Submission to the 2013 Review into the Franchising Code of Conduct

Jenny Buchan, UNSW

13 February 2013

Dear Mr Wein,

My submission to the 2013 review of Australia's Franchising Code of Conduct ('The Code')

Part I – public

Credentials

My credentials for making this submission are:

- Commercial lawyer in private practice for 19 years to 1999, specialising in franchising and related fields since 1987.
- Academic researching franchising law at UNSW for the past 11 years.
- Have taught contract law and franchising law and more recently international franchising law at UNSW and in Rennes, France over the past 5 years.
- LLM, Melbourne (1993), which I earned by researching and writing about franchising relationships as the law interpreted them
- PhD, QUT (2010) My dissertation is about why consumer protection, contract and corporations laws leave franchisees vulnerable, especially when their franchisor becomes insolvent.
- Member of the Australian Competition and Consumer Commission's Franchise Consultative Committee 2010 – present.
- Author of book '*Franchisees as Consumers: Benchmarks, Perspectives and Consequences*' (Springer, 2013) http://link.springer.com/book/10.1007/978-1-4614-5614-8/page/1

Terms of reference:

The reviewer is required to inquire into the efficacy of the amendments to the Code contained in the:

1. *Trade Practices (Industry Codes – Franchising) Amendment Regulation 2007 (No 1)*; and
2. *Trade Practices (Industry Codes – Franchising) Amendment Regulation 2010 (No 1).*

Further, the reviewer is required to inquire into:

3. Good faith in franchising;
4. The rights of franchisees at the end of the term of their franchise agreements, including recognition for any contribution they have made to the building of the franchise; and
5. The operation of the provisions of the *Competition and Consumer Act 2010* as they relate to enforcement of the Franchising Code.

Part I

At the outset, I consider that the terms of reference are too narrow given the environment within which franchising now exists. Additionally, the time frame for responding (in the time of the year when many take their summer holidays) is too short for any individual to comprehensively address all 5 topics.

Background

Since 1998 business format franchisors operating in Australia have had to comply with the current Franchising Code of Conduct ('Code'), with slight periodic amendments. The Code largely remains a reflection of the legal and operational environment of franchising as it was in the early 1990s.

Business format franchising today, post the GFC, is a very different beast to what it was 20 years ago. What has changed?

- We understand the business format franchise model a lot better now. Several people have conducted research on the legal and economic aspects of it. For myself, this includes research into contract law, consumer protection law, corporate governance, franchisor insolvency, trademark ownership and registration patterns, retail leasing, stakeholder participation in government reviews, and research into the limitations of mediation.
- The disclosure document is a moment in time snapshot that provides a franchisee with no clue as to the future of the franchise. Once the franchise agreement is signed and the premises are established the franchisee has only the contract to fall back on in real terms. The franchise agreement is replete with obligations on the franchisee but lacks reciprocal franchisor obligations.
- 'A prospective franchisee, attempting to conduct due diligence to verify information disclosed by the franchisor, is confronted with numerous impediments. Unlike the US where a franchisor's disclosure information is available on the public record, in many countries (including Australia) neither the franchisor's disclosure documents nor its pro forma franchise agreements can be

obtained other than direct from a franchisor. This means that the franchisee's advisers cannot compare the offering before them with either the usual documentation for franchisees in the network or with the franchise agreements of other comparable franchisors. This limits the value of professional advice as it is unable to be contextualized'.[1]

- The network of companies and trusts through which franchisors spread risk has become increasingly complex, increasingly involving offshore entities and is impossible for franchisees to conduct meaningful due diligence on.
- Many of the original franchisors have already, or are now ready to exit franchising. In Australia only 50 per cent of the franchisors surveyed in 2010 replied that they were the founder of the original business.[2] Just as the only certainties in life are birth death and taxes, so for franchisors an event that needs to be addressed sooner or later is 'how do I get out of this thing?' Their options are sell (through public float or privately) or wind up (see next point

- Venture capitalists and public corporations also understand the model and its capacity to generate sizeable, virtually risk free, returns to them. Some of these more sophisticated investors are prepared to exit their role as franchisor via 'strategic insolvency' if they are unable to float or otherwise sell their interest when they are ready to exit.

