



Re-evaluating franchise agreements and disclosure practices under the Consumer Protection Act

By Lize Louw, Director, Werksmans Attorneys

LEGAL BRIEF | MAY 2011

Don't be left in the dark following the introduction of the Consumer Protection Act.

Traditionally, South African franchise arrangements have not been subject to specific regulation. The old legal framework used to regulate franchise matters consisted of the common-law principles of the law of contract, supplemented by self-regulation, the Franchise Code of Ethics and Business Practices and certain statutes such as the Competition Act, 1998.

From 31 March 2011, the Consumer Protection Act, 2008 (CPA) and its regulations substantially changed the manner in which South African law regulates franchise arrangements. The legislation devotes several pages to the rights and duties of franchisors and franchisees, the prescribed content for franchise agreements, and the inclusion of international best practice standards which require proper disclosure to franchisees.

In summary, the law for this purpose has changed in four material ways:

- ▶ the CPA has introduced a couple of new formalities for all franchise agreements, including that they must be in writing, written in plain and understandable language, and signed by the franchisee;
- ▶ the CPA has also introduced a cooling-off period, i.e. the right of every franchisee

to cancel a franchise agreement without cost or penalty within 10 business days after signing the agreement, by giving written notice to the franchisor. Every franchise agreement must now contain the exact text of this cooling-off provision (i.e. the text of section 7(2) of the CPA) at the top of the first page of the franchise agreement, together with a reference of the section and the CPA;

- ▶ the CPA regulations contain a number of clauses which must be contained in each franchise agreement, as well as providing for terms and conditions that will be void if they continue to be used in franchise agreements; and
- ▶ the CPA regulations also list the kind of information which must be disclosed to each prospective franchisee (in the form of a "disclosure document") at least 14 days before the franchisee signs any franchise agreement.

As a result of these changes, it is advisable for clients to review their existing franchise agreements and disclosure documents as soon as possible, and to ensure that all franchise arrangements put in place after 31 March 2011 comply with the CPA.

Whereas the draft regulations included a 6 month period within which existing franchise agreements could be amended to comply with the CPA, draft regulation 2(2)(f) has not been included in the final version of the regulations. Accordingly the process of reviewing and redrafting franchise agreements and disclosure documents for compliance with the CPA should be undertaken without delay.

Application of the CPA to franchise arrangements

When considering existing and future franchise arrangements it should be borne in mind that, because of the express provisions of section 5(7) of the CPA, the general exemption in section 5(2)(b) (in terms of which the CPA does not apply to juristic persons whose asset value or annual turnover equals or exceeds the threshold value of ZAR2 000 000) does not apply to franchise arrangements. This means that the CPA will apply to all franchise arrangements, regardless of the size of the franchisee.

Also, the definition of a "franchise agreement" for purposes of the CPA is rather broad. It covers the traditional business concept of a franchise arrangement, but may also cover similar arrangements such as licensing and distribution arrangements.

This definition may prove to be difficult to apply in practice. For instance, a "franchise agreement" means an agreement between a franchisor and a franchisee which, among other things, provides for "consideration paid or to be paid" by the franchisee to the franchisor. The CPA however defines "consideration" to include "anything of value given and accepted in exchange for goods or services". Does this mean in the context of distribution agreements for instance that an agreement will only constitute a "franchise agreement" if the agreement actually envisages payment, rather than other forms of consideration?

The content of franchise agreements

Regulation 2(2) contains four categories of clauses which must now be included in each franchise agreement:

- ▶ provisions which prevent unreasonable or overvaluation of fees, prices or any other direct or indirect consideration;
- ▶ provisions which prevent conduct which is unnecessary or unreasonable in relation to the risks to be incurred by one party;
- ▶ provisions which prevent conduct that is not reasonably necessary for the protection of the legitimate business interests of the franchisor, franchisee or franchise system; and
- ▶ clauses informing a franchisor that it is not entitled to any undisclosed direct or indirect benefit or compensation from suppliers to its franchisees or the franchisee

system, unless this fact is disclosed in writing with an explanation of how it will be applied.

