiguous on the issue, that the courts have been able to find that if the franchisor terminates without good cause this constitutes a breach of the implied duty of good faith.[91] Nevertheless, the courts are not always consistent in their approach and so even where the contract has allowed for termination by the giving of notice, some courts have required that "good cause" be shown before the contract is terminated. It is only when the contract specifically states that the contract may be terminated "without cause" or "for any reason" that the courts have allowed termination without good cause. *Shell Oil Company v Marinello*[92] involved two contracts which could be terminated upon thirty and ten days notice respectively. The franchise agreements persisted for thirteen years and then Shell Oil Company gave notice that it was terminating the relationship in forty-five days. The court prohibited the termination on the basis that the public policy of New Jersey mandated that a requirement of good cause be "read into" all such agreements.[93] However, in *Tulsa*

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87 188 NE 163 (NY 1933).

88 167.

89 Byers 1994 *Journal of Corporation Law* 634 and McLaughlin and Jacobs 1987 *Franchise LJ* 15.

90 McLaughlin and Jacobs 1987 *Franchise LJ* 15.

91 McLaughlin and Jacobs point out that because the courts are not always consistent in their approach it is preferable for questions of termination to be clearly spelt out in the contract. This could avoid a costly dispute, "with unpredictable" results in the future (at 15).

92 63 NJ 402, 307 A.2d 598 (1973).

93 603.

Trailer & Body Inc v Trailormobile Inc[94] the court refused to imply that the duty of good faith allows termination only for good cause because the contract specifically stated that the contract could be terminated "with or without cause upon 60 days notice". A leading decision is *Corenswet Inc v Amana Refrigeration*.[95] In this case the parties had agreed that the contract could be terminated "at any time and for any reason". The Court of Appeals held that "where a contract contains a provision expressly sanctioning termination without cause there is no room for implying a term that bars such a termination".[96] The court also pointed out that these clauses can be beneficial because they permit parties to end a "soured relationship" without the threat of litigation.[97]

The problem is that such clauses allow for opportunistic behaviour. Because of this, Gellhorn advocates the use of unconscionability as a standard for judging franchisor behaviour when terminating a contract.[98] In a later article, he goes even further and suggests that it is unconscionable for a franchisor to have the unilateral right to terminate a contract even when the franchisor determines that he has just cause.[99] In discussing the debate about whether the right to terminate should be governed by a subjective good faith test or whether it should be governed by unconscionability, Gellhorn argues against using the good faith test because a franchisor may have a good reason for terminating and is not acting maliciously, but the consequences of that termination are very far reaching for the franchisee. He argues that the terminated franchisee seeks relief against the harsh effects of termination which may be unfairly placed on him, not against the franchisor's ill-will.[100] He concludes by arguing that even where a termination is commercially justified it should not be permitted when burdens placed on the franchisee "are so disproportionate as to be unfair".

In South Africa, following the court's approach in *Barkhuizen v Napier,* it could be argued that when a franchisor relies on a neutral term to terminate franchise contracts, the courts may refuse to enforce the clause because of the particular

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94 2 Bus Franchise Guide (CCH) 8615 at 16,524 (ND Okla 1986) quoted by McLaughlin and Jacobs in 1987 *Franchise LJ* at 17.

95 594 F2d 129 (5th Ci. 1979).

96 138.

97 138-139.

98 Gellhorn 1967 *Duke LJ* 465.

99 This was said in a discussion of the statutory provision that limited the right to terminate. See Gellhorn "Comment, Uniform Commercial Code §2-302 - Unilateral Right of Termination For Cause Determinable Solely by Franchisor Unconscionable" (1977) 55 *Tex L Rev* 541.

100 Gellhorn 1967 *Duke LJ* 521.

circumstances of the case. The courts must focus on the consequences of termination or refusal to renew for the franchisee rather than on whether the franchisor is acting maliciously. Public policy should not countenance the actions of a person who has been paid an upfront payment and then cancels the agreement before investors have had at least a reasonable time in which to recoup their investment. Focusing on consequences for franchisees will also mean that the courts can extend this approach to situations where the contract gives the franchisor the express power to do what it is doing. For example, if the franchisor is terminating after one year because it makes more business sense to run the store as a company-owned store rather than as a franchise, it will be difficult to argue that the franchisor is acting in bad faith, but the consequences for the franchisee may be very harsh. It could therefore be argued that it could be against public policy to uphold the right to terminate a successful franchise. It is not necessary that this will always be decided in favour of franchisees because courts will have to weigh up the right of franchisors to have their contracts enforced against the right of franchisees to have their legitimate expectations met. Another avenue for franchisors would be to undertake to make a goodwill payment when they terminate the relationship. Franchisees who are being adequately compensated for their loss may have difficulty establishing that it is against public policy to terminate their agreement, especially since this is what the contracts specify and this is what they agreed to.[101]

When contracts do not provide for notice at all, the agreements are terminable

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101 Franchisees must also understand that there is a certain amount of business risk involved and that a franchise may fail through no fault of the franchisor. The formula used for compensating a franchisee when the business is re-claimed by the franchisor may produce a realistic selling price based on market conditions. In 2006, Brenda McQueen, the then chair of FASA, reported that her husband had purchased a franchise for R1 million. He worked extremely hard for five years, he drew very little income from the business and was finally forced to sell it for R800 000. (The example was given at a franchise seminar held in Durban in 2006). She gave this example in the context that franchising involves hard work and is not a sure- fire recipe for success. This is something that most franchisees find very difficult to accept. In an interview conducted with a franchisee of a well-known fast food restaurant in June 2006, the franchisee explained how he had established his outlet in an area that he believed had the potential to be very successful. It was in a shopping centre opposite a large school. However, his expectations did not materialise and after five years he was forced to close the business. His attitude was that this was a business risk that did not succeed. Nevertheless, he believed in the franchise and had established another outlet of the same network in another area which he hoped would be more successful. Such a pragmatic attitude amongst franchisees who have not succeeded appears to be very unusual.

on reasonable notice.[102] However, the courts should, it is submitted, find that it is contrary to public policy to terminate the relationship without good cause. It is suggested that an approach similar to that followed in *Seegmillar v Western Men Inc*[103] be adopted. Here the court examined the intention of the parties, the general nature of franchise contracts and the substantial amount of time and effort and money which franchisees are expected to invest to develop and establish a market for the franchisor's product. The court found that even though the contract could be terminated on sixty days notice, allowing the franchisor to cancel the agreement without cause after such efforts by the franchisee would be unfair. In this particular case the contract did not state that the agreement could be terminated "without good cause" or "for any reason" whatsoever. It is accepted that it would be difficult to argue that it would be contrary to good faith if the parties have been specific about their intentions.

Although it has been suggested that the second stage of the two step test in *Barkhuizen v Napier* may assist franchisees whose franchise relationships are terminated, this requires a broad interpretation of Ncgobo J's judgment. It is questionable whether future courts will interpret the judgment in this fashion. Given the conservative approach of the Supreme Court of Appeal[104] it seems more likely that the courts will be prepared to interfere only in contracts when there is extreme inequality at the time the contract is concluded, and the stronger party has used this inequality to obtain an unfair advantage. The courts will probably therefore take into consideration only the situation which existed at the time the contract was concluded. Generally franchisees are not forced to contract on grounds that infringed their rights to dignity and equality, so they will be unable to argue that the contract should not be enforced. The solution therefore is to introduce legislation to create certainty, as has been done in America. As stated above, in certain states franchise contracts may be terminated only for good cause, and in terms of the Uniform Commercial Code[105] if an ongoing contract does not specify its duration, it is valid for a reasonable time. What constitutes a reasonable time will be determined on a case-by-case basis but in the case of franchising, it is suggested that franchisees who pay lump-sum franchise fees and also

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102 *Juglal NO v Shoprite Checkers* 259E.
103 20 Utah 2d 352, 437 P 2d 892 (1986).
104 As evidence in *Brisley v Drotsky* and *Afrox Healthcare v Strydom*.
105 UCC §2-309(2).

invest in facilities, stock, equipment and training do not expect their contracts to be terminated after a brief period. This is also the approach suggested by Blair and LaFontaine.[106]

5.3 Proposals for reform

This is one area where legislation can and should provide a solution. Byers, in his examination of the American law as it applies to franchising, argued in 1994 that there was a need for a federal franchise relationship law, particularly one that would apply to the termination of a franchise agreement.[107] He argued that some form of regulation of franchise terminations was necessary because "the structure of the franchise relationship itself, by requiring the franchisee to make non-recoverable franchise specific investments, subjects the franchisee to substantial economic risk".[108]

Each American state deals with this differently, but many forbid termination or non-renewal unless the franchisor can show "good cause".[109] This applies in some states to termination and in others to termination and failure to renew. In other states there may be no rule requiring renewal, but francisors are required to repurchase all or part of the franchisee's business. Many state statutes list specific action which constitutes good cause for termination and non renewal and when the good cause requirement can be waived. This was introduced as a result of franchisor lobbying and includes situations such as:

- franchisee failure to pay when due all or some of the royalties or fees owed to the franchisor;
- providing false reports to the franchisor;
- abandoning or ceasing to do business at a specific location;
- failure to correct defects in products or services;
- failure to meet franchisor standards or specifications or repeated

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106 Blair and LaFontaine *The Economics of Franchising* 276.

107 Byers 1994 *Journal of Corporation Law* 635.

108 Byers 1994 *Journal of Corporation Law* 642.

109 See generally Kaufman "An Introduction to Franchising and Franchise Law" in *Franchising Business and Legal Issues* (1992) 81. This applies only to those states that have franchise-specific rules.

violations of any contractual requirements;

- impairment of the trade mark;
- conviction for a crime;
- a court finding of bankruptcy or having bankruptcy proceedings instituted against the franchisee;
- general assignment of business assets to creditors;
- having a receiver or designee take over franchise operations;
- failure to adhere to the terms of any lease, mortgage, promissory note, installment loan, security agreement or other financial instrument the franchisor holds over either the franchise itself or the business premises;
- loss of the right to occupy the premises of the franchised business;
- government seizure of or foreclosure on the franchised premises;
- operating the franchise in a manner imminently endangering public health and safety;
- repeatedly failing to comply with lawful franchise agreement provisions and
- making a material misrepresentation to the franchisor.[110]

Another option is for franchisors who choose not to renew agreements to notify franchisees well in advance of their contract coming to an end. Franchisees are then permitted to sell their outlets to new franchisees and franchisors may not enforce restraint of trade provisions.

Ultimately, and taking into consideration any guidelines, what amounts to "good cause" is a matter for determination by the courts. For example, the court, In *Kealey Pharmacy & Home Care Service Inc v Walgreen Co*[111] refused to find good cause when a franchise agreement was terminated on the basis that the franchisees were producing an inadequate return and should, therefore, be terminated. The court held that the statute required a "failure by a dealer to comply substantially with essential and reasonable requirements imposed on him by the grantor (franchisor)" or "bad faith by

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110 See Emerson *American Business LJ* 582-583.

111 539F Supp 1357, 1366 (WD Wis 1982).

the dealer in carrying out the terms of the dealership (franchise)".[112] The court was in effect requiring the franchisor to have more than an economically sensible reason for terminating the agreement.

Franchisors are entitled to refuse to renew a franchise agreement if the parties fail to agree on changes in the agreement which have been proposed in good faith and which are not there for the purpose of preventing renewal. Proposed in "good faith" means that the new agreements were developed in the course of the franchisor's business and were not designed to discriminate against any franchisee.[113] Glickman states that rent increases have been the subject of most of the litigation challenging a franchisor's good faith in refusing to renew. She quotes an unreported Ninth Circuit Court of Appeals decision where the court held that as long as the franchisor does not have a discriminatory motive or use altered terms as a pretext for denying renewal, the franchisor acts in good faith. The courts do not want to be in a position where they have to second guess the economic motives of franchisors. Franchisees have to show, therefore, that the franchisor's decision is a sham or discriminatory or not in the usual course of business even in circumstances where the contract has been presented to a franchisee on a "take it or leave it" basis. In *Magerian v Exxon Corp*[114] the court found that because Exxon had considered objective criteria such as whether the store had been modernised in the previous two years, the volume of sales, the type of underground tanks and Exxon's internal return when it decided not to renew the franchise, its decision had been made in good faith.

It is suggested that in South Africa, legislation should be introduced to regulate termination and renewal of franchise contracts.[115] This is not necessarily a negative for franchisors because, in America, evidence suggests that franchisees pay more for a franchise where the franchisors' rights to terminate or refusal to renew a franchise are governed by state legislation.[116]

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112 350.

113 See generally Glickman *Franchising* §4.03 [7].

114 Business Franchise Guide (CCH) ¶11, 251 (9th Cir 1997).

115 See proposals in 9.5 below.

116 Glickman *Franchising* §4.03 [7]. McDonald's is generally regarded as one of the most successful franchise operations ever. Love reported that McDonald's never terminates a franchisee without offering either to find a buyer for the outlet or to buy the store itself at market value and resell it to a new franchisee (Love *McDonald's: Behind the Arches* 408). This was, however, in 1986 and it has not been possible to establish whether this is still true.

5.4 Conclusion

This chapter has demonstrated difficulties that are faced by both franchisees and franchisors when franchising is treated as a normal commercial contract subject to the same rules as other business transactions. Franchisors find it extremely difficult to protect their business interests through restraints of trade and franchisees find that they can very easily be deprived of a substantial business asset. There is a need therefore to regard franchising as a *sui generis* business relationship subject to its own rules and a need to introduce legislation to govern termination of the relationship. As far as termination is concerned, franchisors should be required to give errant franchisees an opportunity to rectify defects and they should be obliged to renew the agreements of properly performing franchisees. However, they must always have the right to terminate if franchisees consistently fail to meet their obligations. Alternatively, they should be obliged to compensate franchisees for goodwill.

Studies in more recent years in America suggest that franchisors are not engaging in opportunistic behaviour and that franchises are terminated only to eliminate franchises that are not performing.[117] It must be accepted that franchisors who are terminating relationships could be motivated by their desire to ensure that errant franchisees do not harm their reputations. There is also evidence that franchisors will pay goodwill to franchisees for their franchises rather then become involved in litigation.[118] A franchisor who is perceived to treat its franchisees badly will have difficulty finding new franchisees and since franchisors are in the business of franchising it seems to be a poor business decision deliberately to treat franchisees badly.[119] However, it is argued, that a change in attitude on the part of franchisors must in part be due to the fact that franchisors wish to avoid costly litigation. Terminating or refusing to renew franchises before the introduction of any legislation was relatively simple but now, because franchisors are required to show good cause, franchisors are far more likely to reconsider before they terminate a relationship or refuse to renew it.

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117 Blair and Lafontaine *The Economics of Franchising* 271.

118 This is what Byers 1994 *Journal of Corporation Law* 614 suggests is an equitable solution to the problem.

119 Some franchisors will, however, be moving out of franchising into a corporate-owned network therefore terminating franchises unfairly will not be a problem.

Legislation makes sure that franchisees are protected. Franchisors are also protected because if they do have good cause for terminating the relationship the courts will support their decision.[120]

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120 Blair and LaFontaine *The Economics of Franchising* 275.

CHAPTER SIX
FRANCHISING AND COMPETITION LAW

OUTLINE

Competition law regulates the conduct between competing businesses. Competition matters are regulated, in South Africa, by the Competition Act.[1] Although franchisors and their franchisees are part of the same network, they are, in law, regarded as competitors.[2] The purpose of this chapter is to develop an understanding of how the Act impacts on franchising.[3] The Act provides a framework for regulating anti-competitive conduct but it is still necessary to interpret the law within a particular context. Although the Competition

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1 Act 89 of 1998. Unless otherwise stated all references to "the Act" in this chapter refer to this Act. Most modern states have legislation which is designed to promote and foster competition in the marketplace because it is generally recognised that "free competition carries within itself the seeds of its own destruction by creating the possibility of the formation of cartels and monopolies" (Van Heerden and Neethling *Unlawful Competition* (2008) 12).

2 See in particular *Cancun Trading v Seven-Eleven Corporation* Case No 18/IR/Dec99 and the *Franchising Notice* "The Application of Certain Provisions of the Competition Act 89 of 1998, as amended, to Franchise Agreements" http://www.comptrib.com.

3 The earliest legislation in South Africa dealing with monopolies can be traced back to 1907 when the Cape Meat Trade Act 15 of 1907 was introduced to prevent monopolies from forming in the meat trade. Various statutes were introduced over the years as governments of the day attempted to promote competition within a free market. Despite these attempts the law was largely ineffective and the state failed to deal with monopolistic structures and anti-competitive conduct effectively. In 1955 the Regulation of Monopolistic Conditions Act 24 of 1955 was introduced. This was followed by the Maintenance and Promotion of Competition Act 96 of 1979 which established the Competition Board. Despite two attempts to strengthen the role of the Competition Board (in 1986 and 1990) the government failed to make a discernable difference and the South African economy continued to be dominated by a small number of conglomerates. For a full discussion of the history of competition regulation in South Africa see Becker *Monopolies Review of the Role of the Competition Board* (1992). Re-organising the South African economy became a major focus of the African National Congress even before it came to power in 1994 and, once it assumed power, it immediately set about developing a new competition policy for South Africa. See African National Congress "Policy guidelines for a Democratic South Africa" (1992) quoted by the DTI in "Proposed Guidelines for Competition Policy" (1997). See also Competition Commission Report "Competition Law and Policy in South Africa"(2003) and Lewis "The Competition Act 1998 – Merger Regulation" http://www.comptrib.co.za (accessed on 26 July 2000) . The Act has been identified as one of the most important pieces of legislation in South Africa, second only to the Constitution. See Wilson "Towards the Development of "Rules of Application" in the Interpretation of the Competition Act" http://www.competition-law.co.za/ffp/article/Robert.doc (accessed on 23 Jun 2003).

Commission (the Commission) has issued a *Franchising Notice* which clarifies that the Act applies to franchising, the Commission does not have a detailed competition policy developed for franchising.[4] This chapter therefore focuses on how competition regulation should be interpreted in the context of the franchise relationship.[5] Suggestions are also made regarding the appropriate response to a number of areas of concern that fall within the scope of competition regulation.[6]

6.1 Introduction to franchising and competition regulation

At present, there are very few decided cases that deal specifically with franchising and competition law.[7] However, it is anticipated that as franchising matures as a business

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4 This *Franchising Notice* is intended purely as a guide aimed at clarifying certain matters. It is not binding on the competition authorities (see para 1.1). Some parties have argued that the Act should not apply to franchising because of the nature of the business model, but this has not been accepted by the Commission (para 2.1 and para 2.4).

5 See also Woker "Towards understanding the relationship between franchising and competition law" (2006) 18 *SA Merc LJ* 1.

6 Examples are the appointment of more franchisees within a specific area, the setting of prices and requiring franchisees to purchase their products from more than one supplier.

7 The Tribunal has dealt in any detail with only one franchising matter, namely *Cancun Trading No 24 CC v Seven-Eleven Corporation SA(Pty) Ltd*. On 5 June 2005 the Commission referred five motor manufacturers, two importers and 845 dealers to the Competition Tribunal (the Tribunal) for adjudication of alleged offences in terms of the Act. This investigation followed a previous one that resulted in Toyota SA paying an administrative penalty of R12 million for resale price maintenance, commonly known as price fixing. The Commission was concerned about alleged restrictive provisions in the manufacturers' dealer franchise agreements, the role and activities of dealer franchise councils, and the behaviour of the parties in the context of franchise agreements, particularly with regard to pricing and sales practice (Cockayne "Car Industry takes on Commission's Findings" 5 June 2005 *Sunday Tribune Business Report*). If the matter had proceeded to a full hearing before the Tribunal, the Tribunal would, in all probability, have dealt with the complex question of the relationship between franchising and the law of competition. The manufacturers and dealers, however, settled the matter and whilst they did not admit that they were contravening the Act, they agreed to pay administrative penalties that ranged from R150 000 to R12 million. They entered into agreements with the Commission in terms of s 49D. These agreements were confirmed by the Tribunal, without the Tribunal hearing any evidence, as consent orders in terms of s 58(1)(b). See *Competition Commission v DaimlerChrysler South Africa (Pty) Ltd, Boundless Trade 154 (Pty) Ltd trading as Citroën South Africa, General Motors South Africa (Pty) Ltd, Nissan South Africa (Pty) Ltd, Appointed Dealers of Subaru SA and Volkswagen South Africa (Pty) Ltd & Gauteng Volkswagen Franchised Dealers* Case No 115/CR/Dec05. In February 2006 the Commission and certain BMW dealers entered into a similar agreement. See *Competition Commission v BMW Dealers* Case No 11/CR/Feb06. The agreements focused only on price fixing and the Commission decided that it would not refer the other possible contraventions of the Act to the Tribunal. The Tribunal also imposed a fine of R3 million on Federal Mogul Aftermarket for setting a minimum resale price in respect of

model, competition issues relating to franchising will increasingly become the subject of disputes in South Africa.[8] There has been extensive litigation in other jurisdictions,[9] particularly in America, where antitrust law was seen as a means of curbing at least some perceived franchisor abuses in the time before franchis-specific legislation was introduced.

Competition authorities may not have an appreciation that there are certain *prima facie* competition problems that are inherent in the nature of franchising. There is a need to ensure that regulation does not impede the development of franchising as a business model. An important decision in the European Union (EU) was *Pronuptia v Schillgalis.*[10] The European Court of Justice found that certain terms common to franchise agreements (particularly those that related to market sharing or price limitations) restricted competition,[11] but it also found that circumstances were such that certain restraints should be granted an exemption from competition law.[12] Following this decision and others by the EU Commission,[13] the EU Commission granted a block exemption for certain aspects of

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spare parts. See *Competition Commission v Federal Mogul Aftermarket Southern Africa (Pty) Ltd & Others* Case No O8/CR/Feb01. This was confirmed by the Competition Appeal Court in *Federal Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission* Case No 33/CAC/Sept03. The Commission, in 2005, found Itatile Franchising, Italtile Ceramics and Italtile Ltd guilty of price fixing and threatening to cancel the franchises of those who did not abide by the franchisor's prices. The respondents were ordered to pay a fine of R2 million. See *The Competition Commission v Italtile Franchising and Others* CC Case No 2001 Sep1.

8 *Silent Pond Investments CC v Woolworths (Pty) Limited and Engen Petroleum Limited* involved a number of issues, particularly territorial encroachment, price setting and exclusive dealing, which have implications for competition law but the matter focused on the duty of good faith (see 3.5.3.1 above). The competition issues were not discussed. See also Crotty "Woolworths settles price cuts with Serious Foods".

9 See generally OECD Franchise Report.

10 (1986) ECR 353 (ECJ).

11 Other provisions that enable franchisors to supply their methods and know-how without risk that this information will benefit competitors, were held not to be anti-competitive. In other words, reasonable restraints of trade are not anti-competitive (*Pronuptia v Schillgalis* para 16). For a full discussion of restraints of trade see 5.1.3 above. Likewise, those measures necessary for maintaining the identity and reputation of the network were also held not to be anti-competitive (*Pronuptia v Schillgalis* para 17).

12 General competition laws for the EU are laid down in Articles 81 and 82 (formerly Articles 85 and 86) of the EU Treaty. Article 81 prohibits those agreements "which may affect trade between member states and which have as their object or effect the prevention, restriction or distortion of competition within the common market". These agreements are automatically void (see art 81(2)).

13 *Yves Rocher OJ* No L8, 10 Jan 1987 at 49; *Computerland OJ* No L222, 10 Aug 1987 at 12; *ServiceMaster OJ* No L332, 3 Dec 1988 at 28; and *Charles Jourdan, OJ* No L35, 7 Feb 1989 at 31.

franchise agreements.[14]

Franchising, as a business model, has advantages for both franchisors and franchisees,[15] but because franchisees have tied into the franchisors' most important assets (their trade marks with attached goodwill) franchisors need to exert considerable control over their franchisees. They must ensure that their trade marks are protected and that national goodwill is developed that will enhance the investment made by the franchisors as well as other franchisees. As pointed out by Wachstock and Amarante:[16]

> [T]he franchise prescribes such factors as the "look and feel" of the franchise; the required equipment and supplies used in each franchise to create, display, or market the end product to the consumer; the specifications for that end product; record-keeping methods; and systems of cost control, promotion and advertising. Each of these component parts of ... franchising is an inseparable part of the package. ... Franchisees do not simply buy a trade mark license and run the business as they see fit, and they also do not choose to take certain parts of the system and eschew others.

The extent of franchisor control has been the subject of extensive litigation in other jurisdictions, particularly in America, with one of the primary issues being whether franchising restricts competition in violation of competition regulations.[17] The incorrect

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14 Regulation 4087/88 of 30 Nov 1988. This regulation remained in force until 31 May 2000. It was then superceded by a Block Exemption Regulation 2790/1999 that applied to vertical restraints generally and Block Exemption Regulations 2658 and 2659/2000 that applied to horizontal restraints generally, and not just to franchising. Information regarding the EU Commission, the relevant treaties, regulations and guidelines can be obtained from the Commission website at http://wwweuropa.eu.int/comm. These block exemptions were issued to stem the flow of notifications to the Commission and to provide guidance regarding those transactions which are not regarded as anti-competitive. They also contain a list of restrictions which remain prohibited. These are referred to as hard core restrictions. See generally Audia, Tamussino and Hull "Recent Developments in European Competition Law: Vertical and Horizontal Agreements" (2001) 19 *ACCA Docket* 52.

15 See generally Chapter Two; Glickman *Franchising* §1-1; Illetschko "A Brief Introduction to Franchising" in *Franchise Book of Southern Africa 2001* 17; Beyer *Franchise Law and Practice* §2:4ff and Byers 1994 *Journal of Corporation Law* 612.

16 Wachstock and Amarante "Antitrust and Franchising: Conspiracies between Franchisors and Franchisees under S 1" (2003) 23 *Franchise LJ* 7 at 12.

17 Glickman *Franchising* para 2.01.

resolution of concerns relating to competition issues may result in the entire nature of franchising losing its unique business appeal, and the benefits of franchising being lost. Although certain restrictions may limit competition, co-ordination and co-operation between the parties can also benefit both parties by increasing profits, and it can benefit society by increasing economic efficiency.[18] Understanding the relationship between franchisor and franchisee and understanding how an effective franchise operates within the economy is critical to understanding the role that competition law must play in the promotion and success of franchising in the economy.

6.2 A brief introduction to competition law in South Africa[19]

The Act sets out basic competition rules and is designed to prevent (a) anti-competitive horizontal conduct,[20] (b) anti-competitive vertical conduct,[21] and (c) abuse of a dominant position.[22] In some instances the Act's prohibitions are absolute in the sense that no exceptions are made for them. The only recourse is to apply for an exemption from the Act.[23] These prohibitions are known as per se prohibitions. Agreements that are illegal per

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18 OECD Franchise Report 10.

19 A full discussion of competition policy and law is beyond the scope of this thesis and so this section is merely intended to introduce some important concepts that are relevant to this thesis. For a comprehensive discussion of competition law see OECD Franchise Report and Reyburn *Competition Law of South Africa* (2000).

20 S 1 defines a horizontal relationship as a relationship between competitors. This section deals with agreements between parties that are competing on the same level of the marketing structure. S 4 prohibits restrictive horizontal practices. The most problematic horizontal agreements are those that restrict prices, limit outputs, involve collusive tendering and divide up markets between distributors.

21 S 1 defines a vertical relationship as a relationship between a firm and its suppliers and/or customers. This section deals with agreements between parties that are operating on different levels of the marketing structure. S 5 prohibits restrictive vertical practices. Problematic agreements are those agreements that attempt to control different aspects of distribution such as setting of maximum and minimum prices, the granting of exclusive territories, tying certain products together or requiring a distributor to carry a full line of products.

22 The law does not prevent a firm from being in a dominant position but only from using its dominance to abuse its competitors or consumers by, for example, charging excessive prices or engaging in an exclusionary act (s 8). An exclusionary act is defined as any act that impedes or prevents a firm from entering into or expanding within a market (s 1). The Act also deals with merger control, but for purposes of this thesis a discussion of mergers is not relevant.

23 S 10.

se include vertical and horizontal price fixing agreements[24] and agreements in terms of which competitors divide markets by allocating customers, suppliers, territories or specific types of goods or services,[25] or when competitors collude in tendering for business.[26] Competing firms may enter into other agreements (that are not prohibited per se) but if those agreements interfere with competition they are prohibited, unless one party can show that there are pro-competitive gains that outweigh the anti-competitive effect. Such conduct is subject to the rule of reason and the test will be one of reasonableness.[27] Competing firms that try to shield themselves from competition will, in all probability, be acting contrary to the Act.

The new competition authority consists of a three-tiered structure comprising the Commission, the Tribunal and the Competition Appeal Court. The main role of the Commission is to carry out the day-to-day operations of the Act (including investigating complaints, negotiating consent orders, authorising intermediate mergers and, where necessary, referring matters to the Tribunal).[28] The Tribunal is an adjudicative body that deals with matters relating to prohibited practices, exemptions and larger mergers.[29] The Tribunal also deals with appeals from decisions made by the Commission. The Appeal Court is similar to that of a High Court in status. It considers appeals from or reviews of decisions of the Tribunal.[30]

6.3 The franchise relationship

There has not always been agreement over whether competition regulation applies to franchising because some see franchisors and franchisees as part of the same organisation rather than as competitors. In *Cancun Trading v Seven-Eleven Corporation*,

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24 Ss 4(1)(b) and 5(2).
25 S 4(1)(b)(ii).
26 S 4(1)(b)(iii).
27 Ss 4(a) and 5(c). The terminology has been adopted from America. See *Franchising Notice* para 4.4 and Reyburn *Competition Law* Com-14.
28 S 21.
29 S 27.
30 S 37.

for example, the franchisor argued that a franchise operation must be viewed as a single business entity or association and it must be accepted that it operates in the market as a chain of stores.[31] If this were the case, then franchisors and franchisees would not be in a vertical relationship and franchisees themselves would not be competitors. They would be one entity competing as a unit against other similar businesses, and internal management and control issues would not fall under competition regulation. The Tribunal did not accept this argument. It concluded instead that franchisees are independent businesses because franchisees invest their own capital in their own businesses, pay and are liable for operating expenses, absorb their own losses, and enjoy net profits.[32] The Tribunal also examined the law in a number of other jurisdictions, including America and Europe, and concluded that franchising is not regarded as an intra-firm transaction that is immune from competition laws.[33] The *Franchising Notice* confirms this conclusion.[34]

This conclusion has important implications for agreements that franchisees may

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31 Para 36.

32 Para 37.

33 It seems that the issue is not so clear cut in America. There have been a number of decisions in which the courts have held that a franchisor and franchisee are legally incapable of conspiring in restraint of trade. See Wachsstock and Amarante 2003 *Franchise LJ* 7. In *Williams v Fischer* 794 F Supp 1026 (D Nev, 1992), the court noted (at 1031): "In a fast-food franchise the franchisor does everything to promote a uniform, non-competitive environment between the franchises: each franchise serves substantially the same products, the products are served to the public in the same manner, the franchisor develops products and services for all franchises; the employees dress alike; the decor of each franchise is similar; the franchises are advertised as a single enterprise with a single logo; and the franchisor contracts with each franchise for exclusivity within a certain geographical area to minimise competition between franchises". The court concluded that the franchisor's total control and the common economic goals of all the parties made them a single enterprise, incapable of competing (at 1032). The Ninth Circuit Court confirmed that this was a "common enterprise" (see 999 F2d 445 (9th Cir 1993) at 447). A similar approach was followed in *Hall v Burger King Corp* 912 F Supp 1509 (SD Fla 1995) and *Search International v Snelling & Snelling* 168 F Supp 2d 621 (ND Tex 2001). These decisions must, however, be compared to *Perma Life Mufflers, Inc v International Parts Corp* 392 US 134 (1968). In *Perma Life Mufflers* the Supreme Court reversed a lower court decision that found that a Midas franchise network was a single business entity. The Supreme Court held: "Since [the parties] availed themselves of the privilege of doing business through separate corporations, the fact of common ownership does not save them from any of the obligations that the law imposes on separate entities"(at 141-142). Wachstock and Amarante criticise the *Williams*, *Hall* and *Search* decisions because they do not refer to *Perma Life Mufflers* notwithstanding the fact that this is the "US Supreme Court's most direct discussion of the franchise conspiracy issue" (at 11). However, they do point out that there is merit to these decisions because they recognise that "franchising cannot function – and deliver all of the benefits that it provides to franchisors, franchisees, consumers, and the economy at large – without numerous restrictions on franchisee independence" (at 7).

34 Para 3.3.

enter into amongst themselves and for restrictions that franchisors may impose on their franchisees. Franchisees in the same network are in a horizontal relationship with each other. This means that it is prohibited per se for franchisees to conspire when setting prices,[35] to divide markets by allocating customers, suppliers, territories or specific types of goods or services, and to collude when tendering for business. As these agreements are prohibited per se it is not necessary to consider whether or not there is a justifiable reason for such agreements, or whether they will have any effect on the market. They simply may not be entered into. Franchisees must be careful when entering into any other agreement because these may also be prohibited if they have the effect of substantially preventing or lessening competition. However, franchisees may be able to demonstrate that pro-competitive gains outweigh the anti-competitive effect.

The relationship between franchisors and their franchisees is a vertical one. Minimum resale-price maintenance is per se prohibited,[36] and any other agreement is prohibited if it will prevent or lessen competition, unless one of the parties can show some technological, efficiency or other pro-competitive benefit that outweighs the anti-competitive effect.[37] It is therefore important for franchisors to consider the reasons why certain restrictions are placed on their franchisees. Restrictions should operate to benefit the network as a whole and should not exist merely to enhance the franchisors' profitability at

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35 It is not necessary to have an actual agreement to fix prices as sharing cost and profit information may also constitute price fixing if this is likely to affect price decisions of competitors. This is an area in which franchisee associations or dealer councils can run into difficulties with competition authorities. Dealer councils, common amongst motor vehicle dealerships, are independent franchisee associations that are created by and for the franchisees, usually from the same brand. In America these have been compared to the fledging labour unions that were formed in the early days of the Industrial Revolution: see Caruso "How Independent Franchisee Associations Can Effectively Influence Franchisor Behaviour" (2004) Annual Meeting of the American Association of Franchisees and Dealers http://www.cdcaruso.com (accessed on 14 June 2005). However, labour unions are generally granted an exemption from competition law and have the right, in terms of statutory law, to organise and bargain collectively. In South Africa the Act does not apply to collective bargaining (see s 3(1)(a)). Franchise councils are subject to competition regulation and must be very careful about how they advise their members, particularly when dealing with issues relating to prices and market allocations. See Competition Commission cases discussed above in note 7. See also Taperell, Vermeesch & Harland *Trade Practices and Consumer Protection* (1983) 576, where the authors, discussing the Australian position, warn that if trade associations perform functions such as developing standard terms and conditions of contract and marketing practices, their functions could easily be interpreted as a means of facilitating anti-competitive behaviour, such as price fixing.

36 S 5(2).

37 S 5(1).

the expense of their franchisees and consumers. The types of restrictions which franchisors impose on their franchisees and the implications of these from a competition law perspective are discussed in 6.6 below.

6.4 Franchisor dominance

While there is a need for franchisors to control the way in which franchisees operate, franchisors may become engaged in anti-competitive behaviour which brings them into conflict with the Act. A particular franchisor may act anti-competitively when it occupies a dominant role in the marketplace and its conduct has an adverse effect on the market as whole, or its franchisees may allege that the franchisor is abusing its dominant relationship with its franchisees.

6.4.1 Dominance in the marketplace

One of the main functions of competition regulation is to prevent a dominant firm from abusing its position by, for example, refusing to deal with certain suppliers or by insisting that goods are purchased from specific suppliers only. Usually complaints of dominance emanate from smaller firms that find that they are being excluded from participating in the market by a dominant firm. An example is the American case of *Eastman Kodak Co v Image Technical Services Inc.*[38] Independent service providers complained because Kodak was refusing to supply them, or any Kodak equipment owners who used such independents, with spare parts for its equipment. The result was that independent service providers could not compete with officially recognised Kodak service organisations.

When this type of complaint arises, a firm is regarded as acting contrary to the Act only if they are the dominant firm in the marketplace. Therefore it is necessary first to

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[38] 504 US 451 112 Sct 2073, 2090 (1992).

establish the market in which the firms are operating.[39] Whilst understanding the concept of the "market" is fundamental to applying and enforcing the law, the Act does not provide a definition and it is not always easy to establish this with any certainty.[40] The Act does however define "goods and services".[41] In addition, the Act states that when the term is used in respect of specific goods or services this use includes any other goods or services that are reasonably capable of being substituted for them, taking into account ordinary commercial practice and geographical, technical and temporal restraints. Brookes argues that a "market can be explained by referring to the definition of 'goods and services' in which the principle of substitutability is recognised".[42]

In *Competition Tribunal v Cancun Trading No 24 CC* the Tribunal had to distinguish

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39 It is important to identify the correct product market, functional market and geographic market (see *Competition News* "Transport Costs and the relevant geographic market" Edition 8 June 2002). The product market is determined by factors such as supply and demand substitutability. The functional market relates to the position of the product within the supply chain, from the various processes of manufacture down to distribution and sale to the final consumer. The relevant geographic market will be defined by how easy it is to obtain the product in different locations. The most important components are the geographic and product components. The product market is usually delineated by establishing what a likely buyer would do if there was a small but "significant and non transitory price" increase (usually in the range of 5-10%) imposed by a hypothetical monopolist. If many buyers would swop to another product which was initially thought to be outside the market under consideration, then the market is too small. The market must then be extended to include other products which were initially thought to be outside the target market. A similar process is used to establish the geographic market. An area is identified and if a buyer would be prepared to venture outside this area to find a substitute product if the hypothetical monopolist were to increase the price, then the area is too small and must be extended. In this process the concept of "elasticity of demand" is of crucial importance. Brookes defines this "as the ratio of the percentage change in price that induced the quantity change". If there is a high elasticity of demand for a product then it means that there are lots of substitutes available and a particular firm is not dominant in the market. However, if there is low elasticity of demand then it indicates that there are no substitutes for a particular product. If the hypothetical monopolist were to increase prices consumers would have no alternative but to pay the price. See Brookes "Defining a Market in South African Competition Law" 27 August 2002 http://wwwcomptrib.com (accessed on 28 October 2002).

40 In *Highfield Steel and Vanaduim Corporation Ltd, Van Leer South Africa, and Steelbank Merchants (Pty) Ltd trading as Drumpak* Case No 06/LM/Oct/99 the Tribunal pointed out that "it is near impossible to define relevant markets with absolute scientific precision".

41 S 1(1).

42 See generally Brookes "Defining a Market in South African Competition Law" in which he discusses foreign competition authorities' guidelines from authorities such as the American Department of Justice and Federal Trade Commission, the Canadian Competition Bureau, the Australian Competition Commission, the European Union and the United Kingdom Office of Fair Trading. In addition, the courts in some jurisdictions, such as America, have had considerable experience in demarcating markets. The Act makes provision for any person interpreting and applying the Act to consider appropriate foreign and international law (s 1(3)).

between supermarkets, corner cafés and neighbourhood convenience stores. The complainant franchisees averred that the relevant market was convenience stores in the Western Cape.[43] They argued that convenience stores are distinct from supermarkets because they carry a more limited range of products, their trading hours are longer and they do not locate themselves in shopping malls but at sites easily accessible to residential areas. They also distinguished themselves from corner cafés because they carry a much larger stock. The franchisees concluded that their competitors were other convenience stores such as the Eight till Late franchise and certain of the larger neighbourhood cafés as well as some service station forecourt stores. They further asserted that the franchisor's share of this market was approximately 50%. The Tribunal accepted the distinction between supermarkets, convenience stores and corner cafés but it did not accept the assertion that the respondent possessed 50% of the convenience store market in the Western Cape, because this assertion was "thoroughly unsubstantiated".[44] Moreover, the Tribunal pointed out that the definition of the relevant geographic market, the Western Cape, was not persuasive because the hallmark of a convenience store is convenience.[45] The Tribunal argued that it cannot be said that a store in Plumstead is competing with a store in Sea Point, much less a store in Stellenbosch. The Tribunal said that competition is provided by other stores conveniently close to the residential hinterland served by each

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43 Para 29.

44 Para 30.

45 When determining the geographical market the authorities will consider the area in which the sellers operate and whether buyers will travel to those areas. Brookes states that the "market area selected must both correspond to the commercial realities of the industry and must be economically significant" (Brookes "Defining a Market in South African Competition Law"). So the geographical market is not defined in terms of whether an individual firm operates on a national or local basis. One business cannot, therefore, argue that it is not dominant because there is another producer/seller operating in another area where it would not be commercially viable for consumers to travel to that area in order to obtain that product or service. This argument is particularly relevant to South Africa because many consumers are not able to move around easily and may be confined to a very limited geographical market. Brookes criticises the Tribunal in its decision *JD Group Ltd/Ellerine Holdings Ltd* Case No 78/LM/July00 which involved the possible merger between these two firms because the Tribunal agreed with the merging parties that the geographic market was a national one. The Commission on the other hand argued that there were a large number of local markets. The Tribunal's approach can be criticised on the basis that from a consumer's perspective, a merger between these two furniture stores will mean that, in particular areas, consumers will no longer benefit from a choice of products or suppliers. (The Tribunal did not however allow the merger because the transaction would have resulted in the removal of an "extremely effective competitor" and was likely to substantially lessen competition in the marketplace (para 4.3)).

Seven-Eleven store. It concluded that the relevant geographic market is considerably narrower than that suggested by the claimants and that a more detailed investigation may indeed conclude that Seven-Eleven stores do enjoy dominant market shares when measured by the share of the consumer market enjoyed by convenience stores in each of the neighbourhoods in which the individual stores are located. However, because the Tribunal had not been provided with sufficient evidence it could not reach a conclusion about the relevant market. It is, therefore, important to obtain as much empirical data as possible to substantiate assumptions about the market and how it will be adversely affected by certain conduct.[46]

In franchising matters, the American courts have traditionally held that the relevant market must include all reasonably interchangeable franchise opportunities or products. This means that if there are lots of substitutes available in a particular market then a particular franchisor cannot be regarded as being dominant in the market,[47] and it will not be regarded as acting anti-competitively when restrictions are placed on the way in which its franchisees operate. But a different approach to market dominance was followed by the American Supreme Court in *Eastman Kodak Co v Image Technical Services Inc.* In this matter service providers, to whom Kodak refused to sell replacement parts, alleged that Kodak was dominant in a very restrictive market, namely: the market that consisted of replacement parts for Kodak copiers. Kodak disputed that it had market power because it faced competition from other equipment suppliers.[48] The Supreme Court rejected Kodak's argument that "as a matter of law, a single brand product or service can never be a relevant market". The court held that "because service and parts for Kodak equipment

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46 An example is *Bromor Foods (Pty) Ltd/National Brands Ltd* Case No 19/LM/Feb00. Substantial evidence relating to matters such as business plans and price differentials was led to substantiate the claim that sports drinks constituted a different market to the market for non-alcoholic beverages.

47 See Tribunal Case No 69/AM/Dec01, an appeal from a Commission decision regarding the intermediate merger between Astral Foods Limited and National Chick Limited. This matter involved the merger of two producers of animal feed in the KwaZulu-Natal Midlands area. The Commission was of the view that the geographical area was confined to the KwaZulu-Natal midlands area but the respondents argued that at the very least the whole of KwaZulu-Natal should be considered. The Commission found that very little feed was brought into the midlands from outside and so the geographical area should be confined to the midlands. The respondents accepted this part of the decision and confined their appeal to other issues.

48 Kodak sold only 23% of high volume copiers and only 2% of other copiers.

are not interchangeable with other manufacturers' service and parts, the relevant market from the Kodak-owner's perspective is composed only of those companies that service Kodak machines". As a result of this case, a number of other decisions have found there to be unlawful ties when this type of "lock-in" prevents other firms from entering the market.[49] The issue of market dominance is particularly relevant when faced with tying and exclusive dealing agreements. These are discussed further in 6.5.2 and 6.5.3 below.

6.4.2 Franchisor dominance over franchisees

The core provisions of the Act focus on restrictive practices, abuse of dominance and merger control. In most instances, whether or not the law applies depends on a proper identification of the market being affected.[50] However, franchisees are not usually concerned about the position the franchisor holds in the marketplace as a whole. Rather they are concerned about the dominant position which the franchisor holds over them. Franchisors may place restrictions on their franchisees which, although they have no effect on the marketplace as a whole, affect franchisees in an anti-competitive and/or abusive way. This sort of dominance is referred to as relational dominance, and is usually quite different from issues of dominance in competition matters. Franchisor market power over franchisees usually has nothing to do with franchisor share of the inter-brand market but exists because franchisees have made considerable financial and emotional commitments to the network. Franchisees cannot simply walk away from the network if they are unhappy with the arrangement. The question that must be decided is whether it is correct to seek solutions to this problem in competition law.[51]

A dominant firm is usually one that occupies a large position in the marketplace,[52]

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49 See generally Cantor "Tying, Exclusive Dealing and Franchising Issues" (2001) 42nd Annual Antitrust Law Institute New York City (May 10-11) Chicago (May 17-18) 32.