- The supply of money has been tighter through the GFC, so franchisees' equity is more attractive to franchisors than when money is easier to access.
- The 1976 Swanson Review of Trade Practices in Australia identified that the definition of 'consumer'[3] is central in legislation that regulates anti-competitive conduct and protects consumers from its consequences. Although the dictionary definition of 'consumer' is 'a person who consumes, especially one who uses a product'[4] the Swanson Review urged that 'the definition of consumer should be sufficiently broad to provide protection to a range of business transactions, ... to

1 Jenny Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences*, (Springer, 2013)

2 Frazer, Weaven and Bodey *Franchising Australia 2010*, 112.

3 Trade Practices Act Review Committee Report to the Minister for Business and Consumer Affairs, August 1976, Australian Government Publishing Service, Canberra, 63. (Swanson Report).

4 Bruce Moore (ed), The Australian Oxford Dictionary, (2nd ed, Oxford, 2004) 272.

redress between supplier and consumer, inequalities in the technical expertise required to recognise, and the bargaining power to negotiate, a fair bargain'.[5]

I will address the terms of reference and will then detail why the Code, operating as a piece of consumer protection legislation, can never address the underlying major challenges (bullet points 2-ff above) that face franchisees.

1. Efficacy of the amendments to the Code contained in the *Trade Practices (Industry Codes – Franchising) Amendment Regulation 2007 (No 1)*

Clause 10 was reworded in 2007 and 2010. There is, however, no penalty for a breach of this clause. The *Ketchell* case amounted to little more than a slap on the wrist for the franchisor and provided an endorsement to franchisors that had not been meticulous about record keeping. I note that *Ketchell* subsequently joined the long list of failed franchisors.

Clause 10, and in fact the entire Code, would be more efficacious if damages could be awarded against breaching parties. These damages should not be able to be passed on to the franchise system.

Clauses 15 and 16 were added in 2007 and **Clause 17** was reworded in 2010. I cannot comment on their efficacy but I suggest they be retained.

Clause 17. In view of the number of franchisors that fail or exit franchising I suggest that it would be prudent for the marketing or other cooperative funds be explicitly required to be held in trust for franchisees instead of being incorporated into the franchisor's general revenue. They can then have a chance of recouping the money if an administrator is appointed to the franchisor. This would provide better ultimate protection than an audit and may cost the franchisor less.

Clause 18 was altered in several ways in 2007. **Clause 18(1)** Reducing the time from 60 to 14 days was good but in this electronic age why not reduce it further, even to as little as 3 days? If a franchisor becomes an externally administered body the franchisees need to know as soon as possible so they can make sure the franchisor has, for example, paid the rent to the landlord. Where the franchisee sub-tenant has paid the rent on time to the franchisor, has the franchisor passed it on, or has its financial distress caused it to prefer other creditors and put the franchisee's tenancy at risk.

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5 Trade Practices Act Review Committee Report to the Minister for Business and Consumer Affairs, August 1976, Australian Government Publishing Service, Canberra, 64. (Swanson Report).

Clause 18 – other changes. All this is very interesting but at the end of the day there is nothing much a franchisee can do with the information other than wait for the outcome. These disclosed matters do not give the franchisee the right to terminate their agreement and sue for damages. The franchisor has so few obligations (most requirements of a franchisor are couched in discretionary terms) in a franchise agreement it would be rare for it to be prosecuted for breach of that agreement. It would be useful to franchisees if the franchisor was required to disclose the conclusion of a mediation and the bare details of the outcome.

Double negatives are a feature of the Code. For example **Clause 15 (a)** and **(b)** added in 2007, and **Clause 29 (8)(e)** added in 2010. It would be easier to understand these provisions if they were reworded without double negatives.

Item 2 disclosure: Franchisor details. Franchisors now operate within such complex networks of entities that it would be more meaningful to require a franchisor to provide an organization chart to franchisees containing the full legal name of all parties in the corporate group that the franchisor sits within, and their role. This information is typically only becomes available in an administrators report. This should be accompanied by a credit agency report which would show the debt loading and credit history of the franchisor and its related parties.

2. Efficacy of the amendments to the Code contained in the *Trade Practices (Industry Codes – Franchising) Amendment Regulation 2010 (No 1)*

To comply with **Clause 4** of the disclosure provisions of the Code, Australian franchisors are required to disclose specific information about litigation.

