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Franchise agreement ruling - a principle established and an opportunity missed

By Ian Jacobsberg

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On 3 July 2023, the High Court of South Africa, Gauteng Division, sitting in Pretoria, handed down judgment in the case of *Christina Johanna Steynberg v Tammy Taylor Nails Franchising No. 45 (Pty) Ltd*.

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The judgment had been widely anticipated amongst the franchising community and especially legal practitioners active in the field of franchise law. This was because it was the first case to be decided by the High Court in which it was argued that a franchise agreement was invalid on account of failing to comply with the formal requirements of the Consumer Protection Act (CPA) and especially the regulations promulgated under it.

CPA regulations

The CPA and the regulations came into effect in April 2011. It was an innovative piece of legislation in that it was the first in South Africa to regulate franchising specifically.

The regulations oblige franchisors to provide prospective franchisees with detailed information relating to the financial and other obligations they will be incurring, as well as information relating to the franchise law itself, its executives, financial status and trading record.

These requirements were imposed because, historically, numerous franchisees had seen their businesses fail, and lost vast amounts of money, as a result of entering into franchise agreements “on trust”, accepting the franchisor’s sales pitch at face value and finding out later that the required investment had been vastly understated, or the earning potential of the business overstated, or both.

Non-compliance

Since then, despite it being repeatedly alleged and argued by aggrieved franchisees that their agreements were invalid for non-compliance with the requirements of the CPA and regulations, neither the courts nor the National Consumer Tribunal (the body entrusted with adjudicating disputes arising under the CPA) has pronounced on whether a franchise agreement that does not technically comply with the CPA or regulations is automatically invalid.

One can only speculate as to the reasons for this; I would suggest that, generally, because of the disparity in financial muscle between franchisees and franchisors, most franchisees are reluctant to engage in litigation against franchisors and are forced to accept a disadvantageous settlement to salvage something out of a franchise business that is failing.

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The *Steynberg* case represented an opportunity to pronounce on this issue, which has been the subject of some debate, especially amongst lawyers serving the franchise community.

In her application to court, the franchisee relied on “extensive" grounds of alleged non-compliance, according to Kuny J, who, in June 2022, heard and ruled on a preliminary point, relating to the jurisdiction of the court to hear the matter.

From Kuny J’s judgment, it appears that amongst the regulations the franchisee alleged had not been complied with, were –

- Regulation 2(1) provides: “This regulation must be read together with sections 7 and 120 (1)(e)(ii) of the Act". In purporting to quote regulation 2(1), Kuny J in fact quotes regulation 2(2), which requires every franchise agreement to contain the exact text of section 7(2) of the CPA at the top of the first page. Section 7(2), in turn, provides that the franchisee may cancel a franchise agreement “without cost or penalty" within 10 business days of having signed it;

- Regulation 3 (1) which, in summary, provides that a franchisor must, within 14 days before a franchise agreement is signed, provide a prospective franchisee with a disclosure document, containing details of the franchisor's business, including the number of outlets franchised by it, its turnover and net profit and financial projections in respect of the franchised business the franchisee proposes to run, or businesses similar to it;

- Regulation 3 (3), which requires the franchisor to provide written confirmation of its financial soundness from a person qualified to act as the accounting officer of a close corporation or auditor of a company;

- Regulation 3 (4), which requires the franchisor to provide contact details of its existing franchisees, to enable the prospective franchisee to contact them, with a view to assessing the franchise opportunity, based on their

experiences.

In the result, however, the judgment of the court, handed down by Meintjies J, did not pronounce on whether the franchisor's failure to comply with those regulations affected the validity of the agreement. The learned judge found (correctly) that it was not necessary to do so but, for stakeholders in the industry, this was perhaps an opportunity missed to have some clarity on a longstanding and vital debate.

Not signed and sealed

Instead, the decision turned on another point, arising from section 7(1)(a) of the CPA. Section 7(1)(a) provides that a franchise agreement "must be in writing and signed by or on behalf of the franchisee."

The franchisor had inserted a clause in the franchise agreement reading: "[The franchisee's] signature on behalf of your entity and signature on behalf of the franchisor of this agreement will constitute a binding agreement".

A few weeks after signing the agreement, the franchisee sought to cancel it on the grounds that, in the words of Meintjies J, "it became apparent to her that the [franchisor] had not been open and honest regarding the actual costs relating to the purchase and establishment of the franchise".

When the franchisor produced a copy of the franchise agreement, it turned out that the franchisor had not signed it. The court held, on the strength of the clause quoted above, that the franchisor intended that a binding agreement would only come into effect when it had been signed by both parties.

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The court held that, notwithstanding that section 7(1)(a) of the CPA provided that the signature of the franchisee alone would suffice for a franchise agreement to become effective, it was open to the parties to agree on additional formalities and, therefore, the clause requiring the franchisor's signature had the effect that the agreement would not become effective unless and until the franchisor had signed it.

The court held that, because the franchisor has not signed the agreement, it was invalid and the franchisee was entitled to receive back the franchise fee that she had paid.

The irony

This decision has an ironic twist to it; section 7(1)(a) was enacted for the protection of franchisees as it has often happened that franchise laws, after obtaining the franchisee's signature on an agreement, retain it but do not sign it.

At a later stage, even after the franchisee had been carrying on business for a year or two as if the agreement was in effect, and the relationship had broken down, the franchisor, instead of relying on a breach by the franchisee to cancel the agreement (which the franchisee may dispute), relied on the fact that, because it had never signed the agreement was in fact invalid.

By enacting section 7(1)(a), the legislature sought to prevent the franchisor, which inevitably was the drafter of the agreement and the party responsible for ensuring that all the formalities were carried out, from taking advantage of its own deliberate or negligent omission.

The judgment is undoubtedly, technically correct in law. However, it would have been interesting to see what attitude would

have been taken by the court had the situation in fact been as described above, and it was the franchisor relying on its non-signature to invalidate the agreement. Would the court have put the formal requirements of the agreement, imposed by the franchisor, above the intention of the legislature to protect the franchisee?

ABOUT THE AUTHOR

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