50 For example, s 4(1) and s 5(1) state that an agreement or practice is prohibited if it has the effect of preventing or lessening competition in a market and when dealing with abuse of dominance the firm under investigation must be dominant in a "market".

51 The issue of relational dominance was referred to "tentatively" and "obliquely" by the complainants in *Cancun Trading No 24 CC*. The Tribunal was unable to decide whether this issue should fall within the realm of competition regulation because it was not supplied with sufficient information.

52 See Silberman "The Myths of Franchise Market Power" (1996) 65 *Antitrust LJ* 181.

but a smaller firm can have market power and can also be guilty of abusing a dominant position.[53] Franchisees will probably rely on the provision that franchisors, although not dominant from a numerical point of view, nevertheless have market power in relation to their franchisees. Understood in this way, "dominance" will not be determined by the power the network enjoys in the market, but rather by the relationship between the franchisor and its franchisees.

Using competition law to provide remedies for disgruntled franchisees in these circumstances has received support in America,[54] but Silberman argues that this issue has only a superficial similarity to competition matters and that there are significant analytical differences between competition concerns with market power and the misuse of relational powers under contract law. He maintains that franchise matters that have relied on antitrust law to solve relationship issues are often misstated and inaccurately analysed.[55]

In Canada, abuse of a dominant position is governed by its Competition Act.[56] The law targets cartels and it is necessary to be able to distinguish between a lawful strategic alliance such as joint ventures, buying group ventures, development initiatives or franchises and illegal cartels.[57] Zaid discusses a number of examples of franchisor dominance and, in each of these examples, it is a question of the network (franchisor and franchisees together) engaged in some conduct which "squeezes" out, disciplines or eliminates a competitor outside that network.[58] He does not refer to the situation in which franchisees are accusing franchisors of abusing their relationship power, suggesting therefore, that this abuse is not regarded as an issue which should be dealt with in terms of competition regulation. A similar approach is found in the American case of *Queen City Pizza v Domino's Pizza Inc.*[59] Here the court ruled that where franchisees make allegations of

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53 A firm is regarded as being dominant even if it has less than 35 per cent of the market provided it has market power (s 7(c)). "Market power" is defined as the power to control prices, to exclude competition, or to behave to an appreciable extent independently of its competitors, customers or suppliers (s 1).

54 Grimes "When Do Franchisors Have Market Power? Anti Trust Remedies for Franchisees" (1996) *Antitrust LJ* 105.

55 Silberman 1996 *Antitrust LJ* 181.

56 RSC 1985.

57 Fasken MartineauDuMoulin LLP *Antitrust/Competition & Marketing Bulletin* December 2003.

58 Zaid *Franchise Law* 158.

59 922 F Supp 1055 (ED Pa 1996).

wrongdoing in the post-contractual setting, the principles of contract are involved, and that these concerns are not matters relating to competition regulation.

These arguments help to clarify that relational problems are better dealt with through principles relating to contract law or by the introduction of a code of conduct for franchising rather than by seeking to use competition regulation. Competition regulation is designed to foster competition in the marketplace and to ensure the protection of consumers. Competition matters require a proper economic consideration of the marketplace as a whole. Individual relationship problems should not be treated as if these were competition issues. As Silberman points out "the potential economic power that a franchisor may have in relationship to its franchisees has nothing to do with market power, ultimate consumer welfare, or antitrust".[60] When competition regulation is used to resolve relationship problems there is a confusion of issues and the policy behind the law tends to be lost. Competition regulation should therefore not apply when franchisees are concerned about the influence which franchisors have over them.

In addition, recent developments in the law of contract, provide necessary assistance for resolving relationship issues without confusing the issue with consideration of competition regulation. If it can be shown that franchisors are abusing their dominant position, it would be preferable to consider the terms of the contract. The approach suggested by Davis J in *Mort NO v Henry Shields-Chait* should be followed. In other words the courts must scrutinise the content of the contracts, consider the manner in which the parties created their contractual relationships and the courts must have regard to the parties legitimate expectations. After concluding such an examination the court will be able to evaluate whether there has been an unreasonable promotion of the interests of one of the parties and whether the principle of enforcing the contract can be trumped.[61] When the

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60 Silberman 1996 *Antitrust LJ* 186. The Competition Commission acknowledged the difficult position that franchisees found themselves in when dealing with the Daimler Chrysler restructuring of its network. The RMI challenged the restructuring on the basis that this was a merger and that this would lead to fewer Daimler Chrysler franchisees. The Commission held, however, that because Daimler Chrysler was not dominant in the marketplace there would not be any lessening of competition and therefore the issues raised by the RMI were contractual issues and not competition matters. See Competition Commission "Competition Commission Recommends unconditional approval for Daimler Chrysler to restructure dealer networks".

61 475 H-I.

contract is silent on a particular issue the courts could rely on the duty of good faith inherent in franchise contracts in order to interpret the contract in such a way as to give effect to the legitimate expectations of the parties.

6.5 Restrictions in franchise agreements

Franchising is about imposing vertical restraints because the terms of the agreement organise a vertical relationship between franchisor and franchisee and ensure that there is co-ordination about what would otherwise be independent decisions. The parties make choices regarding the prices they will charge, the quality of the product or service that is offered, choices regarding where products are sourced from, and at what level products or services will be offered.[62] Independent businesses make these decisions on their own, taking into consideration only their own interests. Such an approach cannot succeed in franchising because the business model is based on co-ordination between all the parties. Kaufman explains that the "economic underpinnings of franchising are to be found in the concept of uniformity".[63] Franchisors will, therefore, impose vertical restrictions, such as tying and exclusive dealing arrangements, to ensure that they have control over choices made by franchisees. In addition, franchise agreements usually contain a number of clauses that have the effect of reducing competition between franchisees. Examples are territorial restrictions on franchisee right to trade or preventing franchisors from appointing franchisees within an area that has already been allocated.

If franchisees are allowed to act independently, the system will ultimately break down. The purpose of vertical restrictions is, therefore, to protect the network and such restrictions should be designed to promote the system and to ensure economic efficiency.[64]

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62 OECD Franchise Report 33.

63 Kaufman "An Introduction to Franchising and Franchising Law" in *Franchising – Business and Legal Issues* 13.

64 They may also have other purposes such as protecting intellectual property rights and limiting opportunistic behaviour or free-riding. Free-riding occurs when one franchisee provides services such as advertising material and pre-sales advice regarding the products and services he charges and another does not. One example is a franchise that involves plumbing supplies such as kitchen and bathroom sinks, tap mixers and other accessories. The first franchisee has an attractive show room

However, restrictions can also have the opposite effect. Clearly, it is difficult to state that any particular vertical restraint is per se anti-competitive. The OECD has derived the following lessons from its analysis of the economic effects of vertical franchising agreements:[65]

- vertical restraint such as territorial restrictions, tie-ins, vertical price restraints cannot be viewed simply as anti-competitive. All restraints can either increase or decrease efficiency and so provisions must be examined within their context. (The OECD gives an example of a territorial restraint that may enhance efficiency because it prevents free-riding but which could also be used to reduce interbrand competition).
- Market structure and competition from other businesses is a crucial factor when considering the effects of vertical restraints in franchise agreements. Where the franchise system faces strong competition from other businesses, vertical restraints used by a franchisor will probably not affect competition.[66] The relevant product and geographic market are the most important factors in determining the effects of franchise provisions on economic efficiency. The relevant product market includes products from both other franchise systems or from distribution systems that do not adopt the franchise method. In analysing vertical restraints, competition policy must take into consideration all competitors in the market and, whilst vertical restraints may

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in which all the available products are exhibited but the second franchisee does not, nor does he carry all the available stock preferring to place an order when the consumer has decided what he or she wants. The second franchisee is able to charge lower prices because he does not have to bear the extra costs of this showroom nor the extra costs of having all the available products in stock. Consumers visit the first franchisee in order to get pre-sales advice and to view the available stock before ordering. They then order from the second franchisee because of his lower prices. These problems are avoided when the franchisor obliges the franchisee to provide certain specified services or where franchisees are granted exclusive territories that are sufficiently large to deter consumers from comparing prices.

65. OECD Franchise Report 11.

66 This is critically important from a franchisee's point of view. The franchisee may feel that the franchisor is abusing his dominant position but because there is strong competition in the marketplace this is not a competition issue. This may in fact be conduct which is better regulated by franchise-specific legislation or a code of conduct.

reduce intrabrand, competition this will not necessarily harm economic efficiency.[67]

- Where general market conditions leave open the question of whether a vertical restraint will increase or decrease efficiency, economic analysis provides guidance for identifying those specific circumstances in which a particular restraint may reduce competition or efficiency or increase efficiency. (The OECD gives the example of exclusive dealing. This may be used to decrease competition because it raises entry barriers or it may increase efficiency because it prevents free-riding. In order to decide this question it is necessary to resort to an economic analysis of the situation as a simple competition law on its own will not be able to provide the answers.)
- Economic analysis must consider both long and short term effects of vertical restraints. A restraint may have a short term negative effect but its long term effect may be positive. Allowing the restraint may mean that more franchisees are prepared to enter the network.[68] For franchisors, restraints which protect their intellectual property will lead to them making an increased investment in the future even if this means that franchisees are restricted from competing with them in the short term.
- Economic analysis must consider what is the most likely alternative to a vertical restraint. Vertical restraints are only one method of ensuring that decisions across the network are uniform and another method such as common ownership might not lead to economic efficiency, nor may such a method promote interbrand or intrabrand competition.

There are two important points to note from these lessons. The first is that this is essentially a matter relating to economics and not law. The law may provide a framework outlining what the competition authorities are seeking to achieve or avoid but there are

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67 OECD Franchise Report 15.

68 Franchisees may not be prepared to make a substantial investment in a franchise if franchisors can appoint any number of franchisees in a particular area. Knowing that they will have an exclusive area is, therefore, an important consideration for franchisees when deciding to join a network.

complicated issues relating to economics that must be considered if proper decisions are to be made. In presenting any argument, it is imperative that the parties are fully aware of the economic effect of any decision. Without a proper economic analysis it is unlikely that the competition authorities will make an appropriate decision. An ill-informed decision could have disastrous effects for the development of the business model.[69] The second point is that the economy as a whole must be considered and not just the relationship between the franchisor and franchisee. Most provisions in the franchise agreement will be designed to control freedom of decision making. This is in the nature of the relationship. At some point in time franchisees may feel that franchisors are "abusing" their position or exercising too much control over the way in which franchisees operate "their" businesses. This will not necessarily be an abuse of dominance position as envisaged by the Act. It may well be that this is a relationship issue that should be controlled by some other form of regulation such as the law of contract, franchise-specific legislation or a code of conduct.[70] It would, however, assist matters tremendously if the competition authorities were to have a specific policy for franchise agreements such as the one adopted by the EU.

The block franchise exemption regulation of the EU specified those provisions that are acceptable in franchise agreements and those that are not.[71] The OECD recommends

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69 The same arguments can be raised when attempting to regulate the franchise relationship from a consumer-orientated approach. A disgruntled franchisee may approach the consumer authorities for assistance and these authorities may deal with the matter as if the franchisee was an individual consumer rather than one part of a much larger network. Coming to the assistance of an individual franchisee who appears to have been treated unfairly may have the effect of harming the whole network. The appropriateness of using consumer protection legislation to protect the interests of franchisees is discussed in Chapter Eight.

70 See, for example, the Commission investigation into the Daimler Chrysler restructuring (Competition Commission "Competition Commission Recommends unconditional approval for Daimler Chrysler to restructure dealer networks"). At a meeting at the DTI (Pretoria) with the CAFCOM (November 2001) the competition authorities acknowledged that this was an issue that they were struggling to deal with. This meeting was held to clarify the different responsibilities of the various authorities that receive complaints relating to franchising. The CAFCOM is prohibited in terms of the Consumer Affairs (Unfair Business Practices) Act from dealing with competition issues. Deciding whether a complaint relates to a competition issue or a consumer issue is not always clear and so franchisees are sometimes sent from one authority to another. In addition, if they fail to obtain satisfaction from one authority franchisees will approach another in the hopes of a different answer to their complaints.

71 This block exemption was granted after a number of firms had applied for exemption and had demonstrated that the anti-competitive effect was outweighed by pro-competitive advantages. Although this exemption has been superceded by Regulation 2790/1999 it appears that the practical

that states adopt such a policy because this will lead to greater certainty for business. A case-by-case approach is very expensive both from a business point of view and from the enforcement side, and it also means a greatly increased work load for competition authorities.[72] In addition, Article 81(1) of the EU Treaty, which prohibits agreements that interfere with competition, applies only to agreements that will have an appreciable effect on competition. The EU has issued a *De Minimus* Notice which explains the meaning of "appreciable". This notice has an enormous practical effect, especially for franchise agreements, because if a company is small or has a small share of the market it is unlikely that an agreement will have an "appreciable" effect on competition.[73] Such small companies, therefore, do not have to concern themselves with issues of competition regulation in the same way as their larger counterparts.[74] Nevertheless, there are certain restrictions, in the EU, that are regarded as serious violations of competition law and are referred to as hard core restrictions. These restrictions are those that relate to resale price maintenance, market-sharing provisions and territorial protection. Competition regulation will apply to these restrictions regardless of the size of the business. The *De Minimus* notice, coupled with the exemptions for vertical and horizontal agreements, creates a measure of certainty in business and means that competition authorities are not overloaded with issues which require complicated economic analysis before the law can be applied effectively.

Unfortunately, the South African Act does not make provision for the granting of a block exemption and each franchise network would have to apply for exemption. A suggested alternative is to create a code of conduct in which principles governing the on-going relationship between franchisors and franchisees are articulated. By outlining policy in a code of conduct more certainty can be created regarding acceptable and unacceptable behaviour.[75] In order to formulate such a policy it is useful to consider developments in

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position for franchising remains the same. See generally Audia et al 2001 *ACCA Docket* 52.

72 OECD Franchise Report 13.

73 Audia et al 2001 *ACCA Docket* 57

74 A small company is a company that has an annual revenue of less than €40 million or whose total assets do not exceed €27 million.

75 For further discussion see Chapter Nine.

other jurisdictions regarding specific restrictions commonly found in franchise agreements. These include:

- price setting agreements;
- tying arrangements;
- exclusive dealing agreements;
- territorial restrictions; and
- restrictions that protect intellectual property and know how.

6.6.1 Price setting agreements

Franchisors tend to be consistent in their view that they must be able to dictate the prices at which goods can be sold or services provided because this is what consumers demand. A consumer wants to know that the price he pays for a McDonald's hamburger is the same regardless of the outlet he chooses to patronise. One slimming salon franchisee reported that a another franchisee had been accused of exploiting her customers because she was charging R100 per month more than a fellow franchisee about 20 kms away.[76] This matter was taken up with the franchisor who informed the customer that the franchisee had been "allowed" to reduce her prices because the franchise was struggling. This same franchisee reported that the franchisor refused to allow her to hold a special for her customers who signed up for a repeat course of slimming sessions.[77]

This is a difficult issue because franchisors believe that insisting on standard prices is an important means of ensuring uniformity across the network. At two conferences held to discuss franchising and competition issues, franchisors were asked about the necessity of standard prices. They were unanimous that this was necessary because, they argued, consumers demand this.[78] They also cited examples of national advertising campaigns and

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76 Discussion with ex-franchisee in August 2007.
77 Discussion on 3 October 2007.
78 The first conference was held in Durban (August 2006) and the second in Johannesburg (February 2007).

menus that are printed at head office. Franchisors argued that it does not make economic sense for individual menus to be printed for each outlet and if franchisees are allowed to alter menus this will result in sloppy appearances.

However, minimum price fixing agreements are generally regarded as being one of the most flagrant violations of competition law.[79] Price fixing is regarded as an anti-competitive practice in jurisdictions such as Australia,[80] Canada,[81] France,[82] Germany,[83] New Zealand,[84] America[85] and the EU. In most instances minimum price fixing is prohibited per se so it is unnecessary to show any restrictive effect on competition.

Generally, a seller is not prohibited from specifying maximum resale prices to resellers and it may in certain circumstances be desirable for franchisors to specify

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79 The EU franchise exemption did not apply to minimum price setting agreements (Article 5(*e*)) and they continue to be regarded as hard core restrictions. See Audio et al 2001 *ACCA Docket* 64. In Australia price fixing, governed by s 48 of the Trade Practice Act 1974, is illegal per se, but in New Zealand the Commerce Commission can authorise price fixing if it can be shown that the benefits to the public outweigh the anti-competitive effect of the practice. In *Cancun Trading v Seven-Eleven Corporation* the Tribunal referred to price fixing as a pernicious anti-trust violation (paras 37-44). In recent times the motor vehicle industry has been targeted by the Commission because of alleged price fixing. See note 7 above.

80 S 48 of the Trade Practices Act prohibits resale price maintenance per se. Horizontal price fixing between franchisees is prohibited in terms of s 45 (2). For a discussion of the Australian position see Pengilley "Regulatory Power and Free Trade: The Rules of Engagement in the Era of De-Regulation" (2002) *QUT Law & Justice Journal* 1.

81 S 61 of the Competition Act governs price maintenance and provides that persons engaged in business, producing or supplying a product shall not by agreement, threat, promise or like means, attempt to influence upward, or to discourage the reduction of, the price at which any other person engaged in business in Canada supplies or offers to supply or advertises a product within Canada. In the event of a conviction the guilty party may receive a fine decided upon by the court or five years imprisonment or both.

82 Article 34 of Title IV of the 1986 Ordinance prohibits minimum price fixing per se and a person can be fined for violating the article. Article 7, which deals with agreements that prevent the free effect of competition on prices, also governs minimum price fixing agreements.

83 S 15 of the Act against Restraints of Competition prohibits both maximum and minimum resale price fixing agreements in vertically structured franchise systems. In addition, a franchisor may not, by threatening or causing harm, induce a franchisee to set specific prices.

84 S 37 of the Commerce Act 1986 prohibits resale price maintenance but a recent review found that in certain circumstances price maintenance can be desirable and so the Commerce Amendment Act of 1990 makes provision for the Commerce Commission to allow price fixing if it can be shown that the benefits to the public outweigh its anti-competitive effects. S 30 prohibits price fixing. This section covers controlling or maintaining prices indirectly as well and also covers discounts, allowances, credits or rebates and horizontal arrangements between franchisees.

85 S 1 of the Sherman Act prohibits resale price maintenance and price fixing which is considered a per se violation. These matters frequently arise when dealers or franchisees have their contracts terminated. The offended dealer/franchisee will often allege that his contract was terminated because other dealers complained that he was undercutting their prices.

maximum prices.[86] When franchisors and franchisees set their prices independently, they may each choose a price that is higher than their marginal costs because they both want to achieve maximum profits.[87] This results in a double mark-up. The size of this mark-up will depend on consumer demand for the product as well as on competition from other similar franchise networks. Because franchisees are acting independently, they may not take into consideration the fact that increased prices may result in a decrease in consumer demand which may affect the franchisor's overall profit. Likewise, franchisors may set prices without taking into consideration the price which franchisees will be able to charge consumers and therefore what profit franchisees can make.[88] The OECD asserts that the most direct way of eliminating the double mark-up is for franchisors to set a ceiling on maximum prices[89] and criticises the approach of the American Supreme Court in *Albrecht*

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86 The exception is America, where the Supreme Court, in *Kiefer-Stewart Co v Joseph E Seagram & Sons Inc* 340 US 211 (1950), *Atbrecht v Herald Co* 390 US 145 (1968) and *Arizona v Maricopa County Medical Society* 457 US 322 (1982) 457 US 322 (1982), held that maximum resale price agreements was also per se illegal. In 1984, the Supreme Court again referred to this practice in *Atlantic Richfield Co v USA Petroleum Co* 110 s Ct 1984 (1990). Although its ruling did not alter the per se illegality position as stated previously, as it was dealing with a separate issue, the court made the following comment:

> When a firm ... lowers prices but maintains them above predatory levels, the business lost by rivals cannot be viewed as an "anti-competitive" consequence of the claimed violation ... Low prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition, hence, they cannot give rise to antitrust injury (at 1892).

87 OECD Franchise Report 35.

88 The question of prices for goods, together with royalty fees, is a common complaint from franchisees. In a number of complaints to the CAFCOM franchisees alleged that because of the costs they had to pay to the franchisor they were unable to make a living. Some of those who had operated independent businesses before joining the franchise stated that they had been in a far better position when they operated as independents.

89 OECD Franchise Report 35. The report points out that only a price ceiling is needed and that a minimum price does not contribute to solving the problem. The problem can also be solved by

(1) insisting that franchisees achieve certain sales targets. Franchisee will then ensure that their prices are such that they will be able to achieve those targets; or

(2) by using a two-part tariff: franchisors charge franchisees not only the cost of the actual product but they also charge franchise fees based on profits earned by franchisees. Franchisees want to maximise their profits and so will choose a price that will facilitate this. This will in turn lead to higher profits for franchisors.

The Report also points out that this does not always operate effectively because the parties must co-operate properly and must have full information about market conditions. There must be little uncertainty about consumer demand or risk involved. In practise, this is seldom the case and franchisees can circumvent any controls put in place by the franchisor by reducing the quality of the goods or service offered to consumers. In addition, if franchisees are in a better position to understand the market they are operating in, it is preferable for the franchisor to leave any decisions relating to price to the franchisees.

v Herald Co. In *Albrecht* the American Supreme Court maintained that maximum price setting would encourage collusion amongst the parties regarding the service they were prepared to offer and how much they would charge for these services. Therefore maximum price setting should also be regarded as per se illegal. The OECD is of the view that it is unlikely that franchisors and franchisees would agree on a price fixing scheme that would lead to inefficiencies since they are both interested in franchisees being able to survive in the marketplace. It states that to limit the supply of services for which consumers are prepared to pay would not, usually, be profitable.[90] The OECD explains that there is a difference in the economic impact of minimum resale prices and the effect of maximum resale prices:

- price ceilings can be used to eliminate double mark ups which leads to an increase in economic efficiency. The same cannot be said for price floors;
- price ceilings do not facilitate collusion but price floors can be used to support a cartel; and
- price ceilings cannot be used to limit intrabrand competition but price floors can.

However, maximum prices can be used by franchisors to set maximum prices at such low levels that competent rivals are forced out. Therefore, it is advisable to have rules that cover the situation where price ceilings are set at predatory levels.[91] In South Africa, the Commission can deal with maximum price fixing under the general provisions that allow it to investigate any restrictions that interfere with competition.[92] Thus, the setting of maximum prices must satisfy the test of reasonableness and franchisors should be able to demonstrate that there is a logical reason for setting such prices.

Franchisors may recommend minimum prices provided they make it clear to franchisees that the recommendation is not binding. If the product concerned has its price

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90 OECD Franchise Report 170.
91 OECD Franchise Report 169.
92 Ss 4(a) and 5(a).

stated on it, the words "recommended price" must appear next to the stated price. In South Africa this is governed by s 5(3) of the Act and this is in line with the approach in other jurisdictions.[93] Nevertheless, franchisors must be careful how they conduct themselves because, if a recommended price becomes, in fact, the prevailing retail price, franchisors could be regarded, by their conduct, as being engaged indirectly in illegal price fixing. This was the issue in *Monsanto Co v Spray-Rite Co.*[94] In this case the American Supreme Court held that if the evidence can prove that the manufacturer and others had a conscious commitment to a common scheme, there will be illegal price fixing. The court held, however, that more was needed to support such a conclusion than evidence that a distributor had conformed to suggested prices. There had to be some evidence of communication between distributor and manufacturer which showed that the manufacturer sought agreement to such prices and that the distributor acceded to these demands.

Franchisors may engage in a range of activities which are designed to ensure that franchisees comply with suggested prices. Such tactics may constitute illegal price fixing. Franchisors must ensure that no sanction, penalty or disincentive is meted out to franchisees that do not comply with recommended prices.[95] In 2001 The Competition Commission instituted an investigation into a number of practices adopted by Italtile Franchising, Italtile Ceramics Ltd and Italtile Ltd. Italtile franchisees complained that they were being penalised by the franchisor because they were refusing to adhere to the franchisor's strict pricing requirements. The franchisor threatened to terminate franchises that did not sell products at the set prices.[96] The Tribunal held such threats constituted part of an illegal price fixing agreement. A similar investigation was conducted into the pricing practices of Federal Mogul Aftermarket of South Africa in 2003, because it reduced its rebate to a distributor that was not adhering to the pricing conventions in the industry.[97] This was also found to be illegal price fixing. The Tribunal's approach agreed with the

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93 See Zaid *Franchise Law* 142ff in which he discusses the Canadian approach and Glickman *Franchising* §4.03[5] for a discussion of the position in America.

94 465 US 752 (1984) 768.

95 *Franchising Notice* para 4.11.

96 *Competition Commission v Italtile Franchising and Others* CC.

97 *Federal Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission.*

approach in America where the courts have found the following conduct to constitute illegal price-fixing schemes:[98]

- cutting off supplies to a dealer who does not comply with suggested minimum prices;
- cutting off customer referrals;
- informing a dealer's existing customers that the dealer is unable to provide a proper service; and
- withholding trade discounts such as rebates and allowances.

In Canada it is also an offence to fix prices directly or indirectly.[99] Any attempt to influence the upward movement of prices is illegal.[100] Zaid reports that in 2003/2004 John Deere Limited was investigated by the Competition Bureau for discouraging its dealers from selling lawnmowers below suggested prices. The company was not charged nor did it admit liability but it agreed to pay cash rebates to more than 8 600 customers which constituted a total rebate to consumers of $1.191 million.[101]

6.6.2 Tying Arrangements

A tie is an arrangement "whereby a seller conditions the sale of one product (the tying product) on the purchase of a separate product (the tied product) or on the purchaser's agreement not to purchase the tied product from any other seller".[102] In a franchising context, the tying product is the franchise or trade mark and the sale of the franchise is dependent on franchisees agreeing to enter into a range of other agreements, such as leasing of premises and purchasing of equipment and stock. Franchisees who refuse to

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98 Glickman *Franchising* §4.03(5).

99 S 61(1)(a) of the (Canadian) Competition Act of 1985.

100 Zaid *Franchising* 141.

101 *Ibid.* The South African authorities can also resort to consent orders and in all the matters involving the motor manufacturers, importers and dealers the parties under investigation agreed to pay administrative penalties, without admitting guilt, in order to avoid a full hearing (see note 7 above).

102 *Eastman Kodak Co v Image Technical Services Inc* and the *Franchising Notice* para 4.22.

agree to these other contracts are denied the franchise. Tying arrangements are regarded with suspicion because sellers may be exploiting their control over tying products to force buyers into purchasing products that they may not want, or that they may have preferred to obtain elsewhere on different terms.[103] Seller power in one market allows them to expand into other markets. This impairs competition in these second markets and potentially inferior products may not be subject to normal competitive pressures.[104]

Franchisees complain because they are required to buy their equipment, supplies, lease property or buy other services from the franchisor or other designated suppliers who may be more expensive than suppliers on the open market. A common complaint in South Africa is that purchasers are obliged to take out insurance with specified insurance companies before they are entitled to purchase goods. They are even obliged to take out this insurance in circumstances for which they already have sufficient insurance cover.[105] The requirements that franchisees take out specified insurance, enter into specified rental agreements and purchase certain shop fittings were some of the of the complaints directed by the franchisees against the franchisor in *Competition Tribunal v Cancun Trading No24 CC.*[106]

The Act prohibits a firm from selling goods or services with the condition that buyers must purchase separate goods or services that are unrelated to the object of the contract, unless the firm can show technological, efficiency or other pro-competitive gains that outweigh the anti-competitive effect of its act.[107] This provision applies to dominant firms

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103 *Eastman Kodak Co v Image Technical Services Inc.*

104 *Jefferson Parish Hospital v Hyde* 466 US 2, 104 S Ct 1551, 80 L Ed 2d 2 (1984). See generally Cantor "Tying, Exclusive Dealing and Franchising Issues".

105 If this is part of a credit agreement the conduct is regulated by the National Credit Act. A credit provider may require that a consumer maintain an insurance contract during the term of their agreement and a particular insurer may be recommended but the consumer must be given, and be informed of, the right to waive that proposed policy and to substitute a policy of the consumer's own choice (s 106).

106 The matter was taken on review to the Supreme Court of Appeal in *Simelane and Others NNO v Seven-Eleven Corporation* 2003 (3) SA 64 (SCA).

107 S 9 (iii). The American courts have struggled to establish how much control the seller must exert over the buyer. In *Bob Maxfield, Inc v American Motors Corp* 703 F2d 534, 540 (9th Cir 1983), the court said that actual coercion is an indispensable element of a tie-in but mere sales pressure or persuasion, no matter how strong or obnoxious, does not satisfy the coercion requirement. Then the courts have struggled to establish the level of coercion that is required. In *Mozart Co v Mercedes Benz of North America, Inc* US 870 (1988) the court held that tying language in the contract is

only, and therefore, the first hurdle for an aggrieved franchisee is to show that the franchisor is abusing a dominant position.[108] This immediately raises the question of how dominance is judged. If the Competition authorities focus only on the dominant franchisor position in the relationship it may be fairly easy for franchisees to show abuse of dominance. However, if dominance in the entire market is considered, the question of franchisor dominance will be much more difficult to establish. Nevertheless, even when there is no dominance involved, tying arrangements will probably be judged under the general provision that prohibits restrictive vertical practices that lessen competition in a market, unless it can be established that there are pro-competitive gains that outweigh anti-competitive effects. The Consumer Protection Bill also prohibits tying arrangements because the Bill aims to ensure that consumers have the right to choose from whom they purchase their goods and services.[109] However, the Bill also provides that tying arrangements are acceptable in franchise contracts, if franchisors can show that the requirements are reasonably related to the branded products or services that are the subject of the franchise agreements.[110]

Here the American experience provides useful guidance because tying arrangements were responsible for most of the early antitrust litigation in franchising in America. To avoid the risk of litigation many franchisors require only that goods and services meet certain standards; if the equivalent is available elsewhere, franchisees are entitled to purchase them.[111] However, tying arrangements prove to be necessary when there is a need for quality control and uniformity of products and services, or where franchisors are protecting their trade marks and goodwill.[112] This is known in America as

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sufficient to find that there had been coercion but in *Famous Brands Inc v David Sherman Corp* 814 F2d 517 (8th Cir 1987) the court held that the mere fact that there was a contract enforcing the tie was not sufficient to satisfy the requirement of coercion.

108 Establishing dominance in the context of franchising is a difficult issue (see above at 6.4). In America it has been said that very few franchisors possess a large enough share of their particular market to wield market power. See Cantor "Tying, Exclusive Dealing and Franchising Issues". Given the fact that franchising is relatively new in South Africa, it must be accepted that the position may not be the same.

109 Part C s 13(1).

110 S 13(2).

111 Beyer *Franchise Law Practice* §2.71.

112 *Franchising Notice* para 4.24.

the "business justification defense".[113] The defense is relatively narrow because quality control specifications in the contracts may be sufficient to protect franchisors. A Tying arrangement in such situations would not be needed. In *Metrix Warehouse Inc v Daimler-Benz Aktiengesellschaft*,[114] the court refused to accept the defence to a requirement that dealers carry only Mercedes-Benz replacement parts because, the court said, it would have been feasible for Mercedes-Benz to provide manufacturers with the necessary specifications.[115] In cases where it is too difficult and too complicated to set out all the specifications required,[116] or where there are business secrets involved,[117] the courts have accepted that tying arrangements are necessary.[118]

It is suggested that South African franchisors adopt a similar approach and resort to tie-ins only when this is absolutely necessary. This is another issue which should be governed by franchise-specific legislation or a code of conduct. Ensuring that franchisors resort to tie-ins only when absolutely required could avoid unnecessary and costly litigation, especially if competition authorities view this as a competition matter. In competition matters, it is the competition authorities that investigate and prosecute complaints and they do not suffer from the same constraints, such as a lack of finance, that may inhibit franchisees from instituting legal action. A complaint from a franchisee may be sufficient to launch a commission investigation and errant franchisors may find themselves subject to the substantial penalties contained in the Act.

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113 *Eastman Kodak Co v Image Technical Services Inc* . See, for example, *Susser v Carvel Corp* 381 US 12 (1965) and *Siegel v Chicken Delight Inc* 405 US 955 (1972).

114 828 F2d 1033 (4th Cir, 1987) cf *Mozart Co v Mercedes Benz of North America* 833 F2d 1342 (9th Cir1987). In this case the defense was accepted.

115 1040-1.

116 *Mozart Co v Mercedes Benz of North America.*

117 In *Krehl v Baskin-Robbins Ice Cream Co* 664 F2d 1348 (9th Cir 1982), ice cream was manufactured according to a secret recipe and to provide detailed specifications regarding quality would be to reveal a trade secret. See also *Siegel v Chicken Delight Inc* and *KFC Corp v Marion-Kay Co* 620 F Supp 1160 (SD Ind 1985).

118 In *Chock Full O'Nuts Corp* (1973-1976 Transfer Binder) Trade Reg Rep (CCH) 20,441 (FTC 1973), quoted by Cantor "Tying, Exclusive Dealing and Franchising Issues" 60, the defense was accepted for coffee and baked goods because it found that coffee played a "central role" in the success of the franchise and that the taste of the coffee depended on the franchisor's coffee taster. Similarly, the baked goods were unique to the franchisor and it was held that consumers would be able to detect a difference if the goods were made by other bakers. The defense was not accepted for sandwiches and hamburgers.

6.6.3 Exclusive Dealing

One of the advantages of being part of a franchise network is that franchisees can benefit from the buying power that franchisors enjoy. Franchisors can secure preferential deals with suppliers for their franchisees and bulk buying deals can lead to significant savings for franchisees.[119] Agreements that specify that franchisees must purchase exclusively from their franchisors or from certain specified suppliers are known as exclusive dealing arrangements.[120] The contract in *Silent Pond Investments CC v Woolworths (Pty) Limited and Engen Petroleum Limited* provides an example of such an agreement. The contract imposed a number of obligations on the franchisee, including the obligation to purchase all its products from Woolworths, to refrain from selling products that competed with Woolworths' products and to stock certain core products.

In some instances franchisees complain that the prices they are charged are more than they would have to pay if they arranged their own suppliers. This was one of the complaints of the franchisees in *Competition Tribunal v Cancun Trading No24 CC.*[121] Another example was provided by the slimming salon franchisee. She reported that she had approached the supplier directly in order to obtain certain velcro straps for her slimming machines. When the supplier discovered that she was a franchisee, he refused to supply her with the straps and informed her that she had to buy the straps from her franchisor. The cost of purchasing the straps from the franchisor was 40% more than it would have cost her from the supplier.[122] The same franchisee complained that the franchisor had also established a furniture outlet and all franchisees were obliged to buy their furniture from this outlet. The franchisor also required all existing franchisees to refurbish their establishments. The costs the franchisee incurred were much higher than

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119 Illetschko "A Brief Introduction to Franchising" in *The Franchise Book of Southern Africa 2001* 17.
120 Beyer *Franchise Law Practice* §2.69 and *Franchising Notice* para 4.18.
121 See discussion of this case in 6.4.1 and 6.4.2 above.
122 Discussion in May 2007.

she would have had to pay if she had been allowed to source her own furniture from standard suppliers. The franchisee was particularly frustrated because she had only owned the franchise for six months and did not believe that it was necessary to redecorate.[123]

Franchisees also complain that franchisors make profits not only from the franchisee fee and the monthly royalty but also from secret discounts and rebates that they receive from suppliers. As the court in *Seven Eleven Corporation* pointed out, franchisors do not assist franchisees to set up their stores "out of charity"[124] and they find a variety of ways to remunerate themselves. This matter had a sequel in the Supreme Court of Appeal when 70 franchisees claimed a share of the benefits which the franchisor had received from suppliers.[125] The franchisees argued that according to the standard franchise agreements that they had signed, they were entitled to all the benefits that the franchisor obtained as a result of its bulk purchasing. At the time of contracting they were aware of the ordinary trade discounts which the franchisor called "kickbacks". The franchisees subsequently discovered that the franchisor received other benefits from suppliers such as "early settlement discounts" and rebates. The court a quo held that the franchisees were entitled to a share of the rebates. This amounted to approximately R50 million in claims but the franchisor appealed to the Supreme Court of Appeal. The Supreme Court of Appeal held that the franchisees were not entitled to the rebates because these were given to the franchisor as a reward for growth and because the purchases made by the franchisor had grown.[126] Therefore, the reasons for the rebates did not relate to individual franchisees.

This particular decision generated a great deal of interest in the franchise community

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123 In 1969, Brown reported that such practices were commonplace in America. These agreements were responsible for much of the early franchise litigation in America as franchisees resorted to antitrust laws for assistance (Brown *Franchising: Trap for the Trusting* 14-16). He sites three examples to illustrate why exclusive dealing arrangements are objectionable. In one case the franchisee was obliged to buy pizza products from the franchisor at prices which were 100% to 250% above the prices at which the identical products could have been purchased from competitors. In another case cooking oil was 25% above market price and in the case of a well-known restaurant, franchisees were charged a mark up that ranged from10% to 300%.

124 *Simelane and Others NNO v Seven-Eleven Corporation* 70D.

125 *Seven Eleven Corporation of SA (Pty) Ltd v Cancun Trading No 150 CC*. One franchisee, a close corporation, the sole member of which was Fouche, instituted action against the franchisor in 1999. The matter was keenly followed over a three year period by other franchisees who stood to benefit if the outcome was favourable for the franchisee.

126 196E-G.

and the decision of the court a quo was referred to as a "landmark decision" and a "victory for the small man".[127] The plaintiff, Fouche, explained after the judgment:

> I'm glad, not just for myself, but for the guys out there that lost everything and are now out on the streets ... if we had lost this one [the case], it would have been a disaster for the franchisees.[128]

But the franchisees did lose ultimately when the franchisor's appeal succeeded. The franchisees had withheld their management fees which amounted to R25 million, and they were ordered to pay these fees over to the franchisor. The FASA described this as a "shock decision" and warned all franchisors "to be completely transparent when it comes to disclosure of rebates and discounts to its franchisees".[129]

In most jurisdictions tying arrangements and exclusive-dealing provisions are dealt with in a similar manner and are regarded as acceptable provided they serve important business considerations.[130] There may even be pro-competitive reasons for exclusive dealing arrangements.[131] They may:

- in the case of purchasers, assure supply, afford protection against rises in price, enable long term planning on the basis of known costs, and obviate the expense and storage in the quantity necessary for a commodity having fluctuating demand;[132]
- in the case of sellers, offer protection against price fluctuations and provide

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127 InfoUpdate no1 (9 January 2004) "Court Rules Against 7-Eleven" http://wwwlibrary.co.za/notice/update/2004/issue01.htm (accessed on 1 July 2004) .

128 *Ibid*

129 FASA Newsletter 15 April 2005 http://wwwfasa.co.za/news/2005/Apr_05.htm (accessed on 9 September 2005).

130 See generally OECD Franchise Report. In America, tie-ins have always been treated as per se illegal whilst exclusive dealing arrangements are judged under the rule of reason. But in *Jefferson Parish*, the Supreme Court held that before a tie could be per se illegal, four elements had to be satisfied. Cantor maintains that these elements are difficult to satisfy and so most tying claims are judged by a rule of reason analysis. See Cantor "Tying, Exclusive Dealing and Franchising Issues".

131 *Standard Oil Co v United States* 337 US 293 (1949).

132 *Standard Oil Co v United States* 306.

a more predictable market;[133]

- eliminate divided loyalties between distributors and free-riding;[134]
- assist newcomers to the market as they can determine what amount of capital expenditure is needed.

In the leading American decision, *Jefferson Parish Hospital District No 2 v Hyde,* O Connor J stated that in order to determine whether an exclusive dealing contract is unreasonable:

> [T]he proper focus is on the structure of the market for the products and services in question – the number of sellers and buyers in the market, the volume of their business, and the ease with which buyers and sellers can redirect their purchases or sales to others. Exclusive dealing is an unreasonable restraint of trade only when a significant fraction of buyers or sellers are frozen out of a market by the exclusive deal.[135]

Using this reasoning, the test is whether the exclusive dealing arrangement restrains horizontal competition by allowing suppliers to freeze out other suppliers or buyers. In *Roland Machinery Co v Dresser Industries Inc*[136] the court held that a plaintiff is required to prove that the exclusion "is likely to keep at least a significant competitor of the defendant from doing business in a relevant market and that the probable (not certain) effect of the exclusion will be to raise prices above (and therefore reduce output below) the competitive level or otherwise injure competition".[137] As far as franchising is concerned, the courts in America generally recognise non-competition clauses that are designed to serve important business considerations and Beyer maintains that it is difficult for franchisees to

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133 *Ibid* and *Roland Machinery Co v Dresser Industries* 749 F.2d 380, 384-85 (7th Cir 1984).
134 *Sewell Plastics Inc v The Coca-Cola Co* 720 F Supp 11196 (WDNC 1989).
135 466 US 45.
136 749 F 2d 380 (7th Cir 1984).
137 At 394. In order to decide this it will be necessary to decide whether exclusive dealing in this instance allows increased exercise of market power and thus calls for economic reasoning in order to analyse the competitive effect of the exclusive dealing

establish that restrictive dealing requirements, imposed by franchisors, are illegal.[138]

The EU franchise exemption regulation allowed exclusive dealing agreements provided they complied with certain conditions and limitations.[139] The 1999 block exemption for vertical restraints is much more general in nature and does not contain a list of permitted clauses. The approach by the Commission is that if something is not specifically prohibited it is permitted.[140] It is, however, useful to consider the approach under the franchise exemption regulation because it was specific to franchising and will give an indication of the kind of agreements that have been regarded as acceptable.[141] Exclusive dealing arrangements were allowed for goods that were produced by franchisors and were the subject matter of their franchises.[142] The parties could, therefore, agree that franchisees will not manufacture, sell or use goods that compete with the franchisors' goods and which were the subject matter of the franchises.[143] But, this was allowed only to the extent that this was necessary to protect the franchisor's industrial or intellectual property rights or to maintain the common identity and reputation of the franchised network,[144] and if it was impractical for franchisors to set objective criteria which other parties could use to produce similar quality goods.[145] The Commission did not allow such

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138 Beyer *Franchise Law and Practice* §2.69. See also *Capital Temporaries, Inc v Olsten Corp* 506 f2d 658 (2d Cir 1974); *Postal Instant Press v Jackson* 568 F Supp. 739 (D Colo 1987) and *Joyce Beverages of New York, Inc v Poyal Crown Cola,* 555.F Supp. 271 (SDNY1983).

139 See generally OECD Franchise Report 125 and Articles 2-e, 3-1-a, 3-1-b, 4-1-a, 5-b and 5-c.

140 OECD "Competition Law and Policy in the European Union" (2005) 24 (OECD Competition Policy Report) http://www.oecd.org (accessed on 27 February 2006).

141 It does seem that in many instances the practical position for franchising remains the same. An important development, however, is that the regulation does not apply to small scale agreements where there is unlikely to be any effect on competition unless the agreement relates to certain hard core restrictions such as price fixing and excessive territorial protection. For a discussion of the present position for vertical and horizontal agreements generally see Audia et al 2001 *ACCA Docket* 52, OECD Competition Policy Report and EU Report on "Competition Policy in Europe - the Competition Rules for supply and distribution agreements" (2002) http://www.europa.eu.int (accessed on 27 February 2006).

142 This would be similar to the approach found in the American cases *Krehl v Baskin Robbins Ice Cream* and *KFC Corp v Marion-Kay Co.*

143 Article 2-e. This article did not, however, apply to spare parts or accessories. The same obligation could not be imposed on them. See generally OECD Franchise Report. Restriction on the resale of spare parts continues to be regarded as a hard core restriction in the Vertical Restraints Block Exemption (Audia et al 2001 *ACCA Docket* 65) and no restrictions may be placed on a supplier's ability to sell spare parts to end users, to independent repairers or to other service providers.