Under the 2010 amendments **Clauses 17B1** and **17B2** were added. Confidentiality agreements are imposed on franchisees routinely on entering into and on concluding mediation. Whilst it has to be accepted that a level of confidentiality is appropriate, the problem for franchisees attempting to conduct due diligence is that the primary process mandated in the Code for resolving disputes is mediation. In Australia hundreds of franchise disputes are mediated every year. A franchisor thus may have been involved in mediations with numerous franchisees and there is no way for

potential franchisees to discover that fact, or what the disputes were about.[6] Comments from South Australian Inquiry:

> It is not in the best interests of good business that people can put in place confidentiality clauses in contracts [for example contracts to resolve mediated disputes] and whatever and then proceed to do the wrong thing, potentially.[7]

> Mediation requires little or no government involvement for administration or enforcement. Because of the confidentiality of the process it is difficult to gauge the effectiveness of this strategy. ... Mediation ... is easy for franchisors to control and thus reinforces the imbalance of power ...[8]

> What you have is a high settlement rate [via the Government-funded office of the Franchise Mediation Adviser] of 72 per cent for mediation. The problem is that there were 300 of those, but there were another 770 inquiries [that did not proceed to mediation] and no-one knows what happened to them. ... Somebody had a big enough problem to call the Office of the Mediation Adviser and ask for help, and we have no idea what happened to them. ... but franchisors know what happens in the case of the disposition of mediat[ed] disputes. They can go on and use that information with their other franchisees. But individual franchisees, because of the confidentiality of the process, do not share that information.[9]

Thus the efficient and inexpensive mediation processes designed to redress the prohibitive costs and time lags associated with accessing justice through the courts for franchisee consumer's, become instead a mechanism for disempowering these same consumers. In addition, there is a 'tension between the practical resolution of disputes and accountability for individual decisions'.[10]

All details of mediation conducted to satisfy the requirements of the Code remain confidential including the names of the parties. Thus information about franchisors other than information they supply in disclosure or on their own websites is difficult and/or expensive to obtain, and breaches of the disclosure regime are usually impossible to detect unless they lead to litigation.

The problem of not being able to obtain accurate information about the culture within a franchise has been expressed as: 'Each contract says what it says, but the culture underlying the way parties choose to operate the levers that contract gives them may be producing quite a different effect than appears to a superficial or even a close

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6 Jenny Buchan, Jennifer Harris, Gehan Gunasekara, 'Franchise Mediation: Confidentiality or Disclosure: A Consumer Protection Conundrum'. (Paper presented at the 25th Annual International Society of Franchising Conference, Boston, USA June 2011).

7 Economic and Finance Committee, Parliament of South Australia, Franchises (2008) Evidence to South Australian Inquiry (Oral submission, 14 November 2007, Max Baldock and John Brownsea, State Retailers Association of South Australia).

8 Economic and Finance Committee, Parliament of South Australia, Franchises (2008) Evidence to South Australian Inquiry (Submission 13, Elizabeth Spencer).

9 Parliamentary Joint Committee on Corporations and Financial Services, Commonwealth, Inquiry into the Franchising Code of Conduct (2008) Evidence to Commonwealth Inquiry, (Submission 12, Elizabeth Spencer).

10 Dimity Kingsford Smith, 'Financial services regulation and the investor as consumer' in Geraint Howells, Iain Ramsay and Thomas Wilhelmsson with David Kraft (eds) Handbook of Research on International Consumer Law Edward Elgar, 2010, 434.

reading'.[11] This problem is exacerbated by the mediation process. On settlement of a mediated dispute the parties sign confidentiality agreements. This prevents franchisees from responding to dispute-related questions from researchers, and from giving candid responses to intending franchisees who make contact to seek information about 'what's it like being a franchisee in the system'?

Clause 20A Some franchisees have to make long term commitments that are not well synchronized with the franchise agreement's term. For example, long term premises or vehicle rental or refurbishing rental premises. Is 6 months enough notice? I do not know but it would be instructive to hear from motor vehicle rental franchisees and the like about the adequacy of the current notice period.

Cl 23A Good faith was introduced in 2010. It should be removed. See my comments below.

