



CORPORATE AND COMMERCIAL ALERT

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THE FRANCHISE INDUSTRY CODE

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BEWARE OF EXCLUDING LIABILITY FOR CONSEQUENTIAL DAMAGES IN CONFIDENTIALITY AGREEMENTS

Confidentiality or non-disclosure agreements (NDAs) may limit or exclude the parties' liability for damages in certain circumstances. Clauses such as "in no event shall either party be responsible to the other for indirect, special or consequential losses" are commonplace and are often accepted during contract negotiations, sometimes only subject to them being reciprocal. A clause such as the one above may appear to be standard and to the benefit of both contracting parties, but in the context of a NDA, this clause can have severe consequences for the business owner disclosing confidential information.

THE FRANCHISE INDUSTRY CODE

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The Ombud is empowered to consider and determine disputes between franchisees and franchisors in an informal and expedient manner.



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The Ombud is intended to facilitate the efficient and cost-effective resolution of disputes arising in the franchise industry in South Africa, and which concern the rights and obligations set out in the Consumer Protection Act, No 68 of 2008 (CPA). The clear purpose of the Code is to provide a means for parties in a franchise relationship to resolve disputes without the need for costly High Court litigation or private arbitrations.

The Code and Ombud

In terms of s82(2) of the CPA the Minister of the Department of Trade and Industry may prescribe an industry code regulating the interaction between or among persons conducting business within an industry, or between an industry and consumers. To date, only two industries have issued codes of conduct in terms of this provision. The first is the automotive industry (South African Automotive Industry Code of Conduct) and the second is the goods and services industry (Goods and Services Industry Code).

Like the South African Automotive Industry Code and the Consumer Goods and Services Industry Code, the Code is premised on a self-funding model of regulation in terms of which the Ombud shall be financed from, among other things, contributions levied on franchisees and franchisors.

As noted above, the Code and the Ombud have been established to create the infrastructure and administrative capacity to facilitate and administer the resolution

of disputes between franchisees and franchisors. It operates in addition to the CPA, rather than as an alternative. The Code applies to all franchisors, franchisees and to prospective franchisees.

In terms of the Code, the Ombud is empowered to consider and determine disputes between franchisees and franchisors in an informal and expedient manner. It contemplates parties submitting written representations and documentary evidence to the Ombud for consideration and adjudication. Importantly, the Code does not detract from any other rights and remedies that the parties may have in law, and does not oust the jurisdiction of the courts. Thus, unless the parties agree otherwise, a decision of the Ombud is not final or binding on the parties before it.

Practical considerations

In order for the objectives of the Code to succeed it will be necessary for industry players and other stakeholders to become involved, and for a culture of participation to develop. The Code seeks to facilitate this involvement at board level (being the board of the Ombud) by granting franchisors as a group the right to nominate and appoint one person to serve on the board. Similarly, franchisees as a group, excluding prospective parties to franchise agreements, may nominate and appoint one person to serve on the board.

If properly utilised, the Ombud will hopefully assist in filtering complaints and alleviating the burden on the National Consumer

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Commission, and indeed on the courts. To this end, s69 of the CPA provides that the remedies set out in s69(a) to s69(c) of the CPA must first be exhausted before approaching a court for redress under s69(d). A person must therefore first refer the matter directly to the National Consumer Tribunal, to the applicable ombud with jurisdiction (in this case the Ombud to be established under the Code), provincial consumer court or file a complaint with the National Consumer Commission, before approaching a court. The provisions of s69 of the CPA are thus designed to ensure that parties make use of the dispute resolution framework established under the CPA before turning to the courts.

The Ombud has jurisdiction over any dispute relating to an alleged breach of the CPA by a franchisor or a franchisee. Significantly, it is also proposed that the Ombud will have a wider jurisdiction to determine disputes arising from:

- a franchise agreement or disclosure document, including disputes relating to the interpretation, breach, cancellation and termination of a franchise agreement;
- payments of money which are alleged to be owing in terms of or arising from a franchise agreement;
- the supply of any goods or services or failure to supply goods or service in terms of a franchise agreement; or
- any solicitation of any offer to enter into a franchise agreement.

The Code not only delineates the powers of the Ombud but also prescribes a complaint process. Briefly, once a complainant submits a complaint to the Ombud, including all supporting documentation, it will carry out the necessary investigation and make a recommendation, which includes the potential for the matter to be referred to mediation. Neither the complainant nor the participant shall be bound to accept the recommendation. If the matter is resolved as a result of both parties accepting the recommendation, the Ombud may submit such finding to be made an order of court, to add a layer of legal enforceability to the resolution. The Ombud is also mandated to keep comprehensive records of all complaints, and to compile an annual report including information on complaint types and businesses being complained about. This will hopefully assist in identifying systemic and recurring problems, which participants need to address.

Where a signed franchise agreement contains a dispute resolution clause which provides for dispute resolution other than in terms of the Code, that clause shall govern the resolution of any dispute falling within the terms of such a provided that the clause complies with and gives effect to the CPA; and the applicability of the CPA is not excluded from the resolution of the dispute. It remains to be seen whether or not this will mean that parties are obliged to approach the Ombud in circumstances where their agreement contemplates a private arbitration.

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Franchisees and franchisors will determine the success of the Code and Ombud by how they make use of it, and how it is administered.



The Code contains some key actions the Ombud must take. These include, among others, the following:

- producing an annual report summarising its activities, including the number of complaints received and resolved, a summary of the disputes and the numbers of each kind of dispute; and the number and types of contraventions of the CPA determined to have taken place;
- liaising with any consumer protection authority, franchise industry association or regulatory authority on matters of common interest; and
- promoting awareness of the Code and of the Franchise Industry Ombud and its functions.