144 Article 3-1.

145 Article 3-1-b.

agreements when goods of equivalent quality were available because that would amount to tie-ins that restricted competition by preventing other producers from selling through the franchised network.[146] In addition, the agreements could not prevent parallel imports[147] which allow franchisees to obtain goods from other franchisees or from other dealers. Parallel imports were dealt with by the Court of Justice in the *Pronuptia* case. The court recognised that the franchisor had the right to control the goods offered by franchisees so that consumers would find goods of the same quality with each franchisee. It also recognised that in certain circumstances a provision that required a franchisee to sell only products supplied by the franchisor or designated suppliers may be necessary in order to protect the network's reputation.[148] However, the court stressed that the validity of such an agreement depended also on the nature of the goods being sold and the number of franchisees involved.[149] In this particular instance, fashion items were involved and so it would be difficult and expensive to ensure that objective quality standards were met by all franchisees (of which there were many). The court, however, said that the franchisees could not be restrained from obtaining their products from other franchisees. The *Pronuptia* franchise agreement was granted an exemption by the Commission but certain careful limits were set. The franchisees had to be free to purchase from other franchisees and they could also purchase goods that were not connected with the essential object of the franchise business from other suppliers, provided they met certain quality standards.[150]

In South Africa an exclusive dealing arrangement may amount to an infringement if it lessens or excludes competition, especially if the franchise does not face effective competition from other competitors.[151] It is also prohibited for a dominant firm to insist that a supplier or customer refrain from dealing with a competitor.[152] This again raises the issue of franchisor dominance and how this is assessed in the marketplace.

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146 See generally OECD Franchise Report.
147 Article 4-a.
148 Para 12.
149 *Ibid.*
150 See generally OECD Competition Policy Report.
151 See s 5(1) and the *Franchise Notice* para 4.19. The EU franchise exemption was granted in circumstances in which the franchisors faced considerable competition in the marketplace.
152 S 8(d)(ii).

The Competition Commission recognises that such provisions are permissible when they protect the franchisor's know-how, intellectual property and other skills and provide an incentive to the franchisor to invest in the franchise without the fear of free-riding.[153] However, franchisees must not be prevented from dealing with third parties if goods of a similar quality are available and the franchisor's trade mark will not suffer harm.[154]

6.6.4 Territorial Restrictions

Franchisees are sometimes granted exclusive territories in order to protect them from competition from another identical franchisee or from the franchisor. Such a practice is normally regarded as anti-competitive. Yet a very common franchisee complaint is territorial encroachment: that is, another identical outlet owned by another franchisee or by the franchisor is established within the territory which had previously been serviced by the complaining franchisee. This was the issue that arose in *Silent Pond Investments CC v Woolworths (Pty) Limited and Engen Petroleum Limited* because Woolworths sought to establish a corporate owned store 200 meters away from a franchisee. During the recent Rule amendment proceedings in America, the FTC reported that many franchisees had called on the FTC specifically to ban territorial encroachment as an abusive and unfair practice. The AFA has identified encroachment as one of the issues that hurt franchisees the most.

Territorial restrictions have the effect of reducing competition between franchisees, but franchisees may be reluctant to make a sunk investment and commit themselves to franchise fees if there is a possibility of identical franchises in their areas. Clauses that provide for exclusive territories can also prevent free-riding. Free-riding is a serious problem where services can be used independently of purchases,[155] or where some

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153 *Franchising Notice* para 4.20.

154 Para 4.21.

155 Free-riding would not be a problem, for example, in the fast-food industry because the franchisee does not supply any services that can be consumed independently of the product. Free delivery only takes place if food is ordered from that particular franchisee. But when the supply of products or services are of a technical nature, a consumer may approach one franchisee in order to benefit from services offered, such as technical advice and information, but will then order from another franchisee

franchisees can benefit from the network's reputation in circumstances where they are not making a contribution to the development or maintenance of that reputation.[156] In order to deal with these issues, the franchisor may include clauses that

- place territorial restrictions on a franchisee's right to trade;
- grant franchisees exclusive territories; and
- restrict a franchisee from dealing with customers outside a particular area.[157]

When such clauses have, as their purpose, the desire to create an effective network in which all franchisees are working for the benefit of the entire network and are providing sales and services that are ultimately to the benefit of consumers, franchisors will be able to demonstrate that any anti-competitive effect is outweighed by some pro-competitive gain. Franchisors may, however, want to limit competition simply to increase their own profits or so that networks can reduce their level of service.[158] This occurs particularly where networks are not faced with strong competition from other franchise networks.

Most jurisdictions have grappled with the question of when territorial restrictions are reasonable and permissible and when they are "perniciously anti-competitive".[159] In Australia, for example, territorial exclusivity is not prohibited unless the purpose of the restriction is to lessen competition, and in America the rule of reason is applied.[160] The American courts have recognised that a strict approach regarding territorial division will sometimes work to the ultimate detriment of small business. In *Philadelphia Fast Foods*

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because of lower prices.

156 OECD Franchise Report 42.

157 One way of preventing free-riding is for franchisees to restrict their post-sales service to those consumers who have purchased their products from that particular franchisee.

158 OECD Franchise Report 40.

159 Glickman *Franchising* §4.03(2).

160 In *Continental TV Inc v GTE Sylvania Inc* 433 US 36 (1977), the American Supreme Court overruled a previous decision where it had been held that vertical territorial restrictions were a per se violation. Glickman maintains that the net effect of the *Sylvania* decision is to give franchisors more leeway to impose non price restrictions on franchisees as long as their controls are economically justified. She further points out that the size and market share of the franchisor is a leading factor in deciding whether or not a particular restriction is anti-competitive. Horizontal territorial restrictions remain per se illegal.

v Popeye's Famous Fried Chicken[161] the court pointed out that the granting of an exclusive territory to franchisees tends to promote interbrand competition because franchisees are encouraged to make a greater capital investment. The AFA attempts to lobby for federal legislation in America to ban encroachment have met with considerable opposition on the basis that such legislation is inconsistent with antitrust policies and that it would impede competition.[162] The FTC, in its Rule Amendment process, declined to declare encroachment to be an unfair practice on the basis that, *inter alia,* there was insufficient evidence to show that the harm to a few franchisees outweighed the benefits of expanding markets and extending consumer choice. Instead the FTC opted to increase its disclosure requirements so that franchisees were informed up front about the extent of their exclusive territory, if any. If no territorial exclusivity is granted, franchisors are obliged to add the following warning to their contracts:

> You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.

The FTC is of the view that this information will enable franchisees to make informed decisions and, if they are dissatisfied with the extent of territorial protection granted, they could decline to purchase the franchise. Such an approach ensures that franchisees are properly informed without imposing undue onerous burdens on franchisors and without bringing franchise regulation into conflict with competition regulation.[163]

The European Court of Justice, in the *Pronuptia* case, examined territorial restrictions in franchise agreements and made a recommendation to the Commission that territorial restrictions qualified for an exemption under Article 85(3) provided parallel imports remained possible.[164] Following this decision, and other similar decisions, the Commission

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161 1986-7 Trade Cas ¶67,120 (E.D. Pa 1986) quoted by Glickman *Franchising* §4.03 (2) (e).
162 Greco 2001 *Southern Business Review* 1.
163 See generally FTC *Federal Register* 30 March 2007 15492-15493.
164 Para 21.

granted territorial restrictions an exemption under the franchise block exemption provided they are limited and do not prevent franchisees from supplying particular consumers based on where they live.[165] The Commission was of the view that franchising improves the distribution of goods and offers consumers a fair share of the resulting benefits and that territorial restrictions are indispensable if these benefits are to materialise.[166] The following clauses were specifically exempt:[167]

- clauses that grant territorial protection to the franchisee by the franchisor;
- clauses that oblige the franchisee to exploit the franchise only from the contract premises;
- clauses that require the franchisee to refrain from seeking customers for goods and services which are the subject matter of the franchise outside the contract territory. Such clauses must not, however, prevent a franchisee from supplying goods and services to customers merely because they live outside a particular area.[168] So, whilst franchisees can be prevented from actively seeking out customers outside a particular area, they are entitled to supply customers that have sought them out notwithstanding the fact that the customers reside in another franchisee's area.

In terms of the 1999 Vertical Restraint Block Exemption territorial restrictions are regarded as hard core restrictions with certain exemptions that are very similar to those that applied under the franchise exemption notice.[169]

The Ontario Regulations in Canada, made under the Arthur Wishart (Franchise Disclosure) Act,[170] make express provision for exclusive territories. Regulation 12 states that the franchisor must provide a description of any exclusive territory granted to the

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165 OECD Franchise Report 114.
166 Preamble to the franchise block exemption regulation para 10 Commission Regulation No. 4087/88.
167 See Article 2.
168 Article 5 (g).
169 Audia et al 2001 *ACCC Docket* 64.
170 (O Reg 581/00) S O 2000 c 3.

franchisee. The franchisor must also provide a description of the franchisor's policy, if any, as to whether the continuation of such rights depends on the franchisee achieving a specific level of sales, market penetration, or other condition and under what conditions these rights may be altered.[171]

The granting of exclusive territories is regarded as anti-competitive conduct in South Africa[172] but the *Franchise Notice* states that if the franchisor is able to raise an acceptable defence for engaging in exclusive territory arrangements, no action will be taken against it.[173] Otherwise, it will have to apply for an exemption. The Commission will evaluate the matter on a case-by-case basis.[174] Despite the fact that it is the franchisor that will face an inquiry, granting exclusive territories to franchisees is usually for their (the franchisees') benefit. Franchisees do not want to have to compete with identical outlets in their area. If there is no clause in the contract providing for an exclusive territory, franchisors cannot be prevented from appointing other franchisees or even from competing with their franchisees themselves. This is a constant source of complaint from franchisees and franchisees tend to be of the view that franchisors who do this are not acting in good faith.[175] Franchisors do, however, also benefit from exclusive territory clauses because prospective franchisees are far more likely to invest if they know that they are to be granted an exclusive territory.

In conclusion it is suggested that it will not be difficult to convince the competition authorities that exemptions should be granted because this is something franchisees often expect, franchisors benefit from franchisees who are prepared to make a more substantial investment in their businesses and consumers benefit from a better service provided by more committed franchisees. .

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171 Regulation 13.

172 Horizontal agreements are a per se violation of the Act (s 4(1)(b)(ii)), but vertical restrictions are governed by s 5(1).

173 Para 4.14.

174 *Franchise Notice* para 4.15.

175 See 3.4 below and *Silent Pond Investments CC v Woolworths (Pty) Ltd and Engen Petroleum Limited.*

6.7 Conclusion

This unique business model raises critical issues relating to competition regulation, but co-ordination and co-operation between the parties can benefit society by increasing economic efficiency and can play a significant role in economic growth through job creation and skills development.[176] It may not therefore be difficult to convince the competition authorities that certain restrictions are reasonable. However, a major difficulty with the Act is that there is no provision for blanket exemptions and so many franchisors should be applying to the Commission for a ruling or an exemption.[177] Two agreements may contain similar restraints but they will not necessarily have the same impact on competition. This will depend on what competition the franchise network faces generally. It is, therefore, difficult to state that a particular clause is anti-competitive and each clause must be evaluated within its context.[178] But, evaluating each clause on an individual basis involves costs for individual franchise networks and increases the workload for competition authorities. This is the reason why block exemptions, such as those granted by the EU, are so attractive. It is therefore suggested that a similar approach be adopted by the South African competition authorities even though this would mean an amendment to the Competition Act. This would create certainty in the sector and lead to lower costs, particularly for smaller networks, which would facilitate the development of franchising in South Africa. It

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176 OECD Franchise Report 47.

177 *Franchise Notice* para 4.5. Once the Commission receives an application for exemption, it can respond in one of three ways. It may notify the firm that the conduct it is concerned about does not constitute a prohibited practice. In other words there is no need for an exemption. The Commission may decide that the conduct is a prohibited practice and it may grant a conditional or unconditional exemption or it may refuse to grant an exemption. The granting of an exemption is not a matter of discretion. The Commission must grant an exemption if certain factors are present and it must refuse the exemption if they are not: s 10(2)(a)-(c). Merely because a provision is prohibited, does not mean that it is void, unless the Tribunal or Appeal Court has declared it to be so (s 65(1)). Some agreements that contain anti-competitive provisions will continue in operation and may even run their full term without ever being challenged (see Reyburn *Competition Law* Com-25). The danger is that if a provision is challenged and is found to be a per se prohibition, there could be substantial penalties. As far as other practices are concerned, the situation is not as problematic as penalties will only be imposed if the conduct is substantially a repeat by the same firm of conduct previously found by the Tribunal to be a prohibited practice (s 61(*b*)). At least in this instance a party will have been warned that the conduct is anti-competitive. *Franchise Notice* in para 4.5.

178 See generally OECD Franchise Report.

is also suggested that a franchise code of conduct, introduced in terms of franchise-specific legislation, ought to deal with these issues.[179]

[179] See Chapter Nine. A franchise code of conduct would also provide guidance to franchisees and franchisors particularly when issues are already catered for and only a proper understanding of the law is needed to apply existing principles.

CHAPTER SEVEN
CHOOSING A REGULATORY FRAMEWORK

OUTLINE

The previous chapters have examined the nature of the franchise relationship and the existing laws that apply to this relationship. It has been established that, at present, franchising is regarded as a normal commercial contract, regulated primarily by the general principles of the law of contract. This has been criticised on the basis that franchising is a *sui generis* business model which should be subject to its own rules. It has also been established that, while certain problems are already governed by the laws relating to competition regulation, there are critical areas of concern that remain problematic. These relate specifically to misrepresentations, non-disclosures and termination of the relationship.

The next step is to decide how this business model should be regulated and which body should be responsible for overseeing its regulation. The purpose of this chapter is twofold. First it explores appropriate models for franchise regulation and second it discusses which body should be responsible for this regulation. The various options that are available to regulate franchising are:

- self-discipline;
- self-regulation; and
- legislation.

If self-discipline and /or self-regulation are to provide the framework upon which the sector is to be controlled, aggrieved franchisees will have to rely, to a large extent, on the principles of the common law of contract. This raises the question whether these common law principles are able to provide adequate solutions in the modern commercial world. If

it is decided that legislation is required, it is necessary to consider what legislation would be appropriate. Would it be preferable to introduce franchise-specific legislation or would it be feasible for franchising to fall within the jurisdiction of other legislation such as consumer protection legislation or legislation that governs business in general? In order to decide which body should be responsible for regulating franchising three options are explored:

- a single regulatory body which oversees both competition and consumer issues;
- a single "stand-alone" franchise-specific body which regulates franchising only;
- a broad-based consumer protection body which oversees the franchise sector as a facet of consumer law.

7.1 The regulation of franchising

7.1.1 Self discipline

There are some who argue that business functions best when there is no government interference at all.[1] True protection for consumers and other entrepreneurs is, therefore, through the strengths of the market and the development of competition.[2] Those who advocate this approach argue that if market incentives are inadequate, competitors or consumers may resort to the courts for an appropriate remedy provided for in the common law. This laissez-faire approach to business was prominent in the nineteenth century.[3]

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1 See generally Baldwin and Cave *Understanding Regulation* (1999) and Pengilley "Regulatory Power and Free Trade: The Rules of Engagement in the Era of De-Regulation" (2002) *QUT Law & Justice Journal* 1.

2 Baldwin and Cave *Understanding Regulation* 210-211and INTOSAI Working Group on the Audit of Privatisation "Guidelines on Best Practice for the Audit of Economic Regulation" 4 http://www.nao.org.uk/intosai/ wgap/ecregguidelines.htm (accessed on 8 February 2005).

3 See generally Cranston *Consumers and the Law* (1984)18-76.

This is the approach advocated by the Free Market Foundation and the Law Review Project (LRP).[4] The LRP, an association incorporated under s 21 of the Companies Act,[5] is an independent legal resource organisation that works closely with the Free Market Foundation. The Free Market Foundation is highly critical of over regulation and advocates the removal of excessive restrictions on the economy.[6]

To a large extent, self-discipline is the present model for regulating franchising in South Africa. The only legislation applicable to franchising is legislation that governs business in general and many franchisors are not members of the self-regulatory body, the FASA. The franchise relationship is governed primarily by the contract concluded by the parties and franchisees who believe they have been exploited must resort to the courts for a remedy. The discussion in earlier chapters (Chapters Three, Four, Five and Six) indicates that the existing law does not provide for the appropriate resolution of disputes in the sector. In addition, even if the present regulatory system was appropriate, in order for self-discipline to function effectively, all parties must be operating on an equal basis, they must be aware of their rights and they must have the means to protect those rights. The history of franchising has demonstrated that this is a business model that is open to abuse and that it is a relationship in which one party occupies a superior position.[7] Franchising is, by nature, an unequal relationship which means that this is a business strategy that is probably not suited to be left to the vagaries of the marketplace.

7.1.2 Self-regulation

Generally the aim of regulation is to ensure that consumers are supplied with proper products and services at a fair price, monopoly powers are not abused, and certain social objectives are achieved.[8] Self-regulation occurs when a particular industry assumes

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4 See http://www.freemarketfoundation.com.

5 Act 61 of 1973.

6 Leon Louw, Executive Director of the Free Market Foundation, expressed these views in a discussion of the Consumer Protection Bill. See "Consumer Protection Bill, 2006" http://www.freemarketfoundation.com (accessed on 18 February 2007).

7 See Chapter Three.

8 INTOSAI Working Group "Guidelines on Best Practice".

responsibility for prescribing its own rules and arrangements.[9] Self-regulation involves control by one's peers and occurs when business assumes responsibility for achieving three requirements for efficient regulation. These are:

- setting standards in which "acceptable" and "unacceptable" behaviour is described;
- providing the means for identifying errant behaviour; and
- providing incentives to ensure that behaviour is changed. In other words there must be penalties for non-compliance and rewards for compliance.[10]

In order for self-regulation to function effectively there must be an industry body that has the capacity to monitor and enforce compliance. Unless there is proper monitoring it is impossible to establish whether behaviour is achieving specified standards.[11] Monitoring bodies differ quite substantially in structure, administration and in the powers that they hold.[12] Some of them are recognised by government and have statutory powers whilst others operate quite independently. It has been suggested that such bodies, in order to be truly effective, should ensure that they do the following:[13]

- promote better accounting and record keeping methods;
- sponsor industry meetings and the development of leadership within the industry;
- operate a liaison service between government and industry;
- provide publicity and public relations programs for the industry;
- foster industry-wide technical research;

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9 See generally Baldwin and Cave *Understanding Regulation* Chapter 10.

10 Banner "Alternatives to state-imposed regulation" Discussion paper produced for the INTOSAI Working Group on the Audit of Privatisation (2002) http://www.nao.org.uk/intosai/wgap/9thmeeting/9thuk.pdf (accessed on 8 February 2005).

11 *Ibid.*

12 See generally Pengilley *Trade Associations, Fairness and Competition* (1981) and Business Practices Committee "Report in Terms of section 10(1) of the Harmful Business Practices Act 1988 (Act No 71 of 1988)" *Government Gazette* 13988 18 May 1992 39 (BPC Report 15).

13 Pengilley *Trade Associations, Fairness and Competition* 10 and BPC Report 15 39.

- maintain a labour relations service to promote industry harmony;
- disseminate information amongst its members;
- gather statistics for the industry;
- publish specialised data concerning the industry;
- offer training courses to employees of members;
- provide other services such as credit reporting services, co-operative purchases and the undertaking of economic studies; and
- furnish the industry with specialised technical advice that smaller members in particular may not be able to afford.

In addition, when the industry body is the primary body responsible for regulating the industry it must ensure that standards for the industry are developed; that these standards are made known; that members are assisted and monitored in order to ensure that they are complying with those standards; that complaints are dealt with and that errant behaviour is penalised.[14] These requirements presuppose that the industry body takes a proactive role in the industry rather than simply a reactive one.

Business self-regulation is a technique that can deliver significant benefits to businesses mainly because the cost of regulation is reduced and there is a much more flexible regulatory environment.[15] Self-regulation is often discussed in the context of a business relationship with consumers and is one of the forms of regulation that has made a contribution towards protecting consumers.[16] Complaints also come from fellow traders because traders who are conducting their businesses in an unacceptable manner may have an unfair advantage in the marketplace. In the context of this thesis, self-regulation is one of the ways in which the relationship between franchisors and franchisee can be controlled.[17]

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14 These six tasks have been adapted from Boddewyn's requirements that apply specifically to the advertising industry. See Boddewyn *Global Perspectives on Advertising Self-regulation* (1992) 4.

15 Cranston *Consumers and the Law* 31-62.

16 BPC Report 15 15.

17 This raises interesting questions regarding whether the franchisee is a fellow trader or a consumer. This is a matter of some considerable debate. See 8.2.4 below.

For a time in South Africa there was a trend toward moving away from government intervention and allowing for more self-regulation.[18] There are a host of industries that rely on self-regulation.[19] However, in order to be truly effective there must be an industry body that has the capacity to monitor the industry and to deal effectively with transgressions. There must also be a telling sanction which will deter errant business people from transgressing their particular code. This has proved to be difficult in South Africa because membership of industry bodies is usually voluntary. When faced with evidence of a transgression errant parties simply resign from the organisation, leaving it with no jurisdiction over the matter. The video store franchisee reported that when she reported her concerns to the FASA she was informed that the franchisor had resigned from the FASA, and so the body could not assist her.[20]

An example of an effective industry body is the Advertising Standards Authority (ASA), the self-regulatory body for the advertising industry in South Africa. There are two main reasons why the ASA is successful: (1) the primary players in the industry, such as the print and broadcasting media, belong to the organisation and (2) the principal sanction agreed to by the industry, namely the withholding of advertising time and space, is a very powerful sanction.[21] If the ASA rules that an advertising campaign is unacceptable, the advertisement cannot be used or, if already part of a campaign, it must be amended or withdrawn. In many instances, advertisers will voluntarily agree to amend or withdraw an offending advertisement. If they fail to cooperate, all ASA members are requested not to accept further advertising from the advertiser in question until the matter has been satisfactorily resolved.[22] When an advertiser habitually contravenes the advertising code or appears to be ignorant of the ASA Code's provisions, the ASA may issue a media alert

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18 Certainly this has been the trend internationally. See Boddewyn *Advertising Self-regulation* 5 and Australian Task Force on Industry Self-Regulation "Industry Self-regulation in Consumer Markets" chapter 7 http://www.selfregulation.gov.au/publications (accessed on 23 October 2003) (Australian Task Force Report). However, in South Africa, the tide has turned away from pure self-regulation and is moving towards more government intervention. For further discussion see 7.1.2.2 below.

19 For example, the timeshare industry, direct selling, advertising industry and pest control. In August 2004 the Wireless Application Service Providers Association (WASPA) was formed to regulate wireless application service providers.

20 Interview October 2007.

21 ASA Code ix.

22 ASA Code PG-7.

that no advertising is accepted from that particular advertiser unless the advertiser has obtained prepublication clearance from the ASA.

Other self-regulatory bodies have not had the advantage of such an effective sanction and self-regulatory codes have not been sufficient to control abuses. For example, debt collectors used to be governed primarily by a code of conduct but because of numerous complaints from consumers regarding harassment, debt collectors themselves lobbied government for regulation. The industry is now governed by legislation, the Debt Collectors Act,[23] which establishes a Debt Collectors Council that regulates the industry. Debt collectors, excluding attorneys, are required to be registered before they may collect fees. It is a criminal offence to act as a debt collector without being registered. The Council can conduct hearings into the conduct of debt collectors and if found guilty of misconduct, their certificate of registration can be withdrawn.[24]

7.1.2.1 The advantages of self-regulation

Self-regulation allows businesses to respond much more quickly and efficiently to problems because codes are more flexible than regulation by statute.[25] Codes can be easily revised.[26] Self-regulation is not bedeviled by the procedural problems of court action.[27] Enforcing a code is also usually less expensive.[28] Self-regulation can also be more effective because experts in the industry are able to identify genuine abuses far more

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23 Act 114 of 1998.

24 For further information see http://www.debtcol-council.co.za. In Chapter Nine it is suggested that this legislation should be used as a model for franchise-specific legislation.

25 See generally Australian Task Force Report chapter 6; Office of Fair Trading *A General Duty to Trade Fairly* August 1986; BPC Report 15 47 and Cranston *Consumers and the Law* 59.

26 Office of Fair Trading *A General Duty to Trade Fairly* and BPC Report 15 47. The use of a code has proved to be very effective in regulating wireless application service providers because technology is changing so quickly that it would be extremely difficult, if not impossible, for legislation to keep pace with developments (see generally http://www.waspa.org.za).

27 Boddewyn *Advertising Self-regulation* 5 and the ASA Code.

28 Boddewyn *Advertising Self-regulation* 5. For a discussion of the legal effects of a code of practice see Pearson "The Legal Effect of Some Codes of Practice" (1995) Australasian Law Teachers' Association http://www.austlii.edu.au/special/alta95/pearson (accessed on 24 November 2004).

readily than government officials, and there will be less control over legitimate activities.[29] From an industry perspective, self-regulation often means less government interference.[30]

When industries are involved in regulating themselves, they are able to respond to complaints and to identify solutions by utilising resources and expertise to which government does not have access.[31] Responsibility for enforcing codes lies with people who have expertise in the field and so they are aware of what constitutes fair and reasonable conduct and can more easily persuade their peers to strive for and maintain standards.[32] Self-regulation can provide an effective middle road between no regulation at all and stringent government controls.

A far as franchising is concerned, Kaufmann asserts that self-regulation is "far more efficient, achieves its goals in greater depth and has better results, for all concerned, both franchisors and franchisees, than any government regulation".[33] In an interview with *Entrepreneur.com*, he explained that one of the difficulties with franchising is that it is not an industry. It is, instead, a method of distributing products.[34] Government regulation of franchising means that government must be able to understand multiple industries of which it knows virtually nothing.[35] Stephen Lyn, chairperson of the IFA in 1993, was of the view that franchising should rely predominantly on self-regulation because self-regulation

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29 Rijkens and Miracle *European Regulation of Advertising* (1986). Although these comments were made in the context of advertising regulation they can be equally applied to other industries where self-regulation is applicable.

30 In 2003 it was reported to the CAFCOM that, at a workshop held by the ASA and attended by members of the DTI, the ASA was of the view that it was under threat from its members. Many members were contravening the code and were not supporting the work of the authority. Initially this flouting of the code was enthusiastically received by members, many of whom regarded the authority as unnecessary. However, it was pointed out by an investigator from the DTI that should the ASA collapse, the government, already under pressure to regulate the industry, would have no alternative but to step in. As long as there was an effective industry body in place the government would prefer to leave regulation of the industry to that body. The investigator reported that, following her comments, there appeared to be renewed support for the ASA.

31 See generally Australian Task Force Report chapter 6.

32 Office of Fair Trading *A General Duty to Trade Fairly* and BPC Report 15 47.

33 Smith "A Matter of the State? An attorney discusses the government's place in franchising" http://www.Entrepreneur.com/article 13 May 2002 (accessed 24 November 2004).

34 *Ibid.*

35 *Ibid.*

stresses communication, cooperation and persuasion rather than confrontation.[36] Disputes between franchisors and franchisees are inevitable, but when this occurs problems should preferably be resolved through "negotiation, mediation, arbitration and other alternative dispute-resolution techniques".[37] Statutory regulation, on the other hand, tends to encourage clashes by stressing compulsion, litigation and penalisation.[38] Minimising friction between franchisees and franchisors is critical. Often the aim of dispute resolution in the sector is to nurture the relationship rather than to dissolve it. In addition, asking the industry body to settle a dispute is often a far more feasible option for a franchisee, who usually does not have the resources to approach the courts.[39]

7.1.2.2 The disadvantages of self-regulation

One of the main problems with self-regulation is that membership of industry bodies is voluntary and often the complaints relate to non members over whom industry bodies have no jurisdiction. This was a problem experienced in the debt collecting industry. Enforcement is also dependant on an industry body's ability to enforce compliance and here an effective sanction is often problematic.[40] Many of the activities of industry bodies concern advancing the interests of that particular industry and so complaints are not actively solicited.[41] Industry bodies are often underfunded and do not have the capacity to promote their activities, and because of this consumers and many in the industry are

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36 American Chamber of Commerce "Franchising in Congress and state capitals – regulation – Franchising: A special guide" *Nations Business* (Jan 1993 and reprinted 2004) http://findarticles.com/p/articles (accessed on 24 November 2004).

37 Per Lynn quoted by American Chamber of Commerce "Franchising in Congress and state capitals".

38 Boddewyn *Advertising Self-regulation* 6.

39 This is generally cited as an advantage of codes for consumers who are known to be reluctant to use more traditional legal methods because of the costs involved. Asking an industry body to mediate in a dispute involves no cost to the consumer. The problem with approaching a small claims court is the upper limit on the value of the claim. See generally Office of Fair Trading *A General Duty to Trade Fairly* and BPC Report 15 49.

40 Office of Fair Trading *A General Duty to Trade Fairly* and BPC Report 15 49.

41 Boddewyn *Advertising Self-regulation* 50. See Cranston *Consumers and the Law* 59-62. Cranston points out that industry self-regulation is usually motivated by industry's desire to avoid government interference and usually has little to do with a sense of social responsibility.

often unaware that they exist.[42] Rival traders can also use industry bodies to harass competitors and can interfere with competition.[43] In general, consumer organisations do not believe that private bodies will protect consumers and advance the public interest.[44]

The weakness of self-regulation has been highlighted in a number of investigations conducted by the CAFCOM. Business will often resort to a particular business practice because it has not been declared an illegal practice even though a relevant code may state that this is regarded as unacceptable conduct. The CAFCOM' s investigation into inertia selling, also known as negative option marketing, illustrates this point.[45]

Negative option marketing is a marketing strategy used by entrepreneurs to make an offer regarding new products or services to existing customers.[46] When these customers do not expressly reject the offer it is assumed that the offer has been accepted and their accounts are debited.[47] Over the years, the CAFCOM has received numerous complaints regarding this form of marketing. Another form of inertia selling is unsolicited

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42 The problem of consumer awareness was highlighted in The FinMark Trust Report "Landscape for Consumer Recourse in South Africa's Financial Services Sector" (2007). In this Report FinMark Trust examined the role of ombuds in South Africa.

43 Pengilley *Trade Associations, Fairness and Competition* 10-11 and BPC Report 15 41. In order to function effectively an industry body must be properly financed and funds are generated by charging membership fees. This can be problematic for small businesses and is sometimes given as a reason as to why businesses do not join their industry body (AustralianTaskforce Report Chapter 4). When a scheme is funded by industry membership, costs will be passed on to consumers and this will mean that small businesses are at a competitive disadvantage to their larger counterparts.

44 See generally Boddewyn *Advertising Self-regulation* 7; Barnes and Blakeney *Advertising Regulation* (1982) 23 and *Cranston Consumers and the Law* 59-62.

45 Consumer Affairs Committee "Report in terms of s10(1) of the Consumer Affairs (Unfair Business Practices) Act: Inertia Selling" *Government Gazette* No 26700 18 April 2004.

46 This is usually done through the post and is contained in marketing material.

47 For example, in 2000 a large retailer in South Africa sent its existing customer base an offer to purchase a new insurance policy that would cover them in the event of illness, death or retrenchment. Customers were informed that if they did not respond to the offer, their accounts would be debited from a certain date. Many failed to contact the offeror and it was assumed that they had agreed to purchase the policy. Evidence suggested that most customers were not even aware of the offer, either because they could not read or regarded the marketing material as junk mail and so had not read the offer. An interesting point to note is that marketers who resort to this practice need to build a critical mass for their products otherwise it would not be financially viable or would, at the very least, be far more expensive – to the point where consumers would complain. So they rely on consumer ignorance or apathy. Apathy arises because the product is usually relatively inexpensive, for example, R7 per month for a magazine or R5 per month for a club membership. Although consumers may be irritated and unsure of their rights, they do not investigate the matter further because the sum involved is so insignificant.

marketing.[48] This is the practice of sending unsolicited merchandise to consumers. There is no contractual relationship between the parties, and marketers simply hope that consumers will keep the items and forward their payments. Marketers obtain the addresses of consumers from suppliers of address lists or telephone directories.[49] When consumers do not pay, they are threatened with collection, told that their credit records will be affected or that legal action will be taken against them.

Although inertia selling was not illegal, a number of consumer codes provided guidelines on this practice.[50] These guidelines are contained in the ASA' s Code and the Direct Marketing Association (DMA)' s *Code of Practice*.[51] The ASA Code states:[52]

> Advertisements will not be accepted from those who supply goods without express authority from the receiver of the communication.

Despite this clear proscription, the ASA regularly dealt with the problem of inertia selling. In one case, the ASA reported that customers had to advise a company by telephone that they did not wish to take up an offer. Consumers who "accepted" the offer paid an additional R2.00 per month.[53] A complainant to the ASA pointed out that if the company had 200 000 customers and only 5% made the phone call to reject the offer, an additional R380 000 per month would be generated by the advertiser without the authority to do so. The ASA has stated that it regards inertia selling as an unacceptable practice and that it will not hesitate to take firm action when businesses contravene the ASA Code in this manner.[54]

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48 Christie *Contract* 66.

49 This marketing technique must be distinguished from the practice of sending free samples through the post. Marketers who send out free samples intend the recipients to become the owners of the samples. With unsolicited marketing marketers do not intend the recipients to become owners until they have paid for the goods.

50 See generally BPC Report No 15.

51 The DMA is a voluntary organization that represents, promotes, and serves a range of direct marketing organizations, from call centres and TV infomercial marketers, to print, electronic commerce and mail order organizations.

52 Section 1V clause 3.

53 ASA *Rulings and Reasons* No 1 April 1994.

54 ASA *Rulings and Reasons* No 10 August 1997.

Even though a number of codes dealt explicitly with inertia selling,[55] other jurisdictions have legislated against this practice[56] and the Electronic Communications and Transactions Act[57] contains a provision which states that no agreement is concluded when a consumer has failed to respond to an unsolicited communication,[58] many businesses continued to use the practice. After dealing with complaints on a case-by-case basis, the CAFCOM embarked on a formal investigation[59] which resulted in the Minister of Trade and Industry outlawing the practice. Self-regulation had proved to be inadequate to deal with the problem.[60]

7.1.2.3 The Franchise Association of South Africa

In 1979 a number of franchisors, including Kentucky Fried Chicken, Wimpy and Juicy Lucy, formed the South African Franchise Association (SAFA), now known as the Franchise Association of South Africa (FASA). The FASA is a section 21 company, incorporated not for gain, that aims to regulate the industry in order to promote ethical standards amongst its members.[61] It operates according to a Memorandum and Articles of Association which incorporates its constitution and its *Code of Ethics and Business Practices* (The FASA Code). The FASA is a voluntary body and it depends on the goodwill of its members for

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55 The DMA Code contains similar proscriptions to the ASA (s 5.1 and s 5.2).

56 In Britain for example, consumers who receive unsolicited goods are made the unconditional owners of them after expiration of six months if the business has not reclaimed the goods (Unsolicited Goods and Services Act of 1971 and 1975). This period is shortened to 30 days if the business fails to collect the goods after being notified that they are unsolicited. Unless a business has reasonable cause to believe that it has a right to payment for these goods, it is a criminal offence to demand payment, to threaten any legal proceedings or to invoke any collection procedure such as placing the name of the consumer on a list of defaulters. Similar provisions are also found in Australian legislation (See, for example, the Trade Practices Act 1974 s 64 and s 65 and the Unsolicited Goods and Services Act 1974 (New South Wales)). Other jurisdictions such as America, the EU, Canada and New Zealand also have legislation curbing the use of this marketing practice (see Office of Consumer Affairs Canada "Negative Option Marketing: Discussion Paper" http://www.strategis.ic.gc.ca/SS1/ca/nom_e.pdf (accessed on 24 September 2006).

57 Act No 25 of 2002.

58 S 46(2).

59 In terms of s 8(1)(b). See Notice 4083 *Government Gazette* 21665 20 October 2000.

60 The Consumer Protection Bill also prohibits this practice (s 31).

61 See generally Louw "The FASA's role in the Orderly Development and the Maintenance of Ethical Practices in Franchising" in *The Franchise Book of Southern Africa 2001* 12.

compliance. Many franchisors are not members. In 2002, research indicated that approximately 47% of franchise systems were members.[62] Initially, full membership was open only to companies wishing to franchise their businesses (that is, franchisors). Professional practices that provided services to the industry could apply for affiliate membership. Today membership is also open to franchisees and if franchisee numbers are taken into consideration, 60% of those involved in the sector are FASA members.[63]

The initial restriction on full membership to franchisors could be responsible for a popular belief amongst franchisees that the FASA's main objective is to protect and promote the interests of franchisors. In June 1998 certain franchisee members of the Franchise Steering Committee prepared a document (dated 28 June 1998) in which franchisee complaints were outlined. This was at the time when franchisees were not members of the FASA and this lack of membership was included in the document as one of the major grievances. The document reads:

> It is evident up to this stage that Franchisees, generally across the racial and gender considerations were never considered a vital and integral part of this industry.

The document also sets out the process that was followed to establish the Steering Committee. Initially the DTI had commissioned the FASA to produce a document making proposals for the way forward for the sector. Certain franchisees interpreted this as collusion between the DTI and franchisors and expressed their dismay. As a result, the process was reconstituted and a Steering Committee was set up which included representatives from the FASA and the DTI as well as franchisees. In another letter sent to the Minister of Trade and Industry (dated 30 May 1999), signed by a number of franchisees, the signatories again expressed the view that the FASA represents franchisors only and does not act to protect the interests of franchisees. This was vehemently denied by the FASA. In a letter to the Franchise Steering Committee (dated

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62 FSC Explanatory Report 62.

63 As per research conducted in 2002 (FSC Explanatory Report 62).

26 November 1999) the FASA pointed out that it had tried for seven years to set up a franchisee body but franchisees were not interested. The letter also pointed out that the FASA Code details franchisor activity to the benefit of franchisees and that franchisees also benefit when franchisors join the FASA. They argued that this was so because franchisees are buying their franchises from entities that voluntarily subject themselves to a code of ethics and also that, through the FASA, franchisees have recourse to mediation at no cost. The FASA stresses that it does not represent individual interests but aims to promote ethical franchising and business practices. In pursuing this objective, it acknowledges the equal importance of both franchisors and franchisees.

A study of the FASA Code reveals that many of its provisions are indeed designed to protect franchisees. For example, the Code compels franchisors to provide franchisees with a disclosure document at least seven days prior to the signing of any franchise agreement.[64] This disclosure document must contain specified information:[65] information relating to the business experience of the franchisor and his officers; details of any debt, criminal, civil or administrative proceedings in which the franchisor is cited as an accused, defendant or respondent; and a summary of the main particulars and features of the franchise. The document must include any restraints of trade and terms and conditions relating to termination, renewal, goodwill and assignment of the franchise.

There are however some concerns about the FASA Code. Although the FASA Code provides that the agreement must specify terms relating to termination and renewal, there are no restrictions regarding the content of those terms. If their contracts terminate after a period of ten years and franchisors elect not to renew, for example, franchisees will have to cease using the trade marks and symbols of their franchisors and any reasonable and enforceable restraints of trade may operate.[66] To add to franchisee problems, there is no requirement that franchisors must compensate franchisees for any goodwill.

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64 S 8. The requirement that this disclosure document be provided to prospective franchisees was introduced together with a "cooling-off" period in 1994. At the time this was regarded as a pioneering move. See Louw " FASA's Role in the Orderly Development and the Maintenance of Ethical Practices in Franchising" in *Franchise Book of Southern Africa 2001* 12.

65 Set out in Appendix 1 to the Code.

66 This a matter of significant concern for franchisees. See Chapter Five.

7.1.2.4 The Consumer Affairs Committee

The CAFCOM is a committee established by the Minister of Trade and Industry in terms of the Consumer Affairs (Unfair Business Practices) Act. The Act authorises the Committee to investigate business practices and to make recommendations to the Minister. The Committee is a statutory body in the DTI. Its members are not in the full-time employment of the State but are appointed by the Minister for a period not exceeding five years.[67] The purpose of the Act is to provide for the prohibition or control of unfair business practices, but it does not contain a list of practices that may be considered unfair. This is an enabling Act rather than a prescriptive one, and the Act itself does not prohibit anything. The lack of specific prohibitions is one of the criticisms that has been directed against the Act. Louw is of the view that business should be informed up front regarding what conduct is unfair or unacceptable. This should not be judged after the event. For this reason he argues that the Act is unconstitutional.[68] The applicant in *Janse Van Rensburg NO v Die Minister van Handel and Nywerheid NO*[69] sought an order declaring the whole Act or specific portions of it to be unconstitutional. In particular, it argued that the definition of a "harmful business practice" was unconstitutional because it was too wide and should be declared void for vagueness. Van Dijkhorst J found that certain (relatively minor) sections of the Act were unconstitutional but that on the whole the Act was not unconstitutional. In dealing with the definition of a harmful business practice, the court focused on the words "unreasonably prejudicing any consumer". It held that the word "unreasonably" is not unclear and does not lead to legal uncertainty as it is a concept which is applied in the courts on a daily basis. As Van Dijkhorst J explained: "[I]t is a workable concept and although, considered abstractly, it offers no clarity, in given circumstances it is applicable and useful ... compare for instance the concepts of unfair discrimination, equitable basis, fair labour practice, reasonable measures, appropriate care, reasonable and fair

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67 S 2(5)(a).

68 Louw "The Rule of Law under siege in South Africa" 17 March 2005 http://www.freemarketfoundation.com/ShowArticle.asp?ArticleType=Publication&Article (accessed on 31 May 2006).

69 Unreported TPD case 2658/98 22 Oct 1998.

administrative action and reasonable limitation of rights".[70] Van Dijkhorst J also found that it was not unconstitutional for the Committee to produce guidelines from time to time. On the contrary, this approach makes the abstract concept of a harmful business practice more concrete.[71]

Over the years the Committee has produced a number of consumer codes, including one for franchising entitled the *Consumer Code for Franchising* (Consumer Code). This was developed, in consultation with the FASA in 1995, when the Committee was known as the Business Practices Committee (BPC). The former BPC was very supportive of self-regulation and regarded itself as complementing self-regulatory schemes which operated in particular industries.[72] It instituted an investigation into consumer codes in general and the role which these codes could play in self-regulation.[73] The BPC concluded that codes could make an important contribution toward preventing harmful business practices, and that such codes would provide useful guidelines regarding what was regarded as acceptable conduct and what was not. The BPC devised or approved a number of industry-specific consumer codes including the following: advertising, vehicle recovery services, mail order marketing, credit bureaus, debt recovery, franchising and time sharing. These codes were developed in consultation with the various industries and whilst it was hoped that they would be adopted by the industries as their codes, most industries also published their own codes. Having two codes applicable for one industry is not satisfactory as this could cause confusion, particularly if they have different

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70 At 7 of the unreported judgment. During argument in the Constitutional Court, counsel for the LRP which was admitted to the proceedings as amicus curiae, argued that the High Court erred in not holding the definition of "harmful business practice" unconstitutional. See *Janse Van Rensburg NO v Minister of Trade and Industry* 2001 (1) SA 29 (CC) The Constitutional Court declined to decide this issue because, by then the definition had been amended and so the issue had become moot. Although the Constitutional Court confirmed Van Dijkhorst J's judgment that s 8(5), which empowers the Minister to act against a business before the Committee has completed its investigation, was unconstitutional, it did not criticise the Act as a whole. Since this judgment the Act has been amended to deal with the Constitutional Court's pronouncements. See Woker "Business Practices and the Consumer Affairs (Harmful Business Practices) Act 71 of 1988" (2001) 13 *SA Merc LJ* 316.

71 The Consumer Affairs (Unfair Business Practices) Act provides that the Committee must make known information on policy relating to unfair business practices from time-to-time (s 4). One way in which it does this is by issuing consumer codes.

72 BPC Report No 15 15.

73 *Ibid*.

requirements.

Developing a consumer code for franchising was controversial because many individuals (particularly franchisors) were (and still are) of the view that franchisees are not consumers. The argument is that the Committee has no jurisdiction to deal with matters which are essentially between two businesses. However, the BPC, when issuing the Consumer Code, took the view that a potential franchisee, prior to the franchise agreement being concluded, can be considered a consumer.[74] This view continues to be endorsed by the DTI and the Consumer Protection Bill governs certain aspects of franchising. Using consumer protection measures to protect franchisees is a controversial issue which is discussed further in Chapter Eight.

The Consumer Code recommends that franchisees who are dissatisfied with the treatment they have received should first approach the FASA and, if not satisfied with the FASA's handling of the complaint, should then approach the CAFCOM.[75] The Consumer Code is the starting point for any investigation involving an unfair business practice but the committee will also take into consideration the industry code. This is only the starting point because, even though a particular practice may not covered by either code, the Committee may still investigate the complaint. The Committee may investigate any conduct that is deemed to be an unfair business practice. In addition, the Consumer Code is applicable to all those involved in the sector, regardless of whether or not they are members of the FASA. When a matter involves a sector, such as franchising, which has an active industry body, the Committee will usually consult that body before undertaking a formal investigation.