Risk of failure notice in disclosure. This notice is insufficient to warn franchisees about the specific risk they as a franchisee potentially face if *their* franchisor fails. Every franchise network is structured differently so there are numerous possible scenarios when one party becomes insolvent. It is within the franchisor's power to set out the basic likely consequences. Eg: because you (franchisee) have guaranteed my (franchisor) head lease the consequence of my becoming insolvent could be: the landlord calls in the guarantee, the head lease is terminated so you may lose your sub-lease, etc. The current wording does not go far enough to set out in black and white what the consequences of insolvency may be.

3. Good faith in franchising

Good faith is a term with capacity to mislead franchisees who would believe that it means what it says: good faith. It is impossible for franchisors and franchisees to approach all issues in good faith as their relationship is replete with conflicts of interest. They should not have to adhere to any 'good faith' standard. They run different businesses, with different pressures, different stakeholders, different risks and different potential exit strategies.

It is optimistic to think it would be possible to monitor whether good faith has been adhered to in a franchise. The first question is what is good faith and the second, perhaps even more problematic, is when should it be exercised? My personal view is

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11 Evidence to Economic and Finance Committee, Parliament of South Australia, Official Hansard Report, 6 February 2008, 38 (JR Rau MP).

that there is no room for a standard of good faith in franchising; neither common law nor a specifically defined statutory provision. I would delete **Clause 23A** that was inserted in 2010 as I believe it has the potential to delude the parties into a sense of unachievable entitlement.

Imposing a duty of good faith is a flawed replacement for good governance principles in a relationship that is founded on contract but not regulated by other checks and balances. Within corporations those '[c]hecks and balances are imposed ... through divisions of enterprise with different functions, clear levels of authority, and a management structure'[12] all underpinned by corporate governance principles and legislation and closely overseen by regulators. 'These checks and balances reduce the opportunity for majority interests to exploit minority shareholders and prescribe directors' duties, shareholder remedies, public disclosure, audits, independent directors, securities laws and insolvency procedures'. [13]

'Corporate governance issues arise in an organisation whenever two conditions are present. First, there is conflict of interest, and second, the conflict of interest cannot be dealt with through contract'.[14] Franchising is an example. Although conflicts of interest abound between franchisor and franchisees the franchising model has circumvented the issues that good corporate governance would address because franchisees are not stakeholders in the franchisor's company.

The good faith duty is not as strong as a fiduciary duty so it can result in a decision being taken by a franchisor in good faith that is nevertheless damaging to franchisees. It is not an appropriate duty to impose on parties who will inevitably be in positions of conflict of interest from time to time.

4. The rights of franchisees at the end of the term of their franchise agreements, including recognition for any contribution they have made to the building of the franchise

The answer to this question depends entirely on how the end is brought about? There are several options:

a. By the end of the term arriving

12 Lessing, J. 2009. The Checks and Balances of Good Corporate Governance. Corporate Governance ejournal. [Online]. Available at: http://works.bepress.com/john_lessing [accessed 10 June 2011].

13 Lessing, J. 2009. The Checks and Balances of Good Corporate Governance. Corporate Governance ejournal. [Online]. Available at: http://works.bepress.com/john_lessing [accessed 10 June 2011].

14 RP Austin and IM Ramsay, *Ford's Principles of Corporations Law* LexisNexis Butterworths 13th ed, 2007, 317 citing Oliver Hart 'Corporate Governance: Some Theory and Implications' 1995 105 *Economic Journal*, 678.

b. By the franchisee's breach/insolvency
c. By the franchisor's breach/insolvency
d. By some other situation not caused by either party – eg when Borders folded in Australia about 10 Gloria Jeans' franchisees lost their businesses because they had been located within Borders stores.
e. By mutual consent before the end of the term

Option 4a.

My view is that the franchisor and franchisee / franchisor and master franchisee agree a term, the franchisee pays for the term. In this way a franchise is like a lease. It is not a perpetual right unless it is expressed that way when the parties agree on its price at the start. At the end of the term the parties should be free to walk away from each other, no compensation payable by either party. If they want to renegotiate another term then that is a commercial matter and they are free to do so.

Option 4b.

This is amply covered in the Code and the insolvency law.

Option 4c.

Currently the failure to address the end of term in option 4c above is the worst asymmetry in the Code, and it favours the stronger party – the franchisor. If a franchisee commits an act of bankruptcy the franchisor can immediately terminate their agreement under **Clause 23(b)** and thereby deprive the franchisee's administrator of the opportunity to satisfy the franchisees creditors by selling the agreement. This is not fair on the franchisees creditors, or the franchisee. Conversely, if the franchisor commits an act of bankruptcy the franchisee has to continue to perform its obligations under the agreement while the franchisor's administrator looks for a buyer of the franchisor's business, including the franchise agreements, or recommends winding up.