Regulation 2(2)(d) provides that certain sections of the CPA apply to pre-existing franchise agreements. These include certain parts of section 14 for instance, which regulates the circumstances in which franchisees who are individuals (i.e. not juristic persons such as companies) may cancel fixed term agreements. Regulation 2(2)(e) also provides that any provision in a franchise agreement to which these regulations apply, which is in conflict with Regulation 2, is void to the extent of such conflict. In our view this means that existing franchise agreements (i.e. agreements concluded before 31 March 2011) should also be reviewed to check whether they contain any provisions which would be void as a result.

Regulation 2(3) contains the specific minimum content for each franchise agreement. The discussion that follows does not contain a full list of the requirements, but highlights those which we believe best illustrate the new legislative approach.

Firstly, Regulation 2(3) emphasises the financial aspects of the franchise arrangement, so that each franchise agreement must now also contain the following provisions:

- ▶ clauses informing the franchisee of the direct or indirect consideration payable by the franchisee to the franchisor;
- ▶ confirmation that any deposits paid by the prospective franchisee will be deposited into a separate bank account and a description of how these deposits will be dealt with;
- ▶ rather a lot of detail if the franchise agreement provides that a franchisee must contribute to an advertising, marketing or other similar fund, including clauses informing the franchisee:
 - ▶ of the amount, or if expressed as a percentage, the method of calculation of such contribution;
 - ▶ that moneys in the fund may not be spent on advertising and marketing of the franchisor's franchises for sale;
 - ▶ of any contribution to such a fund will be deposited in a separate bank account and used only for purposes of the fund;
 - ▶ of the franchisor's contribution to such fund, if any; and
 - ▶ of the fact that the franchisor and any franchisor associated franchised businesses do not enjoy any direct or indirect benefit not afforded to independent franchisees; and
- ▶ full particulars of the financial obligations of the franchisee in terms of the franchise agreement or otherwise related to the franchised business, including:
 - ▶ the initial fee payable to the franchisor on the signing of the

- franchise agreement, including the purpose for which it is to be applied;
- ▶ the funds required to establish the franchised business including, purchase or lease of property, site conversion costs, decor and signage, equipment, furniture, hiring and training of staff, opening stock, legal and financial charges, as may be applicable;
- ▶ the initial working capital, where possible, and the basis on which it is calculated;
- ▶ the amount of funding that is available from the franchisor, if any, and the applicable conditions;
- ▶ the total amount that the franchisee must contribute towards the necessary funding before borrowing; and
- ▶ ongoing amounts payable to the franchisor, with details as to:
 - (i) whether the amounts are fixed or variable;
 - (ii) whether all or part of the amounts are included in the price of goods or services that must be purchased from the franchisor or other preferred suppliers;
 - (iii) the dates, or intervals, at which the amounts fall due; and
 - (iv) if any fee is payable in respect of management services provided by the franchisor, details of such services.

Secondly, the CPA regulations prescribe specific content which one would ordinarily expect to find in franchise agreements, but the law now seems to require more detail than is currently the commercial norm. Under this heading for instance, each franchise agreement must as a minimum contain:

- ▶ the name and description of the types of goods or services which the franchisee is entitled to provide, produce, render or sell;
- ▶ the respective obligations of the franchisor and the franchisee;
- ▶ a description of the applicable franchise business system;
- ▶ the territorial rights, if any, granted to the franchisee in detail;
- ▶ a description of the site or premises and location from which the franchisee is to conduct the franchise (and the nature and extent of the franchisor's involvement or approval in the process of site selection if applicable);
- ▶ a description of the trade marks and any other intellectual property owned by the franchisor, or otherwise licensed to the franchisor which is, or will be used in the franchise, and the conditions under which they may be used;
- ▶ particulars of the initial training and assistance provided by the franchisor and, where the franchisor provides ongoing training for the duration of the

franchise agreement, a statement that the particulars of such training and assistance will be provided to the franchisee as and when necessary;

- ▶ the duration and the terms of the renewal of the franchise agreement, provided that such terms and conditions are not inconsistent with the purpose and policy of the CPA; and
- ▶ full details of the franchisor and its directors (there are some exceptions for listed franchisors).