Like the FASA's code, the Consumer Code also requires a disclosure document. This document must provide potential franchisees with sufficient information to enable franchisees to make informed decisions.[76] This disclosure document, together with a copy of the franchise agreement, must be provided to potential franchisees at least seven working days before any binding documents are signed or any irrevocable financial

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74 Consumer Code and Potgieter "Franchise Agreements: Some Related Legal Aspects" in *The Franchise Book of Southern Africa 2001* 29.

75 Consumer Code s 3.

76 S 2.8

commitments are made.[77] All matters material to the franchise relationship must be contained in written agreements and these agreements must set out the rights and obligations of the parties clearly.[78] Franchisors are required to consider carefully those who are selected as franchisees, but cannot refuse to accept franchisees for reasons relating to race, gender, religion, disability or age.[79] Franchisors are required to provide adequate assistance to franchisees prior to the setting up of the businesses, to act fairly in all dealings with franchisees and to attempt to resolve all disputes by fair and reasonable communication and negotiation.[80]

Similar requirements are also found in the FASA's Code.[81] Such requirements are problematic because they deal with relationship issues which are difficult to monitor and resolve. However, a code of conduct is useful when dealing with relationship issues because parties to a code are expected to comply with the spirit of the code rather than with the strict letter of the law. Disputes are also resolved first on the basis of mediation and so it may be easier to get each party to understand the other's point of view. [82]

Unfortunately most of the codes developed by the CAFCOM are generally ignored by those involved in the industries to which they are applicable. One of the primary reasons why these codes have not been successful is because monitoring bodies have failed to materialise or have collapsed. Consumers and competitors then turn to the CAFCOM for assistance. The Committee does not have the capacity to enforce codes in particular industries and so to a large extent the codes have become meaningless. In 2002, the CAFCOM took the decision that it would not be involved in the drafting or updating of any

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77 *Ibid.* The FASA' s Code says that the document must be provided seven days before the agreement is signed.

78 Consumer Code s 2.9.

79 Consumer Code s 2.8.

80 Consumer Code s 2.12 - s 2.15.

81 The FASA Code s 11 - s 17.

82 Because of the difficulties associated with regulating relationship issues, legislation in America, for example, focuses on issues such as pre-contractual disclosure and grounds for termination and avoids dealing with the actual relationship between the parties. It is up to the parties to decide how their relationship should be conducted and what terms and conditions should appear in their agreements. The Model Law produced by UNIDROIT is restricted to disclosure requirements and does not deal with conduct issues. This is consistent with most current franchise legislation. It has been suggested that to require franchising to be subject to business conduct legislation may well put it at a competitive disadvantage (see FSC Explanatory Report).

codes. The Committee also took the view that, where necessary, the Committee would make recommendations that the Minister convert codes into regulations. In the period 2003-2006, on a number of occasions, the Committee discussed the possibility of conducting a formal investigation into franchising[83] with a view to recommending that the Minister convert the Consumer Code into regulations. Unfortunately, due to a lack of capacity and experience in the investigative unit, this was not possible. This lack of capacity and experience in franchising matters also meant that the resolution of franchising complaints was far from satisfactory and lends support to the concern that government bodies are ill-equipped to deal with problems of this nature.

7.1.2.5 Concluding remarks regarding self-regulation

The Australian task force that investigated self-regulation concluded that self-regulation is most effective when there are clearly-defined problems and low risk or little danger of widespread harm to consumers. In such instances, if the self-regulatory body fails to solve a particular problem, there would be little harm done.[84] Effective self-regulation requires large-scale consumer and business education and there must be co-operation from all the industry players.[85] In a competitive market where there is proper consumer education, self-regulation can be very effective because an errant business will quickly find that it will lose market share if it is identified as a business that regularly fails to comply with accepted industry standards. It is highly questionable whether South African markets and consumers have reached this level of education and sophistication. The FASA is a voluntary body, and therefore it relies on the co-operation of its members for success. As research has indicated, many franchisors are not members and when the FASA does

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83 These are conducted in terms of in terms of s 8(1)(b) of the Consumer Affairs (Unfair Business Practices) Act.

84 Australian Taskforce Report chapter 5.

85 Comments made by the Institute of Engineers, Australia quoted in Australian Taskforce Report chapter 5 .

attempt to take action against a member, the errant franchisor may simply resign.[86] Additionally, the other self-regulatory body here, the CAFCOM, is a committee designed to deal with consumer issues. Many franchise matters actually concern business-to-business disputes and it is therefore difficult for the CAFCOM to resolve these matters to the satisfaction of all parties. By its nature, a consumer protection body is designed to deal with matters that involve a single consumer and a supplier. Franchising involves an entire network of franchisees and so it is not possible to resolve a matter without taking into consideration the interests of other parties. Trying to adapt consumer protection measures in the circumstances simply leads to inappropriate resolution of disputes and general frustration.

Self-regulation is proving to be inadequate when it comes to dealing with many of the problems facing the franchise sector. This is because franchisors are not willing to co-operate or because of unethical behaviour amongst some unscrupulous franchisors.[87] Self-regulation has proved to be inadequate in other jurisdictions as well. In Australia, for example, in 1993 the voluntary *Franchising Code of Practice* was adopted and this was administered by the Franchising Code Council. Franchisors were required to make pre-sale disclosures. There was a cooling off period and mandatory mediation for disputes. In 1994, a review of the Australian Code found that this approach was not effective in dealing with serious franchise disputes. Less than 50 per cent of franchisors were registered and so the code could not be effectively enforced. The Franchising Council went into liquidation in 1997. In May 1997 a report on fair trading was released and it recommended that specific legislation be introduced that required compulsory registration of franchisors and compliance with a code of practice. This took place in July 1998 when the *Franchising Code of Conduct* (Australian Code), a mandatory code prescribed under the Australian Trade Practices Act, was adopted.[88] The Australian Competition and Consumer Commission (ACCC) is responsible for the administration and enforcement of

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86 FSC Explanatory Report 63. At the US-Southern Africa Franchising Forum (Johannesburg May 2007) Kobus Oosthuizen, the present chairperson of the FASA, confirmed that this is a problem with self-regulation.

87 Explanatory Report 63.

88 This is a form of co-regulation. See 7.1.4 below.

the Code.[89] In addition, the Office of the Mediation Adviser was established by the Australian Government to help franchisors and franchisees resolve their problems and disputes without embarking on litigation.[90] Trained mediators with commercial experience are located across Australia. They are trained to help parties resolve their disputes and it is estimated that an outcome acceptable to both parties is achieved in about 70 per cent of disputes.[91]

In conclusion, it is submitted that in a sophisticated market with high levels of commitment to self-regulation, self-regulation is a model which is highly desirable for resolving disputes. The South African experience in the advertising industry has proved that self-regulation can be an effective model for regulating an industry. But, the industry is committed to avoiding government regulation and, most importantly, there is a highly effective sanction that encourages commitment from errant advertisers. Nevertheless, even this industry has faced challenges in recent times.[92] Following 1994, after the introduction of the Constitution, many leading advertisers, agencies and the print media began to seek more advertising freedom and challenged the industry's code.[93] The ASA regarded this erosion as a matter of serious concern as this led to calls for more government intervention in advertising matters.[94] The advertising industry is a highly sophisticated industry in South Africa with an effective sanction and yet it is struggling with

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89 The ACCC is an independent statutory authority responsible for administering the Trade Practices Act. The Act prohibits businesses from engaging in any anti-competitive conduct, misleading or unconscionable conduct. See generally ACCC "Franchise Bulletin, Resolving Franchise Disputes" http://www.accc.gov.au (accessed on 24 May 2007). The ACCC reports that franchising in Australia has gone "from strength to strength since the Franchising Code commenced in 1998". See also Martin "The ACCC & Franchising - Recent Developments and Regulatory Directions" (2004) http://www.accc.gov.au (accessed on 24 May 2007).

90 See generally Franchising Policy Council Report.

91 ACCC "Franchise Bulletin, Resolving Franchise Disputes".

92 See for example *Telematrix (Pty) Ltd v Advertising Standards Authority SA* 2006 (1) SA 461(SCA).

93 ASA *Rulings and Reasons* No 5 November 1995. A recent example involved the cellular telephone industry. The major industry players were ignoring the spirit of the ASA Code and were publishing misleading advertisements. The ASA was receiving a steady flow of complaints and was obliged to hold a number of inquiries. In 2006, the CAFCOM decided to hold a formal investigation into the matter with the intention of making recommendations to the Minister. The probable result of such an investigation would have been Ministerial regulations. The industry decided to enter into negotiations with the CAFCOM and the ASA, and it was decided that the ASA Code would be amended.

94 The Consumer Protection Bill is an indication that the government is becoming more proactive in advertising matters.

self-regulation. It is, therefore, understandable that a fledgling sector such as franchising cannot rely solely on self-regulation to solve its problems.

7.1.3 Statutory regulation

Statutory regulation is regulation imposed by the state and has been defined as "the exercise of influence by imposing standards backed by criminal sanctions".[95] According to Baldwin "[t]he force of laws is used to prohibit certain forms of conduct or to demand some positive actions or to lay down conditions for entry into a sector".[96] The state will introduce legislation when business cannot be trusted to control itself and if consumers and competitors lack the means or the will to challenge abuses.[97] The rationale for legislation may include situations in which monopoly powers are being abused, business is engaging in undesirable behaviour such as discrimination, certain harmful outputs such as pollution are being overproduced, misinformation is being given regarding the quality of goods and services or there is a need to take into consideration future generations.[98] Pengilley argues in favour of appropriate government regulation because: "[F]ree enterprise leaves in its tracks a variety of hardships that must be ameliorated if we are to have a society which is not only efficient but which is also caring and kind. We need not only competition policies but also policies to soften the hardships which competition can cause. Both are necessary if we are to function properly as a community worth living in."[99] Banner lists three main characteristics of state-imposed regulation:

- it attempts to change the behaviour of regulated bodies, by detailing how they should or should not behave, for example, through legislation or through licensing;
- it generally relies on government inspection and/or monitoring to detect non

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95 Baldwin and Cave *Understanding Regulation* 35.
96 *Ibid.*
97 Boddewyn *Advertising Self-regulation* 5.
98 Banner "Alternatives to state-imposed regulation".
99 Pengilley (2002) *QUT Law & Justice Journal* 1.

compliance; and

- it imposes punitive sanctions (such as removal of a license, imprisonment or fines) if the regulations are not complied with.[100]

The state is usually responsible for determining the rules, through legislation, for monitoring compliance, for imposing penalties or for granting incentives.[101] In some instances, legislation may create a regulatory agency that is responsible for monitoring behaviour.[102]

7.1.3.1 The advantages of statutory regulation

The BPC, in its report on consumer codes, pointed out that "no modern society can exist without some law or regulation".[103] Many relationships are so complex that they cannot be governed entirely by private arrangements. The BPC explained:

> In the commercial sphere in particular consumers are faced with technologically highly advanced products, contracts that test the wisdom of judges, confusing relationships in the manufacturing and distribution system, and varying levels of competition.
>
> In the total absence of regulation severe social problems are encountered which cannot be addressed by either private regulation, self-regulation or through the common law. The detection of dishonesty, gross carelessness, and exploitation, combined with retribution and compensation where appropriate may not only have a discouraging effect on and influence behaviour in a desired direction, but also serves to spell out acceptable norms of behaviour... . The victims of unacceptable

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100 Banner "Alternatives to state-imposed regulation" .

101 *Ibid.*

102 Examples include the competition authorities established in terms of the Competition Act 89 of 1998 (discussed in Chapter Six); the National Credit Regulator established in terms of the National Credit Act; the Debt Collectors Council established in terms of the Debt Collectors Act and the Registrar of Co-operatives established in terms of The Co-operatives Act 14 of 2005.

103 BPC Report 15 37.

> conduct ... must surely be rendered dispirited if a society openly tolerates unacceptable conduct or combats it ineffectually.[104]

An important function of legislation is that it represents public policy – what is regarded as acceptable or unacceptable conduct in a particular society. Stern explains that it serves to clarify, define and make explicit acceptable and unacceptable norms of conduct. It is "simultaneously a last resort and a precipitator of action".[105]

In 2002, because of numerous complaints regarding inertia selling, the CAFCOM investigated the practice.[106] The Committee concluded that inertia selling was an unfair business practice.[107] It recommended to the Minister of Trade and Industry that it should be declared as such and outlawed. Response to publicity regarding the Committee's investigation indicated that there was large-scale aversion to inertia selling from both business and consumers. But, because the practice was not illegal and, because business stood to benefit from the practice due to consumer ignorance and apathy, many businesses, even reputable ones, resorted to the practice. The standard response to the Committee's concerns was that it was a legitimate form of marketing because it had not been outlawed.[108] Hence it was determined by the Committee that there was a need for

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104 *Ibid.*

105 Stern "Consumer Protection via Self-Regulation" (1971) 35 *Journal of Marketing* 47 reprinted in Gaedeke and Etcheson (eds) *Consumerism Viewpoints from Business, Government, and the Public Interest* (1972) 318-319 quoted in BPC Report 15 at 37.

106 See GN 4083 *Government Gazette* No 21665 20 October 2002.

107 See "Report in terms of s10(1) of the Consumer Affairs (Unfair Business Practices) Act: Inertia Selling" GN 1758 *Government Gazette* 26700 18 August 2004. The Committee supplied the following reasons for its decision:

- some customers may not receive, read or understand the marketing material, notification, brochure or letter and may acquire a product or service without even being aware thereof; and
- Inertia selling imposes a positive obligation on consumers who, should they fail to take positive steps, will be charged. It is unfair to expect a consumer who does not wish to enter into a transaction to take active steps to prevent the transaction from going through.

108 In some cases, businesses attempted to justify the practice by arguing that the service is one which is beneficial, but in order to provide this beneficial product at a low cost, it was necessary to achieve a critical mass. This critical mass could only be achieved by inertia selling as many consumers do not respond to the advertising even when it is clear that it is in their interests to do so. The Committee rejected this argument on the basis that it did not justify taking away consumer choice. Consumers may be charged for a product or service only when they have made a conscious and informed decision to purchase that product or service.

regulation.[109]

The Committee's investigation illustrates the advantages of state-imposed regulation. These can be summarised as follows:

- it creates certainty;
- it carries the force of law;
- it prescribes minimum standards of behaviour; and
- it is subject to public scrutiny.[110]

7.1.3.2 The disadvantages of statutory regulation

Legislation tends to be very rigid and rules that are devised to control a few "bad apples" often also hinder the law abiding.[111] The CAFCOM experienced this when it attempted to make recommendations which would lead to revised Ministerial regulations regarding fraudulent moneymaking schemes. In 2000 the Committee decided to re-open an earlier investigation into moneymaking schemes[112] because it had been faced with a host of schemes which appeared to have been designed specifically to circumvent the Minister's order. One recommendation was that the word "primarily" should be removed from the

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109 Another example is that of parallel imports. As a result of complaints against parallel imports, the BPC undertook an investigation into parallel imports in terms of s 8(1)(b) of the Harmful Business Practices Act. See BPC Report 33: "Parallel Imports" *Government Gazette* 15223 29 October 1993. In the report the arguments for and against parallel imports were set out. The BPC decided that, instead of recommending to the Minister that regulations be introduced, the issue should be dealt with in terms of a consumer code. Such a code would ensure that consumers are informed, *inter alia*, of the fact that they are purchasing parallel imports. In July 1995 the BPC published the *Consumer Code for Electronic Goods*. In terms of this Code distributors of parallel electronic goods must make certain disclosures to consumers. These requirements were generally ignored by importers of such goods and so, in 2005 the CAFCOM decided to revisit the previous investigation. See GN 1868 *Government Gazette* No 28138 13 October 2005. Following this investigation, the Minister published regulations governing the sale of parallel imports. See Consumer Affairs Committee Report No 124 "A further investigation into Parallel imports or grey goods" *Government Gazette* No 28687 30 March 2006. The regulations came into force on 7 February 2007.

110 Baldwin and Cave *Understanding Regulation* chapter 4; Banner "Alternatives to state-imposed regulation" and INTOSAI Working Group "Guidelines on Best Practice".

111 BPC Report 15 37.

112 BPC "Investigation in terms of section 8(1) (b) of the Harmful Business Practices Act 71 of 1988 into money revolving or pyramid schemes" *Government Gazette* 20169 9 June 1999.

definition of a pyramid scheme. The definition reads:

> Pyramid promotional scheme means any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived *primarily* from the person's introduction of other persons into a plan or operation rather than from the sale of products by the participant or other persons introduced into the plan or operation.

The removal of the word "primarily" would mean that it is illegal to compensate someone for introducing another person to the plan or operation. A participant would be compensated only for goods sold and not for recruitment. Defining "primarily" is difficult and, when dealing with investigations, the Committee is frequently faced with the argument that because commission is also earned from selling products, there is no contravention of the regulation. The removal of the word "primarily" would make it very clear that compensation could be paid only when products are sold and not for recruiting members. However, members of the DMA opposed this amendment because, they argued, recruiting new members and establishing the marketing network on which direct selling is dependant, is extremely hard work. Therefore, recruiters should be paid for this aspect of the business. Such an amendment would thus affect both legitimate and illegitimate entrepreneurs.

Once rules are specified in the form of regulations, devious entrepreneurs devise further schemes in order to circumvent those rules and in trying to keep up with developments there may be a multiplication of complex rules.[113] Enforcement authorities have the difficult task of trying to apply complicated legislation to business practices. The example of moneymaking schemes cited above illustrates how finite definitions do not have the flexibility to take into account business behaviour. Many entrepreneurs ensure that

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113 It is suggested that the National Credit Act is an example of this. The actual principles of the Act are relatively simple but in attempting to deal with every eventuality, the legislator has created over complicated legislation which is difficult for even sophisticated consumers to understand. Gabriel Davel, the National Credit Regulator, reported at a Durban Chamber of Commerce breakfast meeting (Durban 12 September 2007) that there had been a sincere attempt to accommodate everyone's concerns including regulators, consumer advocates, business and the legal profession.

they keep "just one step ahead of the law".[114]

Baldwin and Cave list the following disadvantages of statutory regulation:

- it may be inflexible and unresponsive to changes over time;[115]
- complex rules can multiply over time;
- there may be a long delay before the regulation takes effect;
- enforcement is costly and compliance costs are high;
- it may act as a barrier to entry into the market;
- it provides an incentive to meet the standard but no more (this is also known as " gold plating");
- it can lead to "creative compliance" where entrepreneurs will comply with the letter of the law but not with the spirit;[116] and
- there is a risk that regulation will be controlled by the industry so that regulation is biased towards protecting the interests of the industry rather than the general public.[117]

Legislation may also be inappropriate when dealing with an industry or profession that

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114 Director-General of Fair Trading "Trading Malpractices: A Report by the Director-General of Fair Trading following consideration for a general duty to trade fairly" (July 1990) para 1.4 quoted in BPC Report 15 35.

115 Leon Perlman, representing WASPA at the Consumer Law Conference (March 2008) explained that this is why it would be virtually impossible to have legislation to govern wireless application service providers and that self-regulation was the most viable alternative if regulators were to keep up-to-date with technological developments.

116 In order to overcome this problem the Consumer Affairs (Unfair Business Practices) Act has an extremely wide definition of a business practice and authorises the CAFCOM to investigate unfair business practices. The Committee is empowered to investigate any business practices which has the potential to prejudice consumers. The definition of a business practice is extremely wide. It is any business practice that, directly or indirectly, has or is likely to have the effect of either harming the relations between businesses and consumers, or unreasonably prejudicing any consumer or deceiving an consumer or unfairly affecting any consumer. The words "unfairly affecting any consumer" were added to the definition in 1999. This had the effect of broadening the definition even further and as a result, the business practice does not have to be harmful; it simply has to be unfair. The Act will be replaced when the Consumer Protection Bill comes into operation. The Bill defines what is considered to be unlawful conduct (see Chapter Eight). This will probably make it more difficult for the National Consumer Tribunal to keep up with the ingenious schemes of inventive entrepreneurs who will find ways of circumventing definitions.

117 Baldwin and Cave *Understanding Regulation* chapter 4 and Banner "Alternatives to state-imposed regulation".

provides services because it is difficult to legislate quality of service. Baldwin and Cave point out that " [t]he more complex the services provided, the greater the proliferation of rules required, leading to over regulation, legalism, delay, intrusion on managerial freedoms, and the strangling of competition and enterprise".[118]

A major drawback to legislation is that it can interfere with the proper functioning of the market and may inhibit competition by placing unnecessary or onerous burdens, particularly on small businesses. This inhibits innovation and growth.[119] The OECD has reported that deregulation and improvements in the quality of regulation in America has contributed to making America one "of the most innovative, flexible and open economies in the OECD" whilst health, safety and environmental standards are at relatively high levels.[120] A review team[121] set up to review progress in regulatory reform in America reports that two distinct regulatory approaches govern the American regulatory scene:[122]

- a strong pro-competition stance, supported by well developed institutions – this stance means regulators favour competition-neutral policy instruments; and
- openness and contestability of regulatory processes – this approach lowers the chances of the formation of information monopolies and encourages

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118. Baldwin and Cave *Understanding Regulation* 37. See also Banner "Alternatives to state-imposed regulation".

119 Productivity Commission (1999) "Regulation and Its Review 1998-99" AusInfo Canberra 92. President Thabo Mbeki in his " State of the Nation Address" 2005 reported that government intended to introduce tax and labour law exemptions for small business and to make compliance with law and regulations for all businesses simpler (*Sunday Tribune, Business Report* " Mbeki spells out his plan of action for the economy" 13 February 2005). Investors and entrepreneurs frequently complain that South Africa's regulatory regime for business and its labour laws inhibit growth and investment. It is argued that if the South African government is to succeed in its plan to create employment and ease poverty, it is necessary to re-examine the present system. It would, therefore, be counter productive to introduce franchise legislation that does not encourage franchisors and franchise networks to invest or develop in South Africa.

120 OECD "Reviews of Regulatory Reform" (1999), Paris 31 quoted in Productivity Commission "Regulation and Its Review 1998-99" 92.

121 The OECD has review programs in terms of which member countries have their regulatory systems reviewed by teams made up of experts from various OECD Committees. These reviews take a "multi disciplined, in depth approach to examining a country's regulatory reform process". See Productivity Commission "Regulation and Its Review 1998-99" 92.

122 OECD "Reviews of Regulatory Reform" quoted in Productivity Commission "Regulation and Its Review 1998-99" 92.

entrepreneuralism, market entry, boosts consumer confidence and the search for better regulatory processes.

The review concludes that regulations must be flexible, adaptable and cost-effective.[123] Despite this favourable report, the team still found that there were significant obstacles to reform. These included: badly designed or applied regulations; lengthy procedures; excessively adversarial approaches; complicated and rigid formalities; and an overlap between federal and state systems.[124] The problem of overlap between state and federal legislation is found in franchise legislation because not only is there a federal law, but also most states have their own franchise laws with their own requirements for disclosure and registration.

There is a lesson here for South Africa because in certain areas of the law the National Government and Provinces have concurrent jurisdiction. Consumer protection is one such area. This can lead to confusion with both National legislation and provincial legislation applying to a particular matter. The CAFCOM is frequently faced with the problem of deciding whether the Committee or a Provincial Consumer Office should deal with a particular matter. The problem is compounded by the fact that some provincial offices are not as effective as others and some prefer matters to be dealt with by the National Office whilst others, such as the Gauteng Consumer Office, prefer to deal with their own matters.

Chris Darrol, the Executive Director of the Small Business Project,[125] is reported to have told the Africa Investment Forum in 2004 that "complex and nonessential regulations has stunted economic growth and foreign direct investment into Africa".[126] She explained that there was need for African governments to review their regulatory environments. She also reported that those developing countries which had changed their regulations over the

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123 Productivity Commission "Regulation and Its Review 1998-99" 93.

124 *Ibid.*

125 The Small Business Project is driving a Commonwealth Business Council project to promote Africa as an investment destination.

126 *Business Day* "Growth stunted by complex laws" http://www.bday.co.za (accessed on 23 September 2004).

previous five year period had demonstrated the highest growth rate.

7.1.4 Co-regulation – a suggested solution

In the franchise relationship often the intention is to foster and develop that relationship rather than dissolve it. Statutory regulation, with its stress on compulsion, litigation and penalisation, leads to friction between the parties. The self-regulatory approach, on the other hand, while more in line with the general trend towards persuasion, mediation and arbitration, is nevertheless, on its own, not strong enough to satisfy franchisees and government regulators.[127] Government regulators in particular do not believe that private organisations will properly serve the public interest.[128] There has been a growing demand for self-regulation to be subject to external supervision and control to ensure that industry bodies do not abuse their power.[129] The major difficulty will be to decide how much regulation is necessary and who will be responsible for enforcing it. It will be necessary to strike a balance between protecting franchisees and the legitimate business interests of franchisors. As Potgieter states "[i]t serves no purpose to over-regulate/legislate and in the process kill the proverbial goose that can lay the golden egg".[130]

A proposed solution is to provide the FASA (or a similar body) and its Code with statutory backing. This is co-regulation, which is an intermediate step between state-

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127 Robbins, from Educom Consultants, in a letter to the Franchising Steering Committee, dated 10 October 1999, said:

> There is one factor to bear in mind when considering solutions to the scourge of unethical franchising - it is that franchising lends itself to fraud and abuse. The self-regulatory system of FASA has not worked ... The Australian system held out much hope but it has not worked as expected ... No amount of tinkering with voluntary codes of ethics will ever work. We are human - and horribly so. We only respond to discipline. Franchise fraud is considered to be one of the fastest white collar crimes in the UK and elsewhere. To put off legislation is merely playing for time. Now is the time to grasp the nettle.

128 This view was expressed frequently at conferences and workshops held to discuss the Consumer Protection Bill.

129 Page "Self-regulation: The Constitutional Dimension" (1986) 49 *Modern LR* 141-3.

130 Potgieter "Franchise Agreements" in *Franchise Book of Southern Africa 2001* 30. An example of this occurred in the American state of Iowa. Following vigorous lobbying by those who supported the franchisee cause rigorous legislation that governed virtually every aspect of the franchise relationship was introduced. This led to numerous lawsuits and today many successful franchisors avoid investing in Iowa. See generally Byers 1994 *Journal of Corporation Law* 608.

imposed regulation and self-regulation.[131] This is also known as enforced self-regulation[132] or quasi regulation.[133] In this style government provides legislative backing but industry is primarily responsible for developing and administering its own system of regulation.[134] Banner explains that under co-regulation schemes, "rules and principles may be determined by the industry itself, rather than imposed by the state. Monitoring arrangements also tend to be undertaken by the industry itself. The provision of incentives is what distinguishes between self-regulation and co-regulation – under the latter, the state provides incentives for compliance".[135] This is similar to the approach adopted in Australia. In South Africa a precedent for this sort of approach can be found in the Independent Broadcasting Authority Act.[136] In terms of this Act, the ASA and the system of self-regulation established by the advertising industry have been recognised and its Code is now the accepted standard to which all broadcast advertising in South Africa must conform. The Act stipulates that adherence to the Code is a licensing condition for all broadcasters.[137]

7.2 The Regulatory Body

There are three possible structures which could be adopted. The first option is to follow the Australian and American model. Competition and consumer issues are regulated by

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131 Banner "Alternatives to state-imposed regulation".

132 *Ibid.*

133 Quasi regulation suggests far more government involvement than enforced self-regulation. In the case of enforced self-regulation there would be statutory backing for a particular code, and industry members would be obligated by law to belong to the industry regulatory body. For an example see the discussion of debt collectors and the Debt Collectors Council in Chapter Nine. With quasi regulation government plays a major role in creating promoting and administering the code. See generally Productivity Commission "Regulation and Its Review 1998-99".

134 Banner "Alternatives to state-imposed regulation". Some authors distinguish enforced self-regulation from co-regulation. Co-regulation refers to industry-association self-regulation with some oversight by government whereas enforced self-regulation is where individual firms negotiate with government and establish rules which are particular to each firm. See Ayres and Braithwaite *Responsive Regulation* (1992) Chapter 4 quoted by Baldwin and Cave *Understanding Regulation* 133.

135 Banner "Alternatives to state-imposed regulation".

136 Act 153 of 1993.

137 S 57.

a single body which is supported by legislation. The second option is to adopt sector specific legislation which provides for the establishment of a body mandated to regulate the franchise sector only. The final option is to develop a code of conduct under broad-based consumer legislation. The code would be enforced by the body established to oversee consumer protection in general.

7.2.1 The American and Australian model

Legislation in America and Australia established a single body mandated to deal with both business and consumer issues. This is appropriate because the regulation of business concerns is designed to protect consumers as well as rival traders.

7.2.1.1 The American Federal Trade Commission

The American Federal Trade Commission (FTC), an independent agency of the American government, was established in 1914 under the Federal Trade Commission Act.[138] The principal mission of the FTC is to promote consumer protection and eliminate and prevent anti-competitive practices.[139] It has a substantial mandate which includes: the prevention of unfair methods of competition, unfair or deceptive act or practices in or affecting commerce; the seeking of monetary redress and other forms of relief for inured consumers; the conducting of investigations relating to businesses and other entities engaged in commerce; and the making of reports and legislative recommendations to Congress. The FTC is also empowered to prescribe trade regulations which define with specificity acts or practices that are regarded as unfair or deceptive. These are known as FTC Trade Rules and one such rule is the Franchise Rule.[140]

The FTC enforces 46 statutes which are grouped into three categories. Some

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138 Act 15, USC § 41.

139 See http://www.ftc.gov.

140 FTC16 CFR Parts 436 and 437 and FTC *Franchise Register* 30 March 2007. Other Rules issued by the FTC include the Funeral Rule (16 CFR Part 453) and the Used Car Rule (16 CFR Part 55).

statutes relate to both its consumer protection and its competition mission. The Federal Trade Act is one such statute.[141] Other statutes relate only to its consumer mission[142] and others to its competition mission.[143] The FTC investigates complaints which may be referred to it by consumers and/or businesses. It may act on congressional inquires or media reports and issues may arise from pre-merger notification filings. The FTC may investigate a single business or an entire industry and if its investigation reveals fraudulent conduct it may seek voluntary compliance from the offending business through a consent order or it may initiate federal litigation.

7.2.1.2 The Australian Competition and Consumer Commission

The Australian Competition and Consumer Commission (ACCC), established in terms of the Trade Practices Act, is an independent statutory body which is mandated to improve market conduct, encourage fair trade in business and regulate national infrastructure services.[144] The Trade Practices Act deals with all aspects of conduct in the marketplace including anti-competitive practices,[145] unconscionable conduct,[146] industry codes,[147] unfair practices, product safety and information, country of origin claims, conditions and warranties, actions against manufacturers and importers,[148] product liability,[149] and price exploitation.[150] The ACCC is a national agency responsible for enforcing the Trade Practices Act and its role complements that of the state and territory consumer affairs

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141 Other statutes include the Energy Policy and Conservation Act 42 USC §§ 6201-6422 and the Lanham Trade Mark Act 15 USC §§ 1051-1127.

142 Consumer protection laws focus on issues such as labelling, cigarette advertising, the granting of fair credit and debt collection, advertising, operation of and billing collection procedures for certain telephone services, deceptive telemarketing practices, the protection of home ownership relating to mortgages and the prevention of equity stripping.

143 The Clayton Act 12 USC §§ 12-27 prevents unlawful tying agreements and regulates mergers and acquisitions.

144 See http://www.accc.gov.au.

145 Part IV.

146 Part IVA.

147 Part IVB

148 Part V.

149 Part VA.

150 Part VB.

agencies which administer similar legislation in their jurisdictions.[151] As part of its competition mandate the ACCC protects the interests of small business as it is of the view that small businesses, including franchises, are a key feature of a competitive market, and that a properly enforced Trade Practices Act generates many advantages for small businesses.[152] The prohibitions against unconscionable conduct in the Trade Practices Act are designed to protect the rights and interests of consumers and small businesses.[153] Stronger and more powerful parties are prevented from using their superior power in order to abuse those in a weaker position. This does not prevent hard bargaining but it does prevent harsh and oppressive conduct.[154]

The ACCC has published a mandatory Franchising Code under the Trade Practices Act. This Code was introduced in 1998 because of the prevailing view that self-regulation was not sufficient to curb abuses in the sector. The ACCC has also established the Franchising Consultative Panel which is designed to ensure greater industry consultation on issues affecting the sector.[155] The ACCC is of the view that the introduction of this mandatory code has led to significant improvements in the franchise sector.[156]

7.2.1.3 Concluding remarks

It is suggested that the best alternative would be to have a single regulator to deal with both competition and consumer issues. At present there is the Competition Act which is concerned with the regulation of competition matters. This Act establishes three regulatory bodies, the Competition Commission, the Competition Tribunal and the Competition

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151 ACCC Update Issue 13 June 2003 available at http://www.accc.gov.au (accessed on 31 May 2007).

152 ACCC *A small business guide to unconscionable conduct* (May 2005).

153 There are three sections in the Trade Practices Act that deal with unconscionable conduct. These are s 51AC that deals with conduct between businesses, s 51AA that deals with general unconscionable conduct and s 51AB that deals with conduct towards consumers.

154 ACCC *A small business guide to unconscionable conduct.*

155 Samuel "Competition and consumer law and Australia's franchise sector" A perspective of the Australian Competition and Consumer Commission" (2003) Speech to the Franchise Council of Australia, Melbourne available at http://www.acc.gov.au (accessed on 19 April 2004).

156 Martin, ACCC Commissioner "The ACCC & Franchising - Recent Developments and Regulatory Directions" (2004) Address to Franchising Law Master Class available at http://www.accc.gov.au (assessed on 19 November 2007).

Appeal Court.[157] The legislature has recently adopted the Consumer Protection Bill which, once it is operative, will regulate consumer matters.[158] In terms of this Bill the Consumer Commission is to be established. The Consumer Tribunal, which has already been established in terms of the National Credit Act, will have a regulatory role. In addition, there are numerous other regulatory bodies which are concerned with consumer protection such as voluntary[159] and statutory ombuds[160] which provide recourse for consumers in South Africa's financial services sector, and the Debt Collector's Council[161] which exercises control over the occupation of debt collection. This presents a very confusing picture for consumers and can lead to forum shopping.[162] Many genuine efforts to provide a safe environment for consumers are being implemented in isolation without the various bodies being aware of the work done by other similar institutions.[163]

However, it is highly unlikely that a single regulator will be introduced because such a change would require new legislation. Any fundamental changes would have a large impact on the present regulatory system which is still relatively new. Regulators have taken time to establish themselves and their procedures, therefore implementing a whole new system would cause an upheaval in the marketplace. Further, it is highly unlikely that the DTI would support a move to change the present system because of the significant

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157 See Chapter Six.

158 The Bill will become operative 18 months after it is signed by the President. This will give the DTI time to establish the Consumer Commission. See Chapter One note 17.

159 There are six voluntary ombuds schemes that have been recognised by the Financial Services Ombud Schemes Council established in terms of the Financial Services Ombud Schemes Act 37 of 2004. These include the Ombud for Banking Services, the Short Term Insurance Ombud, the Long Term Insurance Ombud, the Credit Information Ombud, the Johannesburg Securities Exchange Ombud and the Bond Exchange Ombud.

160 There are three statutorily appointed ombuds including the Pension Fund Adjudicator, the Registrar for the Council for Medical Schemes and the Financial Advisory and Intermediary Services (FAIS) Ombud.

161 Established in terms of the Debt Collectors Act.

162 An example is the Consumer Protection Bill. The Bill will be relevant in the financial sector but only in instances where other statutes regulating the sector appear to be lacking consumer protection measures. Regulatory authorities may apply to the Minister for an exemption on the grounds that there is other legislation that provides adequate protection (s 5 (3)). It seems therefore that the Bill will apply to the banking sector (except where credit is provided as this is regulated by the National Credit Act) but the insurance sector will be excluded. This has the potential to be extremely confusing for consumers.

163 See in particular FinMark Trust Final Report "Landscape for Consumer Recourse in South Africa's Financial Services Sector".

costs involved to do so.

7.2.2 Franchise specific regulator

As it is highly unlikely that South Africa will enact a statute which establishes a single regulatory body, a number of different regulatory bodies with their own mandates will inevitably remain. That being the case, it is preferable that franchising be governed by its own legislation and its own regulatory body. This body should be an independent statutory authority. The only issue which must then be decided is whether the industry should be responsible for appointing members to this body or whether members should be appointed by the Minister of Trade and Industry.

7.2.2.1 An independent franchise body

Presently the sector is subject to self-regulation by the FASA which is an independent body elected and funded by its members. There is a Council of 20 members, four regional representatives and five co-opted members. These members come from a variety of different backgrounds including franchisors, franchisees, legal firms and service providers such as banks. In this thesis it has been established that franchise complaints traverse a wide range of issues. For example in Chapter Six, which deals with competition issues, it is pointed out that many franchise complaints relate to issues of economics and not just law. The diverse backgrounds of the FASA Council members suggests that these members have considerable experience in issues that apply to franchise disputes. Having such a body responsible for regulating the sector would, in many ways, be of great benefit to the appropriate development of franchising in South Africa. In its vision and mission the FASA states that its primary role is to "define the business of franchising and ensure that all parties adhere to the franchise business principles adopted and accepted internationally".[164]

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[164] See http://www.fasa.co.za/aboutus/vision.htm.

Unfortunately there are a number of problems with leaving the regulation of this sector to such a body. The FASA is proving to be inadequate to control abuses and settle disputes, mainly because membership of the FASA is voluntary and the sanctions it can apply are ineffective. This problem can be solved by providing the FASA with statutory backing, by making membership of the FASA compulsory and by providing the FASA with an effective remedy to control errant members. Errant franchisors could for example have their membership revoked. Such an approach would be in line with the recognition that the ASA has received in the Independent Broadcasting Authority Act.[165]

However, another issue arises which is the perception that a self-appointed body is biased towards franchisors. These fears are not unfounded. At present one of the FASA Council members represents Woolworths and yet in both *Silent Pond Investments CC v Woolworths (Pty) Limited and Engen Petroleum Limited* and in the report by Crotty in the *Cape Times*[166] there are clear indications that Woolworths is not acting in the best interests of its franchisees. Research conducted by the Franchise Steering Committee suggests that franchisees would not accept a governing body that it entirely independent of any government control.

7.2.2.2 An independent statutory authority appointed by the Minister of Trade and Industry

An alternative approach would be to have an independent statutory council appointed by the Minister of Trade and Industry, which will be responsible for administering franchise legislation. In this regard a comparison can be made with the Australian position. When self- regulation proved to be inadequate a compulsory code under the Trade Practices Act was introduced. At present there is no appropriate legislation in South Africa in terms of which this compulsory code can be achieved, but the Debt Collectors Act provides a model which could be followed. This Act provides for the establishment of a council, known as

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165 Act 153 of 1993. The ASA Code is the accepted standard to which all broadcast advertising must conform (s 57). This section applies to all broadcasts, regardless of ASA membership.

166 Crotty "Woolworths settles price cuts with Serious Foods".

the Council for Debt Collectors. It provides for the exercise of control over the occupation of debt collectors and it provides for matters connected with debt collecting. Along these lines franchise legislation could be enacted to provide for the establishment of a Franchise Council.[167] Whilst it may be preferable for the sector itself to elect this Council, as those involved in the sector would be aware of who would have suitable experience to serve on such a body, this would probably not be acceptable to all role players in the sector, particularly franchisees. It is therefore suggested that the Minister of Trade and Industry should appoint the members of this body following a public call for nominations. Members of this Council must have experience in law, economics and franchising.

The Bill proposed by the Franchise Steering Committee[168] makes provision for the Minister to appoint a Registrar of Franchises and any such number of Deputy and Assistant Registrars and other officers as may be necessary for the purposes of the Act. All such persons are public servants. A preferable avenue would be to adopt the approach found in the Debt Collectors Act. Here the Minister appoints the Chairperson and the members of the Council but the Council appoints such personnel as it may deem necessary for the efficient performance of its functions and the management of its administration and it may determine the remuneration and conditions of service of such personnel.[169] This approach allows for far more flexibility and suggests a measure of independence from government. This is in line with the co-regulatory approach discussed above. The Council would have to be funded from registration fees and penalties. For example, any costs incurred by the Council in connection with an investigation could, in appropriate circumstances, be recovered from the errant party.

7.2.3 Drawing franchising under general consumer protection legislation

The final option is to regard franchisees as consumers and to draw franchising under general consumer legislation. There is a view which believes that as franchisees are

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167 The Franchise Bill also suggests that a Franchise Council be established. See Chapter Nine.
168 Also discussed in Chapter Nine.
169 S 7.

entrepreneurs who own small businesses, and who face the same problems as those experienced by consumers, franchising can be regulated by consumer protection legislation. Such an approach means that it is unnecessary to establish another regulatory body which is critical from a costs perspective. Franchise disputes will be dealt with by the consumer protection body. This is the option which the DTI has chosen to follow. It is suggested that of the three options this is the most inappropriate model for regulating franchising. In the context of this thesis the DTI's decision is very significant. Chapter Eight is devoted to a detailed submission that franchising should not be regulated by consumer protection legislation.

7.3 Conclusion

There has been a growing recognition in the DTI, the CAFCOM and the sector itself that legislation should be introduced to regulate franchising. This was clearly articulated by almost all participants at the US-Southern Africa Franchising Forum held in Johannesburg in May 2007. William Edwards, from Edwards Global Services and a past president of the IFA, in his paper "The value of franchising as a way to grow successful SME's in a country" expressed the view that in order to encourage foreign franchisors to invest in South Africa a clear regulatory framework was necessary. He suggested that legislation similar to that introduced in America, which focuses specifically on disclosure of information, should be considered. Further, he advised that even though a disclosure document is not a legal requirement in South Africa, franchisees should be very wary of dealing with American franchisors that did not produce such a disclosure document. Such a document is mandatory in America. If a franchisor is unable, or reluctant, to produce one, this indicates that the franchisor is not promoting a legitimate or sustainable network. He explained that even in America, with its stringent requirements, scams still operate. He warned that scam operators may be eager to invest in an environment where the requirements are not so stringent. Robert Zegers, from the African Development Bank in his paper "Franchising – Development Potential in Africa" explained that the lack of a proper regulatory framework

is inhibiting the development of franchising in most African countries.[170]

Despite the consistent belief in the franchise sector that franchise-specific legislation is the most appropriate route for South Africa to take, this has been rejected. Instead franchising will fall within the jurisdiction of consumer protection legislation. The franchise-specific legislation that has been drafted has been ignored.[171] Officials from the DTI support the view that franchising can be regulated by the same legislation that applies to consumers. The opposing view of this thesis is that franchising is a very specific business model with its own problems and as such should not be regulated by laws designed for another function.

It will be helpful for this argument to determine how franchisees differ from consumers and whether they can be regulated by the same laws the govern the relationships between suppliers and their consumers. The next chapter is devoted to these questions.

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170 The purpose of this particular forum was to investigate an appropriate regulatory environment that would encourage the investment of American franchisors in Africa. The Forum was attended by representatives from a number of other African countries including Namibia, Swaziland and Botswana. Considerable interest was expressed in developing legislation for franchising in these territories.

171 At the US-Southern Africa Forum Mandisa Manjezi, from the DTI, said that the franchise legislation had been put on hold pending the outcome of negotiations relating to the Consumer Protection Bill. During this process there were appeals from the franchise sector for franchising to be removed from the legislation. However, these appeals were not acceded to because, as Zodwa Ntuli, Director General of Consumer and Corporate Regulation said in Parliament, "franchisees had to be protected because they were totally powerless regarding franchisors" (Ensor "State rejects warnings on consumer bill" *Business Day* 11 September 2008 2). At a number of workshops held to discuss the Bill officials from the DTI explained that they were of the view that including franchisees within consumer protection legislation was the most cost effective way of dealing with franchise disputes as it would not be necessary to create a further body to regulate franchising.

CHAPTER EIGHT
FRANCHISING AND CONSUMER PROTECTION LEGISLATION

OUTLINE

The DTI policy document, which deals with developing a new consumer policy for South Africa, points out that small businesses, like consumers, are also vulnerable in the market place. The policy explains that franchisees are exposed to unfair practices and so they must be "explicitly provided for in the law".[1] The Consumer Protection Bill[2] makes provision for the establishment of a National Consumer Commission (the Commission) which will be responsible for consumer education, research and policy development. The Commission will investigate complaints and ensure compliance with the legislation. Disputes will be referred to the National Consumer Tribunal (Consumer Tribunal) which has already been established in terms of the National Credit Act. The Consumer Tribunal will adjudicate on consumer complaints that fall within the proposed legislation as well as those that fall under the National Credit Act. In other words, the legislator will not be establishing a separate adjudicator. So, the Consumer Tribunal will have the responsibility of dealing with franchising disputes.