The law of contract is incapable of satisfactorily 'regulating modern franchise relationships and practices'.[15] This is exemplified clearly when the franchisor fails. 'The justifications for a contract not to be comprehensive in its terms - that it is relational, or too expensive to include all possible future contingencies, or that the franchise agreement needs to be standardised for ease of administration - do not support the omission of terms about franchisor failure; an event whose possibility is real, and whose consequences can be devastating for the franchisee consumer. [I]ncomplete, relational contracts are ill-equipped to deal with franchisor failure after

15 Tanya Woker, 'Franchising – The Need for Legislation' (2005) 17 South African Mercantile Law Journal 49.

the event as the very event that triggers a need to renegotiate, failure of the contract drafter (the franchisor), also signals the impending end of the relationship between the drafter (franchisor) and the other party (franchisees). There is no equitable, logical or cost-based justification for the franchise agreement making extensive provision for some known possible events that would have a relatively minor effect on the network, such as the possibility of a franchisee dying, while failing to provide for known and potentially network-debilitating events, such as franchisor failure'. [16]

Many franchisors become insolvent.[17] 'The franchise agreement purports to be a complete package of rights, distilling the franchisors and franchisees rights and obligations for the duration of the term. Nevertheless, almost without exception, franchise contracts make no reference to franchisees' rights on franchisor failure. The franchisor's insolvency triggers a move to a new equilibrium in which the administrator, and then the liquidator, controls the destiny of franchisees through the twin mechanisms of the franchise agreement and the *Corporations Act'*.[18]

If it is to fulfil its stated purpose of 'regulating the conduct of participants in franchising towards other participants in franchising' **Clause 23** in its entirety should be duplicated to create a right for franchisees to terminate in the same special circumstances. I refer you to the *confidential* part II of my submission.

Option 4d.

This is the franchisor and franchisee's worst nightmare and I think it has to be dealt with on a best endeavours basis by the franchisor. Hopefully it will not happen too often.

Option 4e.

Depending on the cause, and how close the franchise is to the end of its term, the franchisee should be paid compensation for the unexpired portion of the licence and given the opportunity to take over the head lease if the franchisor holds it.

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16 Jenny Buchan, *Franchisees as Consumers: Benchmarks, Perspectives and Consequences*, 83.

17 Ibid, 115-117.

18 Ibid.

5. The operation of the provisions of the *Competition and Consumer Act 2010* as they relate to enforcement of the Franchising Code.

The unconscionable conduct provisions of the CC Act have not been widely used by franchisees. The *Hoy* cases[19] provide a clear example of why franchisees are reluctant to litigate. The franchisee won the case, established that the franchisor had acted unconscionably, but spent $650,000 on legal fees. The term of their franchise agreement had expired by the time the litigation concluded.

One option to see if s 51AC could be made to work better would be to shift the burden of proof to the party that has the evidence to rebut if the conduct is not unconscionable.

General comments

Major areas of the law that have not yet adapted to franchising, including:

Contract law, where the law typically responds to a failure of the market by creating consumer protection laws but does not fully recognise franchisees as consumers.

Corporate governance, where the absence of corporate governance mechanisms means the usual checks on directors having unfettered powers are absent between franchisors and franchisees. (covered under 'good faith' above)

Insolvency law. Weaknesses in the franchise model are brought into stark relief if the franchisor becomes insolvent.

We will now look at each of these areas of law to get a better understanding of the challenges.

Contract law

A New Zealand Judge, Ted Thomas may have been referring to a franchise agreement when he wrote '[t]he sheer commercial absurdity of this lopsided bargain prompts the question as to how it could have come about'.[20] Contracts are the glue that holds the franchise network together. The franchisor's mantra is that both parties are business people and that franchisees can negotiate terms to protect themselves. But, franchise agreements are not 'negotiated'; they are standard form contracts drafted by the franchisor. 'Standard form contracts are typically used by parties who are in a strong

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19 *Hoy Mobile Pty Ltd v Allphones Retail Pty Ltd (No 2)* [2008] FCA 810. In *Allphones Retail Pty Ltd v Hoy Mobile Pty Ltd* [2009] FCAFC 85Allphones unsuccessfully appealed the decision, *Allphones Retail Pty Ltd v Hoy Mobile Pty Ltd* [2009] FCAFC 85 and in *Australian Competition and Consumer Commission v Allphones Retail Pty Ltd (No 2)* [2009] FCA 17 the regulator then prosecuted successfully on behalf of some franchisees who were damaged by the same unconscionable conduct that Hoy had uncovered.

