Recent Court of Appeal decision bolsters protection available for Franchisors

The Court of Appeal of New Zealand last year in the case of David v TFAC Limited questioned the reasonableness of a party relying on alleged misrepresentations or false and misleading conduct under The Fair Trading Act prior to entering into a commercial contract. The case was of considerable importance to the franchise sector. The context was a commercial transaction involving substantially independently advised parties and a franchise agreement that included liability disclaimer clauses. Examples of such clauses include clauses that state that the parties entered into the transaction on the basis of their own judgement and not on the basis of anything said or done by the other. Another clause is an “entire agreement” clause which effectively means the contract purports to contain the totality of representations and understandings between the parties.

The Court of Appeal in the David case commented as an aside to the main issue of the case (the Court found that no misrepresentations were actually made by the franchisor) that in such circumstances it was unreasonable for the party alleging misrepresentation to simply rely on those pre-contractual representations rather than the independent advice they received at the time of entering the contract which included having the terms of the agreement explained to them.

The Court of Appeal has now in a recent case, affirmed the position set out in David’s case. This is likely to bolster further the available protection to franchisors who have well drafted agreements and good procedural processes and systems in place which manage the liability risk leading up to execution of an agreement. The case is PAE (New Zealand) Limited v Brosnahan & Others. It did not involve a franchise agreement which makes it distinctive from the earlier David case but it quotes from it and applies the principles of the David case.

The contract involved the acquisition of shares by PAE from the shareholders of a maintenance company called Central Property Services Ltd. Execution of the agreement followed a process of negotiation with each party being familiar with commercial transactions and being independently legally advised. The trial Judge found that there was no particular imbalance of power between the parties.
In the intervening period of negotiation prior to contracting, the sellers of the shares to PAE are alleged to have made misrepresentations about Central Properties turnover and profitability. They also supplied financial accounts for the company which were later found to contain several errors. PAE alleged that it relied upon the misrepresentations made by the vendors in deciding to enter the agreement and claimed consequential losses of $964,000.00 representing the difference between the contracted purchase price and the true value of the share.

The share purchase agreement was actually drafted by the purchaser’s lawyer and included an “entire agreement” clause which purported to exclude all prior agreements, representations and understandings between the parties. Such clauses are often found in commercial contracts including franchise agreements. “Entire agreement” clauses are not considered absolute or conclusive in protecting a party from liability. The courts have a wide discretion under the Contractual Remedies Act to determine if it is fair and reasonable that the “entire agreement” provision included in the agreement should be regarded as conclusive between the parties.

The Court of Appeal decided that based on the evidence presented at the trial, the purchaser of the shares had every opportunity to make enquiries and safeguard itself against adverse consequences of any misrepresentations. Indeed the purchaser could have included additional warranties in the agreement to protect itself. This commentator notes in passing that in a negotiated franchise agreement such an opportunity to include additional warranties is not always available to prospective franchisee. The parties also had full access to independent legal and financial advice. The Court accepted that it would not be fair and reasonable to allow PAE in the circumstances to circumvent the effect of the exclusion clause. It quoted with approval from the judgement of a previous case (Brownlie v Shotover Mining Limited) where the Judge stated:

“There can be nothing inherently unfair in such an exclusionary clause. It is highly desirable that written contracts should be so drawn as to state all the terms of the intended contract, and so avoid the uncertainties which can arise from allegations of verbal representations or collateral warranties. If parties had not agreed to include express warranties in their written contract, then it is reasonable for them to state expressly that verbal warranties are excluded.”

The Court of Appeal in PAE’s case also dealt with a claim under Section 9 of The Fair Trading Act alleging misleading and deceptive conduct on the part of the sellers
of the shares. This is particularly significant in the context of the earlier David case. It was accepted as good law that it is not possible to contract out of liability under The Fair Trading Act. However in reviewing the evidence presented at the trial, the Court of Appeal accepted that a reasonable purchaser, especially one experienced in commercial matters, should have made appropriate enquiries when contemplating an acquisition of this nature. It was fair and reasonable to hold the parties to the terms of the agreement they signed and the effect of the exclusion clause it included. It was not reasonable to rely on the pre-contractual misrepresentations in the circumstances.

The Court quite specifically considered the consumer protection objective of The Fair Trading Act and the impact of an exclusion clause which purports to exclude that effect. The earlier comments of the Court of Appeal in David's case were referred to and approved. The Court stated in its judgment:

"The parties were agreeing, in unequivocal terms at PAE's instigation, that what the directors had said and done before the agreement no longer mattered. Effectively, they drew down the curtain of liability, excluding from it all preceding conduct. By this means, they also broke the chain of causation.

The Court concluded that there was nothing in the agreement (including the disclaimer clause), which, in its commercial context, was contrary to public policy or contrary to the underlying purpose of The Fair Trading Act.

This PAE decision appears to strengthen the position of franchisors who seek to minimise their liability exposure for pre-contractual representation by including disclaimer clauses in their franchise agreements. It also reinforces the impact of the David case. However, it is this commentator's view that each transaction will still need to be very carefully evaluated in the context of its particular circumstances. This means having regard to the bargaining strength of each of the parties at the time of contracting, their familiarity with commercial transactions, the processes and systems applying as part of the process of negotiation leading up to a formal contract, the degree of independent legal (and financial) advice available to the prospective franchisee, and the degree of reliance on pre-contractual misrepresentation that may exist in particular circumstances. Franchisees can sometimes be commercially unsophisticated and quite vulnerable people.
Prudent franchisor’s should for their part carefully review the disclaimer clauses in their draft agreements and the associated processes and systems leading to execution of franchise agreements. Franchisees for their part need to be acutely aware of the importance of obtaining independent professional advice from experienced franchise advisers and carrying out a thorough due diligence before entering into a serious commercial transaction of the nature of a franchise arrangement.

D S Munn
Partner – Gaze Burt, Lawyers