There are two issues that need consideration: (1) whether it desirable that franchisees should be regarded as consumers; and (2) whether this legislation will solve all issues of concern. In order to decide whether franchisees should be regarded as consumers it is first necessary to examine why there is a need for consumer protection legislation in the first place and who this legislation is intended to protect.

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1 DTI "Draft Greenpaper on the Consumer Policy Framework". For a general discussion of rationales for consumer law and policy see Ramsay *Consumer Law and Policy* 2 ed (2007) 53-106. Although various drafts of the Bill were circulated for comment and all made specific reference to franchising (see DTI, Consumer Protection Bill Final Discussion Draft (October 2005), Draft for Submission (September 2006) and Final Draft (May 2007)) only the final draft contained a definition of franchising. This definition was further amended before the Consumer Protection Bill was finally adopted by Parliament. For a discussion of various definitions of franchising see 2.3 above.

2 All references to the Bill in this chapter refer to the Consumer Protection Bill.

8.1 The need for consumer protection legislation

Although consumer protection policy can be traced back to Roman times, it was in the 1960s that a vigorous consumer movement developed in industrialised countries.[3] The movement is said to have received impetus from a speech entitled "Consumer Message to Congress" made by President JF Kennedy to the American Congress in 1962. In his speech, Kennedy enunciated a Consumer Bill of Rights which included the rights to safety, to information, to choose and to be heard.[4] Following this speech there was an upsurge of interest in consumerism in America, led by its chief proponent Ralph Nader.[5] This led to increased legislative intervention aimed at protecting the rights of consumers and at ensuring that there was effective competition in the marketplace by eliminating rogue traders.[6]

Consumer protection policy developed out of a concern that private individuals who were purchasing goods and services for private use, increasingly found themselves disadvantaged when dealing with businesses.[7] The focus was on private consumers purchasing goods and services for their private use and problems generally related to one of the following areas:[8]

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3 Trebilock "Rethinking Consumer Protection Policy"(2003) in Rickett and Telfer (eds) *International Perspectives on Consumer Access to Justice* http://ssrn.com/abstract=1214262 (accessed on 21 September 2007).

4 Barnes and Blakeney *Advertising Regulation* 61. Consumers International has identified the following consumer rights:

- the right to satisfaction of basic needs;
- the right to safety;
- the right to be informed;
- the right to choose;
- the right to be heard;
- the right to redress;
- the right to consumer education; and
- the right to a healthy environment.

Consumers International is a federation of consumer organisations dedicated to the protection and promotion of consumers' rights worldwide through empowering national consumer groups and campaigning at the international level. It currently represents over 230 organisations in 113 countries. See http://www.consumersinternational.org.

5 Pitofsky "Beyond Nader: Consumer Protection and the Regulation of Advertising" (1977) 90 *Harvard LR* 661.

6 Harvey and Parry point out that although the aim of early legislation in Britain was designed to protect consumers it also did much to protect honest traders against dishonest competition. See Harvey and Parry *The Law of Consumer Protection and Fair Trading* 4 ed (1992) 1.

7 Taperell, Vermeesch and Harland *Trade Practices and Consumer Protection* 3 ed (1983) 563.

8 See generally Harvey and Parry *Consumer Protection*.

- unsafe products;
- deficient goods and services;
- fraudulent trading practices;
- insufficient or misleading information leading to poor consumer choices; and
- economic exploitation because of a lack of competition.

Initially laws devised to deal with consumer issues tended to develop in a rather haphazard fashion and the term "consumer law" was something of a misnomer. In most jurisdictions, including South Africa, there was no comprehensive and systematic body of law which was designed specifically to deal with consumer issues. These matters were seen simply as a part of general commercial litigation.[9] As the consumer movement grew, so did independent research into consumer issues and today consumer protection laws have their own identity within the general field of law.[10]

There is a strong element of paternalism in consumer protection legislation and it is sometimes argued that even where parties make a deliberate choice to use a product or service, this is not always in their best interests.[11] In South Africa, this is reflected in the laws relating to tobacco advertising and the use of tobacco products.[12] Paternalistic considerations give rise to laws relating to the labelling of hazardous products, cooling off periods, the regulation of the granting of credit and the regulation of contractual terms. Senator John Murphy, the then Australian Attorney-General, explained why consumer regulation has a paternalistic element when he introduced the Trade Practices Bill of the Commonwealth of Australia in the Senate:[13]

> In consumer transactions unfair practices are widespread. The existing law is still founded on the principle known as *caveat emptor* – meaning "let the buyer beware". That principle may have been appropriate for transactions conducted in village markets. It has ceased to be appropriate as a general rule. Now the

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9 Harvey and Parry *Consumer Protection* Preface.
10 *Ibid.*
11 Trebilcock "Rethinking Consumer Protection Policy" 16.
12 Tobacco Products Control Act 83 of 1993.
13 This Bill resulted in the Trade Practices Act. See 7.2.1.2 above.

> marketing of goods and services is conducted on an organised basis and by trained business executives. The untrained consumer is no match for the businessman who attempts to persuade the consumer to buy goods or services on terms and conditions suitable to the vendor. The consumer needs protection by law.[14]

In today's sophisticated and complicated market, it is often impossible for consumers to undertake a proper examination of every product and service and so consumers must rely on information that they receive from suppliers. Modern consumers are in a difficult position, even when there is no fraud involved. In some instances, consumers do not even know that they are being adversely affected by the products they buy. Atiyah makes the point that statutory protection is afforded to consumers where personal visual inspection is not likely to reveal defects in the quality of the goods, or where buyers cannot judge for themselves that they are being cheated.[15]

Added to this is the problem that because business and consumers tend to be in an unequal bargaining position, consumers who confront businesses with problems may find that they are simply ignored. Most modern consumers do not have the financial resources to fight for their rights. Litigation is notoriously expensive and, because of the relatively small sums involved, it does not make financial sense for consumers to take the matter to court. The introduction of small claims courts has eased the situation, but the jurisdiction of these courts is limited.[16] When claims fall outside the limit consumers are often without a remedy. So, as Cranston points out, "public control is frequently the only way that consumers will be protected".[17]

In 1996, Consumers International drafted a model law for consumer protection in Africa. It was felt that this was necessary because the articulation of consumer interests was particularly weak, and even non-existent, in most African states. In addition, the majority of consumers in Africa "are vulnerable and disadvantaged due to factors such as gender, age, poverty, illiteracy, physical and mental disability, lack of

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14 Quoted by Harvey and Parry *Consumer Protection* 14 and by Taperell *et al Trade Practices and Consumer Protection* 1308.

15 Atiyah *The Rise and Fall of Freedom of Contract* (1979) 545.

16 In South Africa the claim is limited to R7 000.

17 Cranston *Consumers and the Law* 3. He also points out that "only the articulate, educated, better-off sections of society can invoke private law remedies without assistance" (at xxxxix).

organisation or rural/urban disparity".[18] These vulnerabilities "deprive most consumers of access to affordable, decent and safe technology, goods or services in the fields of basic or essential needs, amenities and facilities such as health, food, energy, housing, finance and banking, transport and communications, and redress through representations in judicial and regulatory bodies".[19]

Consumer vulnerability is a problem that has been found the world over and it is now generally accepted worldwide that some form of legislative intervention is necessary in order to protect consumers.[20] Although South Africa has a free market economy, and it is a basic principle of such an economy that consumers should be able to judge for themselves what is in their best interests, the "free market needs carefully structured checks, balances and safety nets to make it work in a widely acceptable way".[21] The state cannot sit back and allow vulnerable and gullible consumers to be exploited with impunity. To use the words of van Dijkhorst J, "it is a laudable aim of government to protect consumers from exploitation even if that exploitation takes place with their (consumers) enthusiastic co-operation".[22]

8.1.1 The development of consumerism in South Africa

The development of consumerism in South Africa has been a slow process. Before 1994, the South African government did little for consumers and what little protection there was, focused on the white community. The government was responsible for funding some consumer organisations such as the South African Co-ordinating Consumer Council (SACCC),[23] but its budget was minimal. Generally consumer affairs were not regarded as a priority. There were also a few non-governmental consumer organisations (NGOs) that existed through donor funds such as the South African

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18 Consumers International Regional Office for Africa "Model Law for Consumer Protection in Africa" (1996) http://www.consumersinternational.org (accessed on 22 February 2005) Preamble.

19 *Ibid.*

20 See generally Cranston *Consumers and the Law*; Sutton *Sales and Consumer Law in Australia and New Zealand* (1983) 478; McQuoid Mason (ed) *Consumer Law in South Africa* (1997) 7 and Ramsay *Consumer Law and Policy*.

21 Harvey and Parry *Consumer Protection* 18.

22 *Gerhardus Francois Janse Van Rensburg NO v Die Minister van Handel and Nywerheid NO* TPD,case No 22658/98, 22 October 1998 unreported.

23 The SACCC was dissolved in 1995 and its functions are now the responsibility of the provincial consumer offices that fall under the control of the provincial governments.

National Consumer Union (SANCU), the National Black Consumer Union and the Housewives' League.[24]

In 1994, when President Mandela spoke at the opening of South Africa's first democratically-elected Parliament, he committed the government to a policy of consumer protection. In terms of the Constitution, consumer protection is an issue of concurrent jurisdiction between national and provincial government. The national Department of Trade and Industry, through its Consumer and Corporate Regulation Division (CCRD) deals with consumer policy at a national level and its Directorate, Consumer Investigations (one of the sub-units of the CCRD), investigates consumer complaints that are systemic and affect consumers nationally. Those complaints which the Consumer Investigations Directorate cannot resolve are referred to the CAFCOM for investigation. The Consumer Affairs (Unfair Business Practices) Act will be repealed from the date on which the Bill becomes operative and the CCRD will be incorporated into the Commission.

Each province has the power to enact consumer protection measures and each province has a consumer affairs office. Some provinces are still in the process of adopting their own consumer legislation and consumer courts. This process has been completed in Gauteng, Mpumalanga, the Northern Cape, the Northern Province, the Eastern Cape and the Free State.[25] In 2005 KwaZulu-Natal published its Consumer Bill for comment. KwaZulu-Natal has adopted a very different approach to other provinces and, instead of establishing a consumer court or tribunal, the province is opting to use the established courts for settling consumer disputes. The drafters of the KwaZulu-Natal Bill have always been concerned that there are constitutional implications relating

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24 The Housewives' League closed down at the end of 1996 because of a shortage of workers and funds. A shortage of funds is a critical issue faced by most NGOs and the DTI has recognised that if it is to build an effective consumer movement in South Africa it will be necessary for government to provide financial support for a period of time. It is envisaged that this financial support will decline over time as consumer institutions diversify their funding base. The Department has also recognised that if this is to occur then funding of these organisations will have to be accompanied by capacity building, support and mentorship. The difficulties faced by NGOs were articulated frequently at the workshops organised to discuss the Consumer Protection Bill. One entire session was devoted to this topic at the Consumer Law Conference (March 2008).

25 Although the adjudicative bodies are referred to as consumer courts, they are administrative tribunals as the provinces do not have the power to establish courts of their own.

to these consumer courts/ tribunals.[26] The fact that they are referred to as courts (and that members of these tribunals refer to themselves as judges) does cause confusion and it was hoped that this matter would be resolved in the Consumer Protection Bill. However, the Bill continues to refer to consumer courts and so it is likely that consumer confusion in this regard will continue.

Concurrent jurisdiction in consumer matters is not ideal. If these courts are ever in a position to function truly effectively, this could cause confusion for businesses that operate throughout the country. Different courts could reach different decisions. At this stage the Gauteng court is the only one that is operating effectively, which, it is suggested, accounts for the fact that there have not been that many conflicting decisions. It would be preferable if there were a proper system of consumer courts, established under the Department of Justice, which have the power and status of traditional courts. The provinces do, however, liaise with the national office through the Consumer Working Group which was established to promote consumer rights and ensure a coherent approach throughout South Africa. All nine provinces and the DTI are represented on this Working Group.

8.1.2 Existing consumer protection measures

Consumer protection measures can be found in certain industry specific legislation which deals with matters such as finance charges,[27] weights and measures,[28] food,[29] medicines,[30] trade descriptions on goods[31] and false and misleading advertising.[32] General consumer protection measures are found in the national and provincial

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26 These views were expressed in a memorandum by the Law Review Project to the Assistant Director, Consumer Affairs Division Department of Economic Affairs, Kwa-Zulu Natal (28 August 2002).

27 National Credit Act. This Act replaced the Usury Act 78 of 1988 and the Credit Agreements Act 75 of 1980. It has substantially revised South African credit law and provides substantial protection for consumers.

28 Measuring Units and National Measuring Standards Act 76 of 1973.

29 Foodstuffs, Cosmetics and Disinfectants Act 54 of 1972.

30 Medicines and Related Substances Control Act 101 of 1965.

31 Merchandise Marks Act 17 of 1941.

32 There are many statutes which regulate and, in some cases ban, certain types of advertisements. In South Africa tobacco products cannot be advertised (Tobacco Products Control Act 83 of 1983). There are also calls to ban the advertising of alcohol and to control the advertising of fast foods.

Consumer Affairs (Unfair Business Practices) legislation and a number of other statutes which may be administered by the various provinces or by the national government. There are a number of different regulators responsible for enforcing standards and product safety and for ensuring that businesses do not contravene the various statutes,[33] but there is a lack of co-ordination between the various regulators. In addition, consumers are usually not aware of the protection measures contained in these disjointed pieces of legislation and when they are resorted to, they are often applied in an inconsistent manner.[34]

In practice, consumers have always had to rely to a large extent on the general principles of the common law. It is generally accepted that the common law does not afford adequate protection to consumers and that existing legislation applied in its present haphazard manner is ineffective. This is reason why the DTI has developed the Bill. This then leads on to the question: who is the consumer that is entitled to protection in terms of consumer law?

8.2.3 The definition of a consumer

One of the biggest problems with most consumer protection laws in South Africa is that there has been no uniform definition of a "consumer". Consequently, it has always been difficult to identify accurately those individuals whom the state seeks to protect. The demand for consumer protection measures developed because it was believed that suppliers were exploiting private individuals who relied on them for their goods and services.[35] McQuoid-Mason states that everybody in society is a consumer[36] and Nader equates the term consumer with citizen.[37] Therefore, it is suggested that the word

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33 These include the DTI, the South African Bureau of Standards (SABS) and the Departments of Agriculture, Health and Environmental Affairs.

34 In most instances, a contravention of a particular statute is a criminal offence and there are penalties attached. However, the matter must be prosecuted by the normal prosecuting authorities in the ordinary criminal courts and this is seriously problematic. The South African police are not trained to deal with consumer matters and so when consumers complain they are usually told to see their attorney. Many consumers are not in a position to seek legal advice because this would mean extra costs for the consumer. It is also not worth engaging the services of an attorney because of the (relatively) small sums involved.

35 Taperell *et al Trade Practices and Consumer Protection* 563.

36 McQuoid Mason *Consumer Law in South Africa* 1.

37 Cranston *Consumers and the Law* 7.

"consumer" and the intention behind consumer protection legislation is directed at protecting natural persons who are buying, hiring or using goods or services for their own personal use. This approach is supported by the fact that consumer protection measures are introduced to protect the most vulnerable in society who do not have the ability or the means to judge whether the goods or services are suitable for their purposes. In *Standard Credit Corporation Ltd v Strydom*[38] the court held that the underlying idea behind the (now repealed) Credit Agreements Act was to protect consumers and not traders.

However, there is a view that small businesses should also be protected by consumer protection legislation. Taperell, Vermeesch and Harland, for example, point out that in many instances the small businessperson may be in a position similar to that of an ordinary member of the public. Small businesspersons may be inexperienced, lack access to resources and be vulnerable to exploitation in their dealings with larger corporations.

The DTI is also of the view that small businesspersons should be protected by consumer protection legislation. The Consumer Affairs (Unfair Business Practices) Act was designed primarily to protect the interests of natural persons and not business but, at the time of drafting, the legislature saw the need to protect small business ventures. Because of this, the legislation made provision for the CAFCOM to approach the Minister of Trade and Industry and request that he or she declare a legal person to be a consumer. Section 1 of the Act defines a consumer as any natural person to whom any commodity is offered, supplied or made available; any natural person from whom any investment is solicited or who supplies or makes available any investment; and any other person who the Minister with the concurrence of the Committee declares to be a consumer by notice in the *Government Gazette*.

Unfortunately, this has caused endless problems and confusion because when matters involving businesses (particularly franchisors and their franchisees) come before the Committee, legal representatives are consistent in their view that businesses do not qualify as consumers and that therefore the CAFCOM has no jurisdiction to deal with the matter. Attempting to settle matters without resorting to the courts is, therefore, difficult. The contention that FTCK Consultants CC, a franchisee and the first applicant

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38 1991(3) SA 644 (W).

in *FTCK Consultants CC v Shoprite Checkers Ltd*,[39] was not a consumer was a point raised *in limine* by Shoprite Checkers. Shoprite Checkers further contended that since the other three applicants were sureties for the first applicant they were also "not consumers".[40] The court, however, found that it was not necessary for the person who files the complaint to be a consumer and that in any case, the sureties were persons who had "made available an investment" in terms of the definition of "consumer". The court also held that the definition of a "business practice" was not confined to dealings with natural persons and that an unfair business practice could be one which has a harmful effect on consumers indirectly.[41]

The definition of a consumer in *The Concise Oxford Dictionary* provides a useful reference. This dictionary defines a consumer as "one who consumes, especially one who uses a product; person who buys or uses goods or services, a purchaser of goods or services". This definition could apply equally to both natural and legal persons provided they are purchasing goods or services as end users. In other words, a business is a consumer if it is purchasing the goods or services for use in its own business.[42] Harvey and Parry state that the word "consumer" should include anyone who consumes goods or services at the end of the chain of production.[43]

The Bill states that a consumer is a franchisee to the extent applicable in terms of s 5(6)(b) to (e). These sections state that advertisements to enter into franchise agreements, offers by potential franchisors to franchisees, franchise agreements and the supply of any goods or services to a franchisee in terms of a franchise agreement must be regarded as transactions between a supplier and a consumer. Section 5(2)(b)(ii) stipulates that the Bill does not apply to any transaction if the goods are supplied to a person in the supply chain who markets those goods to others but s 5 (6)

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39 2004 (2) SA 504 (T).

40 509E-F.

41 511E-H.

42 On 7 October 2004 the CAFCOM dealt with a complaint between two businesses that involved the sale of printer cartridges. Because the printer cartridges were supplied for use in the business and not for resale, the Committee was of the view that it could deal with the matter without requesting the Minister to declare the business a consumer, before proceeding to deal with the complaint. However, in view of the definition of consumer contained in the Act, this approach was incorrect and, had the business concerned objected, it would have been necessary to approach the Minister. The matter was settled without a formal investigation rendering an application to the Minister unnecessary.

43 Harvey and Parry *Consumer Protection* 7.

(e) says that the supply of any goods or services to a franchisee in terms of a franchise agreement must be regarded as a transaction between a supplier and a consumer. These two provisions are contradictory. From all of this it appears that:

(1) The Bill does not apply to small businesses in general.[44] It may apply when small businesses purchase goods and services for their own use but it does not apply when they purchase goods that they intend to resell to other consumers.[45]

(2) Franchisees will be considered as consumers at the time when they purchase their outlets and they will be considered consumers if they purchase goods and services in terms of a franchise agreement for their own use but it is questionable whether it applies to the purchase of goods for resell to other consumers. The Bill contradicts itself on this point.

(3) The legislation will apply to pre-contractual negotiations and to the terms of the contracts, but it will not apply to the goods or services that are purchased from other suppliers for the purposes of on-sale to other consumers. The legislation will not protect franchisees, for example, when they are complaining about the quality of goods that they have purchased from other suppliers unless it can be argued that this is an agreement which supplements a franchise agreement in terms of s 5(6)(e). It is suggested that there must be some kind of relationship between the franchisor and the third party before it can be suggested that this is a supplementary agreement.

(4) The legislation will not apply to relationship issues that arise once the contract has been concluded. If the terms of the contracts are reasonable at the time the contracts are concluded but franchisors abuse their positions of power over their franchisees a number of years later,

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44 Small businesses that purchase goods for on-sale to other consumers are excluded by virtue of s 5(2)(b)(ii).

45 S 5(2) (b) provides that the Bill will not apply if the value of a transaction exceeds the limit set by the Minister. The intention therefore is that large business-to-business transactions should not be governed by the Bill. This section does not apply to franchise agreements. So even if the value of the franchise exceeds the limit set by the Minister the Bill will apply.

this will not be regarded as a consumer-related matter.[46]

This last point, in particular, is an issue that will cause considerable confusion in the future. Franchisees will expect the Consumer Tribunal to deal with their relationship issues because the legislation specifically applies to them. Explaining to franchisees that at certain stages they qualify as consumers but at other times they do not will perpetuate the frustrations that exist with the present regulatory framework.

8.2.4 Should franchisees be considered consumers?

Consumer protection measures are introduced to protect vulnerable consumers who are not in a position to protect themselves. The following contemporary factors make people vulnerable: poverty (identified as the most important indicative factor in vulnerability); age; race; communication difficulties (those people for whom English is not their first language); gender; disability and special needs; long term health problems; inability to find work; poor literacy, numeracy and social skill; location issues (people living in depressed areas without access to amenities and job opportunities or living in remote rural areas); technology related vulnerability (lack of access to new technologies and in particular the internet affects ability of people to keep up with their peers, enter the job market and have access to information).[47]

There is no doubt that there are many similarities between the problems faced by consumers and those faced by small entrepreneurs. However, it is suggested that it is inappropriate to place franchisees in the same category as vulnerable consumers.

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46 This was a significant issue raised by the RMI in connection with motor vehicle franchisees. Although the terms of the contracts are onerous, this is not on its own regarded as problematic. However, the significant standards required by manufacturers (franchisors) requires a substantial financial commitment (sometimes in the region of R100 million). The fact that franchisors can terminate these relationships for no reason and on very little notice (sometimes 30 days) places franchisees in a very precarious position. See NADA Memorandum to the Minister (2002) and RMI Memorandum to the Minister (2002).

47 For a full study regarding vulnerable consumers see Better Regulation Task Force *Protecting Vulnerable People* United Kingdom September 2000. The Task Force is an independent, voluntary advisory group drawn from a variety of businesses (both large and small), consumer groups, unions and those who are responsible for regulation. All members have a special interest in improving regulation In this report the Task Force discusses some of the factors that need to be considered when identifying and assisting vulnerable consumers in the United Kingdom. Notwithstanding the fact that this report was prepared for the United Kingdom the Task Force has identified factors which are also pertinent to South Africa.

Whilst franchisees may be inexperienced when it comes to operating a particular kind of business, it is unlikely that franchisors would be targeting individuals who fall into the categories listed above as potential franchisees.[48]

Other jurisdictions have struggled with the idea of a franchisee being a consumer. Holmes reports that in Germany, a distinction is made between consumers and merchants and, when dealing with standard contractual clauses, some clauses may be applied to merchants under certain circumstances but are invalid when it comes to consumers. Commentators are divided as to whether a person signing a franchise agreement should be regarded as a consumer or a merchant and so some advise practitioners to include a clause in their standard form franchise contracts wherein franchisees acknowledge that they are signing the agreement as merchants or business persons and not as consumers.[49]

In America, there are conflicting opinions. The mission of the FTC is to protect consumers from unfair or deceptive acts or practices and to promote vigorous competition.[50] The FTC also administers the Franchise Rule, which was introduced to combat problems in the franchise sector in America and to protect franchisees. The FTC acknowledges, however, that franchisees are not ordinary consumers. When Beales, the Director of the FTC's Bureau of Consumer Protection, addressed a subcommittee of the House of Representatives in 2002, he pointed out that franchisees do not just buy products; they invest in a business system.[51] Several American states have held that franchisees do not qualify as consumers who are entitled to protection under state general consumer protection statutes.[52]

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48 Choosing the wrong franchisee is frequently sited as a reason for business failure (see 2.7.1. above).

49 Holmes "International Report, Franchise Law Committee" (27 February 2002) http://www.calbar.org/buslaw/franchise/dev/de020227.htm (accessed on 27 August 2003).

50 Beales "Prepared statement on the Franchise Rule".

51 *Ibid.*

52 In *West Coast Franchising Co v WCV Corp* 30 F Supp 2d 49 (ED Pa 1998) the court held that the franchisee of four video stores lacked standing to bring a claim against the franchisor for violation of Pennsylvania Unfair Trade Practices and Consumer Protection Law because only purchasers and lessors of goods used primarily for personal, family or household purposes are entitled to rely on this statute. In *Sparks Tune Up Centres v Addison, Civ No* 89-1355 1989 US Dist LEXIS 7413 (ED Pa 1989) the franchisee based his counterclaim, when sued for outstanding advertising fees and royalties, on the Ohio Consumer Sales Practices Act. The court held that this statute does not apply because the transaction was not a consumer transaction within the meaning of the statute. This statute defines a consumer transaction as being one which was entered into primarily for personal, family or household purposes.

In *Schaffer v Graybill*[53] the purchaser of a printing store franchise brought an action against the franchisor alleging negligence, fraud, fraudulent misrepresentation, civil conspiracy and emotional distress. The business failed five months after it was purchased. The franchisee argued that he should be treated as a consumer because he had no bargaining power when he entered into the contract, and the contract was dictated on a "take it or leave it basis".[54] The court, however, held that the franchisee was free to reject the deal. He was an experienced businessman and he did not have to purchase the franchise.[55]

Other states have, however, found that franchisees are consumers and as such are entitled to protection in terms of consumer protection legislation.[56] In Florida, the Unfair Trade Practices and Consumer Protection Act,[57] defines a consumer transaction as a "sale ... or other disposition of an item of goods, a consumer service or an intangible to an individual for purposes that are primarily personal, family, or household or that relate to a business opportunity that requires both his expenditure of money or property and his personal services".[58] In *LJS Co v Marks*,[59] the court commented that the section applies when a consumer has purchased "the equivalent of a franchise".[60] In Alabama, the Alabama Deceptive Trade Practices Act[61] defines a consumer as a

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53 2003 WL 21513231(3rd Cir 2003).

54 The court quoted a number of decisions in which the courts found that franchise contracts were not consumer contracts such as *Delinger Inc v Dendler* 415 Pa.Super. 164, 608 A.2d 1061, 1066 (1992); *J & B Ice Cream v California Smoothie* Licensing 31 F 3d 1259 (3d Cir 1994) and *Aamco Transmissions, Inc v Harris* 1990 WL 833336 (ED Pa 1990).

55 *Shaffer v Graybill* para 3. The court also stated that an adhesion contract that will not be enforced must be one that is unconscionable or oppressive, unreasonably favouring one party over another. In these circumstances the arbitration clause applied equally to both parties and so it did not favour one party over the other.

56 See *Deerman v Fed Home Loan Morg Corp* 955 F Supp 1393 (N.D. Ala. 1997). In *Hofsettler v Fletcher* 905 F 2d 897 (6th Cir 1988) the court applied the Ohio Consumer Sales Practices Act (Ohio Rev.Code Ann §1345.01) to transactions involving the sale of insurance and the provision of tax advise to a home based business. The court found that the transactions were aimed at reducing the plaintiff's personal income tax liability and that the creation and operation of a home-based business was merely incidental. An insurance agent travelled throughout America selling life insurance policies by emphasising favourable tax advantages. He told investors that they could drastically reduce or even eliminate their federal tax liability by forming a home-based-business because they could write off all their household expenses as deductible business expenses. Based on these facts the court found that there was ample evidence from which it could conclude that the defendants had violated the Ohio Act.

57 Fla Stat Ss501 201-213.

58 Fla Stat S 501 203 (1). The Bill does not define a consumer, only a consumer transaction.

59 480 F Supp 241 (SD Fla 1979).

60 Para 5.

61 Ala Code §§8-19-1 to 8-19-15 (1993).

person "who buys goods or services for personal, family or household use". Goods are defined as including but not limited to: "any property, tangible or intangible, real personal, or any combination thereof, and any franchise, license, distributorship, or other similar right, privilege or interest".

Charles Miller, an American lawyer who primarily represents franchisors in his litigation practice, argues that some "mom and pop" franchisees could fall more into the consumer category and do require protection from unconscionable agreements.[62] He is not, however, arguing that a franchisee is a consumer. He is simply recognising that similar concerns may apply.

The Reid Committee, which investigated the problems experienced by small business at the instigation of the Australian Government,[63] accepted that small business experienced problems which were similar to those experienced by consumers in their dealings with big business. However, it did not find that franchisees were consumers. Therefore, while the Committee recommended changes to the Trade Practices Act, these changes were tailored so as to provide protection for small businesses.

It is also important to note that the FTC (in America) and the ACCC (in Australia) deal with both consumer protection and competition matters. In South Africa the competition authorities deal with competition matters whereas it is intended that the consumer authorities will deal with consumer matters. Franchisees fall between the two with the result that the focus of neither body is on the concerns of franchisees.

Although it is suggested that franchisees should not be viewed as consumers, this does not deny that there are cogent reasons for providing further protections for franchisees through legislation. However, to apply legislation to franchisees that is specifically designed to protect the weak, poor, vulnerable and illiterate represents a confusion of issues and will lead to difficulties in the future.

8.2 The Bill and franchise disputes

Since franchisees have been included as consumers in the Bill, the next issue which

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62 Miller "Lessons learned from three decades of Franchise Regulation and Litigation in the United States".

63 See 4.3.2.1 above.

must be considered is whether this legislation will solve problems in the franchise sector. By its nature consumer protection legislation is designed to deal with problems that ordinary consumers face in the marketplace. The law deals with issues such as unsafe products and deficient services; fraudulent trading practices; insufficient or misleading information which leads to consumer making poor choices and the exploitation of consumers because of a lack of choice. The legislation is designed to deal with matters such as purchasing fridges or motor vehicles, contracting to have carpets cleaned, entering into gym contracts or cellular telephone contracts or purchasing timeshare, vacation or other similar services. This means that the provisions of the Bill are more suited to dealing with ordinary, everyday consumer transactions than the (far more complicated) investment in a business system.

If the legislation does not provide solutions to the most pressing franchisee concerns, the need for franchise-specific legislation will remain. The discussion in previous chapters has identified the following problems in the sector:

- defining when a business is a franchise;
- misrepresentations and non-disclosure of material information;
- contractual issues including unfair terms, unconscionable conduct; and termination of the relationship or refusal to renew; and
- the need for an effective dispute resolution mechanism.

8.2.1 When is a business a franchise?

Although the first two drafts of the Bill referred to franchising, there was no definition of the concept and, as discussed in Chapter Two, there is confusion regarding what exactly constitutes a franchise. Franchising is a modern business term that is applied to a number of business relationships without any real attempt to understand what is a true franchise and what is not.[64] Referring to a particular business as a franchise when it is not, is problematic because the parties enter the relationship with different expectations. In some instances, the term is used to entice people into paying for

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64 For a full discussion of the difference between franchising and other business relationships see 2.4 above.

something that is nothing more than a scam.[65] As far as the Bill is concerned, calling a business a franchise when it is not a franchise is not that problematic because once a business is referred to as a franchise the legislation will apply. If parties (particularly the franchisor) do not comply with the provisions of the legislation they will be subject to the penalties contained therein.

A more serious concern is when a business, that does constitute a franchise attempts to avoid legislation by referring to the relationship by another term . This was a problem that was experienced in America when franchising legislation was first introduced.[66] Now that a definition has been included in the Bill, it will be easier to decide whether a particular business transaction falls within the ambit of the legislation. The definition will have to be applied on a case-by-case basis particularly if franchisors re-structure their businesses in order to avoid complying with the law. The definition identifies three requirements:

(1) franchisees must pay consideration;
(2) for a marketing plan substantially determined or controlled by the franchisor; and
(3) there must be association with the franchisor's trade mark.

Franchisors will have to relinquish the control that they have over their franchisees, should they wish to avoid the legislation.

This definition will also assist businesses, in that they will be able to judge their activities against this definition in order to establish whether they are required to comply

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65 See discussion of Print Glass and Survival Liqui Sealing in 4.1.1 above. The CAFCOM receives numerous reports of franchises that are advertised on street poles or in the advertising section of newspapers with only a cellular phone number as a contact detail. Prospective franchisees will even deposit money into a bank account in order to receive further information. In one instance six consumers were enticed to purchase fast food outlets, for R391 000 each although there were no systems or structures in place to successfully operate the businesses. The matter was first considered by the BPC in 1999. On 29 February 2000 the Committee considered instituting a formal investigation into the franchise operation but this was not possible as there was insufficient information to make a proper decision. All attempts, by the Committee, to discuss the matter with the so-called franchisor were unsuccessful. After eighteen months of futile effort, the matter was removed from the agenda. See minutes of meeting held on 14 April 2000, item 4.02.

66 Kaufmann "An Introduction to Franchising and Franchising Law" in *Franchising - Business and Legal Issues* 44. See discussion in 2.4 above.

with the provisions of the Bill. This is important because businesses may discover that their operations are in fact franchises when it was never their intention to operate as franchise networks.[67] Since franchise laws were introduced in America, many companies that did not intend to be franchisors in the traditional sense, have discovered that their ways of doing business are franchises in the legal sense. This is usually in the context of a government investigation or prosecution, sometimes accompanied by private lawsuits instigated by franchisees who are unhappy with their business relationships.[68] Kaufmann cites numerous examples of "unwitting franchisors" and their "surprise franchisees".[69]

Identifying when a particular business relationship is a franchise will, however, remain a problem regardless of the legislation that is introduced to protect franchisees. So, until a proper understanding of the concept is developed, and significant franchise jurisprudence, debates over what constitutes a franchise will continue.

8.2.2 Misrepresentations and non-disclosures

As discussed in Chapter Four, this is an area of major concern.[70] The Bill is specifically designed to deal with misrepresentations and non-disclosures. It aims to ensure that consumers understand the terms and conditions of their contracts and that they make informed decisions. In order to curtail allegations of such conduct, the first requirement is that franchise agreements must be in writing and they must be signed by the franchisees.[71] Agreements must also be in plain and understandable language so that the average consumer with minimal experience as a franchisee will be able to

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67 See, for example, the discussion of the business Silk by Design in 2.5 above. The initial decision was to develop a franchise network however, after careful consideration it was decided that this was not a suitable business model. Distributors agree in their contracts that it is not the intention of the parties to enter into franchise agreements.

68 Kaufmann "An Overview of the Law of Franchising" in *Understanding Franchising: Business and Legal Issues* (2001) 77.

69 See Beyer *Franchise Law and Practice* where he discusses problems faced by the accidental franchisor (§2.3) and Siegal "Unsuspecting Franchisors" (April 2001) 2nd Annual Spring Meeting of the Business Law Section and the Intellectual Property Law Section of the State Bar of California La Jolla file:///V/Michael&Rob/calbar/buslaw (accessed on 22 December 2003).

70 Fox and Su 1995 *Oklahoma City University LR* 272 state that "disparity of information is one of the oldest stories in franchising" and that franchisees are "easily defrauded by confidence artists and may not be given accurate or complete information about a franchise business".

71 S 7(1)(a).

understand the content, significance and import of the contract.[72] Franchisees also have the right to cancel within ten business days after signing their agreements. These requirements are not problematic, are of obvious benefit to franchisees and, it is suggested, impose very little burden on franchisors.[73]

Part D of the Bill deals with the right to disclosure and information. The majority of clauses in part D are applicable to normal consumer transactions rather than franchise issues and the problems which franchisees are specifically concerned about are not addressed. The Bill does not deal adequately with the problem of incomplete information from a franchisee perspective. The provisions relating to disclosure and the right to fair marketing practices[74] are more suited to normal consumer transactions. In particular, the Bill does not stipulate what information franchisors should disclose. Other jurisdictions that have sought to solve this vexing problem have introduced franchise-specific legislation in which it is specified exactly what information is required so that there can be no debate. Franchisors are obliged to disclose, for example, their litigation history or financial background. This list is sometimes accompanied with the general requirement that franchisors disclose other information that is necessary for franchisees to make informed decisions. In other words, franchisors are required to go beyond the stated list and if they are aware of other information which might be relevant to assist a prospective franchisee with his decision, they are obliged to disclose that information. The Bill does provide that the Minister may make regulations with respect to information to be set out in franchise agreements.[75] It is to be expected, therefore, that there could be further research into franchise-specific issues and that further regulations should be made if franchisee concerns are to be adequately addressed.[76]

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72 S 22.

73 In previous drafts, suppliers were required to draft their contracts in at least two official languages. This requirement has now been removed from the Bill, but the Commission may prescribe forms or publish guidelines for methods of assessing whether a contract complies with the requirement that documents are in plain language and are understandable to consumers (s 22 (1) and s 22 (3)).

74 Part E.

75 S 7(3).

76 This issue was expressly addressed by officials from the DTI at the Consumer Law Conference (March 2008). They said that it will be up to the franchise sector to bring their concerns to the DTI in order to ensure that appropriate regulations are drafted for the sector.

8.2.3 Contractual matters

An unequal relationship is inherent in the nature of franchising.[77] Therefore contracts are often biased in favour of franchisors. It is a frequent franchisee complaint that standard form contracts drafted by franchisors contain unfair terms or are unconscionable. Problematic clauses include clauses that require franchisees to indemnify franchisors, clauses relating to dispute resolution,[78] and termination clauses.

The Bill deals with these issues and it is apparent that these sections will apply to transactions involving the purchase of franchises.

8.2.3.1 Exemption from liability[79]

Suppliers of goods and services (or any person acting for or controlled by suppliers) are not entitled to exempt themselves from gross negligence.[80] Contractual terms which purport to do so are prohibited.[81] A number of similar clauses are also void unless the fact, nature and effect of those provisions are brought to the attention of consumers before the contract is concluded. These include clauses which purport to limit in any way the risk or liability of suppliers, or which constitute an assumption of risk or liability by consumers, or which impose an obligation on consumers to indemnify suppliers or which amount to an acknowledgement of fact by consumers.

Franchisors may therefore, in using such terms, limit their liability to their franchisees except in instances when the conduct amounts to gross negligence.[82] As franchise agreements must be in writing, franchisors must ensure that such clauses are written in plain language and franchisees must be given an adequate opportunity to

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77 For further discussion see 3.2 above.

78 For example, franchisees may be required to litigate in a particular jurisdiction chosen by franchisors. This is particularly problematic if the franchisor is a foreign franchisor. The CAFCOM has raised this issue in a number of matters.

79 S 51(1).

80 As far as consumer contracts are concerned, this answers the question raised in *Afrox Healthcare v Strydom* concerning whether it is against public policy to allow exemptions for gross negligence. Exemptions from liability for fraud have always been regarded as contrary to public policy (*Wells v South African Alumenite Co* 1927 AD 69).

81 S 51(3)(a) - (c).

82 Limiting liability for intentional wrongdoing is regarded as being contrary to public policy and clauses which attempt to do so will be unenforceable.

read and understand the clauses.[83] In addition, such clauses will have no force and effect unless franchisees have signed or initialled the provisions or otherwise indicated acceptance of these clauses by conduct.[84]

It is common for a franchisors to exclude liability for misrepresentations. In *Seven Eleven Corporation of SA v Cancun Trading No 150 CC*, for example, one of the reasons why the franchisee failed in his action against the franchisor was because the contract precluded reliance on any misrepresentation.[85] In order to be successful the franchisee would have had to prove that the franchisor acted fraudulently. The court found that there was no evidence to establish fraud.

Franchisees will be able to argue that an exemption clause does not apply if they can show that their franchisor acted with gross negligence. Such issues arise most frequently when franchisors make earnings projections. For example, a franchisor projects a particular outlet in a very positive light, thereby inducing the franchisee to purchase the franchise.[86] The franchisee then signs a contract which excludes liability for any representations made during the pre-contractual phase. This occurred in the Canadian case of *Bagai v Sure Corp*.[87] In this particular matter the court found that the franchisor had acted negligently in making certain projections, and that the franchisee had acted on these misrepresentations to his detriment. However, the court also stated that if an exclusionary clause is properly formed and both the franchisee and franchisor have given proper consideration to that clause, the franchisor's liability for negligence can be limited. In *A-Wear Clothing Inc v Axiom Fashions Ltd*[88] the franchisor made certain forecasts and sales projections about the franchise whilst the parties were negotiating. However, he also indicated that these statements were not store specific and they were not guarantees. Further, the contract contained a clause stating that no guarantees formed part of the agreement and that no representations had been made. The franchisor later instituted action against the franchisee for outstanding payments and the franchisee counterclaimed, alleging negligent and fraudulent misrepresentation, because the franchisee's outlet was achieving significantly less than the figures

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83 S 49(3)(a) - (b).
84 S 49(3)(c).
85 197H - 198A.
86 See, for example, *Feinstein v Niggli* discussed in Chapter Four.
87 (2000) 275 AR 370 (QB).
88 (2002) 22 BLR (3d) 234 (BCSC).

suggested by the franchisor. The court, however, found that these figures did not constitute a guarantee and that the franchisor had not acted negligently nor had he committed fraud.

Grant and Germann report that in New Zealand, "virtually all franchise agreements contain disclaimers by which franchisors try to exonerate themselves from liability for misrepresentation".[89] In some instances the courts have held that franchisors have been liable for misrepresentations notwithstanding the presence of such a clause, but in an unreported decision, quoted by the authors, the court held that if the clause had been drafted differently, and had been brought specifically to the attention of the franchisee earlier, the court would have had no difficulty in upholding its validity.[90] The court refused to uphold the clause because "it was simply part of the boiler plate in what [was] quite a lengthy agreement" and one which "potential franchisees might be expected to read ... with glazed eyes". The court said that the clause which stipulated that the franchisee had "carefully read the provisions of the agreement" had "understood them" and had "not relied on any representation" was in effect a lie.

This approach is in line with the South African common law of contract relating to mistake and the reliance theory.[91] The basis of a contract is agreement between the parties. A person who has made a mistake about the nature or effect of the terms of the contract is entitle to resile from the contract if the mistaken party can show that the other party knew that he was making a mistake,[92] ought reasonably to have known that he was making a mistake,[93] or did something which induced the mistake by, for example, misleading the mistaken party as to the nature of the contract.[94] In *Fourie v Hansen* the court held that a signatory to a contract is not bound if the contract contains unusual terms (terms that a reasonable person would not expect to find in that contract) and the other party does not give proper notice that such terms are contained in the contract. The words of the court in *Stirling Sports* are useful in this regard:

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89 Grant and Germann *Franchising Update 2003.*

90 Referred to as the *Stirling Sports* decision March 2002 quoted by Grant and Germann at 17-18.

91 See Chapter Three note 37.

92 *Sonap Petroleum v Pappadogianis* 1992 (3) SA 234 (A).

93 *Horty Investments v Interior Accoustics* 1984 (3) SA 537 (W) and *Fourie v Hansen* 2001 (2) SA 823 (W).

94 *Du Toit v Atkinson Motors* 1985 (2) SA 893 (A).

> Where a franchisor ... wishes to exclude liability it will be well advised to do so in a way which involved a genuine interaction with the potential franchisee and after a process which identifies what, if any, representations have been made and are regarded as being important by the potential franchisee. Such process should serve, in most cases, to identify the extent to which the franchisor is in fact warranting the accuracy of information provided ....
>
> Franchisors will, I think, have to recognise the reality that if they do not tailor their agreements to the facts as they actually are then they will later struggle to uphold exclusion of liability provisions.

The Bill does not really take the matter any further than the common law although it is seeking to make sure that suppliers fulfil their duty to bring unusual terms to the attention of consumers before the agreements are completed. Franchisors would be well advised to insist that franchisees sign or initial these provisions. Signing will make it difficult for franchisees to argue at a later stage that they were unaware of certain terms. If franchisees do not sign next to onerous clauses franchisors will have to show that franchisees indicated acceptance of those clauses by conduct. Carefully constructed limitation of liability clauses will, in all probability, ensure that franchisors are not liable for the statements which they make in the pre-contractual stage. Franchisees will then have to establish that franchisors acted fraudulently or with gross negligence. This will be a difficult onus for them to discharge.