20 *Bobux Marketing Limited v Raynor Marketing Limited* [2001] NZCA 348, para 18 (Thomas J, dissenting) in relation to a distributorship agreement.

bargaining position. They are able to prescribe the terms on which they are prepared to contract on a 'take it or leave it' basis'.[21] They protect the franchisor's interests.

Franchise agreements are also **relational contracts**. In a relational contract it is the assumed that the major foreseeable events that could fundamentally change the relationship will be addressed in the contract; and that other matters will be addressed if they arise. The franchise agreement has to remain **incomplete** to give franchisors the freedom to respond to changes in markets over time. Incompleteness is not an indication of poor drafting or poor planning. Once the franchise agreement moves beyond negotiation or performance to litigation the courts have trouble working out which omissions were intended so as to supply flexibility.

Traditionally contract law stresses the importance of sanctity of the contract, freedom of contract, and an economic interest in certainty of contract. But **freedom of contract** is inconsistent with standard form contracts; **sanctity** and **certainty** are inconsistent with the incompleteness of relational contracts.

Franchise agreements are drafted and signed on the assumption that a franchisor is in control of its own future, well-motivated, successful, honest, and solvent. This is not always the case.

The franchise agreement documents a business-to-business commercial relationship that begins as an exchange between the franchisor-supplier and a franchisee-consumer. The franchisee never relinquishes the role of consumer, it assumes the additional role as business owner. The franchise agreement is drafted by the franchisor. It locates control in the franchisor and ownership and risk with the franchisee. The franchisee has limited options in the face of a detrimental decision by one of the other players in the network.[22] It remains bound to perform its obligations under the contract. Can franchisees protect themselves against the consequences of a rogue franchisor's exploitative, negligent, fraudulent or criminal behaviour by simply negotiating contracts better? The short answer is, no. Contract law alone is not sufficient to provide a solid base for the franchisor/ franchisee relationship.

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21 Willmott, Lindy, Sharon Christensen, Des Butler, Bill Dixon, Contract Law (3rd ed, 2009) Oxford, University Press, South Melbourne, Australia, 583.

22 Croonen EPM, and Brand MJ, "Dutch Druggists in Distress: Franchisees Facing the Complex Decision of How to React to their Franchisor's Strategic Plans" (2010) Entrepreneurship Theory and Practice, 34(5), 1021–1038.

Consumer protection laws

In making the observation that 'the law of contract ... has the greatest impact on interactions where freedom of choice and action and freedom from interference are most coveted',[23] Thomas has identified why franchisors the world over resist legislative intervention in the franchise contract.

The usual policy response to a failure of contract law in a consumer context is to provide consumer protection laws. In franchising these take the form of either pre-contract disclosure requirements, implying terms into franchise agreements, or both.

Pre contract disclosure ceases to be up to date as soon as the franchise agreement is signed. The franchisor is free to change its system at any time and the franchisee cannot predict these changes. Pre-contract disclosure is also only about the franchisor and the business the franchisee is buying. Today's franchisors are nested within complex networks, which the franchisee knows little about. The diagram of REDgroup (see Part II) shows this. Once the liquidator is appointed any protection franchisees may have had under the consumer protection law is replaced by the liquidator's statutory duties under the *Corporations Act*.

Insolvency

Franchisor insolvency attracts increasing attention as the Global Financial Crisis rumbles on. The solvency of the franchisor is critical to its franchisees. The law does not accommodate the franchisees' interests in a neat or predictable way if their franchisor's business fails. The inter-related nature of the franchisor's and franchisee's business together with the pattern of contractual relationships that bind the franchise network together are strengths that become weaknesses for franchisees if a franchisor fails. Insolvency laws, whose list of protected creditors was settled long before franchising became popular, exposes the full extent of the franchisees' vulnerability.