Third, the CPA regulations contain a few unexpected provisions, where it is currently unclear what the legislature intended and what the content of the clauses in question should be. For example, each franchise agreement must now contain "the conditions under which the franchisee or his, her or its estate may transfer or assign the rights and obligations under the franchise" (regulation 2(3)(h)).

General provisions of the CPA which may also regulate the content of franchise agreements

When preparing CPA-compliant franchise agreements, it should be borne in mind that franchisees qualify as "consumers" for purposes of the CPA so that many of the non-franchise specific provisions of the CPA may apply.

For instance, where franchisees buy goods from particular suppliers as part of the franchise system:

- ▶ every franchisee has the right in terms of sections 55 and 56 of the CPA to receive goods that:
 - (i) are reasonably suitable for the purposes for which they are generally intended;
 - (ii) are of good quality, in good working order and free of any defects (for purposes of the CPA, it is irrelevant whether a product failure or defect was latent or patent, or whether it could have been detected by a consumer before taking delivery of the goods);
 - (iii) will be useable and durable for a reasonable period of time, having regard to the use to which they would normally be put and to all the surrounding circumstances of their supply; and
 - (iv) comply with any applicable standards set under the Standards Act, 1993 or any other public regulation.
- ▶ Section 55(3) of the CPA goes on to provide that, if a consumer has specifically informed the supplier of the particular purpose for which the consumer wishes to acquire any goods, or the use to which the consumer intends to apply those goods, and the supplier:
 - (i) ordinarily offers to supply such goods;
 - or

(ii) acts in a manner consistent with being knowledgeable about the use of those goods, the consumer has a right to expect that the goods are reasonably suitable for the specific purpose that the consumer has indicated.

- ▶ In terms of section 56(1) of the CPA, each franchise agreement will include a provision implied by law to the effect that the franchisor warrants that the products it supplies comply with these requirements and standards (except to the extent that the products have been altered contrary to the franchisor's instructions, or after passing beyond the franchisor's control). These implied warranties cannot be contractually excluded.
- ▶ In terms of section 61 of the CPA, each franchisor, as the distributor of the products, is liable for:
 - (i) the death of, or injury to, or illness of any natural person, and any economic loss that results from such harm, and
 - (ii) any loss of, or physical damage to any property, irrespective of whether it is movable or immovable, and any economic loss that results from such harm,caused wholly or partly as a consequence of supplying any unsafe goods, a product failure, defect or hazard in any goods, or inadequate instructions or warnings provided to the consumer pertaining to any hazard arising from or associated with the use of any goods, irrespective of whether the harm resulted from any negligence on the part of franchisor.

These implied warranties of quality and strict liability for goods that the CPA will introduce may materially restrict the franchisor's ability to limit its liability under franchise agreements.

Disclosure documents for prospective franchisees

The aim of the disclosure document which franchisors are now expected to prepare appears to be predominantly concerned with the financial health of the franchise business as a whole.