The Bill does deal with false, misleading or deceptive representations. Section 41 states, *inter alia*, that the supplier must not make any false representations, use exaggeration, innuendo or ambiguity if dealing with a material fact, or fail to disclose material information. It is submitted that this section is also a codification of the common law and does not solve the debate regarding what constitutes a material fact.[95] This is something which consumers, and in the context of this thesis, franchisees, will still have to prove. As far as franchising is concerned it would be preferable to set out what facts are regarded as material facts. In this regard it would be useful to consider the position in other jurisdictions such as Australia and America where franchisors are

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95 See discussion in 4.2.2 above.

required to make pre-contractual disclosures about specific categories of information.[96]

It must be questioned whether these sections of the Bill will assist franchisees in practical terms. Franchisors will merely ensure that franchisees sign next to clauses which have the potential to cause difficulties in the future. This will make it hard for franchisees to argue that they were unaware of the clauses when a dispute arises a number of months or even years later. If it is intended that franchisees receive protection against franchisor negligence, or when franchisors make misrepresentations, the most appropriate method would be for the legislature to declare that provisions in a franchise agreement which purport to limit franchisor negligence or liability for misrepresentation are null and void. This would mean that franchisees would have to prove that the franchisor acted negligently or that the franchisor made a misrepresentation but they would not have to prove gross negligence or deliberate fraud.[97] This does not mean that franchisors will be liable for everything they say, should their statements turn out to be incorrect, but following the approach in *A-Wear Clothing Inc v Axiom Fashions Ltd* , franchisors will have to be extremely careful and will have to ensure that franchisees understand clearly the nature of the projections or promises that they are making.

8.2.3.2 Unfair transactions and unconscionable conduct

The Bill deals with both unfair transactions and unconscionable conduct. These sections will apply to franchising at the pre-contractual stage and will also apply to the terms of the agreement. Franchisors may not, therefore, enter into franchise agreements at a price or on terms that are manifestly unfair or unjust.[98] In deciding whether or not the agreement is manifestly unfair or unjust the following factors are taken into consideration: the fair value of the franchise; the circumstances of the agreement; the nature of the parties to the agreement; their relationship to each other and their relative capacity, education, experience, sophistication and bargaining position. A transaction will be regarded as manifestly unfair or unjust if the agreement

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96 See 4.3 above.
97 This is what is proposed in the Code of Conduct (see 9.9 Part 4.5).
98 S 48.

is excessively one-sided in favour of the franchisor, the terms of the transaction are so adverse to the franchisee as to be inequitable, or the franchisee relied on a false, misleading or deceptive representation or statement of opinion made by or on behalf of the franchisor, to the detriment of the franchisee. Franchisors will have to ensure that their contracts are not excessively one-sided.[99] Here it is useful to refer to suggestions made by Adler and Zaid,[100] who argue that it is important for franchisors to ensure that there are no unnecessary provisions in their agreements which could "colour their agreements in respect of the duty of fair dealing". They suggest that franchisors should make the following changes to their agreements:

- concepts such as "sole" or unfettered discretion should be eliminated;
- franchisees should be given adequate notice periods in which to remedy defaults, take remedial action or when the agreements are being terminated;
- franchise agreements or operations manuals should contain policy statements or defined parameters for the determination of critical items which are only dealt with in a general manual in the franchise agreement such as: determination of prices, formulas, buyout amounts and rights to additional franchises;
- franchisee obligations must not be written in such a way that they are impossible to comply with;
- clear and unambiguous language must be used so that possible areas of dispute are avoided;
- If the franchisor is required to take action in certain circumstances, particularly when the franchisee makes a request, the agreement should outline the procedure to be followed and also specify the time periods;
- where the franchisor has certain rights which may be considered onerous the franchisor should consider making these more reasonable; and
- franchisors should consider alternative dispute resolution.

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99 Adler and Zaid "Drafting Franchising Agreements in the 21ST Century" Ontario Bar Association Third Annual Franchise Law Conference - Franchising in the New World of Disclosure (February 2003) Toronto http://www.hofferadler.com/adler2.htm (accessed 4 September 2006).

100 *Ibid.*

Unconscionable conduct, in terms of the Bill, includes the use of force, coercion, undue influence, pressure, harassment, unfair tactics or other similar conduct.[101] This section will apply to franchisors but, it is submitted, it is highly unlikely that franchisors will resort to such tactics to market franchises. This section will apply rather to tactics used by franchisors when it comes to demanding or collecting payment for the franchise or enforcing the agreement. Franchisors cannot, therefore, use such tactics to persuade errant franchisees to abide by their agreements. A particular area of potential dispute is when franchisors threaten to cancel or refuse to renew franchise agreements because of some perceived breach of contract on the part of franchisees or because franchisees are refusing to abide by changes to the agreement. Franchisors will have to be extremely careful about how they conduct themselves. Franchisors are responsible for monitoring and controlling the franchise network and they do have to ensure that errant franchisees are removed from the network. Clearly, a proper balance will have to be struck between the rights of franchisors to fulfil these obligations and the rights of franchisees not to be subjected to harassment or undue pressure. The penalties for such behaviour could be severe because, if a franchisor has acted unconscionably, a court may restore the franchise fee to the franchisee and it may order that the franchisee be compensated for any losses or expenses.[102]

Franchisees who are concerned about the way in which they are being treated by their franchisor may, however, have difficulty in relying on these sections to solve relationship issues, because the Bill applies to franchising only at the stage when franchisees purchase the franchise. It also applies to the actual franchising agreement, but it does not apply to the ongoing relationship. Therefore, when difficulties arise at a later stage, franchisees are no longer consumers and the dispute is now between two businesses: consumer protection legislation is no longer applicable.

Franchising disputes may arise, not because a particular clause is manifestly unjust, but because the contract is being used in a way that the parties never envisaged. The Bill does not address this issue and so the common law and more

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101 S 40.

102 See s 52. For further discussion of termination of agreements see below.

particularly, the defence articulated *Barkhuizen v Napier,* will have to be considered.[103] Franchisees, it is submitted, will find it difficult to accept that the Commission and the Tribunal are unable to deal with their relationship issues, just as franchisees at present find it difficult to accept the CAFCOM's limited mandate. There is substantial potential for confusion and debate in the future.

8.2.3.3 Termination of franchise agreements

The termination of agreements is a particular consumer concern because consumers often enter into long terms contracts without fully understanding the implications of these contracts. This arises particularly in the case of service contracts. Examples include cellular telephone contracts and gym contracts. The Bill gives all consumers a cooling off period and in the instance of a franchise the period is 10 days.[104] The Bill also allows consumers to terminate the agreement by giving the supplier at least twenty business days notice.[105]

Although the termination section will be of considerable benefit to ordinary consumers, it will not assist franchisees who, having signed long term agreements, subsequently discover that the franchises are not viable.[106] Initially this provision did apply to franchisees, and this was of great concern to franchisors. Eugene Honey explained that successful franchisors want long term contracts with franchisees and will invest considerable time and effort training and assisting franchisees because this is in the nature of the entire idea behind a successful network. Apparently franchisors were concerned that they would have to deal with breakaway franchisees. These are franchisees who will join a network in order to gain access to trade secrets and franchisor know-how. Having received the necessary information and training they leave the network and set up in competition with the franchisor.[107] It appears that

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103 See 3.4.3 above.

104 S 7. Other consumer transactions are subject to a five day cooling off period.

105 S 14(2)(b).

106 For example, the video store franchisee interviewed on 5 October 2007 signed a ten year contract and decided after two years that she needed to cancel the agreement.

107 Comments made at the Consumer Law Conference (March 2008). In a South African context this is particularly problematic because the courts have had difficulty recognising a protectable interest in the franchise relationship and so restraints of trade have proved to be unenforceable. See 5.1.3 above.

franchisor lobbying on this issue was successful because the Bill now states that the section applies to consumer agreements only. A consumer agreement is defined as an agreement between a supplier and a consumer other than a franchise agreement. This means that, whilst franchisees are entitled to cancel during the cooling off period, once the cooling off period has expired franchisees will be bound by their agreements.

The Bill does not deal at all with refusal to renew contracts or cancellation of agreements. Consequently, the various bodies which deal with dispute resolution in terms of this legislation will have no jurisdiction to intervene when franchisees complain that their franchisors are terminating the relationship in terms of the contract.[108] It is anticipated that franchisees will find this lack of jurisdiction difficult to accept.

8.2.4 Dispute resolution

The Bill makes provision for a number of different bodies to deal with disputes. A consumer may refer a matter to an industry ombud if the supplier is subject to the jurisdiction of an ombud. When an errant supplier is not a member of the recognised ombud scheme,[109] the aggrieved person will have to refer the matter to the Consumer Commission or the Tribunal (if this is permitted in terms of the Bill) or to a consumer court or to the ordinary courts.[110]

Persons conducting business within a particular industry may recommend a proposed code to the Commission which in turn may recommend to the Minister that this code be adopted for a particular industry.[111] When this industry code provides for a scheme of alternative dispute resolution, the Commission may also recommend that

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108 For further discussion of termination and the (often) harsh consequences for franchisees see Chapter Five.

109 At the Consumer Law Conference (March 2008) officials from the DTI made it clear that it was not the intention of the Bill to force suppliers to become members of industry organisations as this is regarded by the DTI as being anti-competitive.

110 The recognition given to industry codes of conduct (s 69(1)(b)) only appeared in the final draft of the Bill. It was introduced after it was suggested that to expect the Commission to have expertise over a wide range of industries, particularly when disputes involve a franchise, was unrealistic (workshop held in Pretoria (August 2006)). The Commission can now rely on the expertise of an organisation such as the FASA. A code can also specify the information which franchisors must include in their contracts. These proposals are therefore introducing a system of co-regulation as suggested in 7.1.4 above.

111 See s 82 which deals with Industry Codes of Conduct.

the scheme be accredited as an "accredited industry ombud".[112] The Commission must be satisfied that the scheme is adequately situated and equipped to provide alternative dispute resolution services comparable with those generally provided in terms of any public regulation. The FASA or any other organisation that represents the franchising sector (or any particular industry within that sector) will therefore have to decide whether or not to apply for recognition of their Code. If the Code is recognised and it makes provision for alternative dispute resolution, the Minister may appoint an industry ombud for franchising (or a particular industry) which will be responsible for dealing with disputes.[113]

There are two problems with this approach: (1) the development of a code is not mandatory, and (2) membership of the ombud scheme is not compulsory. The industry/sector[114] itself must decide whether or not to develop an industry-specific code. Although the Bill makes provision for the Minister to prescribe a code or the Commission to recommend a particular code, it is suggested that it is unlikely, given the history of consumer protection in South Africa, that the Commission will develop a code without being prompted to do so by a particular industry or sector.[115] In any event the code must be developed in consultation with persons conducting business within the relevant industry.[116] Therefore without the co-operation of an organisation such as the FASA, it is unlikely that a code will be developed. Further, the Bill does not make it compulsory for all those operating in a particular industry to subject themselves to the jurisdiction of a particular ombud or code.

Consumers may refer their disputes to the Tribunal but the jurisdiction of the Tribunal is limited to dealing with matters such as prohibited conduct. The Tribunal can award administrative penalties but it cannot award damages and only a court can declare conduct to be unfair or unjust.[117] This means that if franchisors and franchisees

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112 S 82(3).

113 An example of a body in a particular industry is the RMI which is a federation of motor vehicle dealers.

114 The use of the word industry is problematic because franchising is not an industry but encompasses many different industries. Individual industries such as the hospitality industry or the motor vehicle industry or the health industry may therefore decide to adopt their own codes.

115 This was a problem which was experienced by the BPC. Although it developed a number of industry-specific codes these were generally unknown in these industries or they were ignored. See discussion in 7.1.2 above.

116 S 82(3)(c)(i).

117 S 52.

fail to reach any kind of amicable solution, franchisees will have to approach the courts for relief. A study of both the Bill and the National Credit Act reveals that the focus is on the amicable resolution of disputes. There are a number of sections in the legislation which refer to consent orders. Such consent orders can include a claim for damages. It is where the parties cannot resolve their disputes amicably that problems are envisaged. The kinds of damages that franchisees usually seek are substantial and it is far less likely that the parties will reach agreement on this sort of issue.[118] The Tribunal is empowered to grant a notice which states that the supplier was engaged in prohibited conduct.[119] Consumers, and in this case franchisees, can produce this notice in court and this will constitute proof that the supplier was engaged in prohibited conduct. However, franchisees are still obliged to prove their damages in a normal civil court and they must prove that they suffered these damages as a result of this prohibited conduct. Franchisees are often not in a financial position to pursue the matter in the courts and will therefore simply abandon their claims. This many-faceted approach will perpetuate the problems experienced by the CAFCOM at present when attempting to resolve disputes. One of the major difficulties faced by the CAFCOM is that it does not have the power to order redress for consumers; it merely has the power to request the Minister of Trade and Industry to halt unfair business practices. This was a major criticism of the Consumer Affairs (Unfair Business Practices) Act[120] and yet the position has not been effectively addressed in the Bill.

8.3 Concluding remarks

There is no doubt that franchisees face many of the same problems that consumers

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118 *FTCK Consultants CC v Shoprite Checkers Ltd* was first dealt with by the CAFCOM. The Committee calculated that if it was to award all the damages claimed by the franchisees this would amount to approximately R40 million. The franchisor was in turn claiming a substantial sum from the various Eight Till Late franchisees for goods sold and delivered. In *Juglal No v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division* the franchisor was claiming R2 371 804,34 from the franchisee. The franchisee denied that he was in debt to the franchisor because of a "wide range of alleged breaches of contract which were said to give rise to a substantial counterclaim for past, present and future damages" (at 255C-D).

119 S 164 National Credit Act. The powers and functions of the Tribunal are set out in the National Credit Act and have not been repeated in the Consumer Protection Act.

120 These comments were made by officials of the DTI at various conferences and workshops held to discussed the proposed consumer protection legislation. This was given as one of the reasons why it was necessary to replace the existing legislation.

face when dealing with their larger, more experienced and better resourced franchisors. Consumers need protection and franchisees need protection because many franchisees do not have the resources to protect themselves. A study of the Bill reveals that the provisions are designed primarily to deal with goods and services which do not meet acceptable standards. The Bill deals with problems in the marketplace experienced on an everyday basis by vulnerable consumers who do not have the resources to fight for their rights. It governs traders who use unacceptable advertising practices to entice unsuspecting purchasers; traders who supply unsafe products; traders who have unfair contract terms which will not allow consumers to return products; and traders who exempt themselves from liability for unacceptable conduct. It also governs situations in which consumers find themselves locked into long term contracts which they cannot cancel.

Similar issues may arise in franchise relationships, but in a very different context. Merely extending this legislation to include franchisees requires an artificial expansion of provisions not designed to deal with these situations.

A further problem occurs when consumer protection legislation makes provision for consumers to have access to consumer protection bodies such as the Consumer Affairs Committee, the Tribunal or a consumer ombud. Such bodies are a critical part of consumer protection legislation because a significant problem faced by consumers is their lack of access to redress. If business were to look to such bodies for protection this could result in these bodies becoming forums for businesspeople to solve their problems rather than resorting to more expensive legal proceedings – even when they can afford the legal route. In order to prevent this from occurring the Consumer Affairs (Unfair Business Practices) Act limits the right of business to make use of the Committee by requiring that the Committee first approach the Minister and request that the business is declared a consumer. Once the Bill becomes operative, approaching the Minister will no longer be necessary and so franchising disputes will have to be dealt with by the consumer protection authorities.

It must be questioned whether legislation that is designed primarily to protect the interests of consumers, who are normally regarded as natural persons, should be used to settle disputes between businesses. The Consumer Affairs (Unfair Business Practices) Act has been severely criticised by the Law Review Project for a number of

reasons, including the fact that the it (the Consumer Affairs Act) is not restricted to *bona fide* consumers and can be used by rival businesses that may be motivated by malice.[121] The Law Review Project is of the view that it is "absolutely vital to consumer protection that the consumer be a *bona fide* consumer and not a business competitor in disguise".[122] It is submitted that it is preferable to limit consumer protection legislation to those who are purchasing goods and/or services for their own personal use, that is, they intend to consume the products or services themselves and will not be supplying them to other persons who fall more easily into the accepted notion of a consumer. It is preferable to have other measures designed specifically for business-to-business disputes if deemed necessary. It is accepted that there are areas of concern in the franchising sector that must be addressed through legislation. This is discussed in the next chapter.

It is useful to consider the warning issued by Mendelsohn.[123] He maintains that there is a worrying trend internationally that those who are introducing legislation do not have a sufficient understanding of franchising. He refers to Indonesia, Russia, Korea and Romania but there is no doubt that the same criticisms can be directed at the drafters of the Bill. The fact that there was no definition of franchising until the final draft was published suggests that the drafters simply saw franchising as a definite type of business relationship which already has a recognised place in South African law. This is clearly not the case. The Model Franchise Disclosure Law published by UNIDROIT comes with a "Health Warning" in which UNIDROIT suggests that before franchise legislation is introduced a number of issues need to be considered.[124] These include the following:

- whether there is a problem, what its nature is, and what action, if any, is necessary;
- whether there is a pattern of abusive conduct, or whether this conduct is isolated or limited to particular industries;

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121 The Project believes that the Act has three disquieting themes: uncertainty, arbitrariness and the tendency to undermine the courts, the common law and the Constitution. This was stated by the Law Review Project in a memorandum to the Consumer Affairs Division, Kwa-Zulu Natal.

122 Law Review Project memorandum to the Consumer Affairs Division, Kwa-Zulu Natal.

123 Mendelsohn *Franchising Law* 415.

124 *Ibid.* See also Peters 2004 *Business Law International* 33

- whether existing laws address the concern and whether they are adequately applied;
- whether an effective system of self-regulation exists;
- whether the proposed legislation inhibits or facilitates entry to franchisors, and its effect on job-creation and investments; and
- the views of interested organisations including national franchise associations.

Many were opposed to this Model Law as it was believed that it might cause legislators to rush into adopting legislation. Nevertheless, it was eventually accepted that this international model law should be drafted because so many countries were not considering their legislation and its effects properly.[125] Peters explains that it was considered to be preferable for an international organisation to prepare a model that is reasonable, well-written and well-reasoned to provide inspiration to those states that were considering franchise legislation.[126]

The DTI has perceived that there are significant problems in the franchise sector. However, there has been no significant research or empirical studies into the nature of franchise-specific problems and how franchise-specific issues should be addressed. There is no indication that the issues suggested in the "Heath Warning" have been addressed. Much of the evidence used to substantiate the need to include franchising within the Bill appears to be anecdotal. Franchising as been "tagged" on without significant research into the impact that this Bill will have on the sector. It was only in the latter part of 2007 that the FASA was made aware that this Bill would be applicable to franchising.[127]

The DTI approach can be compared to the American experience when the FTC introduced its Franchise Rule. Before the Rule was promulgated the FTC held two sets of public hearings. It compiled a record of over 30 000 pages and received 5 000

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125 Peters 2004 *Business Law International* 36.

126 Peters 2004 *Business Law International* 37.

127 At a conference held in Durban (August 2007) Vera Valais, Executive Director of FASA stated that she was unaware of this Bill and its implications for franchising. She then referred the matter to Eugene Honey who undertook to liaise with the DTI on behalf of the FASA. Since then he has been liaising with the DTI but at the Consumer Law Conference (March 2008) he expressed severe reservations regarding the implications for franchising.

pages of complaints by franchisees about franchisor practices. There was extensive testimony and commentary from industry members, government agencies and academics.[128] When the FTC embarked on its rule amendment process in 1995 it began by publishing a Federal Register notice calling for public comment on the Rule. It received 75 written responses.[129] Numerous public workshops were held in which franchisees and franchisors participated as well as other stake holders such as state franchise regulators. A preliminary report was published which was subjected to public comment. At each stage of the process, the FTC invited comment on the economic impact of the Rule, and also on the costs and benefits of each proposed Rule amendment.[130]

In South Africa, the Franchise Steering Committee carried out some research into the sector, inviting public comment and holding public workshops, and it has proposed franchise-specific legislation. This was done in consultation with those involved in the sector and appears to have the backing of the FASA. The Committee also considered the Model Law proposed by UNIDROIT. The Committee's research, proposed legislation and explanatory report appear to have been ignored by the drafters of the Bill. In addition, RMI and NADA supplied extensive memoranda to the Minister of Trade and Industry. These organisations report that they received no response from the DTI to their submissions.

Public consultation has focused on the need to protect vulnerable and disadvantaged consumers and it has been said that this legislation has an unashamed bias in favour of the consumer.[131] This approach is potentially damaging to the franchise sector because there is a need to balance the rights of franchisors (which must protect their networks) against the need to protect franchisees from fraudulent and opportunistic behaviour. Franchisee problems should not be considered in isolation. The interests of the entire network may be effected when making a decision in favour of an individual franchisee. Again it must be stressed that franchising is a specific, unique concept, deserving of its own recognised status within the law.

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128 Garner *Franchise and Distribution Law and Practice* Chapter 5.
129 FTC *Federal Register* March 2007 15445.
130 FTC *Federal Register* March 2007 15452.
131 Comment made by DTI official at the Consumer Law Conference (March 2008).

CHAPTER NINE
FRANCHISE SPECIFIC LEGISLATION

OUTLINE

In the previous chapter it was submitted that although the Consumer Protection Bill applies to franchising, this will not adequately resolve many problems in the sector and consequently the need for franchise-specific legislation will remain. The Franchise Steering Committee drafted a Franchise Bill in 2002 but this was put on hold because of the Consumer Protection Bill. The purpose of this chapter is to consider appropriate legislation taking into consideration the FSC Bill, the FSC Memorandum and the FSC Explanatory Report. These documents provide valuable insight into the workings of the Committee. The FSC Bill has been criticised in a number of respects and the Debt Collectors Act has been offered as a viable alternative model.

It is submitted that franchise-specific legislation should be fairly brief and should focus on the establishment of a Franchise Council which administers a code of conduct. Franchise-specific legislation should aim to achieve the following:

- the sale of business opportunities as franchises must be prohibited if the opportunity does not meet the requirements of a franchise or there is a likelihood that the franchisor's promises will not be fulfilled;
- prospective franchisees must be provided with sufficient information to ensure that they understand the nature of the relationship and are able to make informed decisions before they purchase their franchises; and
- there must be a speedy mechanism for resolving disputes.

In order to achieve these it is suggested that franchise legislation should provide the following:

- a definition of franchising and related matters;

- the establishment of a body to monitor the sector;
- the adoption of a code of conduct (which will regulate the conduct of participants in franchising including termination of the relationship and provide for dispute resolution).

The chapter concludes with a proposed Franchise Bill (Proposed Franchise Bill), a code of conduct and a disclosure document.[1]

9.1 The definition of franchising and related matters

The FSC Bill commences with a section defining the important concepts contained in the Bill. The most important definition is the definition of a franchise agreement. The FSC Bill has adopted the Australian definition[2] which in essence is similar to the definition in the Consumer Protection Bill except that it is more detailed. For example, the definition in the FSC Bill states that the agreement can take the form of a written, oral or implied agreement. It also sets out in more detail the different kinds of consideration, direct or indirect which may be payable, although the list is not exhaustive. It is suggested that it will never be possible to have an absolute definition for franchising because enterprising entrepreneurs will find creative ways to avoid having their relationships classified as franchises. Instead it is suggested that a relatively short definition be adopted which incorporates the three elements discussed in Chapter Two. These are: (1) the franchisor exercises control over the franchisee's method of operation, (2) the franchisee makes regular payments to the franchisor and (3) the goods and/or services are distributed under the franchisor's trade mark. If these three elements are present there is a strong possibility that the relationship constitutes

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1 The Proposed Franchise Bill has been drawn by using the Debt Collectors Act as a model. The Franchise Code of Conduct is drawn from the Australian Franchising Code of Conduct, the Code proposed by the Franchise Steering Committee, the FASA Code and the FTC Final Franchise Rule. The disclosure document is based on the one proposed by the Franchise Steering Committee and on the Australian model. The Franchise Steering Committee disclosure document appears to have been based on the Australian disclosure document as both these documents are virtually identical. See Office of Legislative Drafting, Attorney-General's Department Canberra "Trade Practices (Industry Codes - Franchising) Regulations 1998" available at http://www.accc.gov.au (accessed on 24 May 2007).

2 This definition is set out in 2.3 above.

a franchise. The element of franchise control is most important because it is the amount of control which will determine whether a particular relationship is a franchise relationship.[3] Some flexibility is necessary and matters will have to be decided on a case-by-case basis. It is suggested that the American approach be adopted and the monitoring body issue guides from time to time in order to provide clarity.

In conclusion it is suggested that franchising be defined as an agreement in terms of which:

(1) a franchisor grants a franchisee the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system developed and controlled on an ongoing basis by the franchisor; and

(2) the franchisee's business is substantially associated with the franchisor's trade mark, trade name, logos, advertising and/or other commercial symbols; and

(3) the franchisee pays franchise fees for the rights he enjoys.

9.2 A monitoring body

Franchise legislation must make provision for the establishment of a Franchise Council and for franchisors and franchisees to register with this Council.

9.2.1 The FSC Bill[4]

The FSC Bill proposes the establishment of a Registry under the control of a Registrar of Franchises.[5] The Registrar, Deputy Registrar(s), Assistant Registrars and all employees appointed to assist them will constitute the Franchise Registry.[6] In addition,

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3 See 2.3 above.

4 Although this Bill has been put on hold, the proposals are discussed as if they are still being considered because, if it is subsequently accepted that the Consumer Protection Bill does not effectively regulate franchising, this Bill may be resurrected.

5 Parts IX and X.

6 The drafters adopted the approach found in the Trade Marks Act 194 of 1993. See FSC Memorandum 60.

a Franchise Council will be established.[7] The Chairperson of the Council will be the Registrar. It appears that the control of franchising will vest primarily in the Registrar and that the role of the Council will be merely advisory.

The Registrar and any other officers will be appointed by the Minister of Trade and Industry and they will be public servants. The FSC Bill does not specify that these officers must have any experience in franchising. On the other hand members of the Council, which will also be appointed by the Minister, must consist of persons who have a demonstrated knowledge and experience in matters relating to franchising.

It is submitted that this approach is not appropriate as it amounts to state imposed regulation. While is it argued that there is a need for some regulation in the sector, it is questionable that it is necessary for the state to go so far as to assume total control over something which is essentially a business matter. Public servants are not trained in the operation and control of business operations and other similar bodies do not fall within the ambit of the DTI.[8] In addition, the Registrar will have extensive powers in terms of the FSC Bill and any decision, determination or ruling made by the Registrar will have the same effect as an order made by a Judge of the High Court. This suggests that a very senior person with substantial experience in franchise matters will have to be appointed.

9.2.2 A suggested alternative

Rather than use state imposed regulation, a system of co-regulation as suggested in Chapter Seven should be adopted. The legislation should provide statutory recognition for the establishment of an independent body which should be known as the Franchise Council. Its members should be appointed by the Minister of Trade and Industry from nominations received from the franchisor sector and other interested persons such as those that provide services to the sector.[9] Ministerial appointment would deal with the concern expressed by franchisees that this is a body designed to represent the interests

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7 Part VIII.

8 Examples of independent bodies include the Competition Commission and Tribunal, the National Consumer Commission and Tribunal, the Debt Collectors Council, the Financial Services Statutory Ombuds Council and the Commission for Conciliation, Mediation and Arbitration.

9 Examples would include financial institutions and the legal profession.

of franchisors only. Its members should have experience in the franchise sector and should be broadly representative of franchisees, franchisors and service providers. Certain members could be employed on a full-time basis and other members could serve part-time and only receive remuneration for the time spent on franchise matters.[10]

This is the approach found in the Debt Collectors Act. The Act provides for the establishment of a juristic person known as the Council for Debt Collectors and its role is to exercise control over the occupation of debt collectors. It controls the registration of debt collectors, deals with improper conduct on the part of debt collectors and it publishes and administers a code of conduct. Such an approach would not be substantially different from that followed by the franchise sector at present with its reliance on self-regulation. In this way, the voluntary body, the FASA, would be replaced with a body that has statutory recognition. It would be compulsory to join this body and adhere to its code. This would overcome the difficulties experienced by the FASA, for whom membership is voluntary.

9.3 Registration

9.3.1 The FSC Bill

The FSC Bill advocates the adoption of stringent registration requirements, and all the various parties and organisations involved in the promotion of franchising will be required to register with the Registrar. Registration requirements will apply to both franchisees and franchisors as well as to franchise consultants and franchise brokers. Franchisors will not be permitted to offer franchises for sale unless the Registrar has issued an authorising notice.[11] The drafters followed the Malaysian approach and a substantial number of documents will have to be submitted to the Registrar for perusal before permission to operate a network in South Africa will be granted. These include an application for registration, disclosure documents, franchise agreements, operations manuals, training manuals, and the latest financial statements certified by auditors or

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10 This is the approach adopted by the Consumer Tribunal (only one member is employed on a full-time basis) and the Competition Tribunal (only three members are employed full-time).

11 Section 2(6).

accounting officers. The Registrar will be able to request any additional information and applicants will have to pay the prescribed fee. All information supplied will have to be current and it will be a criminal offence for anyone to supply false information or to omit material information. The Registrar will have thirty days to consider applications. If registration is not effected within that time, franchises will be deemed registered. The Registrar will also be able to grant conditional registration. Registration will be valid for one year only, and sixty days prior to the expiry of that time the franchisor will have to apply to renew its registration for a further twelve months. This application will have to be accompanied by a renewal fee. Applicants will need to file material changes to their documentation only, but they will have to supply the latest financial statements certified by their accounting officers or auditors, and they will have to supply any additional information requested by the Registrar.

The registration requirements for franchisees are much simpler as their registration is aimed merely at data collection.[12] Franchisees will have to comply with certain requirements and will be required to pay an annual fee.[13] Franchisees will not be able to commence business until they had received written notice from the Registrar permitting them to do so.[14] The requirements for the registration of consultants and brokers have not been specified in the FSC Bill and such requirements will have to be developed by the Registrar.[15]

The issue of whether or not franchisors should be required to register is controversial, mainly because of the work involved, which leads to increased costs.[16] This is acknowledged in the FSC Memorandum but is not considered to be problematic because legitimate franchisors already have much of the documentation in place, and so there will be no further costs involved in drafting documents. The only cost will be a filing cost.[17] However, it is not the cost of preparing the documents that is problematic; it is the cost of operating and maintaining the Franchise Registry. It is obvious from these requirements that the Registrar will be required to review the documents in order to be satisfied that a genuine franchise system is in place before

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12 FSC Memorandum 56.
13 S 10.
14 S 10(5).
15 S 11.
16 See also discussion in 4.4.2 above.
17 FSC Memorandum 54.

franchisors will be allowed to begin operating. It seems that the same will apply to franchisees and this process will have had be repeated on an annual basis. There may be noble intentions behind these onerous requirements, but it is questionable whether this system will be workable in practice. These requirements, it is suggested, amount to gross over-regulation. In addition, such an approach will require a substantial staff of trained individuals and a complex administrative system.[18] This raises the question of how this extensive operation will be funded. If this is to be funded from filing fees, it seems that these fees will have to be substantial, which will impact heavily on franchisors and could inhibit the development of small and medium enterprises. However, the fact that the various officers will be state employees suggests that the state will be expected to fund this Registry. This could be the reason why the DTI has been reluctant to promote this Bill.

Once the process is underway the Registrar will, in all probability, find that the workload is impossible to cope with. Such problems appear to have been anticipated because the FSC Bill makes provision for deemed registration.[19] The FSC Memorandum acknowledges that such a section is controversial but states that it is a commercial reality that franchisors that have made the decision to sell franchises want to do so "as soon as possible". The drafters propose that the only effective solution is to have a deemed registration process.[20] It is suggested that including such a section could make a mockery of the process, and that franchisors may be in the precarious position of not knowing whether at some future time their registration could be terminated. It is suggested that this could inhibit even legitimate offerings from making a substantial investment in their networks.

The FSC Memorandum simply states that registration will be valid for twelve months only because no country requiring registration allows for indefinite registration. This, it is submitted, is insufficient reason to resort to such a cumbersome and probably expensive procedure. The FSC Explanatory Report examines the various procedures

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18 S 7(4) provides that the registration certificate is only *prima facie* proof of compliance with the Act because the intention is that the Registrar will merely examine the application for content and will not therefore conduct a comprehensive investigation (FSC Memorandum 61). However, the FSC Memorandum also explains that the Registrar will have to provide proper reasons for any refusal for registration as is required by the Constitution so, it is suggested, that it is difficult to see how the Registrar can comply with the requirements of the Bill without resorting to a full investigation.

19 S 4.

20 FSC Memorandum 55.

adopted in different jurisdictions but it does not examine the difficulties which these jurisdictions have faced with enforcement. For example, the Report states that in America, some states require that franchises be registered, but it fails to examine the extensive literature that it available regarding this requirement. Nor does it explain how some states are changing their procedures because of the difficulties they have encountered.[21]

9.3.2 A suggested alternative

It is accepted that some form of registration will be an important means of preventing scams and ensuring that legitimate franchisors are properly prepared before advertising their offerings. Nevertheless, it is proposed that the requirements should not be so onerous. Franchisors should be required to submit certain essential documents to the Franchise Council and provided those documents are supplied, registration must be granted. The Council should rather focus its resources on enforcement than on lengthy franchise reviews. Requiring franchisors to submit certain essential documents would, it is submitted, go a long way to ensuring that scams or improperly prepared franchises are not operating without resorting to over-regulation. Franchisees, before purchasing their outlets, could also ensure that the documents have been filed with the Council and that the documents they have received are the same as the ones that have been filed. Franchisors must be expected to keep their documents up-to-date whenever a material alternation is made. This procedure would be similar to the procedure followed in the notice filing states in America.[22]

Because the process of registration is aimed at preventing fraud it seems unnecessary for franchisees to follow the required registration process, which only places an added burden on the administrative authorities. Franchisees should simply be expected to notify the Council that they are operating and to pay an annual registration fee. Additionally, consultants and brokers should not be required to

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21 Originally, all the registration states in America, reviewed the disclosure documents filed with them, but over time five of the fourteen states have opted out of the review process. Baer is of the view that other states may follow suit. See Baer "Lessons learned from Three Decades of Franchise Regulation and Litigation in the United States" 16 and 4.3.1.2 above.

22 Such as Wisconsin and Indiana (see 4.3.1.2 above).

register. The FSC Memorandum explains that the requirement of registration for consultants and brokers was included because "it is often found that they lack knowledge and experience in franchising, making for inferior quality advice ... it is often found that they do not understand franchising".[23] It is suggested that this requirement is over-regulatory and it will be difficult to decide which entities were providing advice regarding the purchase of franchises. It is accepted that there may be a role to play for the Franchise Council in general education regarding the nature of franchising and its benefits and pitfalls, but it is not feasible for a body that is aimed essentially at preventing the sale of fraudulent or poorly prepared offerings to include in its mandate all those who are giving advice regarding the purchase of a business.

Franchisors and franchisees should be required to pay an annual registration fee because the intention is that they will benefit from a properly regulated environment. If they fail to pay this fee their registration will simply lapse. It is anticipated that franchisors that close networks or franchisees that cease operating or sell their outlets will inform the Council that they are no longer operating. This is a similar process to that adopted by the FASA at present and many parties are already following a similar system. Provision can also be made for other parties to register with the Council as associate members, such as consultants and brokers, and they can then benefit from the fact that they are registered with the Council. Such membership should not be compulsory because it would be extremely difficult to monitor the activities of all those who are involved in giving advice about business.

9.4 Code of conduct

Franchise legislation must make provision for the Council to adopt a code of conduct. The Council must be responsible for amending the code as and when it is deemed necessary. The reason for recommending that a code of conduct be adopted is because it is much quicker and simpler for the Council to amend a code then it is for legislation to be amended. The Council would, therefore, be able to respond to developments in the sector. A similar approach has been adopted in the Debt

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[23] FSC Memorandum 56.

Collectors Act. The FSC Bill also makes provision for a code of conduct. The difficulty with the FSC Bill is that certain matters are regulated both in the Bill and in the code of conduct. For example, the FSC Bill deals with certain aspects of the disclosure document and the franchise agreement, unfair practices and general conduct. These are issues which also relate to the parties' conduct and so there may be differences of interpretation between the legislation and the code. Although the legislation would prevail over the code, it is suggested that when there is a code regulating the parties conduct these matter should be left to the code. The advantage again is the ease with which codes can be amended should the need arise.

The code must regulate disclosure of material information, the terms and conditions that should or should not appear in franchise agreements, and unfair practices.

9.4.1 Disclosure document

The requirement that franchisors make certain disclosures has been the surest means of protecting franchisees from abuses. Introducing such measures into South Africa will bring franchise law in South Africa into line with other jurisdictions. The purpose of a disclosure document is to give prospective franchisees information in order to enable them to make reasonably informed decisions. Franchisors should supply current and material information. In order to eliminate debates regarding what is material information, most jurisdictions specify the information that is required. But there should also be a general clause requiring franchisors to specify any further material information that will assist franchisees to make informed decisions.

It is suggested that the approach adopted in other disclosure jurisdictions such as America and Australia be followed, and that franchisors be made to make detailed material disclosures in the following categories:

- the nature of the franchisor and the franchise system;
- the franchisor's financial viability including a fully audited financial statement of the franchisor and litigation history;
- information regarding franchisor business experience, renewal and

extension conditions and training of franchisees;

- the cost involved in purchasing and maintaining a franchise outlet including fees, royalties, promotional expenses;
- the terms and conditions that govern the franchise relationship that is, the responsibilities the franchisor and franchisee will have to each other including termination and renewal rights;[24] and
- the names and addresses of current franchisees who can share their experiences within the network.

Earnings claims are a particularly controversial subject. This is so because this is the kind of information which franchisees are anxious to hear, but franchisors may over-inflate profits to make their offerings seem more attractive. It is difficult to project how successful an outlet will be, and if an outlet fails to achieve the advertised profit levels, franchisees will, in all probability, blame their franchisors, accusing them of misrepresentation. The American Franchise Rule requires franchisors who make earnings claims to be able to substantiate these claims. Franchisors must disclose the basis and assumptions that underlie these claims. Garlick advises clients to ensure that any oral claims by franchisors are put in writing in the disclosure document. If franchisors are not prepared to do this, this could be an indication that there are problems with the claims.[25] Franchisors who are not prepared to make earnings claims should be required to state explicitly that they are not making any earnings claims, and that earnings are dependent on a variety of factors. If however, they chose to make earnings claims they must have a reasonable basis for such claims and they must be able to substantiate them. They must also disclose the basis and assumptions that underlie these claims.

Franchisors must be required to deliver their franchise agreements and disclosure document to prospective franchisees at least fourteen days before agreements are concluded. If franchisors fail to provide disclosure documents, franchisees must have the right to cancel the agreements and obtain damages.

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24 It must be noted that whilst the Franchise Rule requires the franchisor to disclose important information about its policies and practices, including information about renewal and termination of the franchise, it does not prescribe what those terms and conditions should be.

25 See generally Garlick *Franchise Law and Practice* §3.111.

The code of conduct contained in the FSC Bill includes an extensive list of required information under specific headings which is similar to that required in other jurisdictions such as America and Australia. This can be compared to the approach followed by the FASA. The FASA Code requires franchisors to have a disclosure document which must be given to franchisees but it does not specify what information must be contained in the document. The problem here is that this could lead to disputes at a later stage regarding whether certain information is material or not. Therefore, it is suggested that the approach in the FSC Bill should be followed. The result will be a substantial disclosure document.[26] However, this information is vital for franchisees if they are to make informed decisions and any reputable franchisor would already have such information available. These requirements will not place an onerous burden on franchisors and will alleviate the potential for dispute in the future.

In addition, it is suggested that the American warning to franchisees regarding the problem of non-exclusive territories is included.[27] The disclosure document must contain a warning if it is intended that the franchisee is not entitled to an exclusive territory under the section dealing with franchise site (premises or territory). The warning, which should be in bold type, should read as follows :

> You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels or distribution or competitive brands that we control.

It could be argued that this specific warning is unnecessary because the agreement and the disclosure document will contain information regarding the franchisee's territory. However, many franchisees do not understand that even if they are given an express area in which to operate this does not preclude further outlets from being established, unless their agreement specifically states that their area is an exclusive one. In order to avoid further disputes such as that in *Silent Pond Investments CC v Woolworths* it is suggested that such a warning is warranted.

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26 See 9.10 below.

27 FTC *Federal Register* 30 March 2007.

9.4.2 Contractual terms

Franchise agreements must be in writing. They must contain a cooling off period of fourteen days, a description of the fees that are payable, the circumstances governing transfer of the franchise to another party and they must specify the duration of the contract period and the circumstances in which the relationship may be terminated. However, detailed regulation of the terms that should or should not be included in franchise contracts is problematic because this amounts to regulating the relationship between the parties. Most jurisdictions and the UNIDROIT model law refrain from regulating relationship issues and focus instead on proper disclosure. Franchise agreements cover a variety of different areas involving a multitude of different laws and so it is difficult to produce a statute that prescribes the terms and conditions of franchise contracts. In many instances when individual franchisees complain that particular terms are unfair or harmful there may be benefits for the whole network or for consumers in general, so it is not possible to have sector-wide provisions regulating the terms of private contracts. In addition, as discussed in Chapter Three, this is a living document which will develop over time. It is necessary, therefore, to allow for certain terms to be framed relatively broadly to accommodate future developments.

Comprehensive franchise agreements, as recommended by the FASA,[28] will specify franchise obligations, franchisee obligations, a description of the intellectual property owned by the the franchisor and licensed to the franchisee, details regarding ongoing training and assistance provided by the franchisor and any contributions that the franchisee is expected to make towards marketing the brand. Therefore, making it mandatory for franchisors to include such terms in their contracts will give guidance to franchisors and could avoid the potential for disputes at a later stage.

During the Rule amendment process, franchisees called for the regulation of certain relationship issues such as prohibiting or limiting the use of restraints of trade, encroachment of franchisees' territory and restrictions on the source of products or services.[29] However, such restrictions may protect legitimate franchisor interests and so it is not feasible to outlaw them completely. Franchise agreements should instead

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28 See Chapter Three.

29 FTC *Federal Register* 30 March 2007 15447.

provide adequate details of such issues together with the warning regarding territorial exclusivity discussed above.

9.4.3 Unfair practices

The parties must be required to act in accordance with the duty of good faith and fair dealing. Such a provision would require both parties to do nothing that would have the effect of destroying or injuring the right of the other party to obtain and receive the expected fruits of the agreement. Emphasising the duty in the code of conduct will reinforce the importance of fair dealing between the parties, although this requirement simply confirms the common law, and the duty of good faith will not override an express provision in the contract. This will also ensure that franchisors are more explicit in their contracts about what the parties can or cannot do.

In addition, franchisors should not unreasonably discriminate between franchisees in a franchise system. The use of the word "unreasonable" implies that a franchisor may take a particular franchisee's personal circumstances into consideration and may allow him special treatment as long as there is a reasonable business explanation for doing so.

9.5 Termination of the franchise contract

The FSC Bill deals with a number of issues which are relevant to termination of franchise agreements including the right to transfer the franchise, the right to terminate a franchise agreement, and compensation if franchisors refuse to renew their existing agreements. This is an issue which relates to conduct between the parties and therefore it is suggested that this should be included in the code of conduct rather than the legislation. This is similar to the Australian approach. In Australia sections that deal with transfer of the franchise, termination when the franchisee is in breach of the agreement, termination when there is no breach by the franchisee and termination in special circumstances are found in the Australian Franchise Code.[30] It is suggested

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[30] Part 3 clause 21-23.

that South Africa follow the Australian example.

9.5.1 The right to transfer the franchise

In Chapter Five it was pointed out that successful franchisors seldom deny franchisees who wish to transfer their outlets to another franchisee the right to do so without a good reason. But the law does not prevent franchisors from engaging in opportunistic behaviour. It is necessary, therefore, to ensure that franchisees who are no longer able to operate their outlets are entitled to transfer their rights in a manner that is fair to both franchisees and franchisors. The FSC Bill provides that franchisees request permission to transfer in writing.[31] Franchisors must give consent in writing and will not be allowed to withhold consent unreasonably. They will be allowed to withhold consent if the proposed transferee will not be able to meet the financial obligations under the franchise agreement; will not meet reasonable requirements of the franchise agreement; will not meet the written selection criteria of the franchisor; or does not agree in writing to comply with the obligations of the franchise agreement. Franchisors will also be allowed to decline permission if this will adversely affect the franchise system, or the existing franchisee does not remedy a notified breach of the franchise agreement. Franchisors will have thirty days in which to give this consent or provide reasons as to why consent was being withheld. After thirty days the franchisor will be deemed to have given its consent.[32]

It is suggested that this proposal in the FSC Bill presents a reasonable compromise between the rights of franchisors and the rights of franchisees and that a similar section be adopted in the Proposed Franchise Code of Conduct.[33] The provision which allows for deemed consent is important to ensure that franchisors do not unduly delay the process.[34]

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31 S 16.
32 S 17.
33 See Part 6 of the Franchise Code of Conduct discussed in 9.9 below.
34 FSC Memorandum 58.