Insolvency is a set of statutory procedures through which a company can be moved from a situation of financial stress to a resolution of that stress. In the first stage, called administration, an administrator is appointed to determine whether the company can be (1) returned intact to the control of the directors, or (2) restructured and returned to the control of the directors, or (3) put into liquidation.24 If option 3 is

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23 E W Thomas, The Judicial Process: Realism, Pragmatism, Practical Reasoning and Principles (2005) 325.

24 http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Resources#4

chosen the administrator immediately becomes the liquidator and proceeds to wind the company up. The liquidator's role is to dispose of the failed company's assets and pay its creditors. For most of their investment, franchisees are not creditors.

A clear theme running through the reasons for failure are that the franchisor, not the franchisees, are the authors of the system's fate.

Contract remedies

Franchisees do not sue an insolvent franchisor for 5 reasons.

1: The franchisor has not breached the contract by becoming insolvent. The contract is silent about franchisor solvency.

2: the contract law is of limited effectiveness. The contractual remedy of an award of damages is a useless remedy against a party with no assets.

3: the powers given to administrators and liquidators under the *Corporations Act* trump contract law rights.

4: insolvency of the franchisor will not free franchisees from contracts entered into between franchisees and other parties.

5: Noone except a liquidator can initiate proceedings against a party in administration without the consent of the court.

Additional problems not directly related to the law

Franchisee expectations

In Australia:

- there is an average of 60 franchisees to each franchisor.
- 52.5 % of franchisees came to franchising direct from salaried employment in 2010.[25]

These former employee franchisees bring with them passion, drive and funds, but their immediate past work environment was one where employees had numerous legal safeguards. Neither their contracts nor the law offer franchisees any safeguards.

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25 L Frazer, S Weaven and O Wright, *Franchising Australia 2008*, Griffith University, 35. A further 4% had 'other experience' which included unemployment and parental duties. A more recent statistic from France shows the figure as being 66% entering franchising direct from a position as an employee in 2010.

The focus of policy makers and regulators is too narrow.

A franchisor and its franchisees, and their relationship to each other, are the traditional concern of franchise policy, law and research. This narrow focus impedes the development of law in 3 ways:

1. This focus draws attention away from the complex network of legal entities within which the franchise system operates.

2. Many policy makers still struggle to understand franchising. They do not see that beyond a common interest in making a profit, the interests of franchisors and franchisees are often not aligned. A consequence of the separation of ownership (by franchisees) from control (by franchisors) is that franchisees face major threats over which they have no control, and currently no legal rights.

3. Consumer law and insolvency law (together with contract law that is administered by the courts if the mediators do not succeed) contribute to franchise law. There is room for the responsible government agencies, the courts and the mediators to talk to each other about franchising and to support research into it by providing full, free access to data. Currently the absence of access to reliable, affordable data hampers research, and hampers a franchisee's ability to conduct due diligence.

A way forward?

Benchmarks

A benchmark is 'a means of evaluating by comparison with a standard or point of reference'.[26] Two benchmarks for measuring the utility and the success of regulation to protect franchisees are:

- Regulation should provide effective protection from serious risks and threats that franchisees as business consumers cannot tackle as individuals.[27]
- There should be accessible, timely[28] and meaningful redress where consumer detriment has occurred.

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26 Bruce Moore (ed), *The Australian Oxford Dictionary* (2nd ed, 2010) 117.

27 Commission of the European Communities, *EU Consumer Policy Strategy 2007 – 2013 Empowering Consumers, Enhancing their Welfare, Effectively Protecting them* (2007) European Commission 5 <http://ec.europa.eu/consumers/overview/cons_policy/doc/cps_0713_en.pdf> at 5 March 2010.

Currently the law fails franchising when measured against both benchmarks.

Conclusion

The law needs to mature along with the maturation of the franchise business model. Effective franchising policy requires an understanding of the real risks and roles franchisors, master franchisees and franchisees assume, and an understanding of their ability or inability to accurately measure, or mitigate these risks.

Franchising does not neatly fit into existing legal frameworks. There are multiple gaps. The most urgent is the accommodation of franchisees if their franchisor fails. So long as the law treats franchising as a simple, two-party, contract-based, commercial relationship, it will miss the mark.

Kind regards

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28 Australian Government Productivity Commission, *Review of Australia's Consumer Policy Framework*, Productivity Commission Report No 45 (2008) vol 2, xv.