This document must contain the following information:

- ▶ the number of individual outlets franchised by the franchisor;
- ▶ the growth of the franchisor's turnover, net profit and the number of individual outlets, if any, franchised by the franchisor for the financial year prior to the date on which the prospective franchisee receives a copy of the disclosure document;
- ▶ a statement confirming that there have been no significant or material changes in the franchisor's financial position since the date of the last auditor's certificate or certificate by a similar reviewer of the franchisor, that the franchisor has reasonable grounds to believe that it will

be able to pay its debts as and when they fall due; and

- ▶ written projections in respect of levels of potential sales, income, gross or net profits or other financial projections for the franchised business or franchises of a similar nature with particulars of the assumptions upon which these representations are made.
- Each franchisor is now also expected to prepare at least three documents which must accompany the disclosure document, including:
- ▶ a certificate from the franchisor's auditors or accounting officer certifying that:
 - (i) the business of the franchisor is a going concern;
 - (ii) to the best of his or her knowledge the franchisor is able to meet its current and contingent liabilities;
 - (iii) the franchisor is capable of meeting all of its financial commitments in the ordinary course of business as they fall due; and
 - (iv) the franchisor's audited annual financial statements for the most recently expired financial year have been drawn up in accordance with South African generally accepted accounting standards, on the basis of accounting policies consistent with prior years, in accordance with the provisions of the Companies Act and all other applicable laws, and fairly reflect the financial position, affairs, operations and results of the franchisor as at that date and for the period to which they relate;
 - ▶ a list of current franchisees, if any, and of outlets owned by the franchisor, stating the specific contact details of these franchisees (e.g. physical address, email and telephone numbers), together with a clear statement that the prospective franchisee is entitled to contact any of the franchisees listed, or alternatively to visit any outlets operated by a current franchisee to assess the information disclosed by the franchisor and the franchise opportunity offered by it; and
 - ▶ an organogram depicting the support system in place for franchisees.

Conclusion

The CPA has fundamentally changed the regulatory framework which applies to franchise arrangements in South Africa. As a result, all clients who may be affected by these changes should take steps as soon as possible to ensure that their franchise agreements and disclosure documents are brought in line with all related requirements.

About the Author



Lize Louw

Title: Director
Office: Johannesburg
Direct line: +27 (0)11 535 8325
Fax: +27 (0)11 535 8625
Switchboard: +27 (0)11 535 8000
Email: llouw@werksmans.com

Lize Louw is a director at Werksmans Attorneys and is currently a member of the firm's Banking and Finance Practice. She is a banking and finance / mergers and acquisitions specialist with a broad spectrum of experience in negotiating and drafting finance, banking and commercial transactions. Her expertise extends to banking and financial services regulation, corporate finance and structuring, debt capital markets, exchange control, project and limited recourse finance, securitisation and private equity. She also advises on black economic empowerment transactions and undertakes due diligence investigations on behalf of clients which include some of the major financial institutions in South Africa and abroad. In addition to a BA LLB from the University of Cape Town, Lize has a LLM degree from Montpellier in France.

Keep us close

THE CORPORATE & COMMERCIAL LAW FIRM

JOHANNESBURG +27 (0)11 535 8000 CAPE TOWN +27 (0)21 405 5100
www.werksmans.com

About Werksmans Attorneys

Established in the early 1900s, Werksmans Attorneys is a leading South African corporate and commercial law firm serving multinationals, listed companies, financial institutions, entrepreneurs and government.

Operating in Gauteng and the Western Cape, and connected to an extensive African network through Lex Africa*, the firm's reputation is built on the combined experience of Werksmans and Jan S. de Villiers, which merged in 2009.

With a formidable track record in mergers and acquisitions, banking and finance, and commercial litigation and dispute resolution, the firm is distinguished by the people, clients and work that it attracts and retains.

Werksmans' more than 170 lawyers are a powerful team of independent-minded individuals who share a common service ethos. The firm's success is built on a solid foundation of insightful and innovative deal structuring and legal advice; a keen ability to understand business and economic imperatives; and a strong focus on achieving the best legal outcome for clients.

* In 1993, Werksmans co-founded the Lex Africa legal network, which now has member firms in 30 African countries.

Nothing in this publication should be construed as legal advice from any lawyer or this firm. Werksmans' legal briefs should be seen as general summaries of developments or principles of interest that may not apply directly to specific circumstances. Professional advice should therefore be sought before any action is taken.

 PROUD MEMBER OF
LEXAFRICA