9.5.2 The right to terminate the franchise agreement

Franchisors must have the right to terminate a franchise agreement but (as pointed out in Chapter Five) this can have very serious economic consequences for franchisees.[35] Again it is suggested that the proposal in the FSC Bill is adopted. This provides that franchisors will not be able to terminate franchise agreements before the expiry date except for "good cause". Franchisors will be able to terminate for good cause if franchisees fail to comply with material terms of their agreements, but franchisees must be given at least fourteen days in which to remedy such breaches.[36] In other instances franchisors will not be required to give franchisees an opportunity to rectify the problem. These situations include when franchisees:

- voluntarily abandon their businesses for a period of seven days or longer;
- are convicted of criminal offences which substantially impair the good will associated with the franchisor's trade marks or other intellectual property;
- suffer civil judgments entered against them and fail to discharge their obligations in terms thereof within forty days of the judgments or otherwise appeal against them, or take action to have the judgments rescinded;
- are placed under administration, judicial management, liquidated or sequestrated (as the case may be) either provisionally or finally; or
- commit material breaches of their franchise agreements three or more times in any calendar year.[37]

These instances of good cause are specified but this is not a closed list. It is anticipated that if franchisors can show "good cause" even if this is not defined in the

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35 The RMI reported that this was a significant problem when the various motor vehicle manufacturers, such as Daimler Chrysler and Volkswagen, restructured their networks in South Africa (interview May 2008). Some franchisees who had been operating for over 30 years lost their businesses without any form of compensation.

36 The Australian Franchise Code provides that the franchisor must tell the franchisee what is required to remedy the breach, allow the franchisee a reasonable time to remedy the breach and if the breach is remedied the franchisor may not terminate the agreement because of the breach (s 21).

37 See Australia Franchise Code s 23 Termination - special circumstances.

legislation they will still be entitled to cancel. Other instances of good cause may include, for example, when franchisees fail to pay royalties that are due, provide false reports, fail to correct defects in products or services, lose the right to occupy premises or make material misrepresentations to their franchisors. It is submitted that "good cause" must relate to some delinquent conduct on the part of franchisees which justifies franchisors taking the decision to cancel. In other words, the franchisees must commit a material breach of the contract.[38] Good cause does not include circumstances when it makes good business sense for the franchisor to cancel the agreement. In these circumstances franchisors should have to compensate franchisees for their goodwill should they wish to cancel or refuse to renew.

9.5.3 Renewal of the contract

Franchisees who wish to renew their contracts once the stipulated period has ended must give notice to their franchisors. The FSC Bill permits franchisors to refuse to renew franchise agreements provided franchisees are paid compensation. Franchisors must repurchase the outlets at a price agreed upon by the parties or the price may be established through mediation or arbitration. This proposal adopts the approach recommended by Byers,[39] and creates a fair balance between the rights of franchisors and the rights of franchisees. There may be many reasons why franchisors elect not to continue with particular outlets or with franchisee-owned networks. It may, for example, make more business sense to continue with a network as a corporate-owned network. However, it is only fair that performing franchisees should be compensated for their hard work and commitment towards developing the brand.

This does not mean, however, that franchisors should be forced to renew or compensate franchisees who are not performing in terms of their agreements. It is suggested that this section of the FSC Bill should be followed but it should be amended to state that franchisors can refuse to renew provided "good cause" is shown, or

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38 In terms of the common law an innocent party is entitled to cancel the contract only if the breach is sufficiently serious to warrant cancellation. However, the contract may contain a clause that empowers the innocent party to terminate the contract for any breach of the terms. The aggrieved party may then terminate for even trivial breaches of contract. See 5.1.2.1 above. The right of franchisors to terminate when the breach is trivial must therefore be regulated.

39 Byers 1994 *Journal of Corporation Law* 614.

alternatively franchisors can refuse to renew franchise agreements on payment of compensation. It would be anomalous if franchisors may prematurely cancel franchise agreements if they can show good cause, but not refuse to renew contracts without paying compensation.

Renewal must take place on the franchisors' current terms and conditions for granting franchises in the same system, but existing franchisees should not be obliged to pay a renewal or extension fee. This requirement may mean that franchisees are obliged to contract on new terms and the new contract may be substantially different to the "old" one. But they cannot complain as long as this "new" contract is the one to which all new franchisees are obliged to agree. The requirement that this is the standard contract for all franchisees would prevent a situation in which franchisors impose onerous burdens on individual franchisees in an attempt to discourage them from renewing their agreements. It is anticipated that in a franchise relationship which develops over time, franchisors will alter their terms and conditions. When franchisees do not want to contract on these new terms they must be prepared to sell their outlets and leave the network. Although from a franchisee perspective, this may seem harsh, renewal according to current terms and conditions does represent a reasonable balance between the rights of franchisors and franchisees.

9.6 Dispute resolution

A significant difficulty for franchisees is the ability to defend their rights even when there is a clear violation of those rights. Many franchisees, who are often small business entrepreneurs, simply do not have the funds for lengthy and expensive litigation. In addition, there is a need to promote co-operation between the parties so that the relationship can be preserved rather than curtailed. In this respect an analogy can be drawn with labour law. The intention of labour law may be to preserve the employment relationship rather than destroy it. Therefore a cost effective, simple and relatively speedy means of resolving disputes must be devised. It is proposed that the matter be referred to the Franchise Council for mediation and if mediation fails the Council can appoint an arbitrator. The Council must also set the terms and conditions for mediation and/or arbitration and must prescribe the fees that must be paid. The Council must

develop a register of mediators and arbitrators who have adequate experience in franchising matters.

The FSC Bill makes provision for a determination by an arbitrator to be final and binding on the parties.[40] This approach may be controversial as such a section denies parties their right to approach the normal civil courts. In Australia, for example, the Code states that parties are not deprived of their rights to take legal proceedings under the franchise agreement. The South African Constitution, however, makes provision for an alternative approach in that it provides that "everyone has the right to have any dispute that can be resolved by application of law decided in a fair public hearing before a court or, where appropriate another independent and impartial tribunal or forum".[41] It is submitted that it is appropriate to make provision for another independent forum in these circumstances because, if the vastly stronger and more financially resourced franchisors can take every matter to the ordinary civil courts, most franchisees will be unable to protect their rights.

It is, however, suggested that a further provision is added to allow for the review of arbitration proceedings. In this regard it is useful to consider s 145 of the Labour Relations Act,[42] which allows any party to a dispute who alleges a defect in any arbitration proceedings, to apply to the High Court for an order setting aside the arbitration award. A defect means that the arbitrator committed misconduct in relation to his or her duties as a commissioner; committed a gross irregularity in the conduct of the arbitration proceedings, or exceeded his or her powers or that the award was improperly obtained.

9.7 Concluding remarks

There is much to be applauded in the proposals contained in the FSC Bill. However it is submitted that this Bill over-regulates the sector. In particular the FSC Bill proposes that franchising be regulated by public officials. In all probability this would mean that franchising would fall under the control of the DTI. This is both undesirable and

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40 S 18.
41 S 34.
42 Act 66 of 1995.

unworkable. Instead, the approach should be one of co-regulation as proposed in Chapter Seven. This would involve introducing franchise-specific legislation which provides for the establishment of an independent council with members who have expertise in the sector. The legislation itself should be simple and should deal with core issues only. The FSC Bill contains a list of offences and penalties and provides for enforcement by the Registrar. If this were adopted many franchisee complaints, particularly those relating to misrepresentation, would be criminalised. This would create further problems in the sector as it would be necessary to rely on the South African Police Services (SAPS) to investigate matters. It is highly unlikely that this would resolve disputes in a speedy and amicable fashion. Involving the SAPS, an approach found in the Consumer Affairs (Unfair Business Practices) Act, has proved to be unworkable. Contraventions of the Consumer Affairs (Unfair Business Practices) Act are criminal offences. It is significant that virtually no prosecutions in terms of this Act have taken place.[43] There is also a general attitude that consumer issues are not that important. For example, in *S v Pepsi-Cola (Pty) Ltd*,[44] a matter involving an illegal marketing technique, Van der Heever J expressed surprise that in the light of the statistics for serious crime in the Western Cape, an officer in the police force could be spared to investigate such a complaint. Although this case was decided over twenty years ago, the crime rate in South Africa continues to be a major problem socially, economically and politically, so it is very difficult to persuade the police that consumer complaints may involve serious criminal offences. The reality is that despite the Minister declaring that certain conduct is illegal, because of the lack of prosecutorial will on the part of the authorities, the guilty parties simply carry on regardless. It is therefore necessary to find a better method than relying on the SAPS to enforce franchise legislation.

Most of the regulatory provisions should be contained in a code of conduct which can be amended at relatively short notice and without the extensive procedures required for the amendments of legislation. In this regard the example found in the Debt Collectors Act provides a useful model. Debt collectors were previously governed by a voluntary code of conduct which failed to control abuses in the industry. Debt

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43 See Chapter Eight note 34.
44 1985 (3) SA 141 (C).

collectors themselves lobbied government for legislation to control their industry which led to the establishment of an independent Debt Collectors Council and the adoption of a code of conduct. The Act was promulgated in 1998 and over the years the Council has registered 19076 debt collectors. There are at present 11057 active debt collectors registered with the Council.[45] In 2007 the Chairman and Secretary of the Council appeared before the Justice Portfolio Committee to report on the Council's activities and achievements. The Chairperson of the Portfolio Committee complimented the Council on what it had achieved without government funding and indicated that it could serve as an example to government departments.[46] A similar approach should be adopted for the franchise sector. My proposed legislation, code of conduct and disclosure document are set out below.

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45 Council of Debt Collectors Newletter No 6 http:// www.debtcol-council (accessed on 28 April 2008).

46 *Ibid.*

9.8. The Proposed Franchise Bill[47]

To provide for the establishment of a council, known as the Franchise Council; to provide for the exercise of control over the franchise sector; and to provide for matters connected therewith.

BE IT ENACTED by the Parliament of the Republic of South Africa as follows:

Definitions

1. In this Act, unless the context otherwise dictates –

"Council" means the Franchise Council established by section 2;

"franchise agreement" means an agreement in terms of which –

(a) a franchisor grants a franchisee the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system developed and controlled on an ongoing basis by the franchisor; and

(b) the franchisee's business is substantially associated with the franchisor's trade mark, trade name, logos, advertising and/or other commercial symbols; and

(c) the franchisee pays franchisee fees for the rights the franchisee enjoys;

"franchise" includes the following –

(a) the rights and obligations under a franchise agreement;

(b) a master franchise agreement;

(c) a sub-franchise agreement;

(d) an interest in a franchise;

"franchisee" includes –

(a) a person to whom a franchise is granted;

(b) a person who otherwise participates in a franchise as a franchisee;

(c) a sub-franchisee in its relationship with a franchisor;

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47 In order to resemble an actual Bill the numbering system adopted in this section and in the next section (Franchise Code of Conduct) is different to that adopted in preceding sections.

(d) a sub-franchisee in its relationship with a sub-franchisor;

"franchisor" includes –

(a) a person who grants a franchise;

(b) a person who otherwise participates in a franchise as a franchisor;

(c) a sub-franchisor in a sub-franchise system;

(d) a sub-franchisor in its relationship with a sub-franchisee;

(e) a master franchisee in a master franchise system;

(f) a master franchisee in its relationship with a franchisee;

"franchise code" means the Franchise Code of Conduct attached to this Act as annexure "A" as amended from time to time by the Council and approved by the Minister and published in the *Government Gazette;*

"franchise fee" includes any direct or indirect consideration including for example:

(a) an initial up-front franchise or similar fee; or

(b) an initial capital investment, total set-up or establishment cost or similar fee; or

(c) a payment for goods and services; or

(d) a fixed continuing fee, or a fee based on a percentage of gross or net income whether or not called a royalty or management or franchise service fee; or

(e) a training or similar fee;

but excluding

the payment of a bona fide wholesale price for goods intended only for resale.[48]

"Minister" means the Minister of Trade and Industry;

"person" includes a juristic person;

"prescribe" means to prescribe by regulation;

"This Act" includes any regulation or notice made or issued under this Act.

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[48] This exclusion is found in the UNIDROIT Draft Model Franchise Disclosure law, in all of the American franchise laws and in the Australian Franchising Code of Conduct. This is to ensure that agency, dealership arrangements and once off sale of business arrangements are not trapped by these laws. There is no need to regulate schemes where all the recipient is required to do is to pay for goods which are to be resold. The UNIDROIT Explanatory Report explains that it is necessary to make this distinction because of the proliferation of brand merchandising (at 19).

Establishment and objects of the Franchise Council

2. (1) There is hereby established a juristic person to be known as the Franchise Council.

(2) The objects of the Council are to exercise control over the franchise sector.

Composition of the Council

3 (1) The Council shall consist of not more than 10 members appointed by the Minister.[49]

(2) The Minister shall appoint as members of the Council –

(a) as chairperson, any fit and proper person with a suitable degree of skill and experience in franchise matters;

(b) as members –

(i) at least two but not more than four franchisors, two of whom shall be appointed after consultation with organisations representing franchisors, who are natural persons and who have been operating as a franchisor for at least three years;

(ii) at least two but not more than four franchisees; two of whom shall be appointed after consultation with organisations representing franchisees, who are natural persons and who have been operating as franchisees for at least three years;

(iii) Such other persons as the Minister deems necessary, from nominations received from interested parties, who have demonstrated knowledge and experience in matters relating to franchising.

(3) The Council shall from time to time elect from among its members a vice-chairperson, who shall in the absence of the chairperson have all the powers and duties of the chairperson, and if neither the chairperson nor the vice-chairperson is present at a meeting of the Council, the members present shall elect a person from their own ranks to preside at the meeting.

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[49] At this stage this is a fairly arbitrary number and is taken from the Debt Collectors Act. There are 24 members on the FASA Board and the Franchise Steering Committee has proposed that its Franchise Council consist of between 3 and 7 members. This Council is however purely an advisory council to the Franchise Registrar. It is more important, at this stage, to ensure that both franchisors and franchisees are represented on the Council and that all members have adequate knowledge and experience of the sector.

(4) A member of the Council shall hold office for a term, not exceeding three years, determined by the Minister at the time of the member's appointment: Provided that the Minister may withdraw an appointment of a member at any time and, provided further, that a member may be reappointed at the expiration of his or her term of office.

(5) No person shall be appointed as a member of the Council if he or she –

(a) is an unrehabilitated insolvent or becomes insolvent and the insolvency requires the sequestration of that person's estate;

(b) has ever been, or is, removed from an office of trust on account of misconduct in respect of fraud or the misappropriation of money;

(c) is subject to an order of a competent court holding that person to be mentally unfit or disordered;

(d) has been convicted of an offence and sentenced to imprisonment without the option of a fine; or

(e) does not reside permanently within South Africa.

(6) A member of the Council shall vacate his or her office if he or she –

(a) becomes subject to a disqualification contemplated in subsection (5);

(b) becomes of unsound mind;

(c) in the case of a member appointed in terms of subsection (2) (b) (I) and 2 (b) (ii) ceases to be a franchisor or a franchisee; or

(d) is absent without leave of the chairperson for more than two consecutive meetings of the Council; or

(e) in the case of a member who is a franchisor or franchisee, has been found guilty in terms of section 15 of improper conduct.

Meetings of the Council

4 (1) The Council shall meet for the first time at the time and place determined by the chairperson and thereafter at least three times in each financial year at the times and places determined by the chairperson, or in his or her absence, the vice-chairperson.

(2) The quorum for a meeting of the Council shall be a majority of its members.

(3) The decision of a majority of the members of the Council present at a

meeting of the Council shall, subject to subsection (2), be a decision of the Council and, in the event of an equality of votes on any matter, the person presiding at the meeting concerned shall have a casting vote in addition to his or her deliberative vote.

Executive committee

5 (1) The Council may appoint three of its members as an executive committee of the Council which shall, subject to the provisions of subsection (2) and the directions of the Council, be competent during the periods between meetings of the Council to perform or exercise all the powers and functions of the Council: Provided that the majority of the members of the executive committee shall not be franchisors, neither shall the majority be franchisees.

(2) The executive committee shall not be competent –

(a) except in so far as the Council may otherwise direct, to set aside or vary a decision of the Council; or

(b) to exercise the power referred to in section 15(3)(a).

(3) Any act performed or decision taken by the executive committee shall be valid in so far as it is not varied or set aside by the Council.

Remuneration and allowances of members of Council

6 Out of the funds of the Council –

(a) such remuneration shall be paid to a member of the Council who is not in the full-time employment of the State;[50] and

(b) such allowances for travelling and subsistence expenses incurred by a member of the Council, shall be paid to him or her in the performance of his or her functions as such a member,

as may be determined by the Minister from time to time generally or in a particular case.

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50 It is not envisaged that as a rule state employees will become members of the council. However, at present Louis Nhlapo, from the Small Enterprise Development Agency (SEDA) an agency in the DTI is a member of the Board of the FASA.

Appointment of personnel

7 The Council may appoint such personnel as it may deem necessary for the efficient performance of its functions and management of its administration and may determine the remuneration and conditions of service of such personnel.

Persons prohibited from performance of certain acts

8 (1) As from a date fixed by the Minister in the *Gazette*, no person shall conduct the business of a franchisor or a franchisee unless that person is registered as a franchisor or a franchisee in terms of this Act.

(2) A notice under subsection (1) shall be published at least at least 180 days before the date referred to therein.

(3) Any agreement concluded between a franchisor and a franchisee either before or after the date referred to in subsection (1) which is incompatible with the prohibition contained in that subsection shall be invalid.

(4) No person, other than a person who has complied with the registration requirement provided for in section 9 shall use the word franchise or any other word(s) or indication(s) having a tendency to mislead or deceive other persons into believing that their business activities are or can be a franchise.

Application for registration

9 (1) A franchisor and a franchisee shall apply for registration with the Council on the prescribed form and the application shall be accompanied by the prescribed application fee.

(2) A person who applies for registration in terms of subsection (1) shall furnish such additional particulars in respect of the application as may be determined by the Council.[51]

(3) The additional information as required by Council shall, despite any other law

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[51] The intention is not to spell out the documents which the Council will require before registration is granted. This information will appear in the Code and the Council can publish guidelines from time to time. Such an approach will mean that the Council can amend its requirements fairly quickly as it deems necessary.

to the contrary, not be open for public inspection.[52]

(4) If the Council is of the opinion that the provisions of this Act have been complied with it shall grant the application and register the applicant as a franchisor or a franchisee.[53]

Certificate of Registration

10 The Council shall issue to every person registered as a franchisor or a franchisee a certificate of registration on the prescribed form.

Register

11 (1) The Council shall keep a register of the names and prescribed particulars of every franchisor and franchisee whose application for registration under section 9 (3) has been approved, or whose registration has been withdrawn or disapproved.

(2) The register contemplated in subsection (1) shall –

(a) be published in the Gazette annually;

(b) be updated every second month by the Council;

(c) be available for inspection by the public at the prescribed places and times.[54]

Payment of subscription fees

13 (1) Every person registered as a franchisor and a franchisee shall pay to the Council the prescribed fees.

(2) If a franchisor or franchisee fails to comply with the provisions of subsection (1) the Council may suspend their registration until the amount owed is received

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52 It is envisaged that the Council may require franchisors in particular to submit confidential information such as operations manuals and financial statements. It would be harmful to their businesses if these were to become public documents.

53 It is envisaged that this will not be a complicated procedure. Franchisors will be required to submit certain documents and if these are submitted, registration will be granted. In the case of debt collectors registrations are done on a weekly basis. It is envisaged that franchisees should complete the registration form in order to inform the Council that they have purchased a franchise and they must pay the required fee.

54 The number of registered franchisees in particular will be useful information for any person seeking to purchase a franchise. They will be able to establish how many outlets are registered within a particular district and will be able to contact these franchisees in order to obtain information about the franchise before purchasing.

by the Council: Provided that if the relevant amount is not paid within three months of the date of suspension of registration, the Council may withdraw the registration.

Code of Conduct

14 (1) The Council shall, subject to the approval of the Minister, adopt a code of conduct for franchising and shall publish such code in the Gazette.

(2) The Council may, subject to the approval of the Minister, amend or repeal the code of conduct adopted by it: provided that such code shall not be wholly repealed by it, unless it is simultaneously replaced by a new code of conduct for franchising so adopted and approved by the Minister and, provided further, that the Council shall publish any such amendment, repeal or replacement in the Gazette.

(3)The code of conduct shall be binding on all franchisors and franchisees.

Improper conduct

15 A franchisor or franchisee may be found guilty by the Council of improper conduct if they, or a person for whom they are vicariously liable:

(a) makes use of fraudulent or misleading misrepresentations when applying for registration with the Council;[55]

(b) fails to disclose material information when applying for registration with the Council;

(c) contravenes or fails to comply with a provision of the code of conduct contemplated in section 13;

(d) contravenes or fails to comply with any provision of this Act;

(e) behaves or acts in any manner amounting to conduct, other than that mentioned in (a), (b), (c), or (d) which is improper in terms of a regulation.

(2) The Council may in the prescribed manner investigate an allegation of improper conduct by a franchisor or franchisee submitted to it in the prescribed

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55 Although the Council will not peruse documents that have been submitted to it at the time of registration, if it is later established that these documents are fraudulent or misleading, the Council will be empowered to take action against the errant party.

manner or have it investigated in the prescribed manner by a committee of members of the Council or by a person or persons nominated by it: provided that a franchisor or franchisee whose conduct is being investigated shall be afforded the opportunity, either in person or through a legal representative, of refuting any allegations made against them.

(3) If the Council finds a franchisor or franchisee guilty of improper conduct, the Council may –

(a) withdraw the registration as a franchisor or franchisee;

(b) suspend the registration for a specified period of time or pending the fulfilment of a condition or conditions;

(c) impose a fine not exceeding the prescribed amount which fine shall be payable to the Council;

(d) issue a reprimand;

(e) recover from the person found guilty the costs incurred by the Council in connection with the investigation;

(f) order the person found guilty to reimburse any person who the Council is satisfied has been prejudiced by the conduct of such person and to furnish the Council within a specified period with proof of such reimbursement; or

(g) combine any of the penalties under this subsection.

(4) Any penalty imposed on a person in terms of subsection 3(a), (b), (c) or (g) may be suspended, either wholly or partially, by the Council on such conditions as the Council may deem appropriate.

(5) The Council may in its discretion assign any of the powers conferred on it under this section, except the power referred to in subsection 3(a) to a committee nominated by it in terms of subsection 2, and may rescind or vary a decision of such a committee.

Withdrawal of registration

16 (1) The Council may withdraw the registration of a franchisor or franchisee –

(a) if the person is found guilty in terms of section 15 of improper conduct or

(b) if after registration, the person fails to pay the prescribed fees in terms of

section 13; or

(c) the person becomes insolvent or in the case of a juristic person, is liquidated; or

(d) the person fails to comply with an order imposed by the Council in terms of 15 (3) (c) (e) and (f).

(2) The Council shall not withdraw the registration of a person unless that person, either in person or through a legal representative, has been given an opportunity to be heard.

(3) The Council shall give the person written notice of its decision under subsection (1) and the decision shall take effect from the date on which the written notice is given to the person concerned.

(4) A person who is aggrieved by any decision in terms of section 16 may appeal to any High Court within whose area the person concerned is carrying on business.

Withdrawal or suspension of a franchisor's registration

17 Where the registration of a franchisor has been withdrawn in terms of section 16(1) or suspended in terms of section 15(3)(b) and there are franchisees already in operation prior to such withdrawal or suspension, the franchisees shall be entitled to continue carrying on their franchised businesses and the franchisor is obliged to continue supporting them, even if an appeal to the High Court is unsuccessful.[56]

Return of certificates of registration on withdrawal of registration

18 Where the registration of a person is withdrawn under section 16 the franchisor

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56 The withdrawal or suspension of registration is a drastic step which could have a profound effect on franchisees who are already operating. This will only be resorted to in circumstances where the franchisor is acting in gross violation of the code or the legislation. The intention therefore is to stop the franchisor from establishing further outlets but it will be obliged to continue supporting those franchisees which have already been established. The suspension of registration will be for a certain period of time to enable the franchisor to make amendments to it operating system in order to ensure that it does comply with the legislation. During the period of suspension it will not be able to establish further outlets. Registration will only be withdrawn completely where the franchisor is totally dysfunctional and in such circumstances it is anticipated that the network will gradually be phased out. The main intention behind suspension or withdrawal is to prevent future harm to prospective franchisees.

or franchisee shall forthwith return to the Council the certificate of registration issued under section 10.

Auditing

19 (1) The accounting records and annual financial statements of the Council shall be audited annually by a person appointed by the Council for such purpose.

(2) No person shall be appointed under subsection (1) unless he or she is registered as an accountant and auditor under the Auditing Profession Act 26 of 2005 and is engaged in public practice.

Financial year

20 The financial year of the Council shall be a year terminating on the last day of February.

Regulations

21 (1) The Minister may, after consultation with the Council, make regulations –

(a) regarding any matter required or permitted to be prescribed in terms of this Act;

(b) regarding generally, all matters which are reasonably necessary or expedient to be prescribed in order to achieve the objects of this Act.

(2) Without prejudice to the generality of the provisions of subsection (1), the Minister may after consultation with the Council, make regulations –

(a) prescribing the fees payable by a franchisor or franchisee to the Council in terms of section 13(1) and the periods within which such fees are payable;

(b) prescribing the circumstances under which a franchisor or franchisee shall not be bound to pay an amount referred to in section 13(1).[57]

(3) Any regulation made under subsection (1) may provide that any person who

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[57] In certain circumstances the Council may wish to exempt certain franchisors or franchisees from paying registration fees. It is envisaged that this may be to encourage small business development or black economic empowerment. The Council may, for example, exempt very small businesses such as a shoe shining franchise or hot dog stand from paying fees. However, such a business will still be required to register with the Council in order to ensure that it is not a scam.

contravenes a provision thereof or fails to comply therewith shall be guilty of an offence and on conviction be liable to a fine, or to imprisonment for a period not exceeding five years.

Offences and penalties

22 Any person who –

(a) contravenes the provision of section 8(1) or 8(4); or

(b) fails to return a certificate of registration in terms of section 18,

shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding five years.

Short title and commencement

23 This Act shall be called the Franchise Act, 200..., and shall come into operation on a date fixed by the President by proclamation in the *Gazette.*

9.9 Franchise Code of Conduct - Annexure "A"

Part 1 General

1.1 Name of the code

This is the Franchise Code of Conduct.

1.2 Purpose of the code

(1) The purpose of the code is to regulate the conduct of participants in franchising towards other participants in franchising.

(2) This code forms part of the Franchise Act, but to the extent that it conflicts with any section contained in the Act, the provisions of the Act shall prevail.

(3) This code is also supplemented by the Disclosure Document, which forms an integral part of this code.

1.3 Definitions

The definitions contained in the Franchise Act shall, unless the context clearly indicates a contrary meaning, apply *mutatis mutandis* to this code.

Part 2 Advertising franchises for sale

(1) All advertisements offering a franchise for sale shall contain full contact details of the person placing the advertisement.

(2) These details shall include, unless it is impractical to do so, –

(a) the full name of the person placing the advertisement;

(b) the full postal and physical address of the person placing the advertisement;

(c) the telephone number and fax numbers of the person placing the advertisement;

(d) the name of a contact person and the information for such person in accordance with subclauses (a), (b) and (c) if different from the information to be provided in terms of subclause (d).

(3) Where it is impractical to provide the information contained in subclauses (a) to (d), the information specified must be deposited and available from the medium used.[58]

(4) All advertisements shall comply in letter and in spirit with the Advertising Standards Authority of South Africa's Code of Advertising Practice as amended from time to time.

(5) No person other than a person having complied with the registration requirements provided for in the Franchise Act shall use the word franchise or any other words or indications having a tendency to mislead or deceive other persons into believing that their business activities are or can be a franchise.

Part 3 Disclosure prior to concluding a franchise agreement

3.1 Disclosure document

(1) A franchisor must, prior to entering into a franchise agreement, and within 3 months after the end of each financial year after entering into a franchise agreement, create a document (a Disclosure Document) for the franchise in accordance with Appendix "1".

(2) The purpose of the disclosure document is to give a prospective franchisee or a franchisee proposing to renew or extend a franchise agreement, information from the franchisor to help the franchisee make a reasonably informed decision about the franchise and to give the franchisee current information from the franchisor that is material to the running of the franchised business.

(3) A franchisor must give a current disclosure document to a prospective franchisee or a franchisee proposing to renew or extend a franchise agreement

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[58] It is envisaged that advertisements may sometimes be fairly small and so it will not be practical for them to contain all the information required. Information must however be given to the newspaper or magazine in which the advertisement appears so that prospective franchisees can check that there is a valid organisation behind the advertisement. It is also expected that members of the media will refuse to carry such advertisements unless they are provided with the required information.

(4) The disclosure document may include additional information under the heading "Other relevant disclosure information".

(5) The disclosure document must be signed by a director or an executive officer of the franchisor.

3.2 Franchisor obligations

(1) A franchisor must give a copy of this code and a disclosure document

(a) to a franchisee at least 14 days before the prospective franchisee:

(i) enters into a franchise agreement or an agreement to enter into a franchise agreement; or

(ii) makes a non refundable payment (whether of money or other valuable consideration) to the franchisor or an associate of the franchisor in connection with the proposed franchise agreement; or

(b) to a franchisee at least 14 days before renewal or extension of the franchise agreement.

(2) A franchisor must not:

(a) enter into, renew or extend a franchise agreement; or

(b) enter into an agreement to enter into, renew or extend a franchise agreement; or

(c) receive a non refundable payment (whether of money or other valuable consideration) under a franchise agreement or an agreement to enter into a franchise agreement;

unless the franchisor has received from the franchisee or prospective franchisee a written statement that the franchisee or prospective franchisee has received, read and had a reasonable opportunity to understand the disclosure document and this code.[59]

(3) Before a franchise agreement is entered into, the franchisor must have

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[59] It is obviously very difficult to force prospective franchisees to apply their minds properly before they enter into binding agreements and many franchisees admit that they did not read the documents properly before they sign them. They simply trusted the franchisor. However by insisting on a signed document in which they state that they have read and considered the document, it is hoped that franchisees will be encouraged to properly apply their minds. Such a document will also protect franchisors in the event of a dispute at a later stage.

received from the prospective franchisee:

(a) signed statements, that the prospective franchisee has been given advice about the proposed franchise agreement or franchised business, by any of:

(i) an independent legal adviser;

(ii) an independent business adviser;

(iii) an independent accountant; or

(b) a signed statement by the prospective franchisee that the prospective franchisee:

(i) has been given that kind of advice about the proposed franchise agreement or franchised business; or

(ii) has been told that that kind of advice should be sought but has decided not to seek it.

(4) Subclause (3) does not apply to the renewal or extension of a franchise agreement with a franchisor.

Part 4 Franchise agreement

4.1 In writing

(1) The franchise agreement must be in writing.

(2) The franchise agreement must be signed by or on behalf of the franchisor and the franchisee.

(3) The franchise agreement must be in plain and understandable language.

(4) The franchise agreement is in plain and understandable language if it is reasonable to conclude that an ordinary franchisee in the class of persons for whom the franchise is intended could be expected to understand the content, significance and import of the agreement.[60]

4.2 Cooling off period

(1) A franchisee may terminate an agreement (being either a franchise agreement or an agreement to enter into a franchise agreement) within

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60 This requirement has been taken from the Consumer Protection Bill (see s 7 read with s 22 of that Bill).

14 days after the earlier of:

(a) entering into the agreement; or

(b) making any payment (whether of money or of other valuable consideration) under the agreement.[61]

(2) Subclause (1) does not apply to the renewal, extension or transfer of an existing franchise agreement.

(3) If the franchisee terminates an agreement under subclause (1), the franchisor must, within 14 days, return all payments (whether of money or of other valuable consideration) made by the franchisee to the franchisor under the agreement.

(4) The franchisor may deduct from the amount paid under subclause (3) the franchisor's reasonable expenses if the expenses or their method of calculation have been set out in the agreement.

4.3 Terms of the agreement

(1) A franchise agreement shall contain but is not limited to –

(a) the name and description of the goods and/or services which the franchisee is entitled to produce, render or sell;

(b) a description of the franchise business and system;

(c) the territorial rights, if any granted to the franchisee;

(d) in circumstances where no territorial rights are granted to the franchisee the following clause in bold type:

You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels or distribution or competitive brands we control.

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[61] This means that, in total, franchisees have 28 days in which to consider whether they really want to be bound by these agreements. They must receive the documents 14 days before agreements are concluded and then they have another 14 days in which to reconsider their decisions. After such a period it is not unreasonable to insist that they are bound by the agreements that they have signed.

(e) a description of the site (premises) and location from which the franchisee is to conduct the franchise business and a copy of the signed lease if the franchisor is the lessor, or a copy of the signed sublease if the franchisor sublets to the franchisee, or a copy of the lease in respect of the site (premises) the franchisor has selected to be leased by the franchisee from a third party;

(f) a statement of the cooling off period as set out in clause 3.2 above;

(g) The conditions under which the franchisee or its estate may transfer or assign the rights and obligations under the franchise subject to Part 6;

(h) a description of the trade marks or any other intellectual property owned by the franchisor, or otherwise licensed to the franchisor which is, or will be used in the franchise;

(i) if the agreement is related to a master franchise, the franchisor's identity and details of the rights obtained by the mater franchisee from the franchisor;

(j) the obligations of the franchisor;

(k) the obligations of the franchisee;

(l) the type and particulars of the initial and ongoing training and assistance provided by the franchisor;

(m) the duration and the terms of the renewal of the franchise agreement subject to Part 7;

(n) if the franchise agreement provides that a franchisee must contribute to an advertising, marketing or other similar fund, the franchise agreement must –

(I) stipulate how it is intended that this advertising, marketing or other similar fund will be spent;[62]

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62 This section has been introduced because the way in which the advertising/marketing fund is spent often leads to disputes. Franchisors tend to spend the fund on national advertising/marketing campaigns in order to develop the brand as a whole. Franchisees are then expected to fund the advertising of their own specific outlets. Franchisees who are contributing to a fund for advertising/marketing often find this difficult to accept and therefore this should be spelt out to them from the outset in the disclosure document.

(II) specify the amount, or if expressed as a percentage, the method of calculation;

(III) stipulate that within 3 months after the end of the last financial year, an annual financial statement will be provided to franchisees requesting a copy, which reflects the fund's receipts and expenses for the last financial year, including amounts spent, and the method of spending on advertising and/or marketing of franchises and the franchise system's goods and services;

(IV) stipulate that the annual financial statement will be audited by a registered accountant or accounting officer (as the case may be) within three months after the end of the financial year to which it relates; and

(V) stipulate that the franchisee is entitled to a copy of the annual statement within 30 days after a request;

(o) the continuing fees (if any) that the franchisee is required to pay.

4.4 Other material information

(1) If a disclosure document does not mention a matter mentioned in subclause (2), the franchisor must tell the franchisee or prospective franchisee about the matter in writing, within a reasonable time (but not more than 60 days) after the franchisor becomes aware of it.

(2) For subclause (1) the matters are:

(a) change in majority ownership or control of the franchisor;

(b) proceeding by a public agency, a judgment in criminal or civil proceedings or an award in an arbitration against the franchisor in South Africa alleging:

(i) breach of a franchise agreement; or

(ii) contraventions of the competitions law; or

(iii) improper conduct; or

(iv) an offence of dishonesty;

(c) civil proceedings in South Africa against the franchisor by at least

10% or 10 of the franchisees in South Africa of the franchisor (whichever is the lower);

(d) any judgment that this entered against the franchisor in South Africa and is not discharge within 28 days;

(e) a change in the intellectual property, or ownership or control of the intellectual property, that is material to the franchise system;

(f) the franchisor has become an externally-administered body.

(3) For subclauses (2) (b), (c) and (d) the franchisor must tell the franchisee:

(a) the names of the parties to the proceedings; and

(b) the name of the court or tribunal; and

(c) the case number; and

(d) the general nature of the proceedings.

(4) For subclause 2 (f), the franchisor must tell the franchisee the name of the administrator or liquidator.

4.5 Void provisions

The following provisions in a franchise agreement are null and void and are of no force and effect:

(1) a provision in terms of which a franchisee agrees not to form an association or not to associate with other franchisees;

(2) a provision in terms of which a franchisee purports to waive rights set out in this code or in the Franchise Act;

(3) a provision which limits or exempts a franchisor from liability for any loss attributable to the negligence of the franchisor;[63]

(4) a provision which limits or exempts a franchisor from liability for any loss attributable to a misrepresentation of the franchisor;[64]

(5) an authorisation for any person acting on behalf of the franchisor to enter the premises of the franchisee for the purposes of taking possession of goods to which the franchise agreement relates;

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63 Outlawing such provisions will probably be regarded as fairly radical by franchisors but for a discussion of why this section is necessary see 8.2.3.1 above.

64 *Ibid.*

(6) a provision which falsely expresses an acknowledgment by the franchisee that –

(a) before the agreement was made, no representations or warranties were made in connection with the agreement by the franchisor or a person on behalf of the franchisor; or

(b) the franchisee has received goods or services, or a document that is required by the code or the Franchise Act to be delivered to the franchisee.

Part 5 Conduct between the parties

5.1 Fair dealing

(1) The parties shall at all times act in accordance with the duty of good faith and fair dealing.

(2) A franchisor and a franchisee, in their dealing with one another, shall avoid the following conduct –

(a) substantial and unreasonable overvaluation of fees, prices and/or any other direct or indirect consideration;

(b) conduct which is unnecessary and unreasonable in relation to the risks to be incurred by one party; and

(c) conduct that is not reasonably necessary for the protection of the legitimate business interests of the franchisor, franchisee or franchise system.

5.2 No discrimination

(1) The franchisor shall not unreasonably discriminate between franchisees in a franchise system.

(2) For the purposes of subclause (1) it shall not be unreasonable discrimination if the franchisor can prove that any discrimination is –

(a) based on franchises granted at different times, and such discrimination is reasonably related to the difference in time; or

(b) related to one or more programs for making franchises available

to persons with insufficient capital, training, business experience or education, or lacking other qualifications and benefits such persons; or

(c) related to efforts by the South African government, any of its agencies or third parties to promote variation in goods and/or services, growth in franchising and benefits such persons to which it is granted;[65] or

(d) related to efforts by one or more franchisees in the franchise system to cure operational deficiencies in their businesses and benefits such persons to which it is granted; or

(e) based on other reasonable distinctions considering the purposes of this code or the Franchise Act and is not arbitrary.

5.3 Disclosure of benefits

(1) A franchisor shall disclose to its franchisees any direct or indirect benefit it receives from suppliers to its franchisees or franchise system.[66]

(2) Such disclosure shall be in writing with an explanation of how it will be applied.

5.4 Notice of breach

(1) A franchisor shall give written notice about a breach of agreement by a franchisee and allow the franchisee, at least 14 days in which to remedy the breach.

Part 6 Transfer of the franchise

6.1 Request in writing

(1) A request for a franchisor's consent to transfer of a franchise must be made in writing.

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65 This would allow franchisors to comply with the BEE obligations without fear of complaint from other franchisees.

66 This solves the problem which franchisees experienced in *Seven Eleven Corporation SA (Pty) v Cancun Trading No 150 CC*.

6.2 Franchisor response

(1) A franchisor must not unreasonably withhold consent to the transfer.

(2) The franchisor must stiputlate in the franchise agreement the conditions upon which it will grant consent.

(3) For subclause (2), circumstances in which it is reasonable for a franchisor to withhold consent include:

(a) the proposed transferee is unlikely to be able to meet the financial obligations under the franchisor agreement; or

(b) the proposed transferee does not meet a reasonable requirement of the franchise agreement for the transfer of a franchise; or

(c) the proposed transferee does not meet the selection criteria of the franchisor; or

(d) agreement to the transfer will have a significantly adverse effect on the franchise system; or

(e) the proposed transferee does not agree in writing to comply with the obligations of a franchisee under the franchise agreement; or

(f) the franchisee has not paid or made reasonable provision to pay any amount owing to the franchisor; or

(g) the franchisee has not remedied a notified breach of the franchise agreement.

(4) The franchisor is not entitled to charge a fee or receive any consideration for considering an application to consent to a transfer.

(5) The franchisor is entitled to charge an amount equal to the initial training fee charged to franchisees to train the franchisee if consent is given and training takes place.

(6) The franchisor is taken to have given consent to the transfer, if the franchisor does not, within 30 days after the request was made, give the franchisee written notice –

(1) that consent is withheld; and

(2) setting out why consent is withheld.

Part 7 Renewal of the franchise agreement

7.1 Renewal of the franchise agreement

(1) A franchisee who wishes to renew its franchise agreement shall give written notice to the franchisor at least 60 days prior to the expiry of the then term of the franchise agreement.

(2) The renewal terms shall be the same as the initial term unless this is altered by agreement between the parties.

(3) Renewal shall take place on the franchisor's then current terms and conditions for granting franchises in the same system, provided that the franchisee shall not be obliged to pay a renewal fee for such renewal.[67]

(4) The franchisor shall provide the franchisee with a copy of its then current disclosure document and franchise agreement within 14 days of receipt of the franchisee's notice in terms of subclause (1).

(5) If the franchisee is not prepared to execute such agreement, to the extent that it differs from the then current franchise agreement, the franchise terms shall end on expiry of the then term and the franchisee shall have no claim for failure to renew unless the proposed agreement contravenes this code or the Franchise Act.

(6) Where a franchisee fails to give notice of its intention to renew and the franchise agreement continues between the parties, the agreement shall be regarded as having been renewed on the same terms and conditions for a period of one year.[68]

7.2 Refusal to renew the franchise agreement

(1) A franchisor may refuse to renew a franchise agreement in the following circumstances:

(a) the franchisor can show good cause, as provided for in subclause 8.2 (3), for refusing to renew; or

(b) the franchisee is in breach of the current franchise agreement at

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67 See discussion in 9.5.3 above.

68 This would solve the problem which was experienced in *Golden Fried Chicken (Pty) Ltd v Sirad Fast Foods CC* (see 5.1.2.3 above).

the time of giving the renewal notice; or

(c) the franchisor agrees to compensate the franchisee at a price to be agreed upon between the parties or, failing agreement, in accordance with the provisions of clause 9.4 (dealing with arbitration).

(2) For the purposes of subclause (1) (b) above the price shall include the market value of goodwill as well as the market value of stock still in the possession of the franchisee at the date of termination.

Part 8 Termination of the franchise relationship[69]

8.1 Termination by agreement or arbitration order

(1) A franchise agreement may be terminated by agreement between the parties.

(2) For subclause (1) above a term of a franchise agreement that a franchisor can terminate the franchise agreement without the consent of the franchisee is not taken to be consent.

(3) Both parties to the franchise agreement may agree to termination through mediation.

(4) A franchise agreement may also be terminated before expiry where an arbitrator makes a ruling to that effect in terms of clause 9.4.

8.2 Termination for good cause

(1) A franchisor may terminate a franchise agreement before the expiry date for good cause as provide for in subclauses (2) and (3) below.

(2) Good cause shall include, but is not limited to –

(a) the failure of a franchisee to comply with any material terms of the franchise or any other related agreement entered into between the franchisor and the franchisee; and

(b) the failure of the franchisee to remedy the breach committed by it

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69 See Chapter Five.

within the period stated in a written notice given by the franchisor, which shall not be less than 14 days, for the breach to be remedied.

(3) Good cause shall include, but without the requirement to give notice and an opportunity to remedy the breach, when the franchisee –

(a) voluntarily abandons the franchised business for a period of 7 days or longer; or

(b) is convicted of a serious offence; or

(c) suffers a civil judgement entered against it and fails to discharge its obligations in terms thereof within 40 days of the judgement or otherwise appeal against, or take action to have the judgement rescinded; or

(d) is placed under administration, judicial management, liquidated or sequestrated (as the case may be) either provisionally or finally; or

(e) commits a material breach of the franchise agreement 3 or more times in any calendar year and the franchisor has issued at least two written notices for the breaches to be remedied.

Part 9 Dispute Resolution

9.1 Definitions

In this part:

complainant means the person who starts a complaints procedure;

parties means the complainant and the respondent in a dispute arising under a franchise agreement or this code;

respondent means the person with whom the complainant has a dispute.

9.2 Internal resolution of disputes

(1) A franchise agreement must provide for a complaint handling procedure.

(2) The complainant must communicate to the respondent in writing:

(a) the nature of the dispute; and

(b) what outcome the complainant wants; and

(c) what action the complainant thinks will settle the dispute.

(3) The parties should make every effort to resolve disputes between them in good faith through fair and reasonable direct communication and negotiation.

(4) If the parties are unable to agree the matter may be referred by the parties to a mediator.

(5) If the parties cannot agree on a mediator the matter must, within 14 days, be referred to the Council for the appointment of a mediator.

