

Stretching the truth in stretching times

The franchisor's over-optimistic projections and a franchisee's rose-tinted glasses are a dangerous combination

Patrick Casey



That franchises do well in a recession is a widely prevalent perception. This is down to a number of factors including the lure of self-employment in an uncertain employment market and the security that comes from the support of an established franchise system. Like any business, however, a recession brings its share of challenges.

To get franchisees in the door, franchisors provide financial information to prospective franchisees concerning projected turnover. This can lead to conflict if actual turnover falls short of the projected turnover. In a recession, there may be a temptation for franchisors on the one hand to stretch the truth and for prospective franchisees on the other to look through rose-tinted glasses at the possible cashflow a franchise business may generate. This dangerous combination may also lead to increased calls for regulation of the franchise industry – something which has escalated since the Green Acres fraud controversy blew up in January 2008.

So what can franchisors do to minimise their risk in these challenging times? Providing franchisees with some form of financial projection for a franchise business will generally be unavoidable but there are some important principles for franchisors to consider in doing so. In particular:

- all estimates of projected turnover must have a reasonable basis. There is no textbook approach to follow and the methodology used should be tailored to the franchise operation in question. Familiarisation with

the local market for the franchise operation and the local economy will inevitably be relevant considerations;

- the basis upon which the financial projections have been made should be disclosed in writing and franchisees should be encouraged to undertake their own analysis of the projections in conjunction with an accountant;

- prospective franchisees should be informed in writing that any financial projections are estimates only and are not guarantees of future income. This approach is reflected in the disclosure document information set out in the Franchise Association of New Zealand's ("FANZ's") code of practice;

- franchise agreements will often include exclusion clauses that seek to protect franchisors from liability in respect of representations made before the franchise agreement is entered into. These exclusion clauses are not a panacea but can be effective in protecting a franchisor from allegations of misrepresentation provided they are tailored for each franchise and agreed in a manner which involves genuine interaction with a franchisee. This means that an exclusion clause should not be hidden as a bland statement in the back of a lengthy franchise agreement so it is read with glazed eyes. The focus must be on full and frank disclosure to franchisees.

And in light of the pressures that may be created by a recession, would calls for increased regulation of the franchise industry be justified? I think not.

While prevention through adherence to the above principles will

always be better than cure, our legal system is already well equipped to deal with those franchisors who choose to stretch the truth in their financial disclosure to franchisees. In particular, despite calls for an enhanced dispute resolution process for franchisors and franchisees, our experience of cases that have dealt with projected turnover disputes in the last decade is that franchisees can (and will continue to) find recourse against rogue franchisors through the New Zealand court system.

The call by some for mandatory information disclosure by franchisors (including disclosure of financial projections) will also not in itself prevent projected turnover disputes arising between franchisors and franchisees. While the disclosure requirements in the FANZ disclosure document, if carefully used, will often provide the franchisor with even more protection against claims of misrepresentation, mandatory information disclosure does not deal with the underlying issue of what information is provided and whether it is accurate.

Whatever approach New Zealand may take to the issue of franchise regulation, disputes between franchisors and franchisees relating to projected franchise turnover will continue.

A simple warning therefore for franchisors – when you stretch the truth, watch out for the snaphack!

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