In terms of s82(7) of the CPA, the National Consumer Commission still has an obligation to monitor the effectiveness of any industry code. This oversight mechanism is key in order to ensure that it functions effectively, and can be amended progressively as issues are identified that require attention.

Conclusion

Franchisees and franchisors will determine the success of the Code and Ombud by how they make use of it, and how it is administered. Central to this is fostering an awareness of its functions and how it may assist businesses.

In this regard, the Code requires franchisors to include, in all disclosure documents and franchise agreements, a notice stating that they are bound by the provisions of the Code and undertaking to comply with the provisions of the Code. All disclosure documents and franchise agreements should also include a notice advising franchisees that they are entitled to refer any dispute to the Ombud, and providing the franchisee with the contact details of the franchise industry Ombud. Franchisors are also obliged to ensure that a copy of the Code is made available on request to any potential franchisee from whom an offer to enter into a franchise agreement is being solicited and to any franchisee with whom a franchise agreement has been concluded.

If successfully implemented, the establishment of the Code and Franchise Industry Ombud will provide welcome relief to the already over-burdened National Consumer Commission.

Justine Krige

BEWARE OF EXCLUDING LIABILITY FOR CONSEQUENTIAL DAMAGES IN CONFIDENTIALITY AGREEMENTS

When the person who received the confidential information shares or uses it in breach of a NDA, the business owner who disclosed the information may suffer indirect, special or consequential losses.

Claiming special damages will be easier if the NDA includes a clause stating that "the business owner will be able to claim special damages if the confidentiality provisions are breached".



Confidentiality or non-disclosure agreements (NDAs) may limit or exclude the parties' liability for damages in certain circumstances. Clauses such as "in no event shall either party be responsible to the other for indirect, special or consequential losses" are commonplace and are often accepted during contract negotiations, sometimes only subject to them being reciprocal. A clause such as the one above may appear to be standard and to the benefit of both contracting parties, but in the context of a NDA, this clause can have severe consequences for the business owner disclosing confidential information.

In *Lavery and Co. Ltd v Jungheinrich*, 1931 AD 156, the courts distinguished between:

- "general damages" as damages that flow naturally and generally from a breach of contract and which the law presumes that the parties thought would result from such a breach of contract; and
- "special damages" as damages that, although caused by the breach of contract, are ordinarily regarded in law as being too remote to be recoverable, unless the parties when entering into the contract, actually contemplated that such damages would likely be caused from a breach of the contract and agreed that the defaulting party will be liable in the event of such breach.

"Indirect damages" and "consequential damages" refer to indirect or consequential damages that flow from a breach of contract which damages will not constitute "general damages" or "special damages".

When the person who received the confidential information shares or uses it in breach of a NDA, the business owner who disclosed the information may suffer indirect, special or consequential losses. For example, to attract a private equity investor or joint venture partner, the owner of a start-up may need to disclose her

trade secrets, ideas, intellectual property and customer information to such investor. They then enter into a "standard NDA" to protect the business owner, stating that "the investor must keep the confidential information confidential", but also stating that "neither party will be liable for special, indirect or consequential losses suffered by the other parties". If the potential investor or joint venture partner breaches the NDA and divulges the start-up owner's trade secrets, ideas, intellectual property or customer information to another of its investee companies or sells the confidential information to a third party in breach of the NDA, the investor or third party could potentially use the confidential information to make a huge profit. The courts may find that the only damage suffered by the start-up is a loss of profits that constitutes indirect, special or consequential losses. As the parties expressly excluded liability for such special, indirect or consequential losses in the NDA, the start-up will have lost its trade secrets, ideas, intellectual property and customer information (likely its biggest asset) and will have no remedy for loss of profits against the potential investor or partner. Claiming special damages will be easier if the NDA includes a clause stating that "the business owner will be able to claim special damages if the confidentiality provisions are breached".

BEWARE OF EXCLUDING LIABILITY FOR CONSEQUENTIAL DAMAGES IN CONFIDENTIALITY AGREEMENTS

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Don't agree to limit or exclude liability for special, indirect or consequential damages where a party breaches its confidentiality obligations, or the NDA may not be worth the paper it is written on.



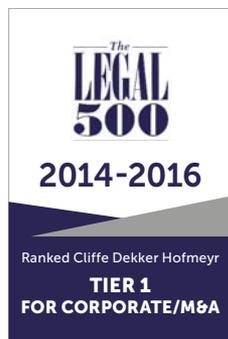
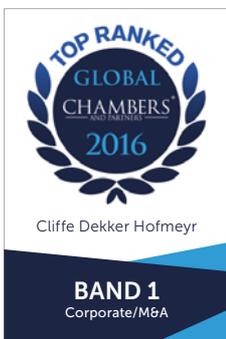
Damages for breach of contract aim to put a party in the position such party would have been had the contract been properly performed. The start-up in the example above might be able to prove the benefit to the receiving party or a third party, but it will be difficult for the start-up to prove the actual loss that it suffered.

Entering into a NDA does not afford a business owner who needs to share its confidential information with absolute protection, but by remembering the following points when negotiating a NDA, the business owner can reduce its risk:

- check whether the agreement will apply one way (if only one person is disclosing information) or both ways (if both parties are disclosing information);

- clearly define what constitutes "confidential information";
- agree that confidential information may only be used to evaluate the business or business opportunity;
- define the duration of the agreement (expect that the business owner will want to make this as long as possible and an investor will want it as short as possible); and
- don't agree to limit or exclude liability for special, indirect or consequential damages where a party breaches its confidentiality obligations, or the NDA may not be worth the paper it is written on.

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