9.3 Mediation

(1) In the absence of agreement either party may refer the matter to the Franchise Council for the appointment of a mediator.

(2) The Council shall appoint a mediator on such terms and conditions, including payment of a mediation fee by one or more of the parties, as it deems appropriate.

(3) The mediator may decide the time and place for mediation, except that mediation must be conducted in South Africa.

(4) The parties must attend the mediation and try to resolve the dispute.

(5) For the purposes of subclause (4), a party is taken to attend mediation if the party is represented at the mediation by a person who has the authority to enter an agreement to settle the dispute on behalf of the party.

(6) If the dispute is not resolved within 30 days of the start of mediation, the mediator may terminate the mediation and must issue a certificate stating:

(a) the names of the parties; and

(b) the nature of the dispute; and

(c) that mediation has finished; and

(d) that the dispute has not been resolved.

(7) Where mediation fails, the Council must refer the matter to arbitration.

9.4 Arbitration

(1) Failing successful mediation, the dispute must be referred to arbitration

by the Council.

(2) The Council shall appoint an arbitrator on such terms and conditions, including payment of an arbitration fee by one or more of the parties, as it deems appropriate.

(3) In the absence of arbitration procedures stipulated by the Council or the Arbitrator, the Arbitration Laws of South Africa will apply.

(4) A determination by the arbitrator shall be final and binding on the parties except as provided for in subclause (5).[70]

(5) Any party to a dispute who alleges a defect in any arbitration proceedings may apply to the High Court for an order setting aside the arbitration award –

(a) within six weeks of the date that the award was served on the parties unless the alleged defect involves corruption; or

(b) if the alleged defect involves corruptions, within six weeks of that date on which the corruption is discovered.

(6) A defect referred to in subclause (5) means –

(a) that the arbitrator –

(i) committed misconduct in relation to the duties of an arbitrator;

(ii) committed a gross irregularity in the conduct of the arbitration proceedings; or

(iii) exceeded the arbitrator's powers; or

(b) that an award has been improperly obtained.

(7) The High Court may stay the enforcement of the award pending its decision.

(8) If the award is set aside, the High Court may –

(a) determine the dispute in the manner it considers appropriate; or

(b) make any order it considers appropriate about the procedures to be followed to determine the dispute.

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70 For an explanation of this section see 9.6 above.

Part 10 Amendments to the Code

This Code may be amended from time to time by the Council, in consultation with the Minister, and such amendments must be published in the *Government Gazette.*

9.10 Disclosure Document - Appendix "1"[71]

1. Front Page Details

The following information must appear on the front page of the document:

- In bold upper case:

  DISCLOSURE DOCUMENT FOR FRANCHISEE / PROSPECTIVE FRANCHISEE[72]
- The franchisor's name.
- The preparation date of the Disclosure Document.
- The following statements:
  - The disclosure document contains some of the information you will need in order to make an informed decision about whether to enter into a franchise agreement;
  - Entering into a franchise agreement is a serious undertaking;
  - A franchise agreement is legally binding on you if you chose to sign it;
  - If this is a new franchise agreement (not a renewal, extension or transfer) you are entitled to a fourteen day "cooling off" period, during which you may terminate the franchise agreement without cost;
  - Read all the documents carefully, talk to other franchisees, assess your own financial resources and capabilities to deal with the requirements of the franchised business;
  - Obtain independent legal, accounting and business advice before signing the franchise agreement;
  - Prepare your own business plan and projections for profit and cash flow;
  - Consider undertaking educational courses that focus on understanding and operating a franchised business especially if you have not operated

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71 There is a fair amount of overlap between the Code of Conduct and the Disclosure Document because the provisions of the Code must be incorporated in the Disclosure Document.

72 Although it is envisaged that the franchisor will develop a standard Disclosure Document for franchisees this document must be amended for each franchisee or prospective franchisee so that it relates to the specific franchised business which the franchisee is contemplating purchasing. This is to avoid the situation where the franchisor develops a generic document and the franchisee assumes that the document relates to his specific outlet. This is a common franchisee complaint particularly when it relates to earning potential. See 4.1.4 above.

a business .before[73]

2. Franchisor Details

- The franchisor's name, registration number (if applicable), postal and physical address, registered office address and principal place of business in South Africa, telephone number and telefax number and an electronic address (if any).
- The name under which the franchisor carries on business in South Africa which is relevant to the franchise.
- A description of the kind of business operated under the franchise

3. Business experience

- A summary of the business experience of the franchisor in the last ten years including length of experience in operating a business or franchise that is substantially the same as that of the franchise.
- Details regarding the directors, members, executive officers or partners of the franchisor or any other person who is likely to have management responsibilities for the franchisor's business operations and the business experience of each of these individuals.

4 Litigation

- Details of current legal proceedings by a public or government agency, criminal or civil proceedings or arbitration, relevant to the franchise, against the franchisor alleging:
  - breach of the franchise agreement; or
  - contravention of the Franchise Act; or
  - contravention of the Companies Act or Close Corporations Act; or
  - contravention of any other law; or
  - misconduct; or

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[73] It must be accepted that whilst these statements may encourage franchisees to seek independent advice before signing their agreements, franchisees cannot be forced to do so. It is impossible to legislate against poor business decisions but at least franchisees will not be able to complain that they were not warned. See, for example, *Seven Eleven Corporation SA (Pty) v Cancun Trading No 150 CC*.

- an offence of which dishonesty is an element.
- Details of any proceeding against the franchisor under any labour law.
- Whether the franchisor or a director of the franchisor or any member or partner of the franchisor has been in the last 10 years
  - convicted of an offence; or
  - subject to final judgment in civil proceedings; or
  - liquidated, insolvent, under administration, under debt review or under judicial managements (whether provisional or final) in South Africa or elsewhere.
- The following information regarding any litigation must be provided:
  - the names of the parties to the proceedings;
  - the name of the court, tribunal or arbitrator;
  - the case number;
  - the general nature and status of the proceedings;
  - the date of any court order or other order;
  - the penalty or damages assessed or imposed.

5. Payments to agents

- Details of any agreement under which the franchisor must pay an amount, or give other direct or indirect consideration, to a person who is not an officer, director, member, partner or employee of the franchisor in connection with the introduction or recruitment of a franchisor.
- These details must include the name and contact details of such person.

6. Existing franchises

- Information regarding
  - the number of existing franchised businesses; and
  - the number of existing franchisees; and
  - the number of businesses owned or operated by the franchisor in South Africa that are substantially the same as the franchise.
- Details of each existing franchisee including
  - the postal and physical address; and

- the telephone number and other contact details; and
- the year in which each franchisee started operating the franchised business.

- This section must conclude with a statement authorising the franchisee to contact any existing franchisee.

7. Terminated franchises agreements

- Information regarding how many franchise agreements were terminated in the previous 5 year period.[74]
- An explanation as to why these agreements were terminated by for example stating:
  - the franchise business was transferred to another franchisee;
  - the franchised business ceased to operate;
  - the franchise agreement was terminated by the franchisee;
  - the franchise agreement expired and the franchisor or franchisee elected not to renew the agreement;
  - the franchised business was re-purchased by the franchisor;
  - the franchise agreement was terminated and the franchisor re-possessed the franchise business.

8 Intellectual Property

- Details regarding the intellectual property relevant to the franchise system.
- These details must include:
  - a description of the intellectual property;
  - details of the franchisor's right to use the intellectual property including who owns the intellectual property;
  - whether the intellectual property is registered in South Africa and if not where it is registered;
  - details regarding any legal proceedings which might affect the franchisor's right to use the intellectual property.
- Where details regarding the intellectual property are confidential the franchisor

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74 See discussion in 4.1.2 above.

will comply with this requirement if the franchisor gives

- a general description of the intellectual property; and
- a summary of the conditions under which the franchisee may use the intellectual property.

9 Franchise territory[75]

- The franchisee's right to receive an exclusive territory.
- If it is intended that the franchisee is to receive an exclusive territory the extent of that territory must be set out.
- If it is intended that the franchisee is not entitled to an exclusive territory the following warning in bold type must appear under this territory:

You will not receive an exclusive territory. You may face competition from other franchisees, from other outlets that we own, or from other channels of distribution or competitive brands that we control.[76]

10 Supply of goods and/or services to a franchise

- Details of:
  - any requirement that the franchisee maintain a level of inventory or acquire an amount of goods and/or services;
  - restrictions on acquisition of goods and/or services by the franchisee from other sources;[77] and
  - ownership by the franchisor or an associate of the franchisor of any interest in any supplier from which the franchisee may be required to acquire goods and/or services; and
  - the obligation of the franchisee to accept goods and/or services from the franchisor or from an associate of the franchisor; and
  - the franchisor's obligation to supply goods and/or services to the

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75 For a discussion relating to the need for this section see 4.1.5 above.

76 This is the warning which the FTC has introduced in order to deal with the common franchisee complaint of encroachment. See 6.6.4 above.

77 See, for example, *Silent Pond Investments CC v Woolworths (Pty) Ltd and Engen Petroleum Limited* . Here the franchisee was obliged to purchase all its products from the franchisor, even products which were not specific to the Woolworths brand.

franchisee; and

- conditions under which the franchisee may return goods;[78] and
- conditions under which the franchisee may receive a refund for returned goods, and from whom; and
- whether the franchisor may unilaterally change the range of goods and/or services offered, and if so, to what extent;[79] and
- whether the franchisor, or an associate of the franchisor, will receive a rebate or other direct or indirect consideration for the supply of goods and/or services to franchisees;[80] and
- whether any rebate or direct or indirect consideration is shared, directly or indirectly with franchisees.

- Where an associate of the franchisor is involved in the abovementioned supply of goods and services the franchisor must explain the relationship between the franchisor and its associate including whether such associate is a relative of the franchisor.[81]
- The franchisor must ensure that any restrictions placed on a franchisee to source its own goods and/or services comply with the Competition Act 89 of 1998.

11. Supply of goods and/or services by a franchise

- The franchisor must provide details
  - of any restrictions on the goods and/or services which the franchisee may supply;
  - of any restrictions on the persons to whom the franchisee may supply goods and/or services.
  - regarding the range of goods and/services which the franchisee must

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78 The RMI representative explained that motor dealer franchisees whose agreements had been terminated were often left with inventory which they could not sell (Interview May 2008).

79 See, for example, *Unilver SA Ice Cream (Pty) Ltd v Jepson*.

80 This addresses the problem which arose in *Seven Eleven Corporation SA (Pty) v Cancun Trading No 150 CC*.

81 One of the slimming salon franchisee's complaints was that a relative of the franchisor owned a furniture outlet from which franchisees were required to purchase all their furnishings for their outlets.

supply.[82]

- The franchisor must explain the extent to which the franchisee is entitled to change the range of goods and/services.[83]

12 Site of the franchise business

- Details regarding the site from which the franchise business is to be operated.
- This must comply with subclause 4.3(1) (e) of the Franchise Code of Conduct if applicable.
- If a similar franchise business has operated previously from the site the franchisor must provide details of that franchised business including the circumstances in which the previous franchisee ceased to operate.[84]
- The franchisee may be required to locate its own premises and establish its own outlet but:
  - this requirement must be explained in the disclosure document; and.
  - the extent to which the franchisor will provide assistance must be explained; and.
  - when the franchisor does not intend to provide any assistance to the franchisee in the location of premises or establishment of its outlet there must be a provision in the disclosure document to this effect.[85]

13 Marketing, advertising or similar funds

For each such fund, controlled or administered by or for the franchisor, to which the franchisee is required to contribute, the franchisor must provide the following details:

- the kinds of persons who contribute to the fund (for example, franchisee, franchisor, outside supplier);

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82 This is important when franchisees do not want to carry a full range of goods because those goods are not popular amongst their particular customers.

83 This would deal with the problem of franchisees who want to include goods and/ or services which are not usually supplied by other franchises in the same network.

84 Such information would be important for potential franchisees when a particular outlet is changing ownership on a regular basis. This may indicate that the outlet is not successful despite the fact that it has been operating from the same premises for a number of years. See, for example, comments made by Delmar in "New franchisees can get fried".

85 It is a common complaint from franchisees that franchisors made promises to them which later did not materialise. Dealing with this explicitly in the disclosure document will help to solve this problem.

- confirmation that businesses owned and/or operated by the franchisor which are substantially the same as the franchised businesses will contribute on the same basis as the franchised businesses;
- how much the franchisee must contribute to the fund;
- who controls and administers the fund;
- by whom the fund is audited;
- the kinds of expenses for which the fund will be used;
- whether the franchisor or its associated supply goods and/or services for which the fund pays, and if so, details thereof.

14 Payment

- Details of the range of costs necessary to start operating the franchised business.[86]
- These costs must be based on current practice.
- The details must including the following:
  - purchase or lease of fixed property;
  - equipment, fixtures, other fixed assets, construction, remodelling, signage, lease improvements and decorating costs;
  - inventory required to begin operation and the cost thereof;
  - how often this inventory needs to be up-dated or replaced;[87]
  - security and other deposits, business licenses, insurance and other prepaid expenses;
  - additional funds, including total capital investment working capital, any fees payable whether once-off or continuing required by the franchisee before operations begin.
- The details for each payment must include:
  - description of the payment;

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86 See discussion in 4.1.3 above.

87 The video store franchisee complained that she was not informed of the cost involved with keeping videos up-dated on a monthly basis. Almost immediately after purchasing the franchise which was fully stocked she was expected to outlay another R60 000 for new releases. This extra cost had not been explained to her and was unexpected (interview October 2007). Similar problems were experienced by the franchisee in *Academy of Learning (Pty) Ltd v Hancock*. See 4.1.3 above.

- amount of the payment or the formula used to work out the payment; and
- when the payment is due; and
- whether the payment or any part thereof is refundable and, if so, under what conditions.

- If the amount cannot be calculated precisely, the franchisor must give the upper and lower limits of the amount.

15 Financing

- Material conditions of each financing arrangement that the franchisor, or its agent or an associate of the franchisor, offers to the franchisee for establishment and/or operation of the franchised business.
- The material conditions of the financing arrangement include the following:
  - any requirement that the franchisee must provide a minimum amount of unborrowed capital and working capital;
  - any requirement that the franchisee was provide personal guarantees for the financing arrangement.

17 Franchisor's obligations

- A summary of the terms of the franchise agreement that deal with the obligations of the franchisor.
- This summary must include:
  - any obligation on the franchisor to provide training before the business starts; and
  - any obligation on the franchisor to provide training during the operation of the business; and
  - any costs which the franchisee will incur in relation to such training.

18 Franchisee's obligations

- The franchisor must provide a summary of the terms of the franchise agreement that deal with the obligations of the franchisee.
- This summary must set out the franchisee's obligations in regard to:
  - site selection and acquisition;

- requirements for starting the franchised business;
- development of the site, premises, vehicle and equipment;
- training before the franchised business starts and during the operation of the business;
- opening of the franchised business;
- complying with standards or operating manuals;
- warranties and customer service;
- territorial development and minimum performance criteria;
- maintenance and appearance of premises;
- insurance;
- marketing of individual franchised businesses;[88]
- indemnities and guarantees;
- participation requirements for the franchisee or its directors, members, management team or employees;
- records and reports;
- inspection and audit requirement.

19 Restraints of Trade

- Details regarding any restraints of trade which are imposed on the franchisee.
- This must include:
  - restrictions on the franchisees's operation of other businesses during the term of the franchise agreement; and
  - any restrictions which apply after the franchise agreement is terminated.

20 Termination of the franchise relationship

- This section must comply with Part 7 and 8 of the Franchise Code of Conduct.
- In addition the franchisor must provide information regarding the following:
  - the term of the franchise agreement;
  - renewal and extension of the franchise agreement;

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[88] This is important because franchisees contribute to a national marketing fund which is used to promote the brand. However franchisees may still be required to market their individual outlets. This requirement sometimes causes problems because franchisees believe that this is also the responsibility of franchisors.

- variation of the franchise agreement;
- conditions which the franchisee must meet to renew or extend the franchise agreement;
- termination by the franchisor;
- termination by the franchisee;
- the franchisee's goodwill on termination or expiry;
- the franchisor's obligations when a franchise agreement is terminated, expires or is not renewed;
- the franchisee's rights to transfer the business.

- The franchisor must provide information regarding the process to be followed on death or disability of the franchisee, or a director, member or shareholder of the franchisee who may be regarding as the "controlling mind" of the franchise business.

21 Obligation to sign related agreements

- A summary of any requirements under the franchise agreement for the franchisee or directors, shareholders, beneficiaries, owners or partners of the franchisee to enter into any of the following agreements:
  - a lease, sublease, licence or other agreement under which the franchisee can occupy the premises of the franchised business;
  - any credit agreement;
  - any agreement under which the franchisee gains ownership of, or is authorised to use, any intellectual property;
  - a suretyship agreement, including a guarantee, mortgage, security or other deposit, indemnity, loan agreement or obligation to provide a bank guarantee;
  - a confidentiality agreement.[89]

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89 For a discussion of the need for such agreements see 5.1.3.2 above.

22 Earnings Information[90]

- Any earnings information for the franchisee must be based on reasonable assumptions.
- Earnings information must include information from which historical or future financial details of a franchise can be assessed.
- Earnings information must be based on the specific franchised business which the franchisee is considering purchasing.
- Earnings information that is a projection or forecast must include the following details:
  - the facts and assumptions on which the projections or forecasts are based;
  - the extent of the enquiries and research undertaken by the franchisor and any other compiler of the projections or forecasts;
  - the period for which the projection or forecast relate;
  - an explanation of the choice of the period covered by the projection or forecasts;
  - whether the projections or forecasts include depreciation, salary for the franchisee and the cost of servicing the loans;
  - assumptions about interest and tax.
- If the franchisor choses not to make earnings claims it must be stated explicitly that no earnings claims are being made, and that earnings are dependent on a variety of factors.

23 Financial details

- The franchisor must provide a statement at the end of the last financial year, signed by at least one director, member or partner of the franchisor, which states that in his/her opinion there are reasonable grounds to believe that the franchisor will be able to pay its debts as and when they fall due.

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90 Information about earning potential is one of the first things that franchisees want to know, but if the projected profits are not achieved this leads to allegations of misrepresentation and fraud, even if honest projections are made. Basing projections on substantial evidence is therefore very important. See 4.1.4 above. Alternatively, franchisors must state clearly that they are not making any earnings projections.

- Financial details must be accompanied by a registered practicing auditor/registered practicing accounting officer's certificate on their letterhead
  - certifying that the business of the franchisor is a going concern; and
  - certifying that to the best of his/her knowledge, the assets of the franchisor's business exceed its liabilities; and
  - certifying that to the best of his/her knowledge, the franchisor is able to meet its current contingent liabilities.
- There must be statements to the effect that:
  - this certificate is updated on an annual basis and will be made available to existing franchisees within 30 days of a specific request; and
  - the updated certificate will be made available to franchisees when their agreements are renewed or extended.

24 Other relevant disclosure information

- A summary of the terms of the franchise agreement that deal with the following matters:
  - the franchisor's right to inspect financial and other records/statements of the franchised business;
  - the option or right of first refusal, if any, for the franchisor to buy the franchised business;
  - confidentiality of the franchisor's information;
  - confidentiality of the franchisee's information;
  - details of the operation or establishment of any franchisee representative body.[91]
- The franchisor may include any other relevant disclosure information that does not contradict information which is required to be given.

25 Complaint handling procedure

- A mechanism to handle complaints and resolve disputes that complies with Part

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91 For example the RMI or NADA.

9 of the Franchise Code of Conduct.

26 Updates

- Statement to the effect that:
  - the disclosure document is reviewed on an annual basis; and
  - the disclosure document is updated within 30 days of any material changes to the franchise system; and
  - the franchisee and any renewing franchisees will receive a current version of the disclosure document.

27 Receipt

- On the last page of the disclosure document the franchisor must:
  - state that the franchisee is entitled to keep the disclosure document unless the franchisee declines to purchase the franchised business in which case the disclosure document must be returned to the franchisor; and
  - provide a form on which the prospective franchisee can acknowledge receipt of the disclosure document.

CHAPTER TEN
CONCLUSIONS

OUTLINE

The purpose of this chapter is to draw together the specific findings established by this research. Most of these findings have been thoroughly discussed in the preceding chapters and certain conclusions have been elucidated. It is therefore unnecessary to repeat them in any detail.

10.1 Franchising is a unique method of operating a business.

Franchising is a modern business phenomenon which has developed rapidly in many jurisdictions since the 1950s and 1960s. It is a method of marketing goods and services and has proved to be a highly successful means of expanding a business operation. It is one of the options which is available to a successful entrepreneur who is embarking on an expansion plan. The other options include taking in partners, employing agents or setting up a distribution network.

10.2 Franchising can contribute to the Government's economic development goals

Franchising is a sector that has the potential to contribute to job creation, wealth and economic generation and the overall growth of the small business sector. In particular, franchising can contribute significantly to achieving the goal of black economic empowerment because it offers continuous training and there is a transfer of skills from

experienced entrepreneurs to their (often inexperienced) franchisees.[1] Business skills that promote employability are learnt by both franchisees and their employees. The continued support and backup provided by franchisors together with the fact that the business concept is a tried and test one, ensures that new business owners will have a greater likelihood of success.

Franchising also encourages investment into the South African economy as international franchisors enter the market through master franchisor licenses. In addition, franchising offers South African businesses the chance to contribute to export earnings as they expand into other African and international markets. For franchisors, franchising offers a cost effective means of expanding a successful enterprise as it does not require the capital commitment which establishing a chain requires. Franchising also creates a significant amount of opportunity in non-franchised industries that support franchising. These include businesses that supply products, manufacture packaging or provide real estate.[2]

10.3 Certain features of this business model can lend itself to abuse

This research has demonstrated the extent of economic power that rests in the hands of franchisors and it has shown how this power can be used to the detriment of franchisees. It is the function of franchisors to protect their systems, maintain standards and develop their brands by expanding their networks, and therefore franchisors will insist on certain levels of performance, impose restraints to protect their intellectual property and appoint further franchisees. Franchisees who complain or who are unable to meet franchisor demands may find their contracts terminated and they may even be liable for damages. Even though franchise outlets are sold on the basis that franchisees are purchasing their own businesses, they have no security of tenure and

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1 In its report, the Franchise Steering Committee outlines the manner in which franchising can achieve these goals and discusses the advantages of franchising. For further discussion of the advantages of franchising for both franchisors and franchisees see Chapter Two.

2 See PriceWaterHouseCoopers Report, in which it is stated that franchised businesses in America generate a significant amount of economic activity but they stimulate even more economic activity in non-franchised businesses (often referred to as the ripple effect).

may find after years of commitment to a particular brand that their businesses are taken away without any form of compensation.

10.4 The law that regulates franchising at present is inadequate to control abuses

The law that regulates franchising at present consists primarily of the common law of contract. *Barkhuizen v Napier* has made a significant contribution to the law but it is how this case is interpreted by future courts that will determine the extent to which it will be of assistance to franchisees. It is questionable whether the courts will recognise the inequality of the relationship to the extent that the two stage test for public policy outlined by Ncgobo J will be of assistance to franchisees. Nevertheless, it is submitted that franchisors must not only ensure that the terms of their agreements are not contrary to public policy, they must also take into consideration the circumstances of their franchisees when seeking to enforce those terms. The Constitutional Court has decreed that a court may refuse to enforce a contract because the special circumstances of the case indicate that it would be contrary to public policy to do so. It is suggested that this decision may be of assistance to those franchisees whose contracts are terminated without good cause and without compensation. In addition, franchisors should ensure that their contracts are not excessively one-sided and, when enforcing their contracts they should act in good faith. It is suggested that franchisors consider the suggestions made by Adler and Zaid (set out in Chapter Eight) when drafting their contracts.[3]

At present franchising disputes are resolved using traditional contractual principles. These principles are applied as if the franchise agreement was a discrete contract concluded between two equal partners. This does not reflect reality. The common law must recognise the inherent inequality in the relationship and that franchising involves an ongoing and developing relationship. It is suggested, therefore, that the principles of relational contracts, as discussed by Hawthorne, must be applied to franchise relationships.

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3 Adler and Zaid "Drafting Franchising Agreements in the 21st Century".

Other statutes which regulate business in general are also applicable. In this regard the Competition Act is the most important. The Competition Commission has clearly stated that franchising is governed by the Competition Act. This has important implications for franchising because some recognised franchise practices are regarded as anti-competitive. In particular, price fixing, a common practice in franchising, is a per se violation of the Competition Act. Franchisors may recommend prices to their franchisees but they may not prescribe them and more importantly they may not penalise franchisees who do not adhere to these suggested prices. Other common practices which franchisees complain about, such as tying arrangements and exclusive dealing agreements, may also be regarded as anti-competitive. Franchisors must ensure that any restrictions which are imposed on their franchisees are designed to protect the franchisors' intellectual property, and their networks as a whole, and are not designed merely to restrict competition.

10.5 Self-Regulation is an important means of developing ethical practices, but its role is limited

The common law of contract is supplemented by self-regulation and the FASA Code of Ethics and Business Practices. This is a voluntary organisation financed by its members. The FASA has made a significant contribution to the development of ethical practices in franchising and the focus of its code is on protecting the interests of franchisees. However, the role that this body can play in franchise regulation is limited mainly because not all franchisors belong to the FASA and it does not have an effective penalty for penalising errant franchisors. When franchisors are challenged by the FASA some respond by resigning, and so the FASA has no further jurisdiction over them. Nevertheless the manner in which the FASA operates and its code can provide useful guidelines for developing a co-regulatory approach to the regulation of franchising.

10.6 There is a need for franchise-specific legal rules

Despite the developments in the common law and the applicability of the Competition

Act to franchising, the need for franchise-specific rules remains. Franchising is a widely promoted method of expanding a business in the modern world. However, there is no such thing in South Africa as "franchise law". In contrast, other business methods have well-developed legal rules and, although the normal principles of commercial law are also applicable, there are specific rules which apply to specific business arrangements. These business arrangements have a recognised place within the law. There is a need, therefore, to develop a similar recognition for franchising. In particular the common law must recognise the unique nature of franchising and franchise-specific legislation must be developed. These rules must deal with the main areas of concern highlighted in this research, namely: misrepresentations and non-disclosures made during the pre-sale phase; disputes that arise during the relationship and termination of the relationship. Where the common law is inadequate to deal with these areas of concern, franchise specific legislation should be introduced.

10.7 The franchise contract will always form the basis of the relationship

The central feature of the relationship will always be the contract, because the relationship is extremely complex and, as franchising is not a single industry, it is impossible to regulate the relationship entirely by statute.[4] Every network must have its own contract which embodies the relationship between franchisor and each franchisee. Statute may be able to provide structure to the contract, in that it will specify the kinds of information that should be contained in a franchise contract, but the contract will contain the essence of the relationship.[5] An example here would be in the case of territorial exclusivity and encroachment. Encroachment is a serious problem faced by franchisees and yet it would be extremely difficult to have legislation which was specific about the extent of a franchisee's territory. This would depend on the type of

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4 Hadfield 1990 *Stanford LJ* 927.

5 Kaufmann "Franchising Business Strategies and Legal Compliance" in *Franchising 1988: Business Strategies and Legal Compliance* (1988) 11.

franchise and the market in which that franchise is operating.[6] The FTC states that the granting of a protected territory is a private contractual matter which the parties must determine for themselves. However, the FTC in its final Franchise Rule requires the franchisor to disclose the extent of the territory granted and to provide a warning in the case that exclusive territory is granted. Such information will allow franchisees to make an informed decision without bringing franchise regulation into conflict with competition regulation and without imposing unnecessary onerous burdens on franchisors.[7] It is suggested that South Africa adopt a similar approach.

10.8 The common law of contract will continue to be inadequate in a modern business context to resolve franchise disputes

It is suggested that even if the common law did accord franchising a unique identity within the law with its own legal rules, such as partnership and agency, this would not resolve problems within the sector. In particular, the common law requires franchisors to disclose material information in order for franchisees to make informed decisions however, it does not specify what constitutes material information within a franchise context. In addition, certain relationship issues, such as termination of the contract must be regulated. Finally, an appropriate method of resolving disputes must be devised. The FASA provides a mediation service for its members but this has not proved to be successful. Franchisees are obliged to pursue their grievances through the normal civil courts. The majority of franchisees do not have the finances do to this and so aggrieved franchisees often simply abandon their franchises.

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6 For example, two identical franchise outlets could be established on opposite sides of a freeway. A rule that no identical outlet can be established within a one kilometre radius would then impede the development of this franchise network, and could prove to be extremely frustrating for consumers who cannot access the franchise when only one is established on one side of the freeway.

7 FTC *Federal Register* 30 March 2007 at 15491.

10.9 Legislation must be introduced to regulate the sector

South African law applicable to franchising will not be put on a satisfactory footing unless appropriate legislation is enacted. There are a variety of factors that support such enactment, including: the international nature of franchising;[8] the inability of the common law to provide workable solutions; and the fact that the present legal framework is out of step with international trends. Legislation to govern franchising could facilitate the expansion of this business model by ensuring that the relationship between the parties is fair, and by providing dispute resolution mechanisms that ensure the appropriate settlement of disputes. This is in line with government's desire to create jobs and encourage black economic empowerment through the development of small business opportunities.

10.10 Consumer Protection Legislation is an inappropriate means of regulating the sector

The DTI has recognised that there are significant problems within the sector and the department proposes to resolve these problems through the introduction of the Consumer Protection Bill. Although a considerable amount of research was conducted into problems in the consumer market, very little research appears to have been done in the franchise sector. The FASA was only consulted in 2007, when the Bill was reaching its final stages of drafting. The decision to make this Bill applicable to the franchise sector appears to have been made without proper planning and foresight and without a sufficient understanding of the sector. Research which has been conducted by organisations such as RMI, NADA, UNIDROIT[9] and the Franchise Steering Committee, has been ignored.

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8 Legislation exists in countries such as America, Australia, Canada, Malaysia, Italy and Spain.

9 Mendlesohn recommends that two publications produced by UNIDROIT are considered. The first is a *Guide to International Master Franchise Agreements* which was published in 1998 and which was "the end-product of hours of discussion between some of the world's most experienced franchise practitioners". The second is *A Model Franchise Disclosure Law with Explanatory Note*. Mendleshohn also discusses the "Health Warning" issued by UNIDROIT (discussed in Chapter 7). See Mendlesohn *Franchising Law* 414.

A thorough analysis of this Bill reveals certain shortcomings. First, the Bill is designed to deal with every day consumer contracts and not the far more complicated relationship between a franchisor and its franchisees. Second, the Bill only applies to the relationship at the time when the contract is concluded and it does not apply to the relationship issues which arise during the contract period. Franchisees will find this very difficult to accept and will expect the Consumer Commission or the Tribunal to intervene in relationship disputes. Third, the sections which deal with termination apply to everyday consumer contracts and are not applicable to franchising. This will cause confusion in the franchise sector as franchisees may expect the Tribunal to deal with termination disputes. Finally, the methods of dispute resolution set out in the Bill will not assist franchisees who are of the view that their contracts are unfair or that they have suffered damages. Only a court can decide on the question of fairness and only a court can award damages. Franchisees will therefore still have to pursue their grievances in the normal courts. In summary, the Bill fails to address central concerns in the sector.

10.11 The Bill proposed by The Franchise Steering Committee over-regulates franchising

The Franchise Steering Committee conducted an investigation into this sector in 2000. The result of the investigation was proposed legislation in the form of a Franchise Bill. For a period of time, the franchise sector was of the view that this legislation would be introduced but nothing further has been heard of this proposal. A detailed study of the Franchise Bill reveals that it is unsuitable for regulating the sector. First it establishes a Franchise Regulator which places the regulation of the franchise sector firmly within the control of the DTI. It is not the function of government to control business. Second, it has very stringent registration requirements for franchisors. Not only are franchisors required to register their various documents with the Regulator, these documents will be perused in order to see whether they are suitable. Franchisees are also expected to register with the Regulator as are those who promote franchising as a business model. To service these requirements will require skilled public officials with an extensive knowledge of different businesses. Third, franchisors, franchisees and

franchise promoters are required to renew their registrations every year. This will place an onerous burden on the Regulator. Finally unacceptable conduct on the part of franchisors, is criminalised. This means that complaints must be laid with the South African police services who will have to relied upon to investigate matters and forward them to the prosecution services for prosecution in the criminal courts. The Franchise Bill can be criticised on the basis that it over-regulates the sector.

10.12 There is a need for balance between the rights of franchisors and the rights of franchisees

Franchisees have always been at the forefront of demands for further and stronger regulation because of the economic power which rests in the hands of franchisors. Concerns about protecting franchisees could lead to over regulation as is seen in the FSC Franchise Bill. Some commentators argue that business thrives best when there is minimal state intervention. In 1992 the State of Iowa in America introduced legislation that regulated almost every aspect of the franchise relationship.[10] This led to numerous lawsuits and so it has been suggested that franchisors tend to abstain from investing in Iowa.[11] This is must be avoided in South Africa. Kursh points out that there is "no magic in franchising, no surefire formula for success".[12] There are numerous reasons why a franchisee will fail and these reasons are similar to those found in business failures generally. Kursh states: "People become disillusioned. They don't like working seven days a week. They don't like being 'needled' all the time to keep a place clean, promote and maintain quality, provide courteous service, or to keep proper hours of business. Often (failure) is the result of quarrelling among partners."[13]

It is necessary to balance the right of a business entity to protect its interests and the need to protect those in the industry (and those looking to enter the industry) from predatory or misleading business practices and unscrupulous conduct. Franchisors have an interest in quality control and a duty to protect the interests of the franchise

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10 Iowa Franchise Agreement Bill, IOWA CODE ANN § 523H1 (West 1993).
11 Byers 1994 *Journal of Corporation Law* 608.
12 Kursh *The Franchise Boom* 16.
13 Kursh *The Franchise Boom* 51.

network. They may even drive a "hard bargain" but they cannot overstep the mark by engaging in conduct that is unconscionable sometimes known as franchisor opportunism.[14] On the other hand, franchisees should not be able to rely on the legal system to sustain their business interests in circumstances where they are incompetent.[15] There is, therefore, a critical need to distinguish opportunistic behaviour from credible justifications that franchisors may provide for their conduct.

10.13 Franchise specific legislation must be adopted

Franchise-specific legislation must be developed to regulate and sector and it is suggested that the model adopted by the debt collecting industry be followed with certain modifications A Franchise Bill must make provision for the establishment of a Franchise Council. This Council must regulate the sector through a Code of Conduct. This approach will introduce a system of co-regulation. The Minister of Trade and Industry will play an oversight role in that he or she will appoint the Council but the Council will be responsible for enforcement of the Code. Franchisors will be obliged to register with the Council but this registration will be relatively simple and will not include the perusal of the documents submitted by franchisors. This will ensure that there is a legitimate franchise system in place without being over-regulatory. The onus will be on franchisees to examine these documents in order to ascertain whether the franchise suited their needs. Franchisors and franchisees will be required to pay an annual fee and these fees would fund the Council. This is similar to the self regulatory process in place at present. Franchisors and franchisees join the FASA as members and they are obliged to pay regular franchise fees. Instead of this being a voluntary process, it would become compulsory.

The suggested legislation, the code of conduct and the disclosure document, are set out in Chapter Nine. The following documents have been used to draft these documents:

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14 Baer et al "Lessons learned from three decades of Franchise Regulation and Litigation in the United States".

15 One of the main criticisms of opponents of extended franchise legislation in America to cover relationship issues is the fact that this legislation will make it very difficult to terminate relationships with unsatisfactory franchisees who are capable of damaging the whole network. See Greco 2001 *Southern Business Review* 7.

- The Debt Collectors Act;
- The Franchise Bill;
- The Australian Franchising Code of Conduct and Disclosure Document;
- The FASA Code; and
- The FTC Final Franchise Rule.

SILK SENSE DISTRIBUTOR AGREEMENT Annexure "A"

APPOINTMENT OF DISTRIBUTOR

AGREEMENT

made this (day, month and year) between

SILKSENSE CC

(a close corporation formed with the object of distributing flower arrangements made from silk flowers imported into South Africa by SILK by DESIGN CC. The members of SILK by DESIGN CC are also members of SILKSENSE CC. The registered office of SILKSENSE CC is at (address))

(hereinafter referred to as SILKSENSE)

and

(Name)
(address of distributor)
(hereinafter called the distributor)

INTRODUCTION

WHEREAS

1. SILK BY DESIGN CC imports silk flowers into South Africa and its members have established the business SILKSENSE in order to provide a regular source of silk flower arrangements to individuals and businesses;

2. SILKSENSE has developed a small business opportunity which involves establishing a network of distributors who will each build their own businesses

operating for their own account and who will enter into lease agreements with individuals and businesses for flower arrangements provided by SILKSENSE

3. SILKSENSE is the owner of certain intellectual property rights used in conjunction with this business opportunity;

4. The distributor desires to establish and operate the business of leasing these flower arrangements to individuals and businesses and for this purpose to use SILKSENSE'S business systems and intellectual property rights;

5. SILKSENSE hereby licenses such use subject to the terms and conditions of this agreement.

IT IS HEREBY AGREED as follows:

1. **Period**.

This agreement will come into force when the distributor makes payment to SILKSENSE in accordance with clause 2 and will terminate in accordance with the provisions of this agreement.

2. **Price**

Upon signature of this agreement the distributor will pay SILKSENSE R60 000. This payment is made up as follows:

R20 000 is payment for the rights granted in terms of this agreement and for the advice and assistance (including the operating manual) given to the distributor to enable the distributor to establish a successful business R40 000 is for stock (silk flower arrangements) which the distributor will order from the general stock offered by SILKSENSE. The number of arrangements will depend on the size of arrangements ordered by the distributor. The price of each arrangement will be in accordance with clause 4.5 below. Such order will constitute the distributor's opening stock

3. **Operational Area**

SILKSENSE hereby grants to the distributor the non-exclusive right during the continuance of this agreement to purchase silk flower arrangements for leasing to third parties in the following territory ( ).

4. **Duties of SILKSENSE**

SILKSENSE will, provided the full price as set out in clause 2 above has been made:

4.1 provide the distributor with an operations manual which will give guidance regarding the establishment of a successful business;

4.2 provide additional advice as required by the distributor and provided such advice is reasonably required for the establishment of a successful business. However, it is understood and agreed between the parties that this is not a franchise agreement and SILKSENSE will not dictate to the distributor (subject to this agreement) regarding the day to day operation of the business. Matters such as hours of work and contracts of lease concluded between the distributor and third parties will be in the discretion of the distributor

4.3 SILKSENSE will disclose improvements and developments in the business system to the distributor.

4.4 SILKSENSE will make available to the distributor all services and facilities which SILKSENSE makes available to other distributors. Where improvements and additions to the business system involve improvements and additions to the operation manual these will be disclosed to the distributor and will form part of the intellectual property, the use of which is licensed to the distributor in terms of this agreement.

4.5 SILKSENSE will allow the distributor a discount of 7.5% of the full trading price as shown in SILKSENSE'S price list, subject to the right of SILKSENSE to change the prices of its products without notice

4.6 SILKSENSE is not obliged to

4.5.1 intervene in any disputes which may arise between the distributor and the persons with whom the distributor has contracted. The

distributor is responsible for entering into contracts with individuals and businesses for the leasing of silk flower arrangements and for ensuring that the terms of such contracts are performed timeously.

4.5.2 have stock of particular items. Distributors must chose stock as available from time to time

5. **Duties of the distributor**

5.1 While this agreement is in force the distributor will not engage directly or indirectly in any capacity in any other business venture which is in the nature of SILKSENSE'S business without SILKSENSE'S written permission;

5.2 The distributor will have regard to the suggested price list as published by SILKSENSE from time to time when setting her own prices for flower arrangements;

5.3 The distributor will at all times keep her arrangements clean and in good condition;

5.4 The distributor will lease the flower arrangements in the same condition as they are received by her and will not alter, remove or in any way tamper with any of SILKSENSE'S trademarks, except that the distributor will have the right to attach to the flower arrangement a plate, label or other device bearing her name and address indicating that she is the supplier of the flower arrangements and is an authorised distributor of SILKSENSE;

5.5 The distributor may remove damaged flowers but must replace them with products sourced from SILKSENSE or from SILK by DESIGN

5.6 The distributor will display on her card and other stationary "An authorised SILKSENSE distributor";

5.7 The distributor will continue to expand her client base and will purchase flower arrangements for the purpose of leasing them to her clients. It is expected that the distributor will repeat her initial orders (in terms of number of units) after one year and again every year thereafter. Should the distributor fail to expand her client base SILKSENSE reserves the

right to appoint further distributors in the territory set out in clause 3.

5.8 The distributor will pay for all flower arrangements ordered and accepted by her on delivery. Orders will be placed and delivery made at SILKSENSE'S address or to such other address as may be subsequently notified by SILKSENSE.

5.9 The distributor will at all times maintain a professional relationship with the members of SILKSENSE and SILK by DESIGN and other distributors and in particular will not engage in conduct which may constitute unlawful competition.

5.10 The distributor will indemnify SILKSENSE and keep it indemnified against all claims of whatever nature, whether real or imagined, criminal or civil, together with any legal fees and costs incurred by SILKSENSE out of the establishment and operation of the distributor's business.

5.11 The distributor acknowledges that she does not have any prior knowledge of the business system or any aspect of the know-how or the trade secrets. The distributor will not divulge to any person any aspect of the business system, the know-how or the trade secrets otherwise than for the purposes of this agreement.

5.12 The distributor will not do anything which may adversely affect the intellectual property rights belonging to SILKSENSE. In particular the distributor may not pass off products sourced from other suppliers as flowers from SILKSENSE or SILK by DESIGN and may not use (otherwise than set out in this agreement) any of the trade marks belonging to SILKSENSE or SILK BY DESIGN without their written authority.

6 Operating manual

All provisions of the operating manual, any new edition of the operating manual and any amendments to or revisions of the operating manual form part of this agreement save that in the event of any conflict between the terms of this agreement and a provision in the operating manual, the provisions of this agreement will prevail. The distributor will not make any copies of the operating

manual without SILKSENSE'S prior written consent and upon termination of this agreement will return all copies of the operating manual to SILKSENSE.

7. Relationship between the parties

It is understood and agreed between the parties hereto that the agreement will not be construed as constituting the distributor as an agent of SILKSENSE for any purpose whatsoever. The distributor will be entitled to describe herself as an authorised dealer or distributor of SILKSENSE'S products but will not describe herself as an agent for SILKSENSE or in any words indicating any relationship of agency existing between the parties.

8. No cession, assignment or lease

The rights and obligations of the distributor are personal and may not be ceded, assigned, let or otherwise disposed of in any manner whatsoever without the prior written permission of SILKSENSE. In particular the distributor may not sell her business without the prior written permission of SILKSENSE. SILKSENSE agrees not to withhold its consent unreasonably.

9. Acknowledgement by the distributor

The distributor acknowledges that the success of her business venture in terms of this agreement depends to a large extent on her own business ability. The distributor acknowledges she has entered into this agreement after making an independent investigation and that SILKSENSE has made no warranty, express or implied, as to the potential success of the business.

10. Termination of this agreement

10.1 Either party shall have the right to terminate this agreement by giving ? months notice in writing to the other.

10.2 SILKSENSE shall have the right at any time by giving notice in writing to the distributor to terminate this agreement forthwith in any of the following events:

10.2.1 **on breach**. If the distributor commits any breach of any terms of

this agreement all of which are declared to be material and failing to remedy the breach within 14 (fourteen) days of written notice by SILKSENSE calling upon the distributor to remedy the breach complained of;

10.2.2 **on insolvency etc.** If the estate of the distributor is sequestrated or if she enters into any arrangement with her creditors or takes or suffers any similar action in consequences of debt.

10.3 In the event of SILK by DESIGN CC ceasing to carry on business as importers of silk flowers SILKSENSE may at any time terminate this agreement by giving ? months notice in writing to the distributor.

11. General

11.1 No waiver by a party of any breach, failure or default in performance by the other party, and no failure, refusal or neglect by a party to exercise any right hereunder or to insist upon strict compliance with or performance of the other party's obligations under this agreement, shall constitute a waiver of the provisions of this agreement and a party may at any time require strict compliance with the terms of this agreement.

11.2 This agreement constitutes the entire agreement between the parties who acknowledge that there are no other oral or written undertakings or agreements between them relating to the subject matter of this agreement. No amendment or other modification of this agreement shall be valid or binding on a party hereto unless reduced to writing of executed by both parties hereto.

11.3 All the provisions of this agreement shall be severable and no provisions shall be affected by the invalidity of any other provision of this agreement.

SIGNED at on this day of

_____

Distributor

_____

For and on behalf of
SILKSENSE

Witnesses:

1